

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact: _____, ID No.

Telephone Number:

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Date:
July 25, 2007

LEGEND:

Taxpayer	=		
Hurricane	=		
New Lender	=		
Area	=		
Year A	=	\$p	=
Year B	=	\$q	=
Date D	=	\$r	=
Date E	=	\$s	=
Year F	=	\$t	=
Date G	=	\$u	=
Year H	=	\$w	=
\$j	=	\$x	=
\$m	=	\$y	=
\$n	=		

Dear

This responds to your request for a private letter ruling dated February 27, 2007. Specifically, you request a ruling that you may defer gain realized under § 1033 of the Internal Revenue Code from insurance and sale proceeds received for the destruction and damage of property by Hurricane.

FACTS:

Background

Taxpayer owned and operated a rental apartment complex (Complex) in Area consisting of 30 two-story apartment buildings, each containing eight units. Complex also included a clubhouse, a swimming pool, and two tennis courts. Taxpayer provided maintenance services for Complex and collected rents. Complex was constructed in Years A and B, at a total cost of \$u for both land and construction.

Taxpayer obtained the initial financing for Complex through two governmental loan programs designed to provide incentives for construction of low and moderate income rental housing. One federally insured loan program provided Taxpayer with financing at a lower interest rate and a longer maturity term (35 years) than what was available through conventional financing. Under another program, Taxpayer obtained tax-exempt bond financing at an even lower rate of interest.

In order to obtain these loans, Taxpayer had to comply with stringent federal and local regulations. The apartment units had to be rented solely to individuals with incomes in the low to medium income range for that locality. Also, there were restrictions on the amount of rent that could be charged. These limitations were to remain in effect for a period equal to half the length of the longest maturity period (35 years) of the tax-exempt bonds issued for the project. During this period, any use other than as low and moderate income rental housing was prohibited. The federally insured loan could not be prepaid before 10 years (the 10-year lock-in period). Also, Complex could not be sold without federal agency approval, and then only if the buyer agreed to accept the continuing restrictions on the property. These restrictions were specified in the regulatory agreement executed by Taxpayer and recorded in the local county records.

Default on Initial Financing and Bankruptcy

During the first decade of operations, Taxpayer experienced significant financial difficulties that prevented it from meeting its obligations under its federally insured loan. Threatened with foreclosure, Taxpayer filed for protection under Chapter 11 of the Bankruptcy Code. Within two years of the filing, Taxpayer emerged from bankruptcy under a plan of reorganization. Under the plan, some of Taxpayer's old indebtedness (the federally insured loan and the tax-exempt bonds) was replaced by a new loan in the amount of \$w obtained from New Lender (the New Loan). In order to obtain the New Loan under the plan, Taxpayer had to reaffirm the regulatory agreement and restrictions. It also had to agree to extend the restrictions through Year H. Prepayment of the New Loan, in whole or in part, was prohibited through Date G (an additional 10-year lock-in period). In addition, Taxpayer's partners were required to contribute approximately \$x to be used toward the cost of refinancing and payment of Taxpayer's other creditors.

Taxpayer's financial difficulties persisted after bankruptcy. Taxpayer could not raise the additional equity required under the plan. About half of Taxpayer's partners did not contribute any additional funds. The rent restrictions permitted only nominal net cash flow each year. The permitted rent increases were insufficient to offset the increases in operating costs.

The Involuntary Conversion

Hurricane struck Area on Date D. The storm destroyed the roofs of 20 of the 30 apartment buildings of Complex, resulting in significant water damage to the apartment units within those buildings and rendering them uninhabitable (the Destroyed Buildings). The remaining 10 buildings (the Damaged Buildings), the clubhouse, and the landscaping were significantly damaged, but were not destroyed. The tenants in the Damaged Buildings continued occupancy after Hurricane. Local authorities required Taxpayer to demolish the Destroyed Buildings (which consisted of 160 apartment units) to avoid health hazards. Taxpayer partially repaired the Damaged Buildings (consisting of 80 units), the clubhouse, and the landscaping.

The destruction of 160 apartment units resulted in an immediate two-thirds (2/3) loss of rental revenues. The projected annual gross rental income dropped from \$p to \$m. However, Taxpayer remained liable for all payments due under the New Loan, as well as operating expenses and other costs. Taxpayer estimated it would need 28 months to reconstruct the Destroyed Buildings and projected an operating deficit of \$n during reconstruction. Taxpayer's business interruption insurance covered only a 6 month period. Upon expiration of that coverage, Taxpayer defaulted on the New Loan.

The estimated cost to demolish and reconstruct the Destroyed Buildings was \$t. The total casualty insurance proceeds received by Taxpayer through Date E, 10 months after Hurricane, was only \$q, net of business interruption insurance.¹ Because of the widespread property damage sustained throughout Area, and the volume of insurance claims filed by Area residents and businesses, Taxpayer's insurance carrier did not promptly process Taxpayer's claims. Taxpayer was uncertain during this time as to the amount of insurance proceeds it would receive and when it would receive them.

As of Date E, Taxpayer projected a shortfall of \$s (\$t minus \$q net casualty insurance proceeds) needed to reconstruct the Destroyed Buildings. However, under the terms of the New Loan, Taxpayer was required to hold and operate Complex as low and moderate income rental apartments after any reconstruction of the Destroyed Buildings until the middle of Year H. As stated above, Taxpayer was only marginally solvent from the time of the bankruptcy to Hurricane. After Hurricane, Complex could not provide a sufficient return to justify Taxpayer's reinvestment of \$t to rebuild Destroyed Buildings and continue operations. Taxpayer had no funds for reconstruction, whether through insurance, new equity investment, or borrowing. By the close of Year F, Taxpayer was again threatened with foreclosure. Taxpayer's only means to avoid foreclosure was to sell Complex in its entirety. Taxpayer sold Complex for \$y in December of Year F.

LAW AND ANALYSIS

Section 1033(a) provides, in part, that if property (as a result of its destruction in whole or in part) is compulsorily or involuntarily converted into money, the gain if any shall be

¹ By December of Year F, immediately prior to the sale of Complex, Taxpayer had received only \$r of casualty insurance proceeds.

recognized except to the extent the electing taxpayer, during the replacement period specified, for the purpose of replacing, purchases other property similar or related in service or use to the property so converted. In the event that an election is made, the gain shall be recognized only to the extent that the amount realized upon the conversion (regardless of whether the amount is received in one or more taxable years) exceeds the cost of the replacement property.

In the present case, Taxpayer seeks to defer the recognition of gain realized from the insurance proceeds for the damage and destruction of the components of Complex. Taxpayer also seeks to defer gain from the sale of Complex in its entirety, including the Damaged Buildings, the Destroyed Buildings, and the underlying land.

Insurance Proceeds

Consistent with the holdings in Rev. Rul. 60-69, 1960-1 C.B. 294, and Rev. Rul. 67-254, 1967-2 C.B. 269, Taxpayer may defer gain realized from casualty insurance proceeds that are timely used to repair the damaged and destroyed property or to acquire new property similar or related in service or use to the converted property. Rev. Rul. 60-69 involved a government taking an easement to facilitate the construction of a dam that would partially flood the taxpayer's land where its manufacturing plant was located. The taxpayer used the condemnation award to safeguard its plant from flood conditions to assure its continued operation. Rev. Rul. 67-254 involved a state condemnation of a portion of the land where the taxpayer's plant was located. The taxpayer stored its manufactured products and housed its delivery trucks on the condemned portion. The taxpayer used the condemnation award to rearrange its plant facilities on the remaining land to create a new storage area. In both rulings, the Service concluded that the improvements to land held by the taxpayer to assure the continued utility of the taxpayer's remaining property used in its business were qualifying replacements for purposes of § 1033(a)(1).

In the present case, Taxpayer used part of the insurance proceeds to demolish the Destroyed Buildings. The local government of Area required the demolition to prevent health hazards. Taxpayer also used part of the insurance proceeds to partially repair the Damaged Buildings, clubhouse, and landscaping. To the extent that Taxpayer used the insurance proceeds for these purposes, it may defer the gain relating to the insurance proceeds under § 1033(a)(1). Taxpayer intends to use part of the casualty insurance proceeds to acquire qualifying replacement property to the extent the proceeds exceeded the amount used for the demolition of the Destroyed Buildings and the repair of the damaged property. This reinvestment, if timely, will satisfy the requirements for deferral of gain realized under § 1033.

Sales Proceeds

Section 1033 does not apply to defer gain from the sale of Complex, in its partially damaged or destroyed condition, if the sale was voluntary. Damage or destruction of part of a property does not always necessitate a disposition of the whole. Case law establishes that, if the property can be repaired economically and restored to usefulness for its intended business purposes, then a sale of the whole property is voluntary. In *C.G. Willis, Inc. v. Commissioner*, 41 T.C. 468 (1964), *aff'd per curiam*, 342 F.2d 996 (3d Cir. 1965), the taxpayer sold a partially damaged ship even though the ship was repairable and reusable. The sale proceeds were used to purchase a barge that better served taxpayer's business. The court denied deferral for the sale proceeds, concluding that the ship was not sold because of the conversion. Rather, it was sold as the "result of a business decision by the owner that the money equivalent of the unrepaired ship would serve its business interests better." *Id.*, at 475. See also *Wheeler v. Commissioner*, 58 T.C. 459 (1972) (choice of taxpayer to destroy building negated characterization of conversion as involuntary).

However, if the damaged property is no longer available for the taxpayer's intended business purposes, then the subsequent disposition is part of the original event constituting an involuntary conversion of the whole. *Williamette Industries, Inc. v. Commissioner*, 118 T.C. 126, 133 (2002) (where the disposition of timber, harvested early because of damage by wind, ice, fires and insects, was necessary to prevent further economic losses); Rev. Rul. 80-175, 1980-2 C.B. 230 (applying § 1033(a) to proceeds received from the sale of timber downed by high winds, earthquake, or volcanic eruption).

If two properties are part of the same economic unit and one is involuntarily converted, making the other unavailable for its intended business purpose, the sale of the both properties is treated as an involuntary conversion. The principle of economic necessity for the sale of separate, but interdependent, properties is expressed in *Masser v. Commissioner*, 30 T.C. 741 (1958), *acq.*, 1959-2 C.B. 3. In *Masser*, the taxpayer owned a freight terminal building and eight neighboring lots that it used for trailer parking. When the local government condemned the eight lots, the taxpayer sold the freight terminal because it could not operate its business economically without the neighboring parking area. The taxpayer had acquired the terminal and the lots at the same time from different sellers and would not have acquired one property without the others. The Tax Court in *Masser* held that for the taking of one property to constitute the involuntary conversion of other property belonging to the taxpayer, there must be an economic nexus between the properties such that the conversion of one necessitates the sale or disposition of the other. In other words, the properties must be so closely related economically that together they constitute a single economic unit. The court held that the two properties in *Masser* were a single economic unit and that the taking of one part of that economic unit was the same as the taking of the whole.

In Rev. Rul. 59-361, 1959-2 C.B. 183, the Service applied *Masser*, holding that where the facts and circumstances show a substantial economic relationship between the

condemned property and other property sold by the taxpayer, so that together they constituted a single economic unit, the proceeds from a sale may qualify for deferral as an involuntary conversion.

In Rev. Rul. 78-377, 1978-2 C.B. 208, the Service considered the applicability of § 1033 to defer gain from the sale of a shopping center when only part of the property was destroyed by fire and the remaining undamaged portion was still economically viable and available for use independent of the damaged portion. This ruling provides a two-part analysis under *Masser* and Rev. Rul. 59-361. Under this analysis, the proceeds from a sale may be treated as an involuntary conversion only on findings that (1) the involuntarily converted property could not reasonably be replaced, and (2) there is a substantial economic relationship between the damaged property and the sold property so that together they constitute an economic unit. To demonstrate a “substantial economic relationship,” the taxpayer must show that the property sold could not practically have been used without the replacement of the converted property. The ruling held that under the facts, § 1033 did not apply to defer the gain from the sale of the shopping center because (1) the fire damaged part could have been replaced, and (2) the undamaged part could have been used without the fire damaged part.

Using this two-part analysis, the enquiry in the present case becomes (1) whether the Destroyed Buildings could be replaced, and (2) whether the Destroyed Buildings and the other components of Complex constitute an economic unit.

(i) Destroyed Buildings could not reasonably be replaced.

In the present case, reconstruction of the Destroyed Buildings was not an economically viable option because Taxpayer was required to operate Complex as low and moderate rental income housing. Before Hurricane, because of the restrictions, Taxpayer’s historical economic return on investment was nominal, and its net cash flow was less than \$j. After Hurricane, reconstruction of the Destroyed Buildings required a substantial investment of new money. Taxpayer did not have the \$s required to demolish and rebuild Destroyed Buildings. Taxpayer projected large operating deficits during the estimated 28 month reconstruction period as a result of the loss of two-thirds (2/3) of its apartments and rental income. Even if Taxpayer had been able to borrow sufficient amounts to make up for the shortage, the restricted rents would have been insufficient to service the loan or provide a return on investment.

This case is similar to the taxpayer in *Masser* where, after the taking of the eight lots used for parking trailers, the terminal was no longer an economically viable operation. Here, Taxpayer was marginally solvent before Hurricane. After the storm, Taxpayer had no means for financial recovery except for selling Complex. As in *Masser*, it made no economic sense for Taxpayer to retain property that it could no longer use profitably in its business. This case is distinguishable from Rev. Rul. 78-377 where the taxpayer could have replaced the fire damaged property and the undamaged property was still

usable to the taxpayer. It is also distinguishable from *Willis* where the damaged property was sold, not because of the damage to the property, but for business advantage. In this case, we conclude that Taxpayer could not reasonably reconstruct the Damaged Buildings.

(ii) Complex constituted a single economic unit.

There was a substantial economic relationship between the land and improvements that comprise Complex. The Damaged Buildings, Destroyed Buildings, underlying land, and other land improvements were acquired and constructed by Taxpayer for use as one economic unit. Complex was constructed as a single rental housing project of 30 apartment buildings containing 240 apartment units. The amenities of Complex (the clubhouse, swimming pool, tennis courts, and landscaping) were constructed for use of the tenants of the 30 apartment buildings. Complex as a whole was subject to the same financing arrangements and restrictions. In its entirety, Complex had to be operated as low and moderate income housing. No provision existed for release of any of the apartment buildings or any other portion of Complex from these financial obligations or from the restrictions until the middle of Year H. Revenues from all 30 apartment buildings were taken into account by the New Lender in making the New Loan. Complex could not practically have been used without the reconstruction of Destroyed Buildings. Taken together, these facts demonstrate a substantial economic relationship existed between the components of Complex such that Complex could not have been operated without Destroyed Buildings. In this case, we conclude that Complex was one economic unit.

CONCLUSIONS

Based on the foregoing rationale, because Destroyed Buildings could not be reconstructed, and because Complex was one economic unit, Complex was no longer economically viable and available to fulfill its business purpose after the involuntary conversion. Thus, the sale of Complex was not a voluntary sale, and the gain from the sale may qualify for deferral under § 1033, provided Taxpayer satisfies the other requirements (including timely acquisition of qualified replacement property). Accordingly, we rule as follows:

1. Taxpayer may defer the gain realized from the insurance proceeds for damages sustained to Complex (including the Damaged Buildings, the Destroyed Buildings, clubhouse, and landscaping) under § 1033 to the extent that the proceeds were used to repair the Damaged Buildings, clubhouse and landscaping, and to demolish the Destroyed Buildings, or reinvested in qualified replacement property, provided Taxpayer satisfies all other requirements of § 1033.

2. Taxpayer may defer the gain realized from the sale of what remained of Complex (including the Damaged Buildings, all other improvements and the underlying land) under § 1033, provided that Taxpayer timely reinvests proceeds in qualified replacement property and satisfies all other requirements of § 1033.

CAVEATS

Except as expressly provided, no opinion is given concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that this letter may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material facts submitted in support of the request for rulings, they are subject to verification on examination.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

Donna Welch
Senior Technician Reviewer, Branch 4
(Income Tax & Accounting)

Enclosure (1)