OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
February 19, 1999

CC:DOM:IT&A:2
GL-703459-98

UILC: 1033.02-00
165.00-00
6041.03-00

Number: **199915050**
Release Date: 4/16/1999

MEMORANDUM FOR
ARC-GL CC:MSR:GL

FROM:
Acting Assistant Chief Counsel (Income Tax & Accounting)

SUBJECT: Oklahoma City Bombing Disaster Relief

This Technical Assistance is in response to your request for assistance dated April 15, 1998 regarding the tax treatment of government payments made to taxpayers to repair or replace property damaged as a result of the bombing of the Alfred P. Murrah Federal Building in Oklahoma City on April 19, 1995. These payments were made pursuant to the "Chamber Grant" program and Phases I and II of the Community Development Block Grant (CDBG) Program. Technical Assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be cited as precedent.

ISSUES:

1) Did taxpayers owning property that was damaged or destroyed by the bombing have a claim for reimbursement to which there was a reasonable prospect of recovery in 1995?

2) Under § 1033, may taxpayers defer recognition of gain realized on payments received under the Oklahoma City bombing disaster relief measures?

CONCLUSIONS:

1) Taxpayers who met the stated program criteria and were eligible to apply for a Chamber Grant in 1995, had a claim for reimbursement and a reasonable prospect of recovery in 1995 and were not entitled to a deduction under § 165 to the extent of the expected recovery. Taxpayers also had a claim for reimbursement and a reasonable prospect of recovery in 1995 under Phase I of the CDBG program and were not entitled to a deduction under § 165 to the extent of the expected recovery. If taxpayers improperly deducted the casualty loss in 1995 they should amend their 1995 returns to eliminate the casualty loss deduction.

Oklahoma City did not approve Phase II of the CDBG program until 1996. Thus, taxpayers applying for funds under Phase II did not have a claim for reimbursement and a reasonable prospect of recovery in 1995 and could deduct losses for 1995 under § 165.

2) Under § 1033, taxpayers may defer recognition of gain realized on payments received under the Chamber Grant Program and Phase I of the CDBG program, and payments received under Phase II as compensation for bomb damage, if taxpayers otherwise comply with the provisions of that section. Gain realized on payments received under Phase II to stimulate economic recovery and community revitalization may not be deferred under § 1033.

Property owners who properly claimed a casualty loss deduction under § 165 in 1995 and who subsequently received reimbursements for property damaged or destroyed by the bombing should recognize ordinary income in the year the reimbursement was received to the extent that the deduction resulted in a tax benefit in a prior year. Any gain attributable to the reimbursement in excess of the recognized ordinary income may be deferred under § 1033.

FACTS:

Oklahoma City was declared a disaster area following the bombing of the Alfred P. Murrah Federal Building on April 19, 1995. To reimburse property owners for uncompensated property losses attributable to the bombing, Oklahoma City made grant funds available to property owners from two sources. The first $600,000 fund was made available through the Small Business Grant Assistance Program (the Chamber Grant Program), and the second, through the $39 million supplemental appropriation administered as the CDBG program. The Chamber grants were originally provided in the form of forgivable loans and were disbursed by the Chamber of Commerce. These were provided as an emergency measure immediately after the bombing and before Congress had allocated emergency relief

funds in the form of the $39 million supplemental CDBG program. Once the supplemental allocation was made available to Oklahoma City, the Chamber loans were converted to grants with CDBG funds.

A property owner could have applied for and received up to $10,000 per property in 1995 under the Chamber Grant Program. The City maintained the option to deny a Chamber Grant application and consider the request under the $39 million supplemental appropriation when those funds became available.

Congress specifically provided the $39 million supplementation "...to assist property and victims damaged and economic revitalization due to the bombing of the Alfred P. Murrah Federal Building..." This program consisted of two phases.

On November 14, 1995, the City enacted Phase I of the bombing recovery program. Phase I addressed the need for repairs, primarily external repairs, to buildings and property damaged by the bombing, limited to $20,000 per property. The intent was solely to return damaged properties to their pre-bomb condition. Grant funds were provided only to pay that portion of damages uncompensated by other sources. For example, if an affected property owner was partially compensated through donations or other sources directed towards correction of bomb damages, the property owner was only eligible for this funding to the extent of damages not otherwise covered. Similarly, if a property owner was insured, the owner was eligible for grant funds only to the extent of the deductible amount, if any, or the difference between the insurance settlement amount and the actual cost of repairs.

On January 16, 1996 the City enacted Phase II of the CDBG program. The objectives of Phase II were to provide additional funds for bomb-damage reimbursements and to revitalize the affected area by attracting new businesses and encouraging the expansion of existing businesses. Property owners with damage claims in excess of $20,000 could submit a claim for grant funds under Phase II of the program. Phase II also made loans available to property owners for the purpose of revitalizing the downtown area.

The property damage reimbursement phases of the CDBG program generally operated as follows. Bomb affected property owners and businesses submitted applications to the City for assistance. Damages were assessed by a consultant Architecture and Engineering firm on contract to the City. The firm's report, together with any eligible requirements for work already done (emergency repairs) was reviewed by a committee composed of senior City officials and the Executive Director of the Urban Renewal Authority. Based on their review, the Committee made a recommendation for funding to the Mayor and City Council. Once approved by the Council, checks were issued for reimbursement and /or the owner was

authorized to hire an architect to prepare plans and specifications to address the approved repairs. Bids were taken on unrepaired damages and work undertaken in accordance with the recommended scope of repairs. No enhancements to damaged properties were funded by the grants except as required to comply with current life/safety Code requirements. Only verified property damage was addressed under this program.

LAW & ANALYSIS:

Section 165

Section 165(a) generally provides a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Government funds earmarked to reimburse taxpayers for property damage attributable to a casualty constitute "compensation" within the meaning of § 165(a). See e.g. Londagin v. Commissioner, 61 T.C. 117 (1973) (Federal and State funds used to reduce SBA mortgage balances on property damaged in an earthquake); Spak v. Commissioner, 76 T.C. 464, 467 (1981) (use of government funds to purchase flood-damaged property for an amount in excess of post casualty fair market value); Rev. Rul. 71-160, 1971-1 C.B. 75; Rev. Rul. 74-206, 1974-1 C.B. 198.

Treas. Reg. § 1.165-1(d)(2)(i) provides in part:

> If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

As noted above, the regulation requires both a claim and a reasonable prospect of recovery as a prerequisite to the denial of a loss. The regulation does not define the meaning of the term "claim." Moreover, the question of when a taxpayer has a claim under a governmental disaster relief program appears to be an issue of first impression.

We believe the term "claim" as used in the regulation should be interpreted to

include rights to payment under a funded[1] government program. In our view, a claim arises when a government program has been created that has criteria for qualification thereunder that allows intended beneficiaries of the program to identify themselves with reasonable certainty, and also provides the procedural steps, if any, that such beneficiaries must follow to assert their claims. That a taxpayer's actual right to payment might prove contingent under the government program's terms does not mean there is no claim. Rather, that factor becomes relevant only to the issue of whether a taxpayer has a reasonable prospect of recovering on the claim.

Chamber Grants

We conclude that a taxpayer meeting the stated program criteria, and therefore eligible to apply for a Chamber Grant in 1995,[2] had a claim for reimbursement within the meaning of Treas. Reg. § 1.165-1(d)(2)(i) for that year unless the claim was denied in 1995. The next issue to be resolved concerns whether such a taxpayer also had a reasonable prospect of recovery on that claim in 1995.

Obviously, a taxpayer actually approved for a Chamber Grant in 1995 had a reasonable prospect of recovery under the Chamber Grant Program in that year. However, we believe that any taxpayer eligible to apply for a Chamber Grant in 1995, but not actually approved for such grant in that year, also had a reasonable prospect of recovery under the program in 1995. Although an applicant for a Chamber Grant had no assurance of receiving such a grant, the amount of money appropriated for the Chamber Grant program gave those eligible to apply at least a reasonable prospect of recovery under the program. Thus, losses reimbursable or eligible for potential reimbursement under the Chamber Grant Program should not be allowable deductions for 1995. Taxpayers who improperly claimed the deduction

---

[1] For this purpose a government program is funded when the necessary money has been appropriated to implement the program.

[2] Section 165(i) provides a special rule for a loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance under the Disaster Relief and Emergency Assistance Act. A taxpayer who meets certain requirements may elect to deduct such a loss for the taxpayer's taxable year immediately preceding the taxable year in which the loss occurred. The City was declared such a disaster area as a result of the bombing. See Rev. Rul. 96-13, 1996-1 C.B. 18, 21. For convenience we have assumed bombing losses will be claimed for 1995 although some taxpayers may be entitled to such losses for 1994 under section 165(i). In any event, a loss must meet all criteria for allowance for 1995 to be eligible for allowance for 1994 under section 165(i).

in 1995 should amend their 1995 returns to eliminate the casualty loss deduction so that taxable income is accurately reflected for the year.

The $39 Million Supplemental Appropriation

As discussed, the City implemented the $39 million supplemental appropriation for the purpose of reimbursing uncompensated property losses attributable to the bombing in two phases: (1) Phase I which the City approved in 1995, and (2) Phase II which the City did not approve until 1996. Damages reimbursable under Phase I were generally limited to $20,000 per property and the amount of funds available for Phase I appears to have been more than adequate to reimburse the qualifying damages up to the per property limit. Thus, a taxpayer who had property damage reimbursable under Phase I had, in 1995, both a claim for reimbursement and a reasonable prospect of recovery on that claim. Therefore, such losses did not qualify for deduction under section 165(a) for 1995. Taxpayers who improperly claimed the deduction in 1995 should amend their 1995 returns to eliminate the casualty loss deduction so that taxable income is accurately reflected for the year.

Because the City did not approve Phase II (under which uncompensated bombing damage to property in excess of $20,000 became reimbursable) of the recovery program until 1996, no taxpayer had a claim under Phase II of the program at the end of 1995. Therefore, uncompensated property losses reimbursable under Phase II, and meeting any other requirements for deductibility, constitute allowable deductions under section 165(a) for 1995. Because the casualty loss deductions were proper, taxpayers that received reimbursements under Phase II for their losses may have had gross income in subsequent years under the tax benefit rule, as explained below.

Section 1033

Section 1033(a) of the Code provides, in part, that if property, as a result of its destruction in whole or in part, is involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized except to the extent that the electing taxpayer, within two years after the close of the first taxable year in which any gain was realized, purchases other property similar or related in service or use to the property so converted. In that event, the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property.

Section 1033(b)(2) provides that if property is converted into money, and the taxpayer purchases qualified replacement property and elects nonrecognition of

gain under § 1033(a)(2), then the basis of the replacement property shall be the cost of such property decreased by the amount of gain not recognized.

Section 1.1033(b)-1(b) of the Income Tax Regulations provides an example; assume A realizes $22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was $10,000 and he spent in the same year $20,000 for a new barn which resulted in the nonrecognition of $10,000 of the $12,000 gain. The basis of the new barn to the taxpayer would be $10,000– the cost of the new barn ($20,000) less the amount of the gain not recognized on the conversion ($10,000).

Property that was damaged or destroyed by the bombing was involuntarily converted "as a result of its destruction in whole or in part" for purposes of § 1033. Accordingly, taxpayers who received grants under the Chamber Grant or the CDBG programs that were provided for the purpose of compensating owners of property damaged or destroyed by the bombing were eligible to defer recognition of the gain realized if they otherwise complied with the provisions of § 1033. On the other hand, gain realized on a loan provided under Phase II of the CDBG program for the purpose of stimulating economic recovery and community revitalization, rather than for the purpose of compensating property owners for bomb damage to their property, may not be deferred. For taxpayers that received grants eligible for deferral under § 1033, expenditures made to repair or replace damaged property are treated as amounts spent to purchase qualifying replacement property, including expenditures for the following items:

(1) Removal of trash and debris;

(2) Abatement of weeds, unsightly bushes, damaged or dying trees;

(3) Demolition of structures which have lost structural integrity; and

(4) Securing of retained structures through replacement of doors and installation of temporary windows.

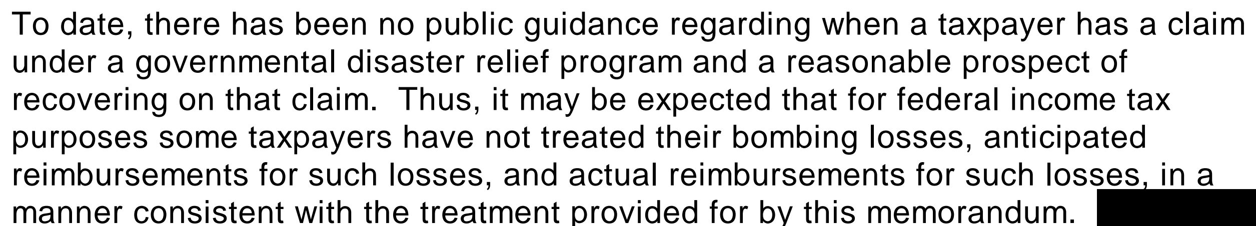
An additional consideration is the application of the tax benefit rule, which ordinarily requires the recognition of gross income in cases where a taxpayer has properly deducted a loss on a federal income tax return, derived a tax benefit from the deduction, and then received compensation for the loss in a subsequent year. Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370 (1983), 1983-1 C.B. 50. The compensation is includible in gross income to the extent of the tax benefit derived from the deduction of the loss in the prior year. Id.; § 111, Recovery of Tax Benefit Items; Treas. Reg. § 1.165-1(d)(2)(iii). However, when the compensation qualifies for nonrecognition from gross income under another provision of law, for example, §

1033, a tension must be resolved between the inclusion required by the tax benefit rule and the nonrecognition allowed. Hillsboro, 460 U.S. 370. With respect to reimbursements under Phase II of the CDBG program, the nonrecognition allowed under § 1033 is overridden to the extent of the tax benefit derived from the § 165 deduction claimed in a prior year. See Rev. Rul. 74-206, 1974-1 C.B. 198. Thus, taxpayers that properly claimed a casualty loss deduction under § 165 in 1995 and subsequently received reimbursements for their losses should include the reimbursements in gross income in the year received to the extent the deduction resulted in a tax benefit. Section 1033 and the tax benefit rule do not apply, however, to the extent of funds disbursed under Phase II (whether as grants or loans) for the purpose of economic revitalization. We have not been asked and express no opinion, about the proper tax treatment of disbursements under Phase II that were not strictly limited to compensating property owners for uncompensated property losses attributable to the bombing.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

Section 165

To date, there has been no public guidance regarding when a taxpayer has a claim under a governmental disaster relief program and a reasonable prospect of recovering on that claim. Thus, it may be expected that for federal income tax purposes some taxpayers have not treated their bombing losses, anticipated reimbursements for such losses, and actual reimbursements for such losses, in a manner consistent with the treatment provided for by this memorandum.



Generally, there will not be prejudice where the taxpayer did not claim a deduction for 1995. For example, suppose a taxpayer, reasoning that Congress's $39 million supplemental appropriation prevented a bombing loss deduction for 1995 claimed no such deduction, although according to the analysis in this memorandum the taxpayer had an allowable bombing loss deduction of $40,000 for that year. In 1997

the taxpayer received reimbursement for all of the taxpayer's otherwise uncompensated property losses attributable to the bombing except for $2,000 worth of losses. Pursuant to Treas. Reg. § 1.165-1(d)(2)(i) and (ii) the taxpayer claimed a $2,000 loss deduction for 1997. Although the taxpayer's treatment conflicts with that provided for in this memorandum (which would generally require a deduction in 1995 followed by an inclusion in gross income for 1997) the taxpayer's reporting for 1995 and 1997 is consistent and has the same effect on aggregate taxable income for the taxable years at issue as the memorandum method. Essentially, the two methods differ only with respect to when particular items are taken into account in the separate taxable years beginning in the year of physical loss and ending in the taxable year in which reimbursement occurs. Thus, absent some special circumstance that might prejudice the government, the taxpayer's tax treatment should not be challenged on audit.[3]

On the other hand, if a taxpayer claims a deduction for 1995 in excess of that allowable according to the memorandum analysis, such deductions generally should be challenged upon audit because of the potential for prejudice to the government. For example, suppose a taxpayer incurred $15,000 of bombing losses in 1995, reimbursable under Phase I of the recovery program, which the taxpayer deducted for 1995. In 1997 the taxpayer receives reimbursement for such losses which the taxpayer includes in gross income. After the statute of limitations for assessment has expired for 1995, the taxpayer amends its 1997 return to exclude the $15,000 reimbursement from gross income.

Generally, the inclusionary portion of the tax benefit rule would require the inclusion in gross income of any recovery with regard to a loss in a prior taxable year provided the deduction for the loss resulted in a tax benefit. However, the Tax Court recognizes an erroneous deduction exception to the inclusionary portion of the tax benefit rule, that is, the rule does not require inclusion in gross income of a recovery in a subsequent taxable year with regard to a prior improper deduction, even one that provided a tax benefit. Streckfus Steamers, Inc. v. Commissioner, 19 T.C. 1, 8 (1952); Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 559 (1980). Under that exception the taxpayer would be entitled to a refund for 1997 even though the taxpayer received a tax benefit from the erroneous loss deduction for 1995. Such a result would constitute a net loss of revenue to the government not related to timing.

Both the Ninth and Fifth Circuit Court of Appeals have expressly rejected the Tax

---

[3] We are assuming that when the Service audits the taxpayer's 1997 return the statute of limitations for claiming a refund for 1995 will have expired. If not, appropriate action should be taken to ensure no possible prejudice to the government.

Court's erroneous deduction exception to the inclusionary portion of the tax benefit rule, finding the Tax Court's rationale for the exception unpersuasive. Unvert v. Commissioner, 656 F.2d 483, 485 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982); Hughes & Luce, L.L.P. v. Commissioner, 70 F.3d 16, 20 (5th Cir. 1995), cert. denied, 517 U.S. 1208 (1996). The City, however, lies within the Tenth Circuit and it appears neither the Court of Appeals for that circuit nor the Court of Appeals for the Federal Circuit has expressly addressed the applicability of the erroneous deduction exception. Therefore, to prevent possible prejudice to the government, audit adjustments should be proposed for taxpayers who claim loss deductions for 1995 or 1994 in excess of amounts allowable pursuant to the analysis in this memorandum unless a special circumstance[4] exists which eliminates possible prejudice to the government.

Notwithstanding the erroneous deduction exception, a taxpayer may still be required to include a recovery of an improperly deducted item for one taxable year in gross income in a subsequent taxable year pursuant to the equitable remedy of quasi-estoppel, also known as the duty of consistency. For the duty of consistency to apply however the taxpayer must at least misrepresent or inadequately disclose some fact or an issue of mixed fact and law relating to the improper deduction. No duty of consistency exists with regard to mistakes of law. *See* Southern Pacific at 560, supra. Assuming that the analysis in this memorandum accurately reflects the law, in all likelihood a court would conclude that a taxpayer who claimed a bombing loss deduction for 1995 in excess of that allowable pursuant to the memorandum's analysis did so because of a mistake of law. Therefore, the Service should not assume that the duty of consistency will apply to negate the possible application of the erroneous deduction exception.

Information Reporting

Section 6041 requires all persons engaged in a trade or business and making payment in the course of the trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed and determinable gains, profits and income of $600 or more in a taxable year to render a true and accurate return to the Secretary of the Treasury setting forth the amount of those gains, profits and income and the name and address of the recipient of the payment. Sections 1.6041-1(b)(1) and (g) of the Income Tax

---

[4] For instance, in the example discussed above, a special circumstance would exist if the statute of limitations for claiming a refund for 1997 expires during the audit of the taxpayer's 1995 return without the taxpayer filing a refund claim for 1997 based on excluding the reimbursement of the erroneously deducted item from gross income for that year.

Regulations provide that payments made by a state or a political subdivision are subject to this reporting requirement.

Section 1.6041-1(c) provides that income is fixed when it is to be paid in amounts definitely predetermined. Income is "determinable" whenever there is a basis of calculation by which the amount to be paid may be ascertained.

As used in § 6041, the term "gains, profits, and income" means an amount that is gross income to the payee.

When Oklahoma City paid a grant to a taxpayer under the CDBG program to make repairs to a damaged building, it could not identify the amount of the payment considered "gains, profits or income" to the payee. The City could not determine a payees' adjusted basis in damaged property or the amount of the payment a property owner actually used to replace or repair the property. Additionally, the City would not know whether payees elected to defer gain under § 1033. Therefore, because the payees' "gains, profits or income" were not fixed or determinable under § 6041, the City was not required to issue 1099 information returns with respect to payments made under the CDBG program. We understand however, that the City did issue Forms 1099 to those who received payments under the CDBG program. The local I.R.S. office may wish to consider methods of dealing with, or forestalling , I.R.S. inquiries directed to taxpayers that are based on Forms 1099 for payments to repair damaged property as a result of the bombing.

This technical assistance is advisory only, and is intended to call attention to well-established principles of tax law that apply in the situation described. Taxpayers uncertain whether these principles or interpretations of tax law should apply to their situations should consider seeking a private letter ruling or, if appropriate, technical advice. Procedures for issuing letter rulings and technical advice are in Rev. Proc. 99-1, 1998-1 I.R.B. 6, and Rev. Proc. 99-2, 1999-1 I.R.B. 73, respectively.