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Improving the Principal Residence Disaster Relief Provisions

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I. Principal Residence Disaster Relief

A major goal of tax reform is equity. Ideally, the Internal Revenue Code would provide rules under which similarly situated taxpayers bear the same tax burden. However, as we bid farewell to natural disaster-ridden 1994, and 1995 begins with more floods in California, similarly situated taxpayers who have lost their principal residences may find themselves with very different tax burdens. Consequently, in regard to these taxpayers, Congress has failed to meet this major tax reform goal. This article proposes a simple code amendment to resolve this congressional failure. Consider the following taxpayers:

On October 27, 1993, Jim and Jane Jones lost their principal residence in the Southern California fires. Their residence was insured at replacement cost. In 1994, Jim and Jane decide to rebuild on their old residential lot with the full amount of their insurance proceeds. Jim and Jane have no tax consequences due to the disaster.

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In this article, the author proposes a simple statutory solution to an inequity in the disaster relief provisions of the Internal Revenue Code. Using two hypothetical taxpayers, Lipman demonstrates that similarly situated disaster-struck taxpayers may not be treated equally. She then analyzes the Service's position in this area, including a discussion of case law in which she focuses on the interactions between sections 1033 and 1034. Lipman then reviews legislative history to discern Congress's intent when it enacted section 1034. Finally, in her conclusion, the author sets forth a simple statutory amendment to remedy this inequity.
On October 27, 1993, Sam and Sue Smith, Jim and Jane's neighbors, lost their principal residence in the same fire. Their residence also was insured at replacement cost. Sam and Sue decide to rebuild their home in another area, so they put their principal residence lot up for sale. On July 1, 1994, the Smiths reinvest their insurance proceeds and additional funds, which pay for the new lot, in a new principal residence located three miles from their old residence. Because the old residential lot is located in a fire hazard area and the residential real estate market is depressed, it does not sell until October 1, 1995. Sam and Sue may have to recognize gain on the sale of their old residential lot.

While both families have similarly replaced their respective fire-destroyed principal residences with new principal residences, the code fails to treat them the same. Because Sam and Sue decided they did not want to rebuild on the same lot, they must suffer potentially adverse tax consequences and negative cash flow. While it seems clear Congress did not intend that these taxpayers recognize gain, the current authority does not allow for nonrecognition. A simple amendment to the code could remedy this unintentional inequity.

II. Application of Current Tax Law

A. Involuntary Conversion

When a taxpayer's principal residence is destroyed and she receives her insurance proceeds, she has a
realization event. /3/ If the amount realized, /4/ the insurance proceeds, exceeds the principal residence's adjusted basis, then a gain is realized. /5/ This gain must be recognized, unless a nonrecognition provision applies. /6/ Under the code, the involuntary conversion provisions can provide nonrecognition treatment. /7/ If all the proceeds from an involuntarily converted property are reinvested in new property that is similar or related in service or use, within the requisite time period, then the realized gain may be deferred. /8

An involuntary conversion includes the destruction of a principal residence by fire, earthquake, flood, or hurricane. /9/ The destruction need not be sudden; a progressive deterioration also will constitute an involuntary conversion. /10/ The destruction of the Joneses' and the Smiths' principal residences by fire potentially qualifies for nonrecognition treatment.

1. Nonrecognition requirements. Complete deferral of conversion gain is available only when property having a cost equal to the conversion proceeds is purchased. /11/ Taxpayers must purchase new property that is similar or related in service or use. /12/ Destroyed or damaged real property must be replaced on or before two years from the close of the tax year in which any part of the conversion gain is realized. /13/ Principal residences damaged or destroyed by a presidentially declared disaster must be replaced on or before four years from the close of the tax year in which any part of the conversion gain is realized. /14/ Both the Joneses and the Smiths have, within the requisite time period, purchased new property having a cost equal to the proceeds; accordingly, neither family must recognize gain on the conversion of their principal residence.

B. Basis in the Replacement Property

The replacement property takes the basis of the converted property, decreased by the amount of any money not reinvested, and increased by the amount of any gain recognized or outside cash invested. /15/ Consequently, the Joneses will have a basis in their new principal residence exactly equal to the basis in their old principal residence. Accordingly, the gain is preserved in the replacement property's reduced basis. The Smiths, however, will have a basis in their new principal residence equal to the basis in their old principal residence (house only, not land), plus the cost of the new land. Because the Smiths were unable to sell their old residential lot before the purchase of their new lot, they had to invest or borrow additional money to buy their new residential lot. Consequently, they will have a cost basis in their new residential lot. /16/

III. Sale of the Former Residential Lot

Suitably, the Joneses and the Smiths, similarly situated taxpayers, have so far been treated the same. However, in 1995, when the Smiths finally sell their old residential lot, the tax consequences are not certain and appear to be less than equitable.

A. Not an Involuntary Conversion

Undoubtedly, the sale of the former principal residence lot is a realization event. /17/ Thus, the gain must be recognized unless a nonrecognition provision applies. /18/ However, because the property was not damaged or destroyed in the fire, it does not qualify for nonrecognition treatment under the involuntary conversion provisions. /19/ The Smiths must rely on another code provision for nonrecognition treatment.

B. Residential Rollover Provisions

Section 1034 provides nonrecognition treatment to taxpayers that sell their principal residence and either two years before or after that sale acquire a new principal residence of equal or greater value. /20/ The Smiths lost their principal residence in the fire on October 27, 1993, and will sell their former residential lot on October 1, 1995. Consequently, if the destruction of the Smiths' principal residence is treated as a sale under section 1034, the gain realized on the sale of the former residential lot may be deferred. The gain deferral will result in a reduction of the Smiths' basis in their new residence, which preserves the gain not currently recognized. /21/ The basis in the new residence will be its cost, reduced by any gain realized, but not recognized. /22/

If section 1034 applies to the sale of the former residential lot, both the Smiths and the Joneses have deferred their entire conversion-related principal residence gain. However, if section 1034 does not apply to the Smiths' sale of their former residential lot, they will have to recognize gain. Accordingly, similarly
situating taxpayers, families that were forced to acquire a new principal residence because of an involuntary conversion, are not treated the same. Thus, if section 1034 does not apply to the Smiths' sale of their former residential lot, an inequity results.

1. IRS position. Section 1034 will apply to the Smiths' sale of their former principal residential lot if that sale is classified as a sale of a principal residence. /23/ The Service has stated that section 1034 applies only to the disposal of a dwelling, not to a sale of land without the sale of the dwelling. /24/ In their official statement, the Service examined the code, regulations, and legislative history, and found nothing that allowed nonrecognition treatment for the sale of land without the sale of a taxpayer's dwelling. /25/ In their analysis, the Service examined three cases, Hughes, /26/ O'Barr, /27/ and Bogley, /28/ before reaching a conclusion. /29/

a. Hughes v. Commissioner. /30/ In Hughes, the taxpayers sold the lot on which their principal residence was located for $20,000 plus the right to occupy a piece of the buyer's property as a new residence for their lives. /31/ After moving into their new residence, the taxpayers bought a new lot, moved their former principal residence to the new lot, and leased their former principal residence to tenants. /32/ The court held that none of the gain on the sale of the former residential lot qualified for nonrecognition under section 1034(a). /33/ The court reasoned that, because the taxpayers retained their principal residence, the sale of the residential lot did not constitute a sale within the meaning of section 1034(a). /34/

b. O'Barr v. Commissioner. /35/ In O'Barr, the taxpayers sold an unimproved portion of the two-acre tract on which their house was located. /36/ The taxpayers subsequently purchased and occupied a new principal residence, but never sold the former residence. /37/ The court held that section 1034(a) did not apply when the property sold does not include the principal residence dwelling. /38/ The court said '[t]he only logical interpretation of section 1034(a) is that it will only apply in situations where a taxpayer has disposed of his old dwelling.' /39/ The court stated that Bogley v. Commissioner, /40/ did not support the taxpayers' position that they could retain their old house and get nonrecognition treatment when they sold off a portion of the land on which it was located. /41/ The court found that the sale of residential land, without the sale of the residential house, does not qualify for nonrecognition treatment under section 1034. /42/

c. Bogley v. Commissioner. /43/ In Bogley, a taxpayer's principal residence consisted of 13 acres and a house. /44/ The taxpayer, while attempting to sell the entire parcel, sold the house and three acres surrounding the house. /45/ Six months later, the taxpayer sold five of the remaining acres to a third party, and two months after that sold the last five acres to the buyer of the house. /46/ The court concluded that the remaining 10 acres retained their character as principal residence and the taxpayer was therefore entitled to nonrecognition of the entire gain under a predecessor of section 1034(a). /47/ The court found that the code does not, even by implication, state that the former principal residence must be sold in its entirety. /48/ Thus, the subsequent sales of land were part of the ongoing sale of the taxpayer's residential estate. /49/

2. Application to the Smiths' sale. To receive nonrecognition treatment under section 1034, the Smiths must demonstrate that the sale of their former principal residential lot was part of the ongoing sale of their old principal residential estate. /50/ Furthermore, the sale of the lot must occur within the requisite statutory time period in section 1034. /51/

The first hurdle for the Smiths to jump is that their principal residence was not sold, it was destroyed in a fire or involuntarily converted. Thus, the question is: Is this type of involuntary conversion a sale for purposes of section 1034? Probably not.

a. Damage or destruction of property. The code explicitly states that in the case of seizure, requisition, or condemnation of a taxpayer's residence, a taxpayer may elect nonrecognition treatment under section
In those cases, the seizure, requisition, or condemnation will be treated as the sale of the taxpayer's principal residence. Consequently, it appears that without statutory authority, the destruction of a principal residence is not treated as a sale for purposes of section 1034. Furthermore, section 121, which provides a one-time exclusion of gain from the sale of a principal residence by an individual who has attained age 55, explicitly states that for purposes of section 121, the destruction, theft, seizure, requisition, or conversion of property is treated as a sale. Thus, it appears that without explicit authority, the destruction of the Smiths' house is not a sale. Consequently, the later sale of the principal residential lot is not part of an ongoing sale of the residential estate because the dwelling, under the code, was not 'sold.'

b. Section 1034 statutory period. Even if the Smiths are able to establish that the conversion of their principal residence was a sale for purposes of the analysis of the subsequent principal residential lot sale, they must satisfy the section 1034 time period requirement. Accordingly, the acquisition of the new residence must occur within a period beginning two years before the date of the sale of the principal residence and ending two years after the sale of the principal residence. Thus, if the conversion is treated as a sale on October 27, 1993, despite the code's failure to treat it as a sale, the new residence must be acquired by October 27, 1995. The Smiths will purchase a new principal residence on July 1, 1995, so the sale and acquisition should qualify for section 1034 nonrecognition treatment. Additionally, the sale of the principal residential lot will occur on October 1, 1995, within the statutory period, so the lot sale also should receive nonrecognition treatment.

3. Congressional intent. The legislative history behind the predecessor of section 1034 indicates that Congress was trying to relieve taxpayers from the burden of gain recognition when they are forced to sell and replace their residence because of an increase in family size or change in their employer's location. While Congress was concerned primarily with providing relief for this 'involuntary conversion' type of sale, it recognized that the administrative burden of confining the relief to these specific situations was too great. Consequently, Congress extended nonrecognition treatment to all residential sales that meet the statutory requirements. The Service has elaborated on its understanding of Congress's intent by stating that '[a]s long as taxpayers continue to retain ownership of their old dwelling unit, we believe it would defeat the intention of Congress if the relief provisions of section 1034 applied.'

IV. Statutory Remedy

The Smiths have not retained their old dwelling unit because it was destroyed in a fire. Certainly, under the code, the Smiths' house has been involuntarily converted. Thus, the Smiths' situation is the type of hardship event that Congress intended to relieve with favorable nonrecognition treatment under section 1034. Accordingly, the code should be amended to provide such treatment.

Section 1034(i) should be amended to include 'damage or destruction of a residence' in its list of condemnations that a taxpayer can elect to treat as a sale of a principal residence. Consequently, the Smiths' subsequent sale of their former residential lot could be treated as part of an ongoing sale of the principal residential estate. Accordingly, if the residential lot is sold within the statutory time period, it would qualify for nonrecognition treatment.

With this proposed amendment, the code, as applied to the Smiths' and Joneses' disaster-related experiences, would have the desired effect of defining conditions under which similarly situated taxpayers bear the same tax burden. Both the Smiths and the Joneses, similarly situated taxpayers, would be treated the same under the amended code. Furthermore, the code would effect Congress's intent to afford nonrecognition treatment to taxpayers forced to replace their principal residence because of an involuntary conversion.

FOOTNOTES


/2/ Id. at 24.

/3/ Section 1001; see generally Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 558-67 (1991) (broadly defining realization as an exchange of properties with legal entitlements that are different in kind or extent).

/4/ Section 1001(b).

/5/ Section 1001(a).

/6/ Section 1001(c).
/7/ See generally section 1033.
/8/ Id.
/9/ Section 1033(a).
/11/ Section 1033(a)(2)(A).
/12/ Section 1033(a)(2) and (a)(2)(A)(ii).
/13/ Section 1033(a)(2)(B)(i).
/14/ Section 1033(h)(1)(B).
/15/ Section 1033(b).
/16/ Section 1012.
/17/ See sources cited supra note 3.
/18/ Section 1001(a).
/19/ Sections 1001 and 1033(a).
/20/ Section 1034.
/21/ Section 1034(e).
/22/ Id.
/23/ Section 1034(a).
/25/ Id.
/26/ 54 T.C. 1049 (1970), aff'd 450 F.2d 980 (4th Cir. 1971).
/29/ The Service also discussed several Revenue Rulings and a fourth case, Snyder v. United States, 321 F. Supp. 661 (D.C. Colo. 1970), aff'd per curiam 445 F.2d 319 (10th Cir. 1971) (stating that the sale of a portion of land surrounding taxpayer's principal residence without a sale of the residence did not qualify for tax relief under section 121); Rev. Rul. 83-50, 1983-1 C.B. 41 (ruling that the sale of land on which taxpayer's principal residence was located without the sale of the principal residence is not excludable under section 121), modifying and rev'g Rev. Rul. 54-156, 1954-1 C.B. 112; Rev. Rul. 56-420, 1952-2 C.B. 519 (ruling that the sale of a portion of the principal residential lot without the sale of the residence did not qualify for nonrecognition treatment under section 1034).
/30/ 54 T.C. 1049 (1970), aff'd 450 F.2d 980 (4th Cir. 1971).
/31/ Id. at 1050.
/32/ Id. at 1052-53.
/33/ Id. at 1056.
/34/ Id. at 1055.
/36/ Id.
/37/ Id. at 502.
/38/ Id.
/39/ Id. at 503.
263 F.2d 746 (4th Cir. 1959), rev’g 30 T.C. 452 (1958).  
41/ O’Barr, 44 T.C. at 503.  
42/ Id.  
43/ 263 F.2d 746 (4th Cir. 1959), rev’g 30 T.C. 452 (1958).  
44/ Id.  
45/ Id. at 747.  
46/ Id.  
47/ Id. at 748.  
48/ Id.  
49/ See id.  
50/ Section 1034(a).  
51/ Id.  
52/ Section 1034(i).  
53/ Id.  
54/ Section 121(d)(4).  
55/ Section 1034(a).  
56/ Id.  
58/ Id.  
59/ Id.  
60/ GCM 38,729 (May 21, 1981).  
61/ Section 1033(a).  
62/ See Bogley, 263 F.2d at 748.  
63/ Id.  
64/ Nellen, Annette, ‘Disaster Relief Provisions: Changes to Section 1033 and the Problems That Remain,’ 22 J. of Real Estate Tax’n 158, 169-72 (suggesting same solution to solve problem of sale of residential lot without dwelling because of its destruction in an involuntary conversion).  
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