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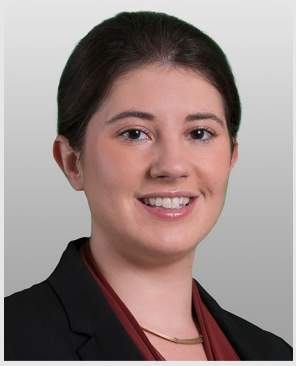

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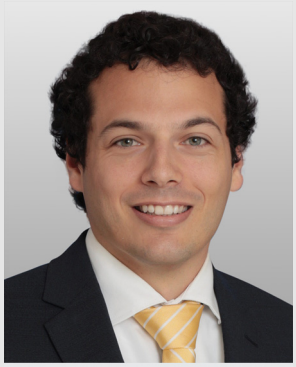

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In this article, the authors explain how taxpayers affected by the COVID-19 pandemic may be able to obtain gain deferral under section 1033.

I. Introduction

In some circumstances, the Internal Revenue Code provides relief from gain recognition arising from the involuntary conversion of property. In particular, at a taxpayer's election, section 1033(a) provides for the deferral of gain recognition if a taxpayer's property is involuntarily converted as a result of a list of enumerated situations, including its "destruction in whole or in part," and if the taxpayer uses the proceeds from the conversion to acquire similar or related replacement property. In instances of federally declared disasters, additional relief is available under section 1033(h)(2): The replacement property need not be "similar or related." Any tangible business property can qualify.

In exploring how section 1033 applies to the COVID-19 pandemic, we propose that the economic (rather than physical) destruction of property is sufficient to trigger section 1033 relief; thus, businesses suffering because of the pandemic may be able to defer gain that would otherwise result in taxable income. Further, because COVID-19 is a federally declared disaster, the additional relief under section 1033(h)(2) should be available, allowing affected taxpayers to acquire non-similar tangible business property.

II. History of Section 1033

Federal laws have provided tax relief for involuntary conversions since 1921. Section 214(a)(12) of the Revenue Act of 1921, which broadly reduced tax burdens after the conclusion of World War I, allowed individual taxpayers to take deductions to the extent that they spent cash proceeds from an involuntary conversion of property (1) to acquire "other property of a character similar or related in service or use to the property so converted"; (2) to acquire at least 80

percent of the stock of a corporation owning that property; or (3) to establish a replacement fund.[1] In spending the proceeds to purchase replacement property or stock, taxpayers were also required to act with good faith. Section 234(a)(14) of the Revenue Act of 1921 contained a similar provision allowing a corresponding deduction for corporate taxpayers.

Section 203(b)(5) of the Revenue Act of 1924 amended the involuntary conversion provision by providing for nonrecognition of gain (as opposed to a deduction) and removing the requirement that taxpayers use proceeds to acquire at least 80 percent of the stock of a company owning similar replacement property. It introduced a more flexible standard that taxpayers must use the proceeds in "acquisition of *control* of a corporation" owning the replacement property.[2] Notably, both revenue acts also contained other gain-deferral provisions. Section 203(b)(1) of the Revenue Act of 1924, for example, contained the precursor to the current code's section 1031, providing for the nonrecognition of like-kind exchanges of property held for productive use in a trade or investment.[3]

The Internal Revenue Code of 1954 contained the first codified version of section 1033. Section 1033 tracked the statutory language of section 112(f) of the Revenue Act of 1938, which in turn tracked section 203(b)(5) of the Revenue Act of 1924, with two notable modifications: First, the 1954 code removed the requirement that taxpayers proceed in good faith in spending the involuntary conversion proceeds to purchase similar replacement property.[4] Second, it removed the establishment of a replacement fund as a qualifying manner of expending the proceeds from an involuntary conversion.[5]

After the provision's codification in 1954, it was not until the Omnibus Budget Reconciliation Act of 1993 that section 1033 was amended again, this time to provide relief for involuntary conversions of a taxpayer's principal residence resulting from specific disasters.[6] As discussed in Section III.C below, this additional relief was expanded again in 1996 for business and investment property affected by specific disasters.

III. Current Section 1033

At a taxpayer's election, section 1033(a) provides for the nonrecognition of gain when property is compulsorily or involuntarily converted "as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof." Nonrecognition is available when the taxpayer acquires replacement property — "property similar or related in service or use to the property so converted" — generally within the two years preceding the close of the year of the conversion.[7] This section provides an overview of some of the key terms and requirements in the statute.

A. Property

For section 1033 nonrecognition, property must be compulsorily or involuntarily converted. Neither section 1033 nor its related regulation defines "property."

To interpret an undefined statutory term, courts often rely on the term's ordinary meaning.[8] This analytic path has led to a very broad construction of the term property for federal tax purposes. For example, the Tax Court has concluded that the term extends to encompass a mere contractual obligation to perform under a prepaid forward contract.[9] Other examples of property include the rights under a lease,[10] a

[1] Revenue Act of 1921 (P.L. 67-98), section 214(a)(12), 42 Stat. 227, 241-242 (1921).

[2] Revenue Act of 1924 (P.L. 68-176), section 203(b)(5), 43 Stat. 253, 256 (1924).

[3] *See id.* at section 203(b)(1).

[4] IRC of 1954, section 1033(a)(3)(A), 68A Stat. 1, 304 (1954).

[5] *See id.*

[6] Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), section 13431 (1993).

[7] Section 1033(a)(2). Subject to adjustments for cash, replacement property generally has a basis equal to the converted property, decreased by money received by the taxpayer that isn't reinvested in replacement property.

[8] *See Crane v. Commissioner*, 331 U.S. 1, 6 (1947) ("The words of statutes — including revenue acts — should be interpreted where possible in their ordinary, everyday senses.").

[9] *McKelvey v. Commissioner*, 148 T.C. 312 (2017) (citing *Black's Law Dictionary*, which defined property as "any external thing over which the rights of possession, use, and enjoyment are exercised").

[10] *Federal Home Loan Mortgage Corp. v. Commissioner*, 121 T.C. 254, 268 (2003).

financing arrangement,[11] a supply contract,[12] and a license, regardless of whether it is exclusive.[13] As the Supreme Court has explained: "Property is more than just the physical thing — the land, the bricks, the mortar — it is also the sum of all the rights and powers incident to ownership of the physical thing. It is the tangible and the intangible."[14]

B. The 'Similar or Related' Requirement

The phrase "similar or related in service or use" isn't defined in the statute or underlying regulations, but as discussed below, courts have held that section 1033 should be liberally construed because it is a relief provision.[15] Although the general rule under section 1033(a) doesn't allow a taxpayer to "defer gain while changing the nature of his investment," the "replacement property need not be an exact duplication of the converted property."[16]

Application of the "similar or related in service or use" standard is fact-specific and depends on the circumstances of each case. In deciding whether two related but nonidentical assets are sufficiently similar or related, the IRS has often used some version of a functional use test, comparing the physical characteristics and end uses of the converted and replacement properties.[17] Courts have expanded on that rubric, analyzing the continuity of the character of the investment and focusing on the statute's underlying purpose: to allow a taxpayer whose property has been destroyed to return "as closely as possible to his original position."[18]

C. Section 1033(h)(2) and Disaster Relief

Section 1033(h)(2) provides an exception to the general rule that the converted and replacement property must be similar or related. If a taxpayer's business or investment property is located in a disaster area and is involuntarily converted as a result of a federally declared disaster, the taxpayer may use the proceeds from the conversion to purchase any "tangible property of a type held for productive use in a trade or business" and elect not to recognize those proceeds as taxable gains.

Section 1033(h)(2) was added to the code in 1996 in response to the Oklahoma City bombing, to provide that business and investment property is eligible for nonrecognition of gain if involuntarily converted as a result of a presidentially declared disaster.[19] The legislative history explains:

> The property damage in a Presidentially declared disaster may be so great that businesses are forced to suspend operations for a substantial time. During that hiatus, valuable markets and customers may be lost. If this suspension causes the business to fail, and the owners of the business wish to reinvest their capital in a new business venture, the involuntary conversion rules will force them to recognize gain when they buy replacement property that is needed for the new business but not similar to that used in the failed business. This provision will offer relief to such businesses by allowing them to reinvest their funds in any tangible business property without being forced to recognize gain. No such deferral of gain is available, however, if the taxpayer decides not to reinvest in tangible business property.[20]

[11] *Id.*

[12] *Ithaca Industries Inc. v. Commissioner*, 97 T.C. 253 (1991), *aff'd*, 17 F.3d 684 (4th Cir. 1994).

[13] *See Du Pont de Nemours & Co. v. United States*, 471 F.2d 1211, 1219-1221 (Ct. Cl. 1973).

[14] *Dickman v. Commissioner*, 465 U.S. 330, 336 (1984).

[15] *Davis v. United States*, 589 F.2d 446, 450 (9th Cir. 1979); and *Willamette Industries Inc. v. Commissioner*, 118 T.C. 126, 137 (2002).

[16] S. Rep. No. 82-1052, at 2 (1951).

[17] *See* Rev. Rul. 64-237, 1964-2 C.B. 319 (setting forth the functional use test and providing, by way of example, that a taxpayer-owner could not replace a converted manufacturing plant with a wholesale grocery warehouse because the taxpayer's end use of the property had changed too drastically).

[18] *Maloof v. Commissioner*, 65 T.C. 263, 269-270 (1975).

[19] Small Business Job Protection Act of 1996 (P.L. 104-188), section 1119 (1996); H.R. Conf. Rep. 104-737, at 196 (1996).

[20] S. Rep. No. 104-281, at 14 (1996); *see also* TAM 201111004 (relying on the Senate report in explaining the reason for adding section 1033(h)(2) to the code).

IV. Compulsory or Involuntary Conversions

On March 13 the pandemic became a federally declared disaster for all U.S. states and territories.[21] Thus, trade or business property that has been "compulsorily or involuntarily converted as a result of" the COVID-19 pandemic should qualify for the additional relief provided by section 1033(h)(2).[22] In this section, we examine how the pandemic could have resulted in the involuntary conversion of property within the scope of section 1033 so that affected taxpayers may defer gain recognition from proceeds spent on qualifying replacement property, including under the additional relief provided by section 1033(h)(2).

A. Involuntary Conversion Requirements?

Section 1033(a) provides for relief "if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted." Because section 1033(h)(2) requires property to be compulsorily or involuntarily converted, authorities interpreting this phrase under section 1033(a) should be relevant for 1033(h)(2). Authorities interpreting section 1033(a) support the view that economic destruction of property is sufficient to qualify for nonrecognition under section 1033.

In general, an involuntary conversion has been broadly defined to include situations in which "the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes."[23] The IRS and Treasury embraced this definition in Rev. Rul. 89-2, 1989-1 C.B. 259. There, the IRS addressed the application of section 1033 to a taxpayer's real estate used in its business. The land was contaminated through the release of chemicals nearby, and the local government announced that residences and businesses should be relocated "to protect the public health." Citing *C.G. Willis*, the ruling concluded that the real estate had been "destroyed for purposes of section 1033(a)" because it was "no longer useful or available to him for his purposes."

In *Henshaw*,[24] the Tax Court explained that for purposes of section 1033, "one of the meanings of the word 'destroy' . . . is: 'To take away completely the value or usefulness of.' Another is 'to render of no avail.'" The court elaborated that the term "destruction" has "on more than one occasion been construed to describe an act which while rendering the thing useless for the purpose for which it was intended, did not literally demolish or annihilate it." Applying that concept of destruction, the court held that oil immobilized in the ground and unable to be extracted (because of negligence) was destroyed. Even though the oil physically existed and was unharmed, it was useless to the taxpayer.

A few years later, the Tax Court's decision in *Masser*[25] further evidenced that economic destruction qualifies as a conversion under section 1033(a). *Masser* involved circumstances in which one of the taxpayer's two pieces of real estate used in his trucking business came under a threat of condemnation. The taxpayer sold both properties because of the threat because both were needed to efficiently operate the business. The Tax Court viewed the two parcels as one economic unit and held that the taxpayer was entitled to nonrecognition on the sale of the second property, even though it was not under a threat of condemnation, because of the economic impracticality of continuing to hold the second property.

This same point was articulated by the Court of Claims in *Grant Oil Tool*.[26] In that case, the court held that tools dropped into a drill hole were destroyed because "they are no longer of any use or value of the taxpayer or the drilling contractor."

[21] *See* "Letter From President Donald J. Trump on Emergency Determination Under the Stafford Act" (Mar. 13, 2020).

[22] More specifically, section 1033(h)(3) defines "disaster area" and "federally declared disaster" by reference to section 165(i)(5). In turn, that section defines federally declared disaster as "any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act." On March 13, 2020, President Trump declared the COVID-19 pandemic a nationwide disaster in accordance with section 501(b) of the Stafford Act and made federal assistance available to all 50 states, the District of Columbia, and four territories.

[23] *C.G. Willis Inc. v. Commissioner*, 41 T.C. 468, 476 (1964), *aff'd*, 342 F.2d 996 (3d Cir. 1965); ILM 200734021 (citing *C.G. Willis*).

[24] *Henshaw v. Commissioner*, 23 T.C. 176 (1954), *acq.*, 1955-2 C.B. 3.

[25] *Masser v. Commissioner*, 30 T.C. 741 (1958), *acq.*, 1959-2 C.B. 3.

[26] *Grant Oil Tool Co. v. United States*, 381 F.2d 389 (Ct. Cl. 1967).

The court explained that "*in an economic sense* they have been totally destroyed and this complete and unwanted destruction of taxpayer's tool bodies is clearly within the definition of 'involuntary conversion.'"[27]

Thus, in determining whether property has been destroyed within the meaning of section 1033, the inquiry should be whether a taxpayer is precluded, economically or otherwise, from using its property in the intended manner. Destruction results from any act that economically destroys the property or that prevents the property from being used as the taxpayer intended.

Although the COVID-19 pandemic is unlike other federally declared disasters, such as hurricanes or earthquakes, it arguably resulted in the economic destruction of many taxpayers' trades and businesses. The involuntary closure of a taxpayer's business necessarily means that business property cannot be used in the manner it is intended, which is the standard adopted by the authorities for section 1033 destruction.

The additional relief provided by section 1033(h)(2) further demonstrates that economic destruction is a conversion under section 1033(a). The legislative history underlying the enactment of section 1033(h)(2) explains that Congress was concerned that, when "businesses are forced to suspend operations for a substantial time" because of a disaster, "valuable markets and customers may be lost" and such suspension may "cause the business to fail."[28] Lost markets and customers and failed businesses are clearly the province of economic, not physical, destruction.

B. Section 1033: Liberally Construed Relief

This technical analysis of section 1033 is fully supported by the policy underlying, and the courts' liberal interpretation of, that section. Numerous courts have recognized the taxpayer-favorable policy underlying section 1033 and have relied on it in analyzing cases.

Indeed, section 1033 has been interpreted liberally from its earliest days. For example, in *Washington Railway*,[29] the court stated that, regarding nonrecognition for involuntary conversions, a "narrow . . . construction loses sight of the ameliorative intent of the provision. A relief provision should be construed liberally to effect its purpose." The Ninth Circuit affirmed this view in *Filippini*, stating that section 1033 "is to be liberally construed to accomplish [its] purpose."[30]

The Tax Court adheres to the same position, noting in *Willamette* that "section 1033 is a relief provision, and we are to construe it liberally to effect its purpose."[31] Further, in *Masser*, the Tax Court reasoned that taxation is "eminently practical," and that "'a relief provision should be liberally construed to effectuate its purpose.'"[32] Thus, unlike deduction provisions, which are narrowly construed, the relief granted by section 1033 has historically been interpreted liberally, taking economic realities into account.

Also, the concept of destruction under section 1033 generally is more expansive than a "casualty" under section 165. The IRS has ruled that a casualty loss is deductible under section 165(c)(3) regarding an "event that is (1) identifiable, (2) damaging to property, and (3) sudden, unexpected, and unusual in nature."[33] This is compared with an IRS pronouncement holding that an involuntary conversion under section 1033 need not be sudden. Specifically, in Rev. Rul. 66-334, 1966-2 C.B. 302, for example, the IRS concluded that gradual saltwater pollution of an underground water supply qualified as an involuntary conversion.

V. Conclusion

Section 1033 and its predecessors have long provided a form of tax relief to a taxpayer for the lost use of its property stemming from situations beyond the taxpayer's control. Limiting lost use to situations in which property is physically

[27] *Id.* at 395-396 (emphasis added).

[28] S. Rep. No. 104-281, at 14.

[29] *Washington Railway & Electric Co. v. Commissioner*, 40 B.T.A. 1249, 1257 (1939).

[30] *Filippini v. United States*, 318 F.2d 841, 844 (9th Cir. 1963).

[31] *Willamette*, 118 T.C. 126 (internal citations omitted).

[32] *Masser*, 30 T.C. at 746-747 (quoting *Tyler v. United States*, 281 U.S. 497, 503 (1930)).

[33] Rev. Rul. 72-592, 1972-2 C.B. 101. A discussion of the case law under section 165, which may suggest a more flexible standard, is beyond the scope of this article.

damaged would graft onto the statute a condition that is supported neither by its plain meaning nor its underlying policies. Indeed, as discussed in this article, IRS guidance, case law, and the legislative history to section 1033 provide strong support for the view that economic destruction of property qualifies for section 1033 nonrecognition. Thus, section 1033 may provide a tax-efficient path to reorganization for businesses affected by the COVID-19 pandemic. ■