Comments Noting Potential Issues Arising from Destruction of Property and Receipt of Funds Due to the 9/11 Terrorist Attacks

These comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association.

These comments were prepared by individual members of the Sales, Exchanges & Basis Committees. Principal responsibility was exercised by Annette Nellen, Chair of the Sales, Exchanges & Basis Committee. Substantive contributions were made by Erik Jensen, Vice-Chair – Law Development, of the Sales, Exchanges & Basis Committee. The Comments were reviewed by Ellen MacNeil of the Section’s Committee on Government Submissions and by Jerald August, Council Director for the Committee on Sales, Exchanges & Basis.

Although members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Disasters that impact many people can cause issues to arise regarding the tax treatment of losses and recoveries due to the number of taxpayers impacted. The 9-11 terrorist attack and legislation enacted to provide some tax relief to victims raise a variety of tax issues. Individual members of the ABA Tax Section have identified the following list of potential issues for which guidance is needed. We expect that additional issues will arise as individuals and businesses affected by the 9-11 terrorist attacks file their 2001 and 2002 tax returns.

1. Multiple Code Provisions Applicable to Relief Payments Received Due to Non-Business Losses of an Individual: With the addition of §139 to the IRC by the Victims of Terrorism Tax Relief Act of 2001 (P.L. 107-134), taxpayers will sometimes have to consider more than one Code provision to determine the tax consequences of a relief payment. The interaction of these various rules is not clear. Key provisions dealing with the tax treatment of disaster relief payments include:

   a. Under §165, funds received for damage to property are applied to reduce the amount of the casualty loss. For non-business losses, individuals must also reduce their casualty loss by insurance amounts that would have been received had a timely claim been filed.

   b. Generally, an individual does not need to reduce a personal casualty loss by the amount of gifts received by relatives and friends even though the funds are used for repairs. (Rev. Rul. 64-329, 1964-2 C.B. 58). Funds received from an employer or someone else specifically for repairs reduces the casualty loss amount (Revenue Ruling 131, 1953-2 C.B. 112). Government funds received due to damage to property, even when paid to reduce the taxpayer’s mortgage on the damaged property, reduces the casualty loss if payment is attributable to the casualty (Londagin, 61 T.C. 117 (1973)).

   c. New IRC §139 provides that “qualified disaster relief payments” are excluded from an individual’s gross income. A qualified disaster relief payment is “any amount paid to or for the benefit of an individual-- (1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster, (2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster, (3) by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster, or (4) if such amount is paid by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare, but only to the extent any expense compensated by such payment is not otherwise compensated for by insurance or otherwise.”

   d. IRC §123 provides that insurance payments received by an individual to compensate or reimburse him or her for increased living expenses incurred due to loss of use or occupancy of a principal residence are excludable from gross income.

   e. IRC §102 provides that taxpayers may exclude from gross income amounts received as gifts. Amounts transferred by or for an employer to, or for the benefit of, an employee, are not considered gifts per §102(c).

g. Under §1033(h)(1)(A)(i), individuals may exclude any gain realized from the receipt of insurance proceeds for unscheduled personal property in a principal residence located in a Presidentially declared disaster area.

Guidance is needed on how the above rules are to be coordinated, as illustrated by the following examples.

Example 1: Due to damage sustained to his principal residence by the 9-11 terrorist attack, Joe received:

- $50,000 from the government for living expenses
- $10,000 from his insurance company for loss of use of the residence
- $20,000 from his insurance company for destruction of unscheduled personal property
- $30,000 from a non-profit organization for damage to home contents

Under §1033(h)(1)(a)(i), it appears that the $20,000 is excluded and there is no need for Joe to determine the actual gain that may have resulted from receipt of that amount. However, under §139, amounts are only excludable if the payment is for something not otherwise compensated for by insurance or otherwise. It appears that Joe will need to determine the basis of all unscheduled personal property destroyed to determine how much was compensated by the $20,000. If Joe determines that his loss was $25,000, would only $5,000 be excluded under §139? Or, must Joe reduce the $30,000 received from the non-profit organization by the entire $20,000 received from his insurance company? What if the $30,000 was received to provide relief due to destruction of both contents and structure? What is Joe’s basis in any replacement property (must the basis be reduced by any of the amounts received for property damage)?

Is any of the $50,000 taxable due to the receipt of the $10,000 from Joe’s insurance company? Must Joe determine his actual living expenses in order to prove that the $50,000 is excludable under §139 and the $10,000 is excludable under §123 or §139? If §139 or §123 does not apply to portions of the $50,000 or the $30,000, could it otherwise be excludable as a gift under §102 or as received for the promotion of general welfare?

Example 2: Sarah’s husband Sam was killed in the 9-11 terrorist attack. Sarah did not suffer any property damage due to the attack.

The loss of Sam’s income has made it difficult for Sarah to pay the mortgage and other household expenditures. Sarah received the following payments:

- $50,000 from Sam’s employer for unspecified purposes

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1 The special exclusion rule of §1033(h)(1)(A)(i) for unscheduled personal property destroyed in a Presidentially declared disaster only applies to receipt of insurance funds. Thus, in Example 1, the $30,000 received by Joe from a non-profit organization should fall under the general nonrecognition rule of §1033 even though received for the same casualty for which the insurance proceeds were received. Due to this limitation of §1033(h)(1)(A)(i), the complications intended to be alleviated under this provision continue to exist when taxpayers receive other funds, such as from their employer or charitable organizations.

2 The House Report to H.R. 2884 (Cong. Rec. of 12/13/01, page H10130) provides: “For purpose of determining the tax basis of a rehabilitated residence, it is intended that qualified disaster relief payments be treated in the same manner as amounts received on an involuntary conversion of a principal residence under section 121(d)(5) and sections 1033(b) and (h).”

3 The House Report to H.R. 2884 (Cong. Rec. of 12/13/01, page H10131) provides: “it is anticipated that individuals will not be required to account for actual expenses in order to qualify for the exclusion, provided that the amount of the payments can be reasonably expected to be commensurate with the expenses incurred.” In contrast, it appears that §123(b) requires proof of actual additional expenses incurred.
$  80,000  from a non-profit organization for loss of income
$300,000  from a federal government fund

Which of these amounts, if any, are considered under §139 to be received “to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster”? What does “as a result of” mean as used in §139? Are amounts received to cover the loss of income attributable to the death of a primary breadwinner covered by §139? If the living expenses remain the same, are they “incurred” as a result of the disaster? To the extent any of the amounts received by Sarah do not fall under §139, can they be excluded from gross income as a gift or as received for promotion of general welfare? Clarification of the terms used in new §139 are needed, along with an explanation of the interplay between §139 and the exclusion for gifts and payments received for promotion of general welfare.

2. Tax Treatment of Payments Received by a Business: New §139 only applies to payments received by individuals for non-business purposes. Thus, a question remains as to whether any payments received by a business from a charitable or governmental organization could possibly be classified as a gift or otherwise excluded from gross income as received for promotion of general welfare.

Businesses are typically not treated as receiving a gift because there is usually an expectation that the business has or will provide goods or services due to the gift. However, in the case of payments received by a business due to the 9-11 terrorist attacks, there is most likely no expectation that the business will deliver goods or services to the payor organization. Such payments to the business are given without the expectation of anything in return. Thus, it appears that the payments meet the definition of a gift, and are thus excluded from gross income under §102. If labeled as a gift, there should be no concern as to how the business spends the funds. If used to purchase property, the business would have basis in the property. But compare §362(c)(2), which requires a basis reduction for property purchased with a non-shareholder contribution to capital. If used to pay employee salaries, the business would be able to deduct the wage amount. IRC §265 appears to be inapplicable here because the use of the funds by the business is not “allocable” to the excluded gift. Clarification of these issues would be very helpful to businesses.

3. Application of IRC §1033 to Intangible Property: Generally under §1033 if property is involuntarily converted as a result of its destruction in whole or in part, theft, seizure, or condemnation, the taxpayer can defer recognition of gain by investing in property that is similar or related in use. This section has been applied to intangible assets such as FCC licenses,\textsuperscript{4} easements\textsuperscript{5} and contract rights. Further, §197(f)(2) describes how §1033 applies to §197 intangible assets. Therefore, while it appears that §1033 applies to a taking of intangible property, research has not revealed a situation where it was applied to a destruction of goodwill.

Section 1033 apparently applies to cases involving destruction of goodwill or other intangibles, however, specific guidance would be helpful with regard to the receipt of insurance proceeds, or federal, state or local payments.

For example, a janitorial services business that provided services to a building that has been completely destroyed has lost its customer base and goodwill, along with any tangible assets. Insurance proceeds or government payments should be subject to §1033 with regard to the destruction of these intangible assets.

\textsuperscript{4} PLR 9027041
\textsuperscript{5} Rev. Rul. 71-519. Moreover, §1033(h)(2) implies that converted business property can be tangible or intangible property.
This issue is also relevant outside of the §1033 context where an individual does not reinvest insurance or other proceeds received for total destruction of a business and thus needs to determine the character of any resulting gain or loss.

Under what circumstances can a business argue that it lost goodwill in the 9-11 terrorist attack? Assume that a business consisted solely of providing catering services to tenants of the World Trade Center. On 9-11-01, all of its business assets were destroyed. If the business received insurance or other proceeds to compensate it for loss of “business assets,” is part of the proceeds for intangible property? Guidance in this issue would be helpful.⁶

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⁶ The special rule of §1033(h)(2) only applies if tangible trade or business property is acquired; it does not apply to the acquisition of intangible property or investment property. Also, the replacement period remains at 2 years for business or investment property, rather than the 4 years that was provided for principal residences under §1033(h)(1). Given the degree of destruction and the nature of some of the buildings destroyed by the 9-11 terrorist attacks, a 2-year replacement period is likely not sufficient. While taxpayers may request additional time from the Service, it would be simpler if it was automatically provided (by Congress or the Service).