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# ***WNTS Insight***

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## *IRS issues helpful guidance regarding involuntary conversion of inventory in a federally declared disaster*

In recently released Technical Advice Memorandum 201111004, the IRS concluded that inventory involuntarily converted in a federally declared disaster was "property held for productive use in a trade or business" for purposes of section 1033(h)(2). Such inventory therefore qualifies for the involuntary conversion gain deferral rules under section 1033(a)(2). As shown in the list below, the rules discussed in the TAM are relevant to the recent federally declared disasters.

### **Background**

Section 1033(a)(2) provides generally that if property, as a result of its destruction in whole or in part, due to specified causes, is involuntarily converted into money (for example, insurance proceeds), then at the taxpayer's election the gain will be recognized only to the extent that the amount realized on the conversion exceeds the cost of the "similar or related in service or use" property (often referred to as replacement property) that is purchased by the taxpayer within two years after the close of the tax year in which any part of the gain is realized.

Section 1033(h) provides special rules for property that is involuntarily converted by federally declared disasters. Under section 1033(h)(2), if a taxpayer's property held for productive use in a trade or business or for investment is located in a disaster area and is involuntarily converted as a result of a federally declared disaster, then *any* tangible property held for productive use in a trade or business is treated as property similar or related in service or use to the converted property for purposes of section 1033(a).

### **TAM 201111004**

Property owned by the taxpayer, including inventory, was damaged by the 2005 Gulf Coast hurricanes, which were federally declared disasters (formerly known as "Presidentially declared disasters"). The taxpayer received insurance proceeds for its

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damaged inventory, which resulted in a substantial gain. However, relying on section 1033, the taxpayer deferred recognition of the gain by purchasing new store construction property (section 1245 and section 1250 property) and designating this property as replacement property in statements attached to its tax returns. The IRS agent questioned whether, for purposes of section 1033(h)(2), the damaged inventory was "property held for productive use in a trade or business" that could be replaced with new store construction property in order to defer recognition of gain under section 1033(a).

The IRS National Office agreed with the taxpayer's position that inventory involuntarily converted in a federally declared disaster is "property held for productive use in a trade or business" for section 1033(h)(2) purposes. In reaching this conclusion, the IRS National Office reasoned that, if Congress had intended to exclude inventory from section 1033(h)(2) treatment, it would have expressly done so.

According to the IRS National Office, the position that section 1033(h)(2) applies to conversions of inventory is consistent with the legislative history of that provision and Notice 2003-18, answer 7, which provides:

A business may elect under section 1033, to defer the gain on . . . payments received to compensate for losses due to damage to, or destruction of, real property or other tangible assets, including...*inventory used in a trade or business.*" [Emphasis in original.]

...In addition, because the property for which businesses will receive the... grant payments was destroyed in a Presidentially declared disaster, the businesses may use the...grant payments to purchase any tangible property of a type held for use in a trade or business and still defer recognition of the gain.

Accordingly, the IRS National Office concluded that the taxpayer's involuntarily converted inventory in the federally declared disaster was "property held for productive use in a trade or business" for purposes of section 1033(h)(2) and thus could be replaced with new store construction property.

## Federally Declared Disasters

A federally declared disaster is any disaster determined by the President to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the Stafford Act). Under the Stafford Act, a state governor seeks a presidential declaration by submitting a written request to the President through the Federal Emergency Management Agency (FEMA) regional office. In this request, the Governor certifies that the combined local, county, and state resources are insufficient and that the situation is beyond their recovery capabilities.

Following a FEMA regional and national office review of the request and the findings of the preliminary damage assessment, FEMA provides the president an analysis of the situation and a recommended course of action. In 2010, there were 81 federally declared disasters.

A list of declared disasters can be found on the FEMA website (<http://www.fema.gov/news/disasters.fema>). As of May 2, 2011, there had been 24 federally declared disasters in 2011:

<b>Date</b>	<b>State</b>	<b>Incident Description</b>
01/26	California	Winter Storms, Flooding, and Debris and Mud Flows
02/01	Maine	Severe Winter Storms and Flooding
02/04	New Jersey	Severe Winter Storms and Snowstorm
02/11	Utah	Severe Winter Storms and Flooding
02/17	Oregon	Severe Winter Storm, Flooding, Mudslides, Landslides, and Debris Flows
02/18	New York	Severe Winter Storm and Snowstorm
03/03	Connecticut	Snowstorm
03/07	Massachusetts	Severe Winter Storm and Snowstorm
03/17	Illinois	Severe Winter Storm and Snowstorm
03/23	Missouri	Severe Winter Storm and Snowstorm
03/24	New Mexico	Severe Winter Storm and Extreme Cold Temperatures
03/25	Washington	Severe Winter Storm, Flooding, Landslides, and Mudslides
03/25	Oregon	Tsunami Wave Surge
03/31	Tennessee	Severe Storms, Tornadoes, and Flooding
04/05	Wisconsin	Severe Winter Storm and Snowstorm
04/08	Hawaii	Tsunami Waves
04/18	California	Tsunami Waves
04/19	North Carolina	Severe Storms, Tornadoes, and Flooding
04/22	Oklahoma	Severe Storms, Tornadoes, and Straight-line Winds
04/28	Alabama	Severe Storms, Tornadoes, Straight-line Winds, and Flooding
04/29	Mississippi	Severe Storms, Tornadoes, Straight-line Winds, and Associated Flooding
04/29	Georgia	Severe Storms, Tornadoes, Straight-line Winds, and Associated Flooding

05/01	Tennessee	Severe Storms, Tornadoes, Straight-line Winds, and Associated Flooding
05/02	Arkansas	Severe Storms, Tornadoes, and Associated Flooding

**Note:** Disaster areas are limited to designated counties within each state. Taxpayers should review the list of designated counties on the FEMA website to determine if section 1033(h) applies.

## Observations

Section 1033(a) provides the general rule that replacement property must be property similar or related in service or use to the involuntarily converted property. However, under section 1033(h)(2), eligible replacement property includes **any** tangible property held for productive use in the trade or business. The period of time over which deferred gain must be recognized could vary significantly depending upon the type of property that is designated as replacement property.

For example, assume Taxpayer A and Taxpayer B each own inventory that is involuntarily converted by a federally declared disaster in 2011. Later that year, A and B receive insurance proceeds in excess of the basis of the inventory, resulting in realized gain. Both taxpayers use the insurance proceeds to purchase inventory in 2011.

Taxpayer A designates the inventory purchased with its insurance proceeds as replacement property under section 1033(h)(2). Under section 1033(b)(2), the basis of this replacement inventory is reduced by the amount of the deferred gain. As a result, when the replacement inventory is sold, the cost of goods sold will reflect the reduced basis, and the deferred gain will be recognized. If all the replacement inventory is sold during 2012, then Taxpayer A will recognize the deferred gain in 2012.

Assume Taxpayer B purchases a new building in 2012 and designates the new building as replacement property under section 1033(h)(2). Under section 1033(b)(2), the basis of the new building is reduced by the amount of the deferred gain. As a result, as the new building is depreciated, the depreciation expense will reflect the reduced basis, and the deferred gain will be recognized. If the new building is depreciated over 39 years, then Taxpayer B will recognize the deferred gain over 39 years.

According to Reg. sec. 1.1033(a)-2(c)(2), if a taxpayer previously recognized the gain from an involuntary conversion and later (before the expiration of the period in which the property must be replaced) decides to replace the property and defer the gain in accordance with sections 1033(a), the taxpayer should file a claim for credit or refund.

Taxpayers that recognized gain in 2009 or 2010 as a result of an involuntary conversion of inventory in a federally declared disaster but did not elect to defer the gain on their 2009 or 2010 return should consider filing a claim for credit or refund to take advantage of the ability to defer the gain under sections 1033(a) and

1033(h)(2). These taxpayers should review all property acquired during the applicable replacement period and designate property with the longest potential recognition period (for example, 39-year property) as replacement property for the damaged inventory.

Link to WNTS Insight archive: <http://www.pwc.com/us/en/washington-national-tax/newsletters/washington-national-tax-services-insight-archives.jhtml>

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