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by James Atkinson

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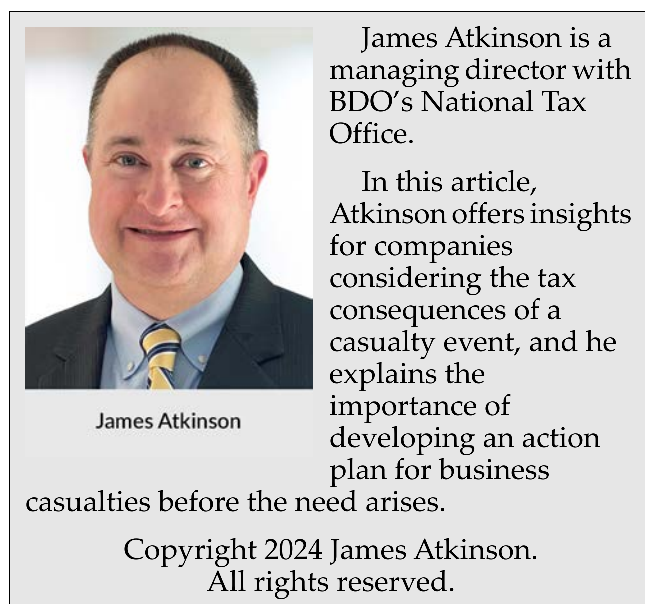
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In this article, Atkinson offers insights for companies considering the tax consequences of a casualty event, and he explains the importance of developing an action plan for business casualties before the need arises.

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Unexpected events like hurricanes, wildfires, earthquakes, and government requisitions and condemnations can damage or even destroy business assets, triggering tax consequences and associated reporting requirements. However, by planning for the tax implications of a possible casualty event before it occurs, companies may be able to mitigate some of the tax impact as well as reduce the number of decisions required amid an otherwise stressful situation.

Threshold issues to consider when evaluating the tax consequences of a casualty event include the nature of the event (including whether it is a "federally declared" disaster) and whether the company has incurred gain or loss for federal tax purposes.[1]

I. Casualty Losses

A casualty that results in a loss is governed by section 165, which generally permits a loss deduction in the year that the casualty occurs.[2] However, a special rule allows the taxpayer to elect to deduct the loss on the prior year's return if the event is a federally declared disaster, potentially permitting a "quick refund" as a means of obtaining a needed infusion of cash in difficult times.[3]

While section 165 refers only to "fire, storm, shipwreck, or other casualty," the IRS defines casualty broadly to include, for example:

- earthquakes;
- fires;
- floods;
- government-ordered demolitions or relocations of property deemed unsafe by reason of disasters;
- mine cave-ins;
- shipwrecks;
- sonic booms;
- storms, including hurricanes and tornadoes;
- terrorist attacks;
- vandalism; and
- volcanic eruptions.[4]

Casualty losses arise from identifiable events that are sudden, unexpected, or unusual — for example, a natural disaster. Slow, progressive deterioration is not a casualty event for which a casualty loss deduction is permitted.[5] Instead, the taxpayer generally recognizes its economic loss

[1]This discussion focuses on the tax considerations for business entities. For a discussion of additional considerations for individuals, see Robert W. Wood and Alex Z. Brown, "FAQs on Taxes for Natural Disaster Victims," *Tax Notes Federal*, July 17, 2023, p. 401.

[2]Section 165(a).

[3]Section 165(i); reg. section 1.165-11. A list of federally declared disasters can be found on the Federal Emergency Management Agency's website. The IRS typically publishes notifications in the Internal Revenue Bulletin shortly after a declaration.

[4]IRS Publication 547, "Casualties, Disasters, and Thefts" (Jan. 10, 2023).

[5]Rev. Rul. 59-102, 1959-1 C.B. 200.

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attributable to gradual deterioration through the decline in its property's fair market value upon its eventual sale, abandonment, or other disposition.

A. Calculating Casualty Loss

The amount of the loss permitted by section 165 is the lesser of: (1) the amount by which the casualty event reduces the property's FMV, or (2) the property's adjusted tax basis.

The casualty loss is calculated by reference to the single, identifiable property that was damaged or destroyed in the casualty event.[6] The single, identifiable property under section 165 is similar to the unit of property used for other purposes of the code and regulations. The potential for shifting tax basis between individual assets by combining them into larger single, identifiable properties (possibly creating or artificially increasing casualty loss deductions for damaged assets with relatively low tax bases) can lead to disputes between taxpayers and the IRS in calculating the allowable casualty loss.[7]

If the company's property is destroyed, the taxpayer can recover the entire remaining basis of the property as a casualty loss, regardless of the property's FMV after the event.

After computing the initial amount of the loss, the company must subtract any reasonably anticipated insurance proceeds to determine the final amount of the casualty loss deduction. Only unreimbursed losses are deductible.

B. Special Rules for Federally Declared Disasters

Casualty losses generally may be deducted only in the year in which the casualty event occurs and the extent of the damage becomes known (the disaster year).[8] However, under section 165(i) the taxpayer may elect to deduct a casualty loss attributable to a federally declared disaster in the prior tax year instead. Federally declared disasters are typically large-scale events like hurricanes, earthquakes, and major wildfires.

Depending on the taxpayer's circumstances, deducting a casualty loss from a federally declared disaster on the prior year's return might help the taxpayer's cash flow in an economically stressful situation by reducing the amount due on the unfiled return for the prior year or through a "quick refund" claim filed under applicable procedures.

The election deems that the casualty event occurred in the prior tax year. The tax consequences of the election apply to any losses sustained by the taxpayer from that disaster, including mandatory adjustments to opening inventory balances if the taxpayer's inventory was damaged or destroyed.[9]

An election under section 165(i) must be made no later than six months after the unextended due date of the taxpayer's original return for the disaster year. A statement containing specific information must be attached to the original or amended return for the prior year in which the taxpayer is claiming the casualty loss.[10] Subject to a consistency requirement, the taxpayer can revoke the election no later than 90 days after the election's due date.

II. Casualty Gains

In some situations, the property's damage or destruction produces a casualty gain instead of a loss. Casualty gains generally result when insurance, salvage, or condemnation proceeds exceed the property's tax basis. Like in any other sale or exchange, casualty gains are taxed under section 1001. The character of a casualty gain is determined under special rules in section 1231(a)(4)(C).[11]

[6] Reg. section 1.165-7(b)(2).

[7] *See, e.g.*, *Weyerhaeuser Co. v. United States*, 92 F.3d 1148 (Fed. Cir. 1996); *Westvaco Corp. v. United States*, 639 F.2d 700 (Cl. Ct. 1980); TAM 200902011.

[8] Section 165(a). *See also Katz v. Commissioner*, T.C. Memo. 1983-8.

[9] Reg. section 1.165-11(c); Rev. Rul. 77-94, 1977-1 C.B. 265.

[10] Rev. Proc. 2016-53, 2016-44 IRB 530.

[11] Reg. section 1.1231-1(e)(3).

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A. Elective Deferral Under Section 1033

Taxpayers realizing a casualty gain may explore deferring that gain using the involuntary conversion rules of section 1033. Section 1033 permits a taxpayer to defer (but not permanently exclude) gain realized from property that has been involuntarily destroyed in whole or in part, stolen, seized, requisitioned, condemned, or threatened with imminent requisition or condemnation.[12]

To defer the entire casualty gain resulting from a qualifying event, the taxpayer must replace the involuntarily converted property with qualifying replacement property that costs at least as much as the amount realized from the damage or destruction to the taxpayer's property (for example, the amount of the insurance proceeds for loss of the property).[13] The replacement property's basis is reduced by the amount of the deferred gain, so the deferred gain will be recognized upon the replacement property's eventual disposition.[14]

1. Qualifying replacement property.

In general, replacement property must be "similar or related in service or use" to the converted property.[15] Section 1033 allows the taxpayer to return as closely as possible to its precasualty position without tax consequences. Consistent with that goal, the nature of the taxpayer's use of the converted property typically determines the types of qualifying properties with which it may be replaced.

For companies that used the involuntarily converted property in their daily business operations, the physical characteristics and the end uses of the converted and replacement properties — from the perspective of the owner-user — must be "closely similar."[16] For example, if a company's gas station is destroyed, the company generally may satisfy section 1033 by purchasing or building a replacement gas station or by using the proceeds to improve another of its gas stations. The company would not satisfy section 1033, however, by using the proceeds from the casualty event to purchase a movie theater to replace the gas station.

In applying that functional use test, courts have rejected both an "aggregate" and an "atomistic" approach to replacing the converted property, requiring instead a "reasonably similar continuation of the petitioner's prior commitment of capital and not a departure from it."[17] Rejecting a strict asset-by-asset application of section 1033, the Tax Court explained in *Maloof* that the provision "requires a reasonable degree of continuity in the nature of the assets as well as in the general character of the business."[18]

The IRS generally agrees that the converted and replacement properties need not be identical and that the functional use test is satisfied if the converted property is replaced with newer, more advanced, and more efficient configurations of assets that serve the same overall function within the taxpayer's business. For example, the IRS agreed that section 1033 was satisfied by replacing a factory with a new factory that manufactured the same product but used an "improved and changed manufacturing process . . . that eliminates, changes, or replaces older technologically obsolete process elements."[19] The replacement factory was sufficiently similar to the destroyed factory for purposes of the functional use test because it performed "the same manufacturing process as the old facility," even though it was not the same as the original factory "on a machine for machine basis."[20]

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[12] For a detailed discussion of the application of these rules to condemnations, see Wood, "Which Property Qualifies for Involuntary Conversion Tax Relief?" *Tax Notes Federal*, Feb. 22, 2021, p. 1261. Comprehensive guidance regarding involuntary conversions is available at Bruce Edwards, "Involuntary Conversions," Tax Management Portfolio 568.

[13] If the cost of the replacement property is less than the amount realized, gain is deferred only to the extent that the cost of the replacement property exceeds the adjusted tax basis of the converted property.

[14] Section 1033(b).

[15] Section 1033(a)(2). However, for real property disposed of by seizure, requisition, or condemnation or sold under threat or imminence of seizure, requisition, or condemnation, the taxpayer may elect the "like-kind standard," which is generally broader than the "similar or related in service or use" standard. Section 1033(g)(1). We will assume for purposes of this discussion that the property is converted because of a casualty and not a condemnation, threat, or the imminence thereof.

[16] Rev. Rul. 64-237, 1964-2 C.B. 319; LTR 202318004.

[17] *Maloof v. Commissioner*, 65 T.C. 263 (1975), quoting *Johnson v. Commissioner*, 43 T.C. 736 (1965). *See also Massilon-Cleveland-Akron Sign Co. v. Commissioner*, 15 T.C. 79 (1950).

[18] *Maloof*, 65 T.C. at 271.

[19] Rev. Rul. 73-225, 1973-1 C.B. 32.

[20] *Id. See also* LTR 202318004; LTR 201636034.

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The involuntary conversion rules also apply to the destruction of the taxpayer's inventory in a casualty event.[21] For example, in *Maloof*, the Tax Court allowed the taxpayer to apply section 1033 to the replacement of both raw materials and finished goods covered by insurance proceeds.

The replacement options are broader for companies that held the converted property for investment rather than for operational use. In the earlier example, if the company held the gas station as rental property, the company generally would be permitted to purchase a movie theater that likewise would be held as rental property.[22] For the taxpayer-investor, the functional use of the capital remains the same — rental income — even if the functional uses of the original and replacement properties by the respective lessees have shifted.

Because the replacement property must be acquired with an intent for it to replace the converted property, the taxpayer may not identify property items acquired before the casualty event as replacement property items.[23] While the intent requirement is not usually a stumbling block in applying section 1033, prudence suggests documenting the taxpayer's intent contemporaneously with its acquisition of the replacement property.[24]

2. Purchasing stock in a corporation owning replacement property.

In lieu of purchasing qualifying assets to replace the destroyed property, the taxpayer may instead purchase stock that gives it a controlling interest in a corporation that owns qualifying replacement property.[25] As with the purchase of replacement assets rather than stock, acquiring controlling interest in a corporation that owns qualifying property does not require a one-for-one match with the destroyed property. The Tax Court has stated:

> Nor does [the IRS] make any argument that each individual machine or piece of equipment destroyed must be replaced by a similar machine or piece of equipment in order for the benefits contained in [section 1033] to apply. If petitioner had used the insurance proceeds in question in the acquisition of control of a corporation owning buildings, machinery, and equipment similar to those which had been destroyed, [section 1033] would apply regardless of whether or not the values of the assets owned by the newly purchased corporation were exactly in proportion to the value of the properties being replaced. . . . The result would be the same even if the purchased corporation was immediately dissolved, in which case the entire transaction would be viewed as a purchase of assets rather than stock.[26]

3. Special rule for federally declared disasters.

The replacement requirement under section 1033 is relaxed if the casualty results from a federally declared disaster. A special rule applies if the property was:

- held for productive use in a trade or business or for investment;
- located in a federally declared disaster area; and
- involuntarily converted because of a federally declared disaster.

In this situation, the taxpayer can replace the converted property with *any* tangible property that is of a type held for productive use in a trade or business — a broader standard than the general functional use test for owner-operators.[27]

4. Same taxpayer rule.

The same taxpayer that realizes the casualty gain must acquire the qualifying replacement property. From a business perspective, companies sometimes prefer having the parent of a group of related entities purchase the replacement property on behalf of a subsidiary that owned the damaged property, for example, when the parent is named as the beneficiary on an insurance policy

[21] *Maloof*, 65 T.C. 263; TAM 201111004.

[22] Rev. Rul. 64-237.

[23] The time limit for acquisitions of replacement property from a related person is imposed in section 1033(i), which generally applies if the gain realized exceeds $100,000.

[24] Rev. Rul. 83-39, 1983-1 C.B. 190.

[25] Section 1033(a)(2)(E)(i).

[26] *Massilon-Cleveland-Akron Sign Co.*, 15 T.C. at 84.

[27] Section 1033(h)(2).

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on the damaged property. However, section 1033 requires property to be purchased by the same taxpayer that owned the damaged or destroyed property.[28] While the taxpayer may acquire the replacement property through an entity that is disregarded for federal income tax purposes, it generally may not acquire the replacement property through another corporation, including another member or the parent of its affiliated group.[29]

Successor corporations may be able to fulfill the replacement requirement of section 1033 if the original and successor corporations are considered the same taxpayer.[30] As a word of caution: A section 381(a) transaction has no effect on the section 1033 replacement period, which is not "reset" by a reorganization. Similarly, the IRS has ruled that converted property owned by a partnership can be replaced by separate replacement properties acquired by multiple successor partnerships.[31]

5. Section 1033 replacement period.

The qualifying replacement generally must occur during the replacement window, beginning on whichever comes first: the disposition of the converted property, or the date that the threat or imminence of requisition or condemnation started. It ends two years after the first tax year in which the taxpayer realizes any gain from the conversion event.[32] If the taxpayer receives insurance proceeds over more than one tax year, the replacement period will begin in the first tax year in which the company receives (or accrues) insurance proceeds exceeding its tax basis in the converted property.

For example, if the company's property is damaged by a storm in 2024 and it receives (or becomes entitled to) insurance proceeds exceeding the property's tax basis in that year, replacement property must be acquired no later than the end of the 2026 tax year to defer the gain's recognition. If the insurance coverage is disputed and remains unresolved until 2025 so that the company will not accrue casualty gain until 2025, the replacement period will extend until the end of its 2027 tax year.

The taxpayer might be able to obtain an extension of time within which to replace the converted property — generally no more than one year — but the circumstances in which the IRS will grant such an extension are limited.[33]

6. Other procedural considerations.

If the affected property is converted directly into only qualifying replacement property, applying section 1033 is mandatory, with the replacement property taking the same tax basis as the converted property (with appropriate adjustments).[34] Section 1033 is elective, however, if the taxpayer instead receives cash (such as insurance or condemnation proceeds) or "dissimilar property" (property that is not similar or related in service or use) in exchange for the damaged or destroyed property.

Electing deferral under section 1033 is straightforward: The taxpayer excludes from gross income the realized casualty gain. Conversely, including the casualty gain in gross income in the year realized serves as an election not to defer the gain. The taxpayer must file amended returns to adjust the amount of casualty gain previously included in or excluded from gross income, whether because the taxpayer later changes its mind regarding the application of section 1033 or because it fails to satisfy the reinvestment requirements in a timely manner.

The applicable regulations direct the taxpayer to attach a statement to the tax return for each year in which any portion of the casualty gain is realized, indicating that the taxpayer is electing to defer the gain. While the IRS has not issued a specific form or schedule for the disclosure, the regulations require the statement to include "all

[28] Rev. Rul. 73-72, 1973-1 C.B. 368.

[29] *Fort Hamilton Manor Inc. v. Commissioner*, 51 T.C. 707 (1969); Rev. Rul. 56-636, 1956-2 C.B. 522. *See also* Rev. Rul. 66-191, 1966-2 C.B. 300 (applying the same rationale in the context of an involuntary conversion of property owned by a partnership).

[30] *See* section 381(c)(13), providing that an "acquiring corporation" within the meaning of section 381(a) is treated for purposes of section 1033 as if it were the transferor corporation. *See* LTR 9630010; LTR 8140045. For a more detailed discussion, see Edwards, "Involuntary Conversions," Tax Management Portfolio 568 at VII.A.2.

[31] LTR 200921009.

[32] Section 1033(a)(2)(B)(i); reg. section 1.1033(a)-2(c)(3). The two-year period is extended to three years for real property converted through condemnation or threat or imminence thereof. Section 1033(g)(4).

[33] Section 1033(a)(2)(B)(ii). *See also* IRS Publication 547, *supra* note 4, at 14.

[34] Section 1033(b)(1).

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of the details in connection with" the involuntary conversion.[35]

The taxpayer also must attach a statement to the original tax return for the year in which it either replaces the affected property or elects not to replace it and to recognize the realized "conversion gain" instead. If the company defers gain from the involuntary conversion and fails to notify the IRS either of the property's replacement or of its decision not to replace the property, the statute of limitations for each year in which gain was realized but not included in income remains open indefinitely regarding that deferred gain.[36]

7. Business interruption insurance.

Unlike insurance proceeds received for the destruction or damage to business property, proceeds of "business interruption insurance" or "use and occupancy insurance" that protect against the loss of profits or similar economic losses are not compensation for the loss of property and thus are beyond the scope of section 1033. Instead, those proceeds "are income in the same manner that the profits for which they are substituted would have been."[37]

B. Potential Replacement Using a QOZ

In lieu of deferring the recognition of realized casualty gains under section 1033, taxpayers might instead consider reinvesting insurance, salvage, or condemnation gains in distressed areas federally designated as qualified Opportunity Zones. QOZs were established under the Tax Cuts and Jobs Act. Qualifying QOZ reinvestment opportunities are available in all 50 states, the District of Columbia, and all U.S. territories.[38]

To defer casualty gain using the QOZ program, the taxpayer must invest some or all of the eligible capital gain in a "qualified opportunity fund" after the event that gives rise to the gain. Generally, QOFs are corporations or partnerships used as QOZ investment vehicles that hold at least 90 percent of their assets in QOZ business assets or QOZ businesses.

Reinvesting eligible capital gain from a casualty event into a QOF offers two distinct federal income tax advantages unavailable through an election under section 1033:

- tax deferral on capital gains invested in the QOZ/QOF until the *earlier* of the disposition of the investment (or other inclusion event) or December 31, 2026; and
- exemption from tax on postacquisition appreciation of the QOZ/QOF investment (but not the original deferred capital gain), if the investment is held for at least 10 years and is sold by December 31, 2047.[39] That includes exclusion of federal income tax on the sale of a business enterprise operated in the QOZ.

Eligible capital gains are realized capital gains (short or long term) from transactions between unrelated parties that occur before the QOF investment. Ordinary income does not qualify for the deferral or other QOZ tax benefits. Thus, determining the correct amount of eligible capital gain by applying the rules under section 1231 is key to calculating the amount eligible for deferral and related tax benefits from a QOF investment.

The QOZ rules use section 267's definition of related parties, except that 20 percent is used as a related-party ownership threshold rather than the normal standard of 50 percent.

The reinvestment period is generally 180 days after the casualty gain recognition event, but it can be longer if the eligible capital gain from the casualty is reported to a potential QOF investor via Form K-1 from a passthrough entity. A deferral investment may not be made directly into QOZ assets, but instead must be made through an equity investment in a QOF. In turn, the QOF may acquire QOZ business assets directly or indirectly through acquisition of corporate stock or partnership units of a second-tier entity, referred

[35] Reg. section 1.1033(a)-2(c)(2).

[36] Section 1033(a)(2)(C)(i).

[37] Reg. section 1.1033(a)-2(c)(8). *See also Massilon-Cleveland-Akron Sign Co.*, 15 T.C. 79.

[38] Notice 2018-48, 2018-28 IRB 9, amplified by Notice 2019-42, 2019-29 IRB 1, lists the census tracts that were approved by Treasury as qualified opportunity zones.

[39] A third benefit — the ability to permanently exclude from income a specific percentage of the original capital gain — required investing in a QOF early enough in the program's history for the QOF investment to be held for either five or seven years by December 31, 2026. That opportunity is no longer available for investments made after December 31, 2021.

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to as a qualified opportunity zone business (QOZB) entity. In the latter, the QOZB entity acquires the QOZ property, completes applicable improvements, and obtains necessary business equipment and other assets to operate the QOZB.

It is important to note that to qualify under the QOZ rules, both a QOF and QOZB must be either a corporation or partnership. While most QOF structures use partnerships, entities disregarded for federal tax purposes are not qualifying entities for these purposes.

Because of the flexibility offered by the rules for a QOZB over that of a QOF, most QOF structures use the second-tier entity concept.

Taxpayers making QOZ deferral elections report the eligible capital gain deferral on Form 8949, "Sales and Other Dispositions of Capital Assets," which must be attached to a timely filed original or amended return.[40] Form 8997, "Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments," must also be filed annually as long as the taxpayer holds the QOF investment.

When the taxpayer anticipates holding the replacement property beyond December 31, 2026, but for fewer than 10 years, the shorter deferral period under the QOZ rules might make section 1033 a more attractive deferral option.

On the other hand, if the taxpayer anticipates reinvesting the conversion proceeds for a minimum of 10 years and can invest them with a QOF that can meet the company's operational needs, the ability to permanently exclude postacquisition appreciation on the original investment makes QOZs an attractive planning option to consider.

For example, when a company's destroyed facility can be replaced with a commercially desirable facility located in a QOZ area, carefully structuring the reinvestment to meet the strict requirements of section 1400Z-2 and the applicable regulations might confer a temporary deferral of all, or a portion of, the original casualty gain as well as permanent exclusion of postacquisition appreciation of the investment made to acquire the new facility and the related business enterprise value.[41]

The QOZ rules are complex and require reinvesting the original capital gain within statutory deadlines. Thus, companies may want to consider the potential benefits of QOZs before the need arises. Interested tax departments should work with advisers who are well versed in these rules and the various reinvestment options.

III. Conclusion

Prudence suggests developing an action plan for potential business casualties before the need arises. One approach would be preparing a basic outline containing:

- each avenue of tax relief potentially available for the types of casualties most likely to confront the business based on its industry, geography, and historical experience;
- how various options would harmonize with the company's potential tax position or business priorities after a casualty (for example, the best options if the company is in a loss position at the time of a casualty; the best options if the company's tax position at the time of the casualty dictates deferring income recognition; or if the company potentially wants to reinvest through a QOZ, potential investment options and steps the company could plan in light of statutory deadlines); and
- for each option, a checklist of steps to take in the immediate aftermath of a casualty scenario, with an eye toward documentation, procedural requirements, and various statutory deadlines that might come into play.

The optimal response to a business casualty frequently cannot be determined until the postcasualty facts become clear. Thus, final tax decisions generally cannot be made before a casualty event, but a business can make thoughtful preparations well in advance. ■

[40] For a more thorough discussion of the QOZ rules, see Billy Morrow, Brandon Pauler, and Mike Dean, "Discussion of the Opportunity Zone Program Including Final Regulations," BDO, June 16, 2020.

[41] Because the taxpayer is not attempting to defer the casualty gain under section 1033, the converted and replacement facilities need not be functionally similar.

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