Tax Planning for Involuntary Conversions: How to Maximize Gain Deferral When a Disaster Strikes

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Introduction

You won't see many panel discussions titled "Tax Planning for Involuntary Conversions" at your next tax conference. After all, section 1033[1] is a relief provision normally used by individuals to defer their gain when their house burns down and they get insurance payments. In the business context, however, companies should think about that provision when planning for their worst-case scenario, because section 1033 can let companies avoid a large realized gain when property is taken or destroyed. And minor changes (for example, revising contract language, preparing appropriate substantiation documents) can determine whether a company must pay tax today, or years down the road. Tax advisers ignore those planning ideas because time is short and the tax savings are contingent. But as Hurricane Katrina recently reminded us, the losses from these disasters can be far too real.

This article does two things. First, it reviews the existing guidance on the question of when payments are made to compensate for lost property, and thus are eligible for section 1033 deferral. Second, it provides tax-planning ideas that can help taxpayers best position themselves to obtain section 1033 relief should their property be involuntarily converted. Those planning tools are easy to implement and generally involve simple steps, such as reviewing contracts to ensure that the language envisions lost-property damages (rather than lost profits or revenues). As such, this is one area where in-house and outside tax advisers can take a proactive approach and show their clients that they are thinking about their clients' larger tax picture before problems arise.

Before getting into specifics, however, let's review the basics of section 1033 and clarify where we are in the section 1033 landscape.

Section 1033 Basics

Section 1033 is a relief provision that lets taxpayers avoid recognizing a realized gain in certain instances. It says that if a taxpayer's property is involuntarily converted into money or dissimilar property, the taxpayer may elect to defer the realized gain by purchasing replacement property and reducing the replacement property's basis by the gain amount.[2] A taxpayer must meet the following three criteria to use section 1033:

(1) the taxpayer's property must be converted into cash or other dissimilar property as a result of its destruction in whole or in part, theft, seizure, requisition or condemnation (or threat or imminence thereof);[3]

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[1] All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
[2] Section 1033(a)(2)(A).
[3] Section 1033(a).

(2) the payment to be deferred must be paid as compensation for the lost property;[4] and
(3) the taxpayer must replace the lost property with similar property within two years.[5]

Practically, section 1033 works like this: When a taxpayer's property is converted, the taxpayer compares the proceeds received (for example, insurance proceeds) to the lost property's basis to determine if the taxpayer will realize a gain or loss on the conversion. If the conversion results in a loss, section 1033 is not used, because there is no gain to defer. If the taxpayer realizes a gain, however, it may be able to defer recognizing that gain by using section 1033. One aspect of the process is determining what proceeds received by the taxpayer go into the gain calculation. Payments by insurance companies to rebuild the lost property will be included in the calculation, but other auxiliary payments (for example, business-disruption insurance proceeds) may or may not be included. Those auxiliary payments are the focus of this article.

Matching issue. This article addresses Criterion 2 -- whether the money received by the taxpayer was paid for the converted property, or for something else. In other words, do the proceeds received "match" the lost property? Taxpayers might receive money from various sources after a section 1033 triggering event occurs. But they cannot just claim that any money received is eligible for deferral. The money must be paid with the intent to compensate the taxpayer for its lost property. Payments made for lost profits or lost revenues -— not lost property —- are not eligible for relief. Thus, the game is to characterize any payments received as lost-property payments, so that section 1033 can be used.

(For you law-review types, I concede that property is hard to define and can be viewed as just the right to earn profits or exclude others. And those two concepts-— the property itself and the right to earn profits from the property -— can blend together. But in real-world section 1033 decisions, that property/profits line exists, and is the operative test. Law professors might deem it a Maginot Line and explain why that divide is flawed. We will ignore that debate, however, and instead focus on how to get your taxpayer's case to fall on the right side of the line.)

To illustrate the matching issue, consider the following example. Wal-Mart has just built a distribution warehouse on some newly acquired land near Savannah, Ga. Wal-Mart is worried about flooding on that low-lying land and buys an insurance policy promising to compensate Wal-Mart if it cannot use its warehouse because of flood damage. Wal-Mart can choose how to structure that policy. It can estimate its per-day losses, and tell the insurer to pay it $X per day to cover the losses. Or Wal-Mart can estimate how much it would cost to rent another warehouse to use during the repair period, and base the contract's damage provisions on property costs.

The economics of the alternative contracts might be the same, but the tax consequences can be markedly different. Under the per-day loss approach, if there is a flood and Wal-Mart receives $10 million in insurance proceeds, the full $10 million is taxable to Wal-Mart because it replaces taxable profits. But if Wal-Mart structured the insurance

[4] Section 1033(a)(2).
[5] Section 1033(a)(2)(B)(i). If real property held for investment or used in a trade or business is converted, however, the taxpayer will have three years to replace the converted property. Section 1033(g)(4).

payments to be compensation for the loss of its property by basing the damages on rental costs, Wal-Mart possibly could defer the gain on the $10 million payment by reducing the basis of replacement property (for example, its next warehouse) under section 1033.

As this example shows, taxpayers can take an active role in shaping the tax consequences of catastrophes they might face. They often can defer recognizing disaster proceeds under section 1033 with a few simple changes.

Payment categories. It is hard to predict when or how a taxpayer's section 1033 event will occur. Some are relatively predictable, but others are not (for example, the September 11 attacks). And a taxpayer's compensation can come from different sources. Generally, however, disaster-compensation payments fit into three main categories: (1) condemnation payments, (2) statutory indemnity programs, and (3) private insurance proceeds. The basic legal rule is the same in each area: Payments are eligible for section 1033 deferral if they are in lieu of lost property, but not if they are for something else (like lost profits or revenues). The decisions in each area tend to have similar legal disputes. Taxpayers argue that the proceeds are for lost property and fit into section 1033, and the IRS says they are ineligible because they replace lost profits or revenues. The context of each type of case dictates what the evidence looks like. For instance, condemnation cases primarily focus on the documents supporting the settlement agreement and the parties' oral negotiations, while private-insurance cases look more to the language in the underlying contract.

For each category, I first review the existing guidance to determine what evidence courts and the IRS have turned to in deciding what side of the property/profits line a given payment falls on. I then offer practical planning ideas to use in helping your clients end up on the right side of this line.

Condemnation Payments

Existing guidance. A condemnation (or other taking) of property is what most people picture when they think of involuntary conversions and section 1033. And thanks to Susette Kelo holding out in her house in New London, Conn., condemnations have been big news lately.[6] Ms. Kelo can take heart, however, in knowing that she can defer any gain on her eventual condemnation sale, if she buys another house.

A condemnation occurs when a government agency decides to take a taxpayer's property for public use. If the government takes the property, it must compensate the owner. And when the case is simple (like taking someone's home), generally all of the proceeds are paid for the property and thus are eligible for section 1033 relief. Things get more complicated in the commercial context, however, in which governments often must pay for the property itself and for business disruption/relocation expenses. In those cases, the taxpayer must decide how much of the second payment is for lost property, and how much is for lost profits or revenues.

That most condemnations are not actually carried out adds to the complexity. Taxpayers often sell their property to the acquiring government agency after the agency says it is taking the property. Those sales under threat of condemnation qualify for section 1033 relief. And the dispute is usually not over the government's condemnation power (although that was the issue in Kelo). The common disagreement is over the price to be paid, with taxpayers disputing the condemned property's value and the cost of their lost business.

[6] Kelo v. City of New London, 125 S.Ct. 2655 (2005).

In those condemnations (or threat-of-condemnation sales), the primary tax issue is: How much of the condemnation proceeds are eligible for section 1033 deferral? To answer that question, the IRS uses the origin-of-the-claim analysis, which looks to what the payments are replacing.[7] If the condemnation proceeds are paid to replace lost property, the payments are eligible for section 1033 deferral; but if the payments replace income or revenue, they are not. And if the valuation dispute is litigated and a judge determines the taken property's value, the section 1033 allocation is simple. The taxpayer should follow the judge's decision (that is, if $100 was for lost property and $50 for lost wages, $100 is eligible for relief).

Most cases are more complicated, however, because even when condemnation proceedings are litigated, they are rarely litigated to a final decision on the merits. And when there is no judicial decision to follow, taxpayers and the IRS must look elsewhere. Where should they look? They should turn to the details of the settlement negotiations. In other words, they should review the internal documents and other evidence supporting the condemnation award to find out what allocation the parties most likely agreed to. That can be difficult, but at least the odds are somewhat stacked in taxpayers' favor. Several courts have given taxpayers the benefit of the doubt in close cases, because section 1033 is a relief provision.[8]

One recent private letter ruling added some meat to those bones by listing the specific items of evidence the IRS will look to in the settled-litigation context. In LTR 199952082, Doc 2000-482, 2000 TNT 1-53, the IRS said that it allocates condemnation awards under section 1033 based on (1) the allegations in the complaint, (2) the defenses asserted, (3) the background of the litigation, and (4) other facts pertinent to the controversy giving rise to the verdict or settlement.[9] The IRS looked primarily to the complaint itself in the ruling, noting that the complaint allocated the damages between lost property and lost profits. It then simply latched on to those percentages, using them as a reasonable measure on which to apportion the proceeds.

The Tax Court adopted a similar allocation approach in Walter v. Commissioner.[10] Walter dealt with the common scenario in which a property owner is not satisfied with the condemnation price and files a suit

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[7] Bagley v. Commissioner, 105 T.C. 396, 406, Doc 95-11034, 95 TNT 241-12 (1995), aff'd 121 F.3d 393, Doc 97-23130, 97 TNT 153-8 (8th Cir. 1997).

[8] See, e.g., Graphic Press, Inc. v. Commissioner, 523 F.2d 585, 589 (9th Cir. 1975) (stating, "Section 1033 is a relief provision; its purpose is 'to aid the taxpayer where he in good faith quickly transforms everything he received into property similar or related . . . in use,'" citing Commissioner v Babcock, 259 F.2d 689, 692 (9th Cir. 1958)).

[9] LTR 199952082, at 10 (citing Est. of Morgan v. Commissioner, 332 F.2d 144, 151 (5th Cir. 1964); and Bent v. Commissioner, 87 T.C. 236, 245 (1986)). See also Robinson v. Commissioner, 102 T.C. 1196, Doc 94-1439, 94 TNT 23-18 (1994), aff'd in part, rev'd in part, and remanded, 70 F.3d 34, Doc 95-10932, 95 TNT 238-7 (5th Cir. 1995).

[10] T.C. Memo. 1971-244.

challenging the adequacy of the price. There was no easy guide to follow here (like there was in LTR 199952082) because the complaint did not provide a property/profits allocation and the suit was settled before trial at an agreed price. So the Walter court decided that the proper allocation approach was to evaluate all of the available evidence.

Walter thus stands for the proposition that if there is no judicial decision, the court will review the litigation-related documents (complaints, depositions, documents, and so forth) to determine the right allocation. Walter rejected the notion that such an allocation was impossible without a court decision. "The fact that the issue of compensation was not finally resolved at trial in the superior court does not mean that we cannot inquire as to the true make-up of the final settlement between the State and the Walters."[11] Walter, together with LTR 199952082, thus illustrates that courts will take an ad hoc approach in the settlement context. Any supporting documents are fair game in making an allocation, which is why it is important to consider section 1033 early in the process.[12]

Often, however, there is no litigation at all when property is sold under threat of condemnation. The property owner and the government agency just get together and negotiate a price. In those situations, the courts look to the details of the negotiations for evidence. For example, in Kendall v. Commissioner,[13] the Indiana Highway Commission decided to acquire Claude Kendall's Indianapolis restaurant (the Key West Shrimp House) to build a new road. The commission sent Mr. Kendall a letter advising him of this decision, and Mr. Kendall agreed to sell the Shrimp House to the commission and relocate his restaurant.[14] Mr. Kendall then hired an appraiser to value the Shrimp House property. The appraiser returned a report valuing the property at $137,300, but the report showed that $44,000 of that value was due to Mr. Kendall's expected lost profits from relocating.[15] The commission and Mr. Kendall eventually settled on a $98,000 purchase price.

The issue before the Tax Court was whether any part of Mr. Kendall's condemnation award was for the lost profits from the forced relocation of his restaurant. Mr. Kendall argued that all of the proceeds were for his lost property and relocation costs,[16] and were thus deferrable under section 1033 (despite his appraiser's estimated lost profits). The court decided the matter based primarily on the substance of the negotiations between the commission's agent and Mr. Kendall's lawyer. It looked first to a "status sheet" prepared by the commission, which said $20,000 of the $98,000 was attributable to lost profits. The court then turned to testimony regarding the negotiations between the parties -– and specifically whether the parties addressed lost profits

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[11] Walter, at 15.

[12] See also Allen v. Commissioner, T.C. Memo. 1998-406, Doc 98-33367, 98 TNT 220-63 (holding that settlement payments were for property rather than punitive damages because the lawyers did not discuss punitive damages at the settlement meeting).

[13] 31 T.C. 549 (1958).

[14] Kendall, at 549.

[15] Kendall, at 549-50.

[16] Payments for relocation expenses are property payments eligible for section 1033 deferral. See LTR 200445004, Doc 2004-21424, 2004 TNT 216-50; E.R. Hitchcock v. U.S., 514 F.2d 484 (2d Cir. 1975).

in their oral negotiations. It cited the substance of the negotiations as follows: "[Mr. Kendall's lawyer] testified unequivocally that he never discussed an amount for the loss of profit or for damage to or destruction of business with [the Commission's agent], and that these factors never entered into consideration in arriving at the price finally agreed upon."[17]

The court was thus faced with conflicting evidence. It had an internal commission report saying that $20,000 was for lost profits, and testimony saying that lost profits were not part of the settlement. To resolve the conflict, the court looked at the restaurant's actual experience after the move, and found that the Key West Shrimp House actually made more money after the move than it had in its old location. Accordingly, the court decided that none of the $98,000 was for lost profits and let Mr. Kendall defer his entire gain on the forced sale.[18] Kendall essentially affirms Walter and LTR 199952082 in their facts-and-circumstances approach to allocating condemnation payments.

Planning ideas. As the Kendall case illustrates, taxpayers can do extensive planning in the condemnation context because it involves personalized negotiations. Taxpayers should always try to influence the negotiation process to maximize their section 1033 deferral. When a condemnation is made, the bulk of the payment is usually to acquire the fee interest in the property. And there is no question that those payments qualify for relief. But when ancillary payments are also made (for instance, relocation payments, precondemnation damages), those payments may not qualify. Section 1033 issues also arise in so-called inverse condemnations, in which government actions reduce certain properties' value. In those instances, taxpayers should adhere to the following planning tips (when possible):

- Do not refer to lost profits or lost revenues in condemnation-related correspondence.
- Suggest that the taxpayer's appraiser focus on property values, not lost profits.
- Prepare a damages schedule to show the government agency early on in the proceedings. And try to use only lost-property measures of damages.
- Instruct negotiators to minimize lost-profits references.
- If an agreement is not reached and a suit is filed, include any lost-property damage calculations in the complaint (and minimize income-statement based damages).
- If a trial is necessary, examine the damages expert's report and planned testimony to ensure minimal references to profits or revenues.

Statutory Indemnity Programs

Existing guidance. Sometimes the government gives you money even when it doesn't take your property. The government often pays individuals and businesses for losses they incur as the result of a natural disaster, or some other tragedy. Those relief payments are a form of social insurance (in addition to private insurance) that protects people from suffering the full impact of an economic disaster. Those programs pop up in various settings. For instance, the government handed out billions of dollars to those hit hardest by the September 11 terrorist attacks (for example, businesses in lower Manhattan, the airline industry). Congress has already allocated more than $60 billion for Hurricane Katrina victims and more relief is expected. Government agencies pay out cash in

[17] Kendall, at 552.
[18] Kendall, at 554.

other settings too. When a large earthquake hit Southern California in 1994, agencies provided relief to affected business owners. Those programs are also prevalent in the agricultural sector, in which relief is provided when severe weather and natural disasters destroy crops -- hardly an uncommon occurrence.

The payments made under some of those indemnity programs will fit squarely in section 1033. For example, in Rev. Rul. 2005-46,[19] a state government enacted emergency legislation that compensated businesses for their property and equipment lost in a natural disaster. The IRS let the recipients defer the payments under section 1033, because they were for lost property. (Note that some relief payments can be a "qualified disaster relief payment" and thus excludable under section 139 -— even better than section 1033 deferral.)

But when businesses are damaged, it is usually not that clear cut. The government might pay each damaged business a flat $100,000, or it might pay $X per month. It might individualize the payments based on each business's characteristics (for example, revenue, assets, profits), or provide the same payment to each business. All of those decisions affect whether a business can get section 1033 relief. If the payments are fixed or are tied to property measures, relief is probably available. For example, the IRS ruled in 2002 that $9,000 payments made by the federal government to ranchers to rebuild their fences destroyed by a fire were eligible for section 1033.[20] But if the payments are based on income-statement measures such as revenues or profits, deferral is unlikely.

Rev. Rul. 75-381[21] illustrates that point. In it, a beekeeper sought section 1033 deferral for proceeds received under the Agriculture Act of 1970 (which was a response to pesticide use that was damaging crops and livestock in surrounding areas). The act authorized the Department of Agriculture to indemnify beekeepers "who through no fault of their own have suffered a loss of honeybees as the result of the utilization of pesticides near or adjacent to the property on which the beehives are located."[22] The department issued regulations implementing that program, which let the injured beekeepers choose to receive payments based on either lost revenues (lost honey sales, lost pollination fees) or lost property ($15/colony, $5/queen nucleus).

To determine whether the payments fit into section 1033, the IRS looked partially at the beekeepers' decisions on how to substantiate their losses. It said payments for lost property would qualify, and that payments for lost revenues would not. In other words, if a beekeeper submitted documents to the Department of Agriculture showing his lost sales, he likely could not use section 1033. But if the beekeeper submitted documentation as to how many beehives the beekeeper lost and their value, the beekeeper probably could defer his gain. That means that if two neighboring beekeepers each lost 20 bee colonies and received $10,000 -— but Beekeeper A filled out the forms using the lost-sales page, while Beekeeper B used the lost-property page -— they could be taxed differently.

Taxpayers should thus note these types of choices when they receive relief payments, because the seemingly innocuous documentation can shift the tax outcome.

19 2005-30 IRB 120, Doc 2005-14289, 2005 TNT 127-2.

20 IRS Information Letter 2002-0074, 2002 WL 31991635.

21 1975-2 C.B. 25.

22 Id., at 2.

Planning ideas. Statutory indemnity programs usually offer less planning opportunities than condemnations, because the compensation rules are often set by the government agency without the taxpayer's input. Sometimes, however, taxpayers can influence the process. Often compensation plans are responding to an outside force that damaged a taxpayer's property or business (for example, the 9/11 terrorist attacks), and the payments can be individualized to meet the taxpayer's needs. If that is the case, the affected taxpayer should try to influence the legislation (or other payment-authorization process) to fit the payments into section 1033. For instance, if your client is a business that lost the use of its commercial dock for two months after a hurricane, and the local government passes a relief bill for the shipping industry, try to influence the legislation language so that it compensates dock owners for the lost use of their property (instead of their lost profits) for the two-month period. The local government officials likely won't object because they won't know about section 1033, and your client's federal taxes do not affect the local government's fisc.

In most instances, however, the statutory payment mechanism will be decided by forces outside your client's control. When that happens, taxpayers should review their options for documenting their losses. Indemnity programs often give taxpayers choices as to how to show their losses (government agencies disdain simplicity). So if your client's program lets businesses prove their losses without referring to lost profits or revenues, pick that method. That will give your client the best argument that the payments compensate for property losses.

And remember to review the legislative history. The documentation forms required to prove a taxpayer's losses are usually drafted by the implementing agencies, not the legislature. The legislative history may show the lawmakers were not focused on lost profits, even though the forms let taxpayers substantiate their losses by showing lost profits. In those cases, consider providing alternative documentation to bolster your taxpayer's section 1033 chances.

Private Insurance Payments

Existing guidance. In addition to public indemnity programs, section 1033 issues often arise in private indemnity (that is, insurance) cases. Businesses usually buy two different insurance policies to protect against property damage. They buy a policy that pays to rebuild/repair the facility, and a policy to cover the harm to their business during the rebuilding period. The proceeds from the first policy are almost always eligible for section 1033 relief. And the payments from the second policy, normally called use-and-occupancy (U&O) insurance, are often ineligible.[23] If U&O policies are structured correctly and compensate businesses for the lost use of their property, however, the proceeds sometimes can be deferred under section 1033.

The basic rule for U&O policies is the same as in the condemnation and statutory indemnity settings: Proceeds compensating for the lost use

23 While historically U&O cases have generated most of the lost-property guidance under section 1033, the most recent guidance has dealt with whether payments under third-party liability insurance are eligible for deferral. See TAM 200322017, Doc 2003-13317, 2003 TNT 105-15.

of property are eligible for section 1033 deferral,[24] but those replacing lost profits are not.[25] That rule was incorporated into the section 1033 regulations, which say that "proceeds of a use and occupancy insurance contract, which by its terms insures against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been."[26]

That language in the regulations cements the profits/property divide. It also suggests the contract terms are what govern the section 1033 allocation for U&O insurance payments. And when U&O insurance contracts are straightforward, the contract terms will decide the outcome. Thus, if the contract says that "in the event of a fire destroying X's store, insurance company will pay $10,000 per day to make up for X's lost profits," the payments will be ineligible for section 1033 relief. But if the U&O contract instead reads "in the event of a fire destroying X's store, insurance company will pay $10,000 per day to compensate for X's lost use of its store, so that X can rent a suitable replacement facility during the repair period," X perhaps can defer that income. (Although there is some debate over whether the mere lost use of property even triggers section 1033.)[27]

Most contracts are not this simple, of course. The U&O payouts might be based on several factors (number of days, lost property, repair costs), which may be interrelated. And the insurance companies often use caps to protect themselves. For instance, a policy might pay $25,000 per day for lost revenues, but not to exceed the daily rental rate of replacement property. Or it may pay $5,000 per day, but with a $250,000 global cap.

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[24] Piedmont Mt. Airy-Guano Co., 3 B.T.A. 1009, 1015 (1926), acq. V-2 C.B. 3 (1926), acq. withdrawn, nonacq. substituted, X-1 C.B. 89 (1931), nonacq. withdrawn, acq. substituted, 1942-2 C.B. 15 (granting deferral to U&O insurance proceeds); Flaxlinum Insulating Co. v. Commissioner, 5 B.T.A. 676, 688 (1926) (holding that proceeds from a U&O insurance policy that compensated for a per diem amount were entitled to deferral); Williams Furniture Corp. v. Commissioner, 45 B.T.A. 928, 937 (1941) (allowing deferral to payments under a per diem policy because the recipient, noting that the taxpayer never provided income-oriented substantiation.)

[25] Miller v. Hocking Glass Co., 80 F.2d 436, 437 (6th Cir. 1935) (holding that payments for actual sustained losses, with no mention of lost use of property, were not eligible for deferral under section 112(f) (now section 1033)); Massillon-Cleveland-Akron Sign Co. v. Commissioner, 15 T.C. 79, 85 (1950) (denying deferral to U&O insurance proceeds based on net profits less fixed costs saved).

[26] Reg. Section 1.1033(a)-2(c)(8).

[27] Compare LTR 9248025 (granting deferral to payments for a 12-year easement to build a road), with Rev. Rul. 38, 1953-1 C.B. 16 (disallowing relief for a five-year condemnation of a taxpayer's warehouse during World War II).

When U&O contracts are complicated like that, it is more difficult to determine from the face of the payment provisions whether a given payment is for lost property or lost profits. The courts must look beyond the contract to determine whether a payment is eligible for section 1033 relief. The IRS noted that in Rev. Rul. 86-12,[28] which says the "written terms of a contract, described as a use and occupancy insurance contract, are not the sole basis to determine whether insurance proceeds from the contract qualify . . . under section 1033 of the Code."[29] As a result, in these so-called "blended payment" cases -— in which the contract bases benefits simultaneously on both lost-property and lost-profits measures -— taxpayers should closely watch the outside evidence being created.

So, what outside sources of evidence will courts look at when given a blended-payment U&O policy? Marshall Foods, Inc. v. U.S.[30] provides a good example. In that district court opinion, the court had to decide what portion of a U&O insurance payment was capital gain (this was not a section 1033 case, but it is analogous). The U&O policy's payment provisions were incredibly vague. The policy purported to compensate Marshall Foods for its "monetary loss," and paid Marshall Foods a $4,000 per diem payment in case its business was interrupted. The court obviously could not get much from that language and was forced to look at outside evidence. In reaching its decision, it reviewed (1) the nature of Marshall Foods' other insurance coverage, (2) the contractual provision triggering the benefit payments, (3) the underwriting information provided to the insurance agent, and (4) the documents provided to the insurer to substantiate the loss.[31] Based on that analysis, the court held that the proceeds were in lieu of lost profits and should be characterized as ordinary income.[32]

In addition to Marshall Foods, two early court decisions on involuntary conversions addressed U&O contracts with blended payments. Both cases demonstrate how hard it is to overcome a lost-profits provision in a U&O contract. In Int’l Boiler Works Co.,[33] the Board of Tax Appeals faced an insurance policy that provided for lost profits plus fixed charges, subject to a per diem cap of $83.33. The board saw the per diem limit as a cap on the policy, whose true value was to insure for lost profits. It therefore held that the payments were not for lost property, and were ineligible for involuntary conversion deferral.[34] A district court faced similar facts in Mellinger v. U.S.,[35] in which a U&O insurance contract provided for the loss of "rent or rental value." Mr. Mellinger asserted that the proceeds were eligible for deferral under the involuntary conversion provision, but the court ruled they were more in the nature of lost profits and thus not deferrable. (It should be noted that the court based its decision in part on the fact that the taxpayer was not occupying the building when the fire destroyed it.) Looking only at those two cases, the standard for characterizing a blended payment as a replacement for lost property appears relatively high.

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[28] 1986-1 C.B. 290.
[29] Id., at 3-4.
[30] 393 F. Supp. 1097 (D. Minn. 1974).
[31] Marshall Foods, at 1099-1100. For a similar list of factors, see LTR 8315007, at 5-6.
[32] Marshall Foods, at 1099.
[33] 3 B.T.A. 283 (1926).
[34] Int’l Boiler Works, at 290-91.
[35] 54-1 USTC par. 9197 (S.D. Texas 1953).

One more recent case reached a different result, and suggests that policies providing benefits limited by both lost profits and a fixed per diem amount are entitled to section 1033 deferral. In Shakertown Corp. v. Commissioner,[36] the Sixth Circuit faced a section 1033 allocation problem under a U&O insurance policy. The policy in question contained two separate limits on the compensation amount. The first was a payment of a fixed weekly sum in case of a total business suspension. The court found that provision to be a lost-property limitation, noting it was "not dependent in any way upon the amount of profits."[37] The second limiting provision was a lost-profits clause, which was invoked if the required weekly payments "exceeded the Assured's net profit plus fixed charges."[38] As such, Shakertown was required to report its actual profits to the insurance adjuster every six months.

Faced with those multiple limitations, the Sixth Circuit surprisingly ruled that the payments were for the lost use of property and let Shakertown defer the payments under section 1033. The court based its ruling not on a legal principle so much as the policy's structure. It first noted that the per diem clause was the stated insuring clause of the policy. The IRS apparently responded to that argument by pointing out that the profits limitation, while not being the stated purpose, still acted to cap Shakertown's benefits. The court dismissed the IRS's reply by noting that the profits clause was just "words of limitation, not words of promissory import."[39] The IRS then noted that Shakertown provided substantial data on its lost revenues to the insurance adjuster during the settlement negotiations.[40]

The court disposed of that argument by pointing out that the adjuster requested all sorts of data but ultimately based his final numbers on lost production instead of lost profits. Overall, the focus on the policy structure seems a bit odd given the general substance-over-form nature of these decisions. The fact that the policy read that it was a policy for the lost use of property subject to profit limitations -- instead of vice versa -- seems irrelevant. Nonetheless, Shakertown supports the assertion that payments under a U&O policy with a lost-profits clause can still qualify for section 1033 relief.

The IRS announced that it would not follow Shakertown in Rev. Rul. 73-477.[41] That ruling dealt with facts essentially the same as in Shakertown and concluded that a policy with both a fixed per diem limit and a lost-profits limit would not qualify under section 1033.[42] The ruling reasoned that because the lost-profit restriction does (or at least could) have an actual economic effect on the payout, it should be respected and the proceeds should be considered compensation for lost profits. Rev. Rul. 73-477, like Shakertown, fails to address the dual-limitations issue head on. And neither attempts to provide any principled guidance on what to do when a policy has two active limiting provisions that point in opposite directions. The decisions could have

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[36] 277 F.2d 625 (6th Cir. 1960).
[37] Shakertown, at 628.
[38] Shakertown, at 629.
[39] Shakertown, at 630.
[40] Shakertown, at 630.
[41] 1973-2 C.B. 302; see also GCM 35266, 1973 IRS GCM LEXIS 286 (explaining the rationale behind Rev. Rul. 73-477).
[42] Note also that the IRS stated in GCM 35193, 1973 IRS GCM LEXIS 345, at 30-31, that there is a "substantial litigating risk" in dual-purpose cases because of Shakertown.

articulated a rule for these situations, such as "if any portion is attributable to lost profits, the entire policy proceeds are ineligible for section 1033." Or they could have split the baby and set down an allocation rule. But they do not. Instead, they both simply pick a side, provide a few facts to support their position, and state the holding.

Planning ideas. Payments under U&O insurance policies give taxpayers perhaps the best opportunity to manage the facts to ensure a favorable section 1033 result, because with U&O insurance taxpayers can control the contract language. Unlike statutory indemnity programs, which are usually drafted by legislators, taxpayers have a say in the payment provisions of their U&O policy. And if a dispute surrounding the contract arises, taxpayers should think carefully about what arguments to make, and what documentation to provide. With that in mind, here are a few specific planning ideas to consider:

- Draft the U&O contract with section 1033 in mind. Ensure that payment provisions refer to the lost use of property, or rental cost of replacement property. If the payment driver is lost profits or revenues, the payments will not be eligible for relief.

- When providing documentation to the insurance company, minimize lost-profits references or support.

- If the U&O contract is litigated, try not to introduce a lost-profits measure as evidence for the claimed damages.

Conclusion

Taxpayers generally don't plan their section 1033 events. No one wants their offices to be destroyed or their factory to burn down. But just because section 1033 events are unplanned doesn't mean taxpayers can't plan for them. Taxpayers can do many things to ensure that if they do realize a gain on involuntarily converted property, that gain can be deferred. That type of tax planning is often simple and rarely has nontax side effects. As such, tax advisers should always think about section 1033 when drafting insurance contracts or documenting losses to payers.