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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Request for Field Service Advice

This Field Service Advice responds to your memorandum dated November 7, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

T =
X =
Y =
Z =

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Location 1 =

Location 2 =

Location 3 =

Year 1 =

Year 2 =

Year 3 =

Year 6 =

Year 7 =

Year 8 =

f =

g =

h =

\$j =

\$k =

\$l =

\$m =

\$n =

\$p =

\$q =

\$r =

\$s =

\$t =

\$v =

\$w =

\$x =

\$y =

\$z =

ISSUE

Do insurance proceeds received on fire damages to property held under a leasehold interest qualify for deferral under I.R.C. § 1033 when the proceeds are reinvested in the acquisition of a new building held in fee simple?

CONCLUSION

The transaction does not qualify for deferral under I.R.C. § 1033.

FACTS

X is the common parent of an affiliated group that files consolidated returns. X is a holding company and operates retail stores through its subsidiaries. In Year 2, X opened a warehouse and distribution center (the "Distribution Center") in Location 1. Y, a wholly-owned subsidiary of X, had entered into a long term lease agreement ("Master Lease") regarding certain undeveloped land with the Industrial Development Board of Location 2 ("Board") and the City of Location 2 ("City") in

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Year 1.¹ Under the terms of the Master Lease, Y was to build the Distribution Center for use by Y on the land, financed in part by certain bonds sold by the Board. The Board was to purchase the Distribution Center from Y after the construction and lease it back to Y for a potential term of 99 years.² Y completed the Distribution Center in Year 2 at a cost of \$x³.

The Distribution Center had the capacity to service approximately f stores, but Y believed that it was under-utilized and decided to enter into a sale/leaseback of the Distribution Center in order to recoup some of Y's costs.

In Year 3, after obtaining an outside appraisal of the Distribution Center, Y entered into a Purchase and Sale Agreement (the "Agreement") with T, an unrelated party, and Y assigned its leasehold interest in the Distribution Center, land and Master Lease for \$s to T's subsidiary.⁴ Concurrently with the sale to T, Y leased the Distribution Center, land and Master Lease (the "Sublease") from T. In addition, Y purchased certain equipment for the Distribution Center that was sold and leased back to Y as part of the Sublease. The initial term of the Sublease was for g years with the option of two renewal periods for a total duration of potentially h years.

¹ Before this date, City was the owner of the land. However, City transferred the land to the Board in order to utilize the Board's statutory ability to negotiate reduced property taxes. City warranted that the Board was the 100% owner of the land.

² The proceeds from the sale of the Board's bonds were to be placed in a Bond Fund and Acquisition and Construction Fund under the Bond Indenture (the "Fund") and controlled by a trustee. Y was to build the Distribution Center, expending a minimum of \$r in the process. As the construction proceeded, Y's expenses were to be reimbursed from the Fund. However, if the proceeds from the Fund were insufficient to finance the construction, Y was to complete the construction and pay the difference. The reimbursements from the Fund were to constitute part of the purchase price for the Distribution Center. The Board was to purchase the Distribution Center from Y for the lesser of the amount originally placed in the Fund or Y's actual construction cost, plus \$100.00. Then, the Board was to lease the Distribution Center to Y for 99 years, including renewal options, starting in Year 1. Y was to have all the benefits of owning the building including depreciation deductions. Further, after the construction of the Distribution Center, Y had the option to purchase the land and Distribution Center for a fixed price plus reimbursement to City of monies expended by City for any site improvements.

³ Of this amount, \$q was the cost of the building, \$p was for the improvements, and \$n was for the fixtures and equipment.

⁴ Y wrote down \$m in its books to reflect a permanent impairment in its value. Hence the net book value was the sale price.

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The Sublease was a triple net lease with Y responsible for the taxes, maintenance and insurance. Y claimed a loss in the amount of \$y from the sale to T.⁵

In Year 6, the facility was destroyed by fire. Y's insurance on the facility covered the building, improvements, and equipment. Y received a total of \$z in insurance proceeds. The Master Lease included a provision that required Y as lessee to repair and/or rebuild the Distribution Center if there were any damages. However, if the Distribution Center was totally destroyed, Y had the option of terminating the lease instead of rebuilding it, provided Y removed all traces of the building and repaid the bond debt. Following the fire, Y decided not to rebuild the Distribution Center. Instead, it reached an agreement with T in which the Sublease would be terminated in exchange for \$j. However, the Board refused to allow Y to terminate the Master Lease. As a result, during Year 6, Y exercised its right under the Master Lease to purchase the land and related land improvements. The purchase price for the land and improvements were approximately \$v and \$w, respectively.

In Year 7, X was purchased by Z and became an affiliate of Z. Z decided to change the replacement property. As a result, X acquired the Location 3 Distribution Center in Year 8 for \$t. This replacement was complete within the 2-year replacement period. X filed an amended tax return for the Year 6 fiscal year claiming a deferral of a portion of the insurance proceeds under I.R.C. § 1033.

LAW AND ANALYSIS

I.R.C § 1033(a) provides generally that gain resulting from the compulsory or involuntary conversion of property as a result of the property's destruction in whole or in part, theft, seizure, requisition, or condemnation into money or into property that is not similar or related in use to the converted property, shall be recognized. However, section 1033(a)(2)(A) provides that the taxpayer may defer recognition of such gain, at its election, if the taxpayer during the period specified purchases other property similar or related in service or use to the property so converted. The taxpayer must recognize gain only to the extent that the amount realized upon such conversion exceeds the cost of such other property. Under section 1033(a)(2)(B)i), if the taxpayer elects to replace its converted property, it must generally replace the property no later than two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

In this case, Y argues that it replaced its leasehold interest with a fee interest in real property. It is well established that replacement of a long-term leasehold interest with a fee interest qualifies for I.R.C. § 1033 non-recognition treatment. In Davis Regulator Company v. Commissioner, 36 B.T.A. 437 (1937), *acq.*, 1937-2 C.B. 7, the United States Board of Tax Appeals held that a taxpayer did not have to

⁵ This loss was calculated as follows: \$x tax basis reduced by \$l for depreciation taken, to get an adjusted basis of \$k. The difference between the sale price of \$s and the adjusted basis was a loss of \$y.

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recognize gain on the receipt of proceeds received with respect to the condemnation of a leasehold interest to the extent that the proceeds were invested in the construction of a building on land owned by the taxpayer. The new building was used for the identical purpose as the converted leasehold. The court's decision was based on the "similar or related in service or use" standard found in the predecessor to section 1033(a)(2)(A).

Similarly, Rev. Rul. 83-70, 1983-1 C.B. 189, concluded that a timely acquisition of a fee simple property interest qualifies under I.R.C § 1033(a) as replacement property similar or related in service to an involuntarily converted 15-year (remaining) leasehold because the fee simple interest property is to be used in the same business and for the identical purposes as the condemned leasehold. In that ruling, the taxpayer was a corporation which leased land improved by an office building and small warehouses for a term of 20 years, for its hauling and storing furniture business. Five years after the lease term, the property was condemned by the city. Subsequently, the taxpayer used the condemnation proceeds to purchase a fee simple interest in real property improved with a warehouse and office to be used for the same purpose as the condemned property.

Unlike Davis Regulator and Rev. Rul. 83-70, the facts of this case involve the conversion of leasehold property by fire rather than condemnation. This case is factually similar to the facts in Woodall v. Commissioner, T.C. Memo. 1991-15, aff'd., 964 F.2d 361 (5th Cir. 1992). In Woodall, the taxpayers were partners who operated a nightclub on leased premises. The partnership was required under the lease to carry insurance coverage for the leased property. The property was damaged by fire and the partnership received insurance proceeds. The partnership repaired the premises, and later decided to buy the premises. The partnership claimed non-recognition of gain on the receipt of the insurance proceeds on the theory that the fee interest in the property purchased qualified as replacement property under I.R.C § 1033(a). Both the Tax Court and Circuit Court held that Woodall was factually distinguishable from Davis Regulator and Rev. Rul. 83-70, because in the earlier case and ruling, the taxpayers gave up their leasehold interest, either by actual condemnation or by sale under threat of condemnation. In contrast, in Woodall,

[t]he taxpayers' problem is that they did not suffer an involuntary conversion of their leasehold. The loss was only to the taxpayer's improvements. ...The fire...did not force the taxpayers to buy the buildings; their lease interest had remained intact. ...The purchase of the building replaced no damaged property and the funds used for its purchase do not fall under I.R.C. § 1033.

964 F.2d at 364.

In this case, the property insured by the insurance policy was the taxpayer's tangible property, not the leasehold interest itself. Moreover, the property destroyed was the tangible property. Here, as in Woodall, Y's leasehold interest

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had remained intact. Y voluntarily settled with T to be released from the Sublease terms and to terminate the leasehold interest for the duration remaining. Thus, the taxpayer cannot claim I.R.C. § 1033 non-recognition treatment for replacing the Distribution Center with the purchase of the Location 3 property because the fire did not affect Y's leasehold interest. As a result, the taxpayer must recognize gains from receipt of the insurance proceeds.

Please call if you have any further questions.

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