

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 13, 2010

Number: **201111004**

Release Date: 3/18/2011

Third Party Communication: None

Date of Communication: Not Applicable

Index (UIL) No.: 1033.03-00

CASE-MIS No.: TAM-128957-10

Director, Compliance

, Territory Manager

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No

Year(s) Involved:

Date of Conference:

LEGEND:

Taxpayer =

Group =

Operating LP =

aaa =

business unit =

ISSUE:

Is inventory that is involuntarily converted in a Presidentially declared disaster "property held for productive use in a trade or business" for purposes of § 1033(h)(2) of the Internal Revenue Code?

CONCLUSION:

Inventory that is involuntarily converted in a Presidentially declared disaster is property held for productive use in a trade or business for purposes of § 1033(h)(2).

FACTS:

Taxpayer is the common parent of a group of affiliated corporations (“Group”) that filed consolidated federal income tax returns for the tax years at issue. Operating LP is a partnership wholly owned by members of Group. During the years at issue, Group and Operating LP were generally engaged in the aaa business. Hereinafter, the term “Taxpayer” refers collectively to Taxpayer, Group and Operating LP.

The operations of some of Taxpayer’s business units were damaged by the 2006 Gulf Coast hurricanes, which were Presidentially (federally) declared disasters.¹ Taxpayer received insurance and salvage proceeds relating to property involuntarily converted as a result of the hurricanes, more than half of which related to lost or damaged inventory. Taxpayer realized gain in excess of basis from these recoveries.

Taxpayer reinvested most of the insurance and salvage proceeds in new store construction property (i.e., § 1245 and §1250 property) and included statements in its tax returns that identified the replacement property. Taxpayer also reduced the basis of the new property by the amount of the deferred gain. Taxpayer expects to reinvest the remaining proceeds within the five-year replacement period for property damaged by Hurricane Katrina.² Since the 2006 hurricanes, Taxpayer purchased and sold inventory, but did not designate any acquired inventory as replacement property for the inventory destroyed.

LAW AND ANALYSIS:

Section 1033(a)(2) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or

¹ Under § 1033(h)(3), the term “federally declared disaster” refers any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Prior to January 1, 2008, the term used in the application of § 1033(h)(2) was Presidentially declared disasters rather than federally declared disasters. See § 706(a)(2)(C) and (D)(i), (ii) and (iii) DivC of Pub. Law 110-343.

² Under § 1033(a)(2)(B), the replacement period generally ends two years from the close of the first taxable year in which any gain from a conversion is realized. Section 1033(h)(1)(B) extends the replacement period for principal residences converted in a federally declared disaster from two years to four years. Although this four year replacement period does not apply to trade or business or investment property, § 405 of P.L. 109-73 extends the replacement period to five years for property in the Hurricane Katrina disaster area that is compulsorily or involuntarily converted on or after August 25, 2005 by reason of Hurricane Katrina, but only if substantially all of the use of the replacement property is in such area.

imminence thereof) is compulsorily or involuntarily converted into money and if the taxpayer during the statutory replacement period, for the purpose of replacing the converted property, purchases other property similar or related in service or use to the converted property, then, at the election of the taxpayer, the gain must be recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property.

Section 1033(h)(2) provides that 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 compulsorily or involuntarily converted as a result of a federally declared disaster, then 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.

Several Code provisions relating to deferral of gain on an exchange or other disposition of property explicitly disallow deferral for dispositions of inventory. For example, under § 1031(a)(2)(A), the deferral of gain under § 1031(a) is not permitted for exchanges of "stock in trade or other property held primarily for sale." Similarly, § 1033(g)(1) applies to certain conversions of "real property (not including stock in trade or other property held primarily for sale)." Section 1033(h)(2), however, does not contain any specific language relating to inventory, stock in trade or property held primarily for sale.³

Although it is arguable that inventory is not property held for productive use in a trade or business or for investment because inventory does not "produce" property or services within the plain meaning of that term, the use of the term "productive" does not necessarily exclude inventory. In addition, the subsection that precedes § 1033(h), § 1033(g), which applies to real property "held for productive use in a trade or business or investment" specifically excludes inventory property from its application. Had Congress intended to exclude inventory from the language "held for productive use in a trade or business or for investment" in § 1033(h)(2), it would have expressly done so as in §§ 1033(g) and 1031(a)(2)(A).

The position that § 1033(h)(2) applies to conversions of inventory is consistent with Notice 2003-18, 2003-1 C.B. 699, which provides guidance on the treatment of grant payments to businesses to aid in the recovery from the September 11, 2001, terrorist attacks, and Congress's explanation of its purpose for enacting § 1033(h)(2). Notice 2003-18, answer 7, provides as follows:

³ In other Code provisions, inventory is treated separately from property used in a trade or business. In §1400N(f)(2), which pertains to clean up costs in the Gulf Opportunity Zone, a distinction is made between property which is (A) held by the taxpayer for use in a trade or business or for the production of income and (B) property described in §1221(a)(1) (stock in trade, inventory, etc.). Also, §1231(b) distinguishes between property used in a trade or business and inventory. Obviously, Congress knows how to make clear distinctions between inventory and other forms of business and investment property. Yet no distinction is made in § 1033(h)(2). In addition, the legislative history of § 1033(h)(2) does not exclude inventory from the deferral treatment accorded a conversion of the property described in § 1033(h)(2). See S. Rep. 104-281 at 14 (1996).

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 added.]

. . . 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.

The legislative history of § 1033(h)(2), in explaining the reason for adding paragraph (h)(2) to §1033, states:

The property damage in a Presidentially declared disaster may be so great that businesses may be forced to suspend operations for a substantial time. During that hiatus, valuable markets and customers may be lost. If this suspension causes the businesses to fail, and the owners of the business wish to reinvest their capital in a new business venture, the involuntary conversion rules will force them to recognize gain when they buy replacement property that is needed for the new business but not similar to that used in the failed business. This provision will offer relief to such businesses by allowing them to reinvest their funds in any tangible business property without being forced to recognized gain. No such deferral of gain is available now, if the taxpayer decides not to reinvest in tangible business property.

S. Rep. 104-281, at 14.

Consequently, because § 1033(h)(2), unlike § 1031(a)(1)(A) and §1033(g), does not exclude conversions of inventory from its application, and there is no indication of Congressional intent to deny inventory businesses the benefit of the special rule in § 1033(h)(2), § 1033(h)(2) applies to Inventory that is involuntarily converted in a Presidentially declared disaster. Moreover, this position that § 1033(h)(2) applies to inventory is consistent with Notice 2003-18.

Accordingly, inventory held by Taxpayer that is involuntarily converted in a Presidentially declared disaster, is “property held for productive use in a trade or business” for purposes of § 1033(h)(2) of the Code.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to Taxpayer(s). Pursuant to § 6110(k)(3) of the Code, this document may not be used or cited as precedent.