Section 1033.—Involuntary Conversions

26 CFR 1.1033(a)–3: Involuntary conversion of a principal residence.
(Also §§ 163, 1034; 1.1034–1(c)(3).)

Involuntary conversion of a residence; deduction for qualified residence interest. If a principal residence is destroyed, and the land portion is later sold, the sale is treated as part of the involuntary conversion of the residence, if the requirements of section 1033(a) are met. Taxpayers may continue to deduct otherwise deductible mortgage interest on a destroyed residence during a reasonable period between the destruction of the residence and its sale or reconstruction and reoccupation.

Rev. Rul. 96–32

ISSUES

(1) If the dwelling portion of the taxpayer's principal residence is destroyed and the remaining land portion of the principal residence is subsequently sold within the period described in § 1033(a)(2)(B) of the Internal Revenue Code, is the sale treated as part of the involuntary conversion of the principal residence to which § 1033(a) may apply to defer recognition of gain realized on the sale?

(2) If the taxpayer subsequently sells the remaining land portion of the principal residence described above or reconstructs the destroyed dwelling and reoccupies it as the taxpayer's principal residence within a reasonable period of time after the destruction, is the property treated as a qualified residence under § 163(h) during the period between the destruction of the dwelling and the sale or reoccupancy?

FACTS

Situation (1)—*A*'s principal residence (within the meaning of §§ 1034 and 163(h)(4)(A)(i)(I)) was destroyed in September 1991 by a tornado that was subsequently declared a disaster by the President. In the same year, *A* received insurance proceeds of $120*x* for the destruction of the dwelling. *A*'s adjusted basis in the property (land and improvements) was $100*x*. *A* did not rebuild the dwelling, but instead sold the land for $10*x* in November 1993. In March 1995, *A* purchased another home for $130*x* and used it as *A*'s principal residence.

Situation (2)—*B*'s principal residence (within the meaning of §§ 1034 and 163(h)(4)(A)(i)(I)) was destroyed in December 1991 by an earthquake that was subsequently declared a disaster by the President. Because the widespread destruction in the region resulted in a severe shortage of available equipment, materials, and skilled labor, *B* was not able to begin reconstruction of the dwelling until June 1993. Upon its completion in October 1994, *B* reoccupied the reconstructed dwelling and used it as *B*'s principal residence. During the period from the earthquake until *B* reoccupied the reconstructed dwelling, *B* lived in rental housing.

In *Situations (1)* and *(2)*, the residences were encumbered by mortgages securing debts the interest on which was qualified residence interest under § 163(h)(3)(A) prior to the disaster. Had the residences not been destroyed, they would have continued to qualify as principal residences under § 163(h)(4)(A)(i)(I). After the destruction of their principal residences, *A* and *B* continued to make payments of principal and interest on their mortgage debts.

LAW AND ANALYSIS—ISSUE (1)

Section 1033(a)(2)(A) 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 imminence thereof) is compulsorily or involuntarily converted into money, which in turn is used to purchase (within the period specified in § 1033(a)(2)(B)) property similar or related in service or use to the converted property, gain will be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property.

Section 1033(a)(2)(B) provides that the period for replacing converted property generally shall be the period beginning on the date of the disposition of the converted property and ending 2 years after the close of the taxable year in which any part of the gain is realized. However, § 1033(h)(1)(B), added by § 13431 of the Omnibus Budget Reconciliation Act of 1993, provides that if a principal residence is compulsorily or involuntarily converted as a result of a Presidentially declared disaster, § 1033(a)(2)(B) shall be applied by substituting ''4 years'' for ''2 years.'' For this purpose, § 1033(h)(3) generally provides that the term ''principal residence'' has the same meaning as when used in § 1034. Section 1033(h) is effective for property converted as a result of disasters determined after August 31, 1991, to be Presidentially declared disasters, and for taxable years ending after that date.

Section 1033(b) provides that the basis of property acquired in a transaction that resulted in nonrecognition of gain under § 1033(a)(2) shall be the cost of the property acquired reduced by the amount of the gain not so recognized.

Section 1.1033(a)–3 of the Income Tax Regulations provides, in part, that § 1033 shall apply in the case of property that the taxpayer uses as the taxpayer's principal residence if its destruction occurs after December 31, 1953. Thus, the nonrecognition of gain provided by § 1034 is not applicable if a principal residence is destroyed and replacement property is acquired.

Section 1.1034–1(c)(3) provides that whether property is used by the taxpayer as a principal residence under § 1034 depends upon all the facts and circumstances in each case, including the good faith of the taxpayer.

In Rev. Rul. 76–541, 1976–2 C.B. 246, a taxpayer owned and resided in a house situated on an undivided parcel of land containing 10 acres, all of which the taxpayer used as the principal residence. During a particular year, the taxpayer sold the dwelling and three immediately surrounding acres at a gain. Later in the same year, the taxpayer sold two more acres at a gain. The taxpayer constructed a new principal residence on the taxpayer's remaining five acres within the period provided under § 1034. Rev. Rul. 76–541 holds that § 1034 applies to defer recognition of the total gain realized on both sales, and that a single replacement period under § 1034(a) (deter-

mined with reference to the date of the first sale) applies. Rev. Rul. 76–541 treats the dwelling and the ten acres of surrounding land as the taxpayer's principal residence. The sale of the first three acres and the dwelling did not alter the ''principal residence'' character of the two-acre portion of land that was later sold during the applicable replacement period.

Consistent with the integral nature of a taxpayer's principal residence for § 1034 purposes, § 1.165–7(b)(2)(ii) provides that, in determining the amount of a casualty loss for residential real property and improvements thereon (such as buildings and landscaping), the improvements are considered an integral part of the residential property so that no separate basis need be apportioned to such improvements. *Cf.* § 1.165–7(b)(2)(i) (a loss incurred in a trade or business or in any transaction entered into for profit is determined by reference to the separate fair market value and basis of each single, identifiable property damaged or destroyed).

In *Situation (1)*, *A* realized $120*x* of insurance proceeds upon the 1991 conversion of the dwelling. *A* may offset the entire $100*x* basis in the property against the amount realized, consistent with the nonapportionment of basis for the computation of casualty loss deductions on residential real property under § 1.165–7(b)(2)(ii). Thus, *A* realized a gain from the insurance proceeds of $20*x* and *A*'s basis in the property is reduced to $0*x*.

A thereafter realized an additional $10*x* of gain on the 1993 sale of the land, for a total gain of $30*x* on the property. Because the principal residence of *A* before the disaster consisted of both the dwelling and the land that was later sold by *A* after the destruction of the dwelling, *A*'s sale of that land will be treated as part of a single involuntary conversion of *A*'s principal residence that occurred on the date the dwelling was destroyed. Thus, § 1033, and not § 1034, will apply to defer recognition of *A*'s $30*x* gain.

For purposes of this § 1033 deferral, *A*'s period for purchasing replacement property under § 1033(a)(2)(B) and (h)(1)(B) begins on the date that the dwelling is destroyed and ends 4 years after the close of the taxable year in which gain is first realized. Because *A* purchased a new principal residence within this period at a cost ($130*x*) that was not less than the sum of the insurance proceeds ($120*x*) and the sales proceeds ($10*x*), *A* may defer recognition of the entire $30*x* gain. *A*'s basis in the new principal residence is $100*x* ($130*x* cost less $30*x* unrecognized gain).

LAW AND ANALYSIS—ISSUE (2)

Section 163(a) allows a deduction for all interest paid or accrued within the taxable year on indebtedness. Section 163(h)(1) generally provides that, in the case of taxpayers other than a corporation, no deduction is allowed for personal interest. Section 163(h)(2)(D) specifically excludes from the definition of the term ''personal interest'' any qualified residence interest.

Section 163(h)(3)(A) provides that the term ''qualified residence interest'' means any interest paid or accrued during the taxable year on acquisition or home equity indebtedness with respect to any qualified residence of the taxpayer. Section 163(h)(4)(A)(i) defines the term ''qualified residence'' to mean (I) the taxpayer's principal residence, within the meaning of § 1034, and (II) one other residence of the taxpayer selected by the taxpayer for purposes of § 163(h) for the taxable year and used by the taxpayer as a residence.

In *Situation (1)*, *A*'s property will continue to be treated as a qualified residence under § 163(h) for purposes of *A*'s deduction of the interest that *A* paid on the mortgage debt until the date on which *A* sold the property.

In *Situation (2)*, *B* began and completed reconstruction of the dwelling, and reoccupied it as *B*'s principal residence, all within a reasonable period of time after it was destroyed. Accordingly, *B*'s property will continue to be treated as a qualified residence under § 163(h) for purposes of *B*'s deduction for the interest that *B* paid on the mortgage debt during that period. *See* H.R. Rep. No. 99–426, 99th Cong., 1st Sess. 299 (1985), 1986–3 C.B. (Vol. 2) 299 (accompanying the Tax Reform Act of 1986, which enacted § 163(h)).

HOLDINGS

(1) If the dwelling portion of the taxpayer's principal residence is destroyed and the remaining land portion of the principal residence is subsequently sold within the period described in § 1033(a)(2)(B), the sale is treated as part of the involuntary conversion of the principal residence to which § 1033(a) applies to defer recognition of gain realized on the sale if the requirements of that section are met.

(2) If the taxpayer subsequently sells the land portion of the principal residence described above within a reasonable period of time after the destruction, the property will continue to be treated as a qualified residence under § 163(h) during the period between the destruction of the dwelling and the sale of land. Likewise, if the taxpayer reconstructs the destroyed dwelling and reoccupies it as the taxpayer's principal residence within a reasonable period of time after the destruction, the property will continue to be treated as a qualified residence under § 163(h) during that period.

Holdings (1) and (2) apply whether or not the destruction occurred in connection with a Presidentially declared disaster. These holdings also apply if the property is a second residence within the meaning of § 163(h)(4)(A)(i)(II).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 74–206, 1974–1 C.B. 198, is clarified to provide that, in the context of a casualty involving a taxpayer's residence, a taxpayer need not allocate the basis of the taxpayer's residence between the house and the land to compute a § 165 casualty loss deduction or the gain eligible for deferral under § 1033, but instead may use the aggregate basis of the house and the land.

DRAFTING INFORMATION

The principal author of this revenue ruling is George Wright of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Wright on (202) 622-4950 (not a toll-free call).

Section 1034.—Rollover of Gain on Sale of Principal Residence

26 CFR 1.1034–1(c)(3): Property used by the taxpayer as his principal residence.

If a principal residence is destroyed and either the remaining portion is sold or the dwelling is

reconstructed and reoccupied, within a reasonable period of time after the destruction or damage, is the property treated as a principal residence within the meaning of § 1034, and therefore as a qualified residence under § 163(h) during a reasonable period between the destruction of the dwelling and its sale or reconstruction and reoccupation as a qualified residence? See Rev. Rul. 96–32, page 5.