Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B02
PLR-125117-05

Date:
January 23, 2007

In re: letter ruling request regarding casualty loss deduction

Legend

Taxpayer:

Lease:

Original Property:

Date 1:

Date 2:

Agreement:

Lessor:

Date 3:

Date 4:

Casualty Event:

Amount 1:

Date 5:

Replacement
Property:

B:

X percent:

Dear :

This is in response to your letter dated Date 1, and your amended letter, dated Date 2, filed on behalf of the above-named taxpayer, in which you request the following rulings:

1. Taxpayer will be allowed a loss deduction under § 165 of the Internal Revenue Code equal to the excess of (a) the cost of replacing the property that Taxpayer is obligated to replace pursuant to Lease over (b) the property damage insurance proceeds from the casualty payable to Taxpayer.

2. The deduction described in paragraph 1 will be allowed to Taxpayer in the year or years in which Taxpayer actually expends funds to replace the property in excess of the property damage insurance proceeds from the casualty payable to Taxpayer.

FACTS & REPRESENTATIONS

Taxpayer is a limited liability company that uses an overall accrual method of accounting. Taxpayer entered into Lease of Original Property with Lessor on Date 3.[1] Under the terms of Lease, Taxpayer was responsible for maintaining and repairing Original Property, as well as paying

[1] For purposes of this letter ruling, the term "Taxpayer" includes Taxpayer acting through one or more business entities disregarded as entities separate from Taxpayer for federal income tax purposes.

taxes. Taxpayer was also obligated to procure and maintain various types of insurance coverage for Original Property, including fire and property damage insurance. If the Original Property was either damaged or destroyed by casualty, Lease required Taxpayer to replace the Original Property

. To the extent that the proceeds from the insurance policies were insufficient to cover the costs of replacement, Taxpayer was solely responsible for all additional costs.

The Original Property was destroyed by Casualty Event. Prior to the destruction, Taxpayer spent approximately Amount 1 for leasehold improvements.

Taxpayer filed claims with its insurers and has received some insurance proceeds, but Taxpayer and the insurance companies continue to dispute property damage insurance coverage. Taxpayer anticipates that the replacement costs will exceed the amount of insurance proceeds it expects to receive.

Taxpayer has provided the following representations concerning tax ownership: a) Taxpayer was not the owner of the Original Property for federal tax purposes; b) Taxpayer will not treat itself as the tax owner of the Replacement Property; c) Taxpayer had and will have no right to acquire title to the Original or Replacement Property; and d) Taxpayer did not enter into any informal or formal agreements concerning renewal of Lease. For purposes of this letter ruling we assume, without ruling, that Lessor, not Taxpayer, was the tax owner of the Original Property, and that Taxpayer has and will

have a depreciable interest to the extent of Amount 1 of leasehold improvements that were made prior to the casualty, as well as to the extent of amounts, if any, required to be capitalized as a result of the replacement activity and future leasehold improvements.

LAW & ANALYSIS

Issue 1. Casualty Loss Deduction

Section 1.165-7(a)(1) of the Income Tax Regulations states in part that any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under § 165(a) for the taxable year in which the loss is sustained.

Section 263(a) provides that no deduction is allowed for any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property.

Sections 263A(a) and (b) provide that a taxpayer that produces real property must capitalize into the basis of the property both the direct costs of the property and the share of indirect costs properly allocable to the property. Section 263A(g) provides that the term “produce” includes construct, build, install, manufacture, develop, or improve. Section 1.263A-1(e)(3)(iii)(D) provides that losses under section 165 and the regulations thereunder are indirect costs that are not required to be capitalized under section 263A.

In Rev. Rul. 73-41, 1973-1 C.B. 74, an individual taxpayer entered into a lease of residential property in 1969, pursuant to which the taxpayer was required to return the property at the end of the lease term in good order and condition. In 1970, shortly before the lease expired, a fire damaged the property. The loss was not covered by insurance, and the lessee did not surrender the property in good order and condition. The lessor sued the lessee, the parties settled, and judgment was entered for the lessor. The lessee paid the judgment in 1971. The revenue ruling holds that the payment (in excess of the $100 limitation on casualty losses of personal-use property) is deductible in 1971 as a casualty loss under § 165(c)(3) (which permits casualty loss deductions for personal-use, as well as business or investment assets), since “the loss sustained upon payment of the judgment was directly attributable to the fire.”

Rev. Rul. 73-41 was published to update and restate the position set forth in I.T. 3850, 1947-1 C.B. 20, after the enactment of the 1954 Code. The facts in I.T. 3850 are identical to the facts in Rev. Rul. 73-41. In its rationale, I.T. 3850 cited I.T. 2150, IV-1 C.B. 147 (1925), which, like the present case, involved a commercial lessee that replaced leased property destroyed by a casualty pursuant to its obligation under the lease. I.T. 2150 was declared obsolete by Rev. Rul. 67-123, 1967-1 C.B. 383, on the basis that the ruling position is covered by § 165 and § 1.165-7.

Issue 2. Timing of Deduction

The timing of Taxpayer's loss deduction is affected by two rules: (1) under § 165, the loss must be sustained; and (2) under § 461, the requirements that pertain to accrual-basis taxpayers, including the economic performance requirement in § 461(h), must be satisfied.

Section 165(a) states that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 1.165-1(d)(1) provides that a loss shall be allowed as a deduction under § 165(a) only for the taxable year in which the loss is sustained.

Section 1.165-1(d)(2)(i) provides that if a casualty or other event occurs which may result in a loss and, in the year of the casualty or event, there exists a claim for reimbursement for which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not the reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim.

In the present case, Taxpayer will not sustain a loss for purposes of § 165 for amounts covered by its claims for reimbursement, from the insurance companies or otherwise, until the tax year in which Taxpayer no longer has a reasonable prospect of recovery with respect to the claims, because they have been resolved, for example, through settlement, adjudication, or abandonment.

Section 1.461-1(a)(2)(iii)(B) provides that if the liability of a taxpayer is subject to certain Code provisions, including §§ 165(e), 165(i), and 165(l), the liability is taken into account as determined under that section and not under § 461 or the regulations under § 461. Because the loss in the present case is not described in § 165(e), 165(i), or 165(l), § 461 and the corresponding regulations apply. *See* FI-54-93, 1993-2 C.B. 615 (July 1993).

Sections 1.446-1(c)(1)(ii)(A) and 1.461-1(a)(2)(i) provide that under an accrual method of accounting, a liability is incurred and generally is taken into account for Federal income tax purposes in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h)(2)(B) provides that if the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance occurs as the taxpayer provides the property or services. Section 1.461-4(d)(4)(i) provides that in such a case, economic performance occurs as the taxpayer incurs costs (within the meaning of § 1.446-1(c)(1)(ii)) in connection with the satisfaction of the liability.

Economic performance will occur in the present case in the tax years that Taxpayer incurs costs, in excess of the insurance proceeds or other reimbursement it receives or reasonably expects to receive, in connection with the satisfaction of its replacement obligation. Taxpayer will incur costs as Taxpayer provides services or property in connection with its replacement obligation, or as services, property, or the use of property necessary to fulfill the replacement obligation are provided to Taxpayer by other persons or entities. *See* § 1.461-4(d)(7), Examples 1-3.

CONCLUSIONS

Based on the information submitted and representations made, we conclude that:

1. In accordance with Rev. Rul. 73-41, Taxpayer is entitled to deduct as a casualty loss under § 165(a) its basis, if any, in the Original Property and/or leasehold improvements destroyed by the casualty, as well as the costs it incurs to satisfy the uninsured and unreimbursed portion of its replacement obligation. The overall amount deductible under § 165 cannot exceed the value of the Original Property and leasehold improvements immediately prior to the casualty, reduced by reimbursements received or to be received, . Taxpayer must capitalize any costs it incurs to the extent, if any, the Replacement Property exceeds that value.

2. Under §§ 165 and 461, Taxpayer may deduct the replacement costs in the tax year or years in which it incurs costs, in excess of insurance proceeds or other reimbursement that Taxpayer either receives or has a reasonable prospect of receiving, to provide services or property to Lessor in connection with Taxpayer's replacement obligation.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in

support of the request for rulings, it is subject to verification on examination. This letter ruling is limited to the matters specifically addressed. No opinion is expressed as to whether Taxpayer or Lessor is the owner of the Original Property or the Replacement Property for federal tax purposes. No opinion is expressed as to the tax treatment relating to . No opinion is expressed as to the tax treatment of the transactions considered in this ruling, or any conditions existing at the time of, or effects resulting from, those transactions, under the provisions of any sections of the Code or regulations not specifically addressed in this ruling.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. Please attach a copy of this letter ruling to the federal income tax return for the taxable year or years in which the casualty loss will be taken into account.

Sincerely,

Lewis J. Fernandez
Associate Chief Counsel
(Income Tax & Accounting)

By: _____
ANDREW M. IRVING
Senior Counsel, Branch 1
(Income Tax & Accounting)

Enclosures (2)
Copy of this letter
Copy for section 6110 purposes