Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200734021**
Release Date: 8/24/2007

CC:ITA:B05
PRENO-109073-07

UILC: 121.04-00

date: May 23, 2007

to: Associate Area Counsel (SBSE)
Attn: Susan S. Canavello,
Managing Counsel, OCC
New Orleans, LA

from: William A. Jackson, Chief Branch 05
(Income Tax & Accounting)

---

subject: Destruction of Principal Residence for purposes of IRC section 121(d)(5)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND:

Taxpayer:

ISSUE

Absent an actual sale or exchange of the property, has the damage to Taxpayer's principal residence under the facts described below resulted in its "destruction" within the meaning of section 121(d)(5) of the Code, which is treated as a sale of the property for purposes of section 121?

CONCLUSION

For purposes of section 121(d)(5) of the Code, whether the *destruction* of a taxpayer's principal residence has occurred is a question of fact. Based on the facts of this case, the level of damage to Taxpayer's principal residence results in its destruction for purposes of

section 121(d)(5) and thus, the property may be treated as sold for purposes of section 121.

FACTS

Taxpayer's property was substantially damaged as a result of a natural disaster. The property was damaged to such an extent, that it must practicably be rebuilt. Although components of the residential structure remain standing, subsequently enacted land use regulations essentially require deconstruction followed by elevation, total first floor and roof, and near total second floor reconstruction at an expense exceeding the fair market value of the entire property prior to the disaster. The fair market value of the property prior to the damage in question is estimated at $250,000. The fair market value after the disaster is estimated at $75,000. Taxpayer's adjusted tax basis in the property is $170,000, and the costs of repair are estimated at $359,000. Taxpayer received $359,000 in insurance and other proceeds, and will receive $40,000 in excludible section 139(g) hazard mitigation payments.

Taxpayer meets the ownership and use requirements of section 121(a) of the Code, and is aware that the recognition of gain may be deferred under the provisions of sections 1033(a)(2) and 1033(b). However, Taxpayer has inquired whether he may treat the involuntary conversion as itself a 'sale' under section 121(d)(5).

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived, including gain derived from dealings in property. See section 61(a)(3). The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); 1955-1 C.B. 207. Gross income does not, however, include receipts of all kinds. For example, recoveries of capital, or basis, or amounts representing compensation for damages of property, are not accessions to wealth unless they exceed basis.

Section 1016(a)(1) of the Code provides that proper adjustment shall be made to the basis of property for expenditures, receipts, losses, or other items properly chargeable to capital account.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain. Section 1011(a) provides generally that the adjusted basis for determining gain from the sale or other disposition of property is the basis determined under section 1012 (cost), adjusted as provided in section 1016. Under section 1016, basis is adjusted by expenditures, receipts, losses, and other items properly chargeable to capital account. Under section 1001(c), the entire amount of gain must be recognized, except as otherwise provided.

Section 1033(a)(2)(A) of the Code provides, in part, that if property (as a result of its destruction *in whole or in part* (emphasis added), theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money, and, during the period specified in section 1033(a)(2)(B), the taxpayer purchases property similar or related in service or use to the converted property, at the election of the taxpayer, gain will be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property.

Section 121(a) provides that a taxpayer may exclude gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, the taxpayer has owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more. Under section 121(b) of the Code, the amount of gain excludable under section 121 is limited to $250,000 for single taxpayers and $500,000 for married taxpayers filing a joint return. Section 121(c) permits pro-ratable exclusions in the case of certain sales or exchanges occurring by reason of unforeseen circumstances (e.g., involuntary conversions).

Under section 121(d)(5)(A) (Involuntary Conversions) the *destruction* (emphasis added), seizure or condemnation of property is treated as a sale of the property for purposes of section 121. Section 121(d)(5)(B) provides that, in applying section 1033, the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to section 121, reduced by the amount of gain not included in gross income pursuant to section 121.

Under section 121(d)(5)(A) the destruction of property is treated as the sale of the property for purposes of section 121. The statute and legislative history are silent regarding the legislative intent behind the term "destruction" as used in section 121(d)(5)(A). Further, we have found no case law defining the term for purposes of section 121. Moreover, the term "destruction" is not specifically defined for other purposes in the Code. Absent Subtitle E (Alcohol, Tobacco and certain other excise taxes), the word "destruction" is only used in the Code where a section may expressly apply to either partial or total destruction. For example, many sections of the Code use the phrase "destruction in whole or in part" (such as, sections 143 (mortgage revenue bonds), 512(a)(3)(D) (unrelated business taxable income for exempt organizations), 1033 (involuntary conversions), 1231 (long-term capital gain includes involuntary conversions of property used in a trade or business). This suggests that the term destruction may encompass both partial and complete destruction when specified. However, the lack of this common phrase in section 121 may indicate that Congress specifically intended the deemed sale rule of section 121(d)(5)(A) to apply only to a *complete destruction* (emphasis added).

Other Code sections use the phrase "destruction or damage" (such as, sections 451(d) (destruction of crops) and 1400L (tax credit for New York Liberty Zone). This suggests that the term destruction is distinguishable from damage and does not encompass partial destruction.

Because section 121(d)(5)(A) does not expressly apply to a partial destruction, we read section 121 to apply solely to a complete destruction, e.g., *in whole*, of the residence. There is no definition of complete destruction in the Internal Revenue Code. Therefore, other sources must be referred to in determining the meaning of this term.

In construing a statute, courts generally seek the plain and literal meaning of its language. United States v. Locke, 471 U.S. 84 (1985). More specifically, words in a revenue act generally are interpreted in their "'ordinary, everyday senses.'" Commissioner v. Soliman, 506 U.S. 168, 174 (1993) (quoting Malat v. Riddell, 383 U.S. 569, 571 (1966) (quoting Crane v. Commissioner, 331 U.S. 1, 6 (1947))); see also Helvering v. Horst, 311 U.S. 112 (1940) ("common understanding and experience are the touchstones for the interpretation of revenue laws"). The meaning of the term destruction is "to ruin the structure" or "to put out of existence." Merrian-Webster Online Dictionary, http;//www.m-w.com/dictionary/destruction (last visited Aug. 28, 2006). See James A. Ballentine, Ballentine's Law Dictionary, 3rd Edition 343 (1969) (defining destruction as "a wrecking, tearing down, breaking up, or burning up"). Cf. C.G. Willis, Inc. v. Commissioner, 41 T.C. 468 (1964) (stating that involuntary conversion within the meaning of section 1033(a), means that "the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes"); Rev. Rul. 80-175, 1980-2 C.B. 230; Williamette Indus., Inc. v. Commissioner, 118 T.C. 126 (2002).

The use of the term "destruction" in the above sources suggests that, in the case of a residence, complete destruction occurs when the residence is damaged to the extent that the remaining structure cannot be utilized to advantage in restoring the property to its prior condition. Thus, one factor to consider in determining if a complete destruction of a taxpayer's principal residence has occurred is whether, based on this plain and literal meaning of the term "destruction", the residence is damaged to the extent that the remaining structure cannot be utilized to advantage in restoring the property to its prior condition.

Another factor to consider in determining complete destruction of property is whether the cost of repair substantially exceeds the fair market value of the property prior to its damage. In such a case, it may not be economically feasible to repair property that has already sustained partial destruction. The lack of economic feasibility of repairing damaged property is a factor suggesting complete destruction of the property.

Although we have found no legal authorities under section 121 that consider the economic feasibility of repair in determining the destruction of property, it is helpful to consider authorities regarding involuntary conversions under section 1033. In Revenue Ruling 80-175, 1980-2 C.B. 230, taxpayers sold timber that had been damaged as a result of a hurricane. The ruling holds that gain from the sale of the damaged timber was eligible for nonrecognition under section 1033. The rationale in the ruling for including the downed timber as property that was involuntarily converted was that the sale of the downed timber was dictated by the damage caused by the hurricane: "the downed timber was not

repairable, and was generally no longer useful to the taxpayer in the context of its original objective." The ruling distinguished this situation from the case in C.G. Willis, Inc. v. Commissioner, 41 T.C. 468 (1964), where the court considered application of section 1033 of the Code to the proceeds of the sale of a partially damaged ship, which, along with insurance proceeds, was reinvested by the taxpayer in property similar or related in service or use. The court in that case denied the claim for nonrecognition treatment because, since the ship was repairable, "[i]t cannot be said that the sale of the unrepaired ship was a RESULT of its partial destruction." 41 T.C. at 475.

Thus, in the context of section 1033, the lack of economic feasibility of repair can result in the sale of partially damaged property being treated as part of the involuntary conversion of the property. Similarly, it would seem reasonable to consider economic feasibility of repair of a damaged principal residence in determining whether the damage amounts to a complete destruction for purposes of section 121(d)(5).

Whether damage to a taxpayer's principal residence is sufficient to result in its destruction for purposes of section 121(d)(5) is a factual determination. In this particular case, there are sufficient facts and circumstances to conclude that Taxpayer's property was destroyed, *in whole*, as a result of the disaster. It is not required under the above rationale that the taxpayer's principal residence be completely destroyed by or at the time of the catastrophic event, only that its complete destruction be caused by such event. A residential structure that must be essentially deconstructed prior to reconstruction, has been destroyed for purposes of section 121(d)(5). From the information presented, it appears that Taxpayer's principal residence was damaged to such an extent that the remaining structure cannot be utilized to meaningful advantage in restoring the property to its prior condition. The fact that Taxpayer will nonetheless choose to reconstruct his principal residence at the same location does not vitiate this conclusion. Further, the cost of repairing the Taxpayer's residence in this case substantially exceeds the fair market value of the residence prior to the catastrophic event, thus making repair economically unfeasible. The law does not require taxpayers to make uneconomic choices.

Assuming no additional basis adjustments or casualty loss considerations, Taxpayer's gain on the transaction/deemed sale is $189,000 (($359,000 - $170,000 = $189,000). Since this amount is less than $250,000, all gain may be excluded from such deemed 'sale' under section 121(a). Section 121(d)(5)(B) provides that, in applying section 1033, the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to section 121 ($359,000), reduced by the amount of gain not included in gross income pursuant to section 121 ($189,000), or $170,000, which is Taxpayer's basis in the property. Accordingly, for purposes of section 1033, were it to be applicable, Taxpayer has no gain to defer.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Thank you for soliciting our views in this matter. If you have any questions concerning this memorandum, please contact us at (202) 622-4960.