NATURAL DISASTER, TAX DISASTER?

Tax implications of a destroyed property insurance settlement for both taxable and tax-exempt clubs

By James J. Reilly, CPA, JD

Although the formation of hurricanes is possible throughout the entire year, the U.S. Atlantic hurricane season begins in June and ends in November. Few natural disasters contain the destructive force of a hurricane, which can have sustained winds in excess of 150 miles per hour. Tornadoes can also occur at any time in the United States, but tornado season in the Midwest and surrounding areas generally occurs from April through July. Violent tornadoes can have winds in excess of 200 miles per hour.

Although winds from strong tornadoes may exceed the winds from strong hurricanes, hurricanes generally cause much more damage because the destructive core in hurricanes can be many miles wide. In addition, hurricanes are long in duration and cause damage from powerful winds, storm surges and flooding due to rainfall. Tornadoes, in contrast, are generally a few hundred yards in diameter, short in duration and typically cause damage from heavy rain, large hail and powerful winds. Hurricanes and tornadoes take a terrible toll on the affected communities, and as evidenced by news reports, it is not uncommon for a hurricane or a tornado to destroy club property:

- ***Pensacola Country Club:*** First clubhouse was destroyed in the Hurricane of 1906, which had winds of 105 mph;
- ***Hibiscus Golf Club:*** Hurricane Andrew resulted in more than 500 fallen trees, damage to irrigation control boxes and 10,000 feet of water lines *(1992)*;
- ***Mountain Lake Golf Club:*** In excess of 2,000 trees were "uprooted, destroyed or damaged beyond recovery" during Hurricane Charley *(2004)*;
- ***Lakewood Golf & Country Club:*** Heavy damage to the golf course and clubhouse due to Hurricane Katrina *(2005)*;
- ***Hamilton Farm Golf Club:*** Lost power and 150 trees were downed or damaged in Hurricane Sandy *(2012)*; and
- ***Lake Panorama National:*** Fifty mature trees were uprooted or sustained significant damage in tornado *(2014)*.

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Fortunate Clubs

Fortunate clubs, those clubs whose officers and directors had the foresight and financial ability to insure the club's property, may receive insurance proceeds in connection with the destruction of club property. Are such proceeds taxable?

It is not unusual for an officer or director of a club to contact the club's tax advisor regarding the receipt of insurance proceeds in connection with hurricane or tornado damage to the clubhouse or golf course. A club's management is often comprised, in part, by volunteer officers and directors who are experienced tax accountants and attorneys or who have access to such persons at their respective accounting or law firms. When such persons approach the club's tax advisor, it is not uncommon for them to have already considered the issue of the taxability of insurance proceeds under Internal Revenue Code ("IRC") § 1033, which is not an unusual statutory provision to contemplate, especially with respect to taxable clubs, but not necessarily for tax-exempt clubs.

Taxable Clubs

The receipt of insurance proceeds by a club is, as a general matter, a taxable event. In the case of insurance proceeds received in connection with the destruction of property, the taxable income is not the amount of the insurance proceeds, but the taxable amount is the excess of the insurance proceeds over the tax basis of the property destroyed. Simply stated, a taxable gain may result when an insurance settlement is greater than the destroyed property's cost basis.

IRC § 1033(a)(2) provides, in part, that if property (as a result of its destruction in whole or in part) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, gain (if any) shall be recognized, except as provided. Emphasis added.

With respect to insurance proceeds, the goal of a club's management, as a general matter, is to avoid having the club taxed on insurance proceeds used to restore the club's property to pre-natural disaster condition. Yet, in attempting to accomplish such goal, club management has to wrestle with the inherent limitations contained in IRC § 1033 with respect to replacement property and reinvestment period. If certain criteria is met, the club may be relieved from recognition of taxation with respect to such gain.

IRC § 1033(a)(2)(A) provides that if the taxpayer, during the period specified, for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer, the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property. Such election shall be made at such time and in such manner as the Secretary may by regulations prescribe. Emphasis added.

The non-recognition of gain provisions inherent in IRC § 1033 are long-standing. In Revenue Ruling 55-517, a corporation suffered extensive damage to its property as a result of the Hurricane of 1954, and the amount of insurance payments it collected for damages exceeded the basis of the property damaged. The corporation elected to use the insurance proceeds to replace the damaged property. Pursuant to such election, the corporation acquired a parcel of land and entered into a contract with a contractor to build a structure similar in service and use to the property destroyed. The cost of the new construction exceeded the insurance proceeds received from the involuntary conversion.

The ruling acknowledged that the non-recognition of gain provisions of IRC § 1033, as they relate to involuntary conversions of property, provide, in effect, that where property is compulsorily or involuntarily converted and the taxpayer, during the replacement period specified, purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer, the gain shall be recognized only to the extent that the amount realized from such conversion exceeds the cost of the replacement property.

Replacement Period

Club management should be mindful that the replacement period with respect to reliance on IRC § 1033 is limited. IRC § 1033(a)(2)(B) provides, in part, that the replacement period shall be the period beginning with the date of the disposition of the converted property and ending:

- Two years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or
- Subject to such terms and conditions as may be specified by the Secretary.

Similar or Related Use

In the case where property is converted into money (insurance proceeds), a club may elect not to recognize gain by a timely replacement of the converted property with, as a general matter, property that is similar or related in service or use.

The similar or related use statutory requirement with respect to the involuntary conversion of property (property that is completely or partially destroyed, for example, by natural disaster, including hurricanes and tornadoes) may be a challenge to comply with because neither the IRC or the treasury regulations promulgated thereunder define "similar or related in service or use," but case law and IRS rulings provide club management with some guidance. Generally speaking, similar or related in service or use requires:

- The reinvestment must be made in substantially similar business property;
- The reinvestment must be a reasonably similar continuation of the prior commitment of capital and not a departure from it;

- The replacement property need not exactly duplicate the converted property but the character of the investment is not permitted to be changed; and
- The transaction permits a club, whose enjoyment of its property is interrupted without its consent, to arrange to have that interruption ignored for tax purposes by returning as closely as possible to the club's original position.

The following IRS rulings and/or cases should be considered in contemplating "similar in use" property:

- Improved property immediately converted into a parking lot replacing a parking lot. The purchased property is suitable for the use for which the converted property was employed. *(Rev. Rul. 58-245).*
- Improved property where the improvements had no value replacing unimproved land. In this case, it was noted that the improvements, consisting of shoddy structures, had a negative value because they reduced the value of the land. *(William A. Scheuber TC Memo 1966-107, rev'd on another issue, 371 F.2d 996 (1967))*
- Two buildings used for a particular purpose replaced with one building used for the same purpose. *(Cotton Concentration Co. v. Commissioner, 4 B.T.A. 121 (1926))*
- Land requiring clearing before use as a building site replacing a cleared building site. *(Gaynor News Co., Inc. v. Commissioner, 22 T.C. 1172 (1954))*
- Replacing the equipment of a land based fish processing plant with the equipment on a fish processing vessel qualified under the similar or related use rule because the physical characteristics and end use of the equipment purchased are identical to those of the equipment destroyed. *(Rev. Rul. 77-192)*

Applying IRC § 1033

Example A

A clubhouse having an adjusted basis of $3,000,000 was destroyed by a hurricane. The insurance proceeds were $3,700,000. The taxable club purchased a new clubhouse for $4,000,000 within the time period provided by IRC § 1033. No gain should be recognized, and the basis of the new clubhouse should be computed as follows:

Insurance proceeds	$3,700,000
Adjusted basis of destroyed clubhouse	3,000,000
Actual gain	$ 700,000
Recognized gain	0
Gain not recognized	$ 700,000
Cost of new clubhouse	4,000,000
Less: Gain not recognized	700,000
Basis of new clubhouse	$ 3,300,000

Example B

A clubhouse having an adjusted basis of $3,000,000 was destroyed by a hurricane. The insurance proceeds were $3,700,000. The taxable club purchased unimproved land (not subject to a construction contract) for $4,000,000 to be used to extend its golf course within the time period provided by IRC § 1033. In Bratton v. Rountree, the court faced what it categorized as a unique situation in that the converted property was a building and the replacement property was unimproved realty. In Bratton, it was noted that the fact that these are different kinds of properties would seem to be a clear indication that IRC § 1033(a)(2)(A) does not apply. Assuming that Bratton would be applicable in this case, the $700,000 gain would likely be recognized:

Insurance proceeds	$ 3,700,000
Adjusted basis of destroyed clubhouse	3,000,000
Gain recognized	$ 700,000
Basis of new land	$4,000,000

The following IRS rulings, treasury regulations and/or cases should be considered in contemplating "not similar in use" property:

- Unimproved real estate replaced with improved real estate does not qualify under the similar or related use rule. *(Treas. Reg. § 1.1033(a)-2(c)(9)(i))*
- Replacing a bowling alley, including a lounge area and a bar, with a billiard center, including a lounge area and a bar, did not qualify under the similar or related-use rule. *(Rev. Rul. 76-319)*
- Replacing a destroyed building with unimproved real estate (with no verifiable intent to construct a building) did not qualify under the similar or related use rule. *(Bratton v. Rountree, 37 AFTR 2d 76-762)*
- Replacing a land based fish processing plant and general store with a fish processing vessel and a general store did not qualify under the similar or related-use rule. *(Rev. Rul. 77-192)*

Federally Declared Disasters of Property

As a general matter, if a club replaced property that was involuntarily converted with property that was not similar or related in service, the club would recognized gain. If a hurricane or tornado overwhelmed a community and the U.S. President declared such community a disaster area, the tan-

Tax-exempt Clubs

Example C

A tax-exempt club had a clubhouse with an adjusted basis of $3,000,000 that was destroyed by a hurricane. The insurance proceeds were $3,700,000. The club purchased a new clubhouse for $4,000,000. No gain should be recognized, and the basis of the new clubhouse should be computed as follows:

Insurance proceeds	$ 3,700,000
Adjusted basis of destroyed clubhouse	3,000,000
Actual gain	$ 700,000
Recognized gain	0
Gain not recognized	$ 700,000
Cost of new clubhouse	4,000,000
Less: Gain not recognized	700,000
Basis of new clubhouse	$ 3,300,000

In this case, the result under IRC § 1033 (see Example A) with respect to a taxable club is similar to the result under IRC § 512(a)(3)(D) for a tax-exempt club.

Example D

A tax-exempt club had a clubhouse with an adjusted basis of $3,000,000 that was destroyed by a hurricane. The insurance proceeds were $3,700,000. The tax-exempt club purchased unimproved land to be used to extend its golf course for member use for $4,000,000. In GCM 39397, it was noted that in connection with the non-recognition of gain rules set forth in IRC § 512(a)(3)(D), the replacement property need not be similar in nature, or in use, to the old property. The only requirement in the statute is that the property purchased by the club must be used directly in the performance of the club's exempt function.

Insurance proceeds	$ 3,700,000
Adjusted basis of destroyed clubhouse	3,000,000
Actual gain	$ 700,000
Recognized gain	0
Gain not recognized	$ 700,000
Cost of golf course improvements	4,000,000
Less: Gain not recognized	700,000
Basis of new land	$ 3,300,000

The result under IRC § 1033 (see Example B) with respect to a taxable club is very different to the result, in this case, under IRC § 512(a)(3)(D) for a tax-exempt club.

gible replacement property acquired, and held for productive use in a business by the club, would be treated as similar or related in service or use.

IRC § 1033(h)(2) provides that if property held for productive use in a trade or business or for investment 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 shall be treated as property similar or related in service or use to the converted property so converted. Emphasis added.

The legislative history of IRC § 1033(h)(2) advises that this provision provides relief to businesses by allowing them to reinvest their funds in any tangible business property without being forced to recognized gain. The treatment afforded by IRC § 1033(h)(2) is beneficial because it relaxes the similar or related in service or use standard and broadens the scope of replacement property available to be acquired to replace the destroyed property. If a club receives insurance proceeds because of the destruction caused by a hurricane, tornado or other disaster, club management should investigate, along with the club's tax adviser, to determine if the club is in an area covered by a presidential declaration of federal disaster.

Tax-exempt Clubs

As previously noted, it is not unusual for an officer or director of a club to contact its tax advisor regarding the receipt of insurance proceeds in connection with hurricane or tornado damage to the clubhouse or golf course to discuss an IRC § 1033 analysis. Is that the preferable approach for a tax-exempt club?

Tax-exempt clubs are, as a general matter, not subject to the payment of income taxes because IRC § 501(c)(7) provides for the exemption from federal income tax of clubs organized and operated exclusively for pleasure, recreation, and other non-profitable purposes. The tax exemption for social clubs was designed to allow individuals to join together to provide themselves with social or recreational activities and facilities without tax consequences, and social clubs are exempted from tax not as a means of conferring tax advantages, but as a means of ensuring that the members are not subject to tax disadvantages as a consequence of their decision to pool their resources for the purchase of social or recreational services (*Portland Golf Club v. Commissioner, 110 S. Ct. 2780 (1990)).*

Consistent therewith, tax-exempt social clubs are not taxed on their member income. Member income, which is also known as exempt function income, includes dues, fees, charges or similar amounts paid by members of the social club as consideration for providing members and their dependents and guests with goods, facilities or services in furtherance of the exempt purpose of the social club.

The unrelated business taxable income (UBTI) provision for tax-exempt clubs is more broadly drafted than the UBTI provisions applicable to many other exempt organizations. With limited exceptions, non-member revenues received by tax-exempt clubs are subject to the UBTI.

IRC § 512(a)(3) — with respect to tax-exempt clubs, the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less allowed deductions which are directly connected with the production of the gross income (excluding exempt function income), computed with permitted modifications.

What if a tax-exempt club receives insurance proceeds because of damage to the club from an insurance company? A complicating factor for a tax-exempt club that receives insurance proceeds because of the destruction of the club's property is that insurance payments are sourced to nonmembers. Based on the preceding discussion, it seems clear that insurance proceeds are not exempt function income. Are the insurance proceeds taxable to the tax-exempt club?

The first impression with respect to a tax-exempt club that receives revenues from a nonmember, an insurance company, in connection with the destruction of its exempt use property is that such revenues would be subject to the UBTI. That being said, it seems that Congress anticipated this type of occurrence and provided a mechanism to defer UBTI in such case.

IRC §512(a)(3)(D) states that if property used directly in the performance of the exempt function of tax-exempt club is sold, and within a period beginning one year before the date of such sale, and ending three years after such date, other property is purchased and used by such club directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such club's sales price of the old property exceeds the club's cost of purchasing the other property. For purposes of this provision, the destruction in whole, or in part, of property shall be treated as the sale of such property. Emphasis Added.

A simple example of the IRC § 512(a)(3)(D) non-recognition of gain provision is set forth in Internal Revenue Manual 7.27.7.4.: A social club sells its clubhouse. The gain on the sale will not be taxed if the entire proceeds are reinvested in a new clubhouse within three years. *(S. Rep. No. 91–552, 91st Cong., 1st Sess. 72 (1969), 1969–3 C.B. 470.)*

IRC § 512(a)(3)(D) does not specify the type of other property that must be purchased in order for a club to avoid paying taxes when it receives insurance proceeds because of the destruction of its property. Furthermore, the treasury regulations do not address the matter. Yet, it seems reasonable, based on the plain language of IRC § 512(a)(3)(D), to conclude that the only statutory requirement is that some other property must be purchased by the club and used directly in the performance of the club's exempt function, but it is always comforting if there is precedential guidance available. Fortunately, there is such guidance:

- In Atlanta Athletic Club v. Commissioner, 980 F.2d 1409 (11th Cir. 1993), the club realized a gain from the sale of land that was used by its members for pleasure and recreation: running, jogging and other club activities. The proceeds from the sale of land were used for the construction of a tennis center and renovation of a clubhouse, both of which were used for the pleasure and recreation of club members.
- In Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985), the Tax Court held that IRC § 512(a)(3)(D) does not require the purchase of property that is similar in kind or use to the property sold.

Furthermore, in the event that there are no final or temporary regulations in place to address a particular issue, it is not unusual for the Internal Revenue Service's Office of General Counsel to look to proposed regulations in determining its position on an issue. In General Counsel Memorandum ("GCM") 39397, August 13, 1985, the Internal Revenue Service ("IRS") Exempt Organizations Technical Division referred to Proposed Treasury Regulations § 1.512(a)-3(e) (withdrawn) which advised that "[t]he other property need not be similar in nature or in use to the old property." In GCM 39397, it was noted that the statute is broad and requires only that other property be purchased and used directly in the performance of the exempt function.

Tax-exempt clubs are generally more fortunate than taxable clubs because of the availability of a longer reinvestment period (four years) and greater latitude with respect to the scope of reinvestment property.

Further Consultation

The consequences to taxable clubs of using insurance proceeds to acquire property that is not similar or related in service to the destroyed property may result in significant income tax liabilities for such clubs. Similarly, the consequences of improper reliance on the non-recognition of gain provision available to tax-exempt clubs may also result in significant income tax liabilities. You would be well served to consider the information contained herein, but also because of the complexities of the tax rules associated with the receipt of insurance proceeds in connection with natural or other disasters, it is imperative that clubs consult with their tax professionals in a timely manner. ■