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Uninsured Casualty Losses Are Within the Scope of I.R.C. Section 1231—*E. Taylor Chewning**

Petitioners reported[1] profits from the sale of breeding cattle as a long-term capital gain under section 1231 of the Internal Revenue Code.[2] In the same return, petitioners deducted from ordinary in-

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* 44 T.C. 678 (1965), *appeal docketed*, P-H FED. TAX SERV. ¶ 56494 (4th Cir., Nov. 12, 1965) (hereinafter cited as principal case).

1. Petitioners are husband and wife, who filed a joint federal income tax return for the taxable year in question (1960).

2. Section 1231(a) of the 1954 Internal Revenue Code provides in part:

"(a) GENERAL RULE—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection—

. . .

"(2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

"In the case of any property used in the trade or business and of any capital asset held for more than 6 months and held for the production of income, this subsection shall

come, under section 165(c)(3),[3] losses sustained from the destruction of their uninsured residential shrubbery. The Commissioner disallowed the casualty-loss deduction from ordinary income, ruling that the loss was subject to the netting provisions of section 1231 and that, since the sale profits exceeded the casualty losses, the loss was to be characterized as a capital loss to be offset against the capital gain. Contrary to previous federal court decisions,[4] the Tax Court sustained the Commissioner's position, holding that uninsured casualty losses of capital assets held for more than six months and neither used in the taxpayer's trade or business nor held for the production of income are subject to section 1231.

With respect to individuals, uncompensated losses are traditionally deductible under section 165(c)(3) if incurred as a result of fire, storm, shipwreck, or other casualty.[5] Petitioner's loss, which was caused by a severe snowstorm, falls squarely within this provision and therefore, absent other considerations, would be deductible from ordinary income. The Tax Court recognized the applicability of section 165,[6] but nevertheless maintained that section 165 was preempted by section 1231, which requires the netting of all recognized gains and losses from (1) sales or exchanges of depreciable and real property used in the taxpayer's trade or business,[7] (2) compulsory

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not apply to any loss, in respect of which the taxpayer is not compensated for by insurance in any amount, arising from fire, storm, shipwreck, or other casualty, or from theft."

3. Section 165 of the Code provides in part:

"(a) GENERAL RULE—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

. . .

"(c) LIMITATION ON LOSSES OF INDIVIDUALS—In the case of an individual, the deduction under subsection (a) shall be limited to—

"(1) losses incurred in a trade or business;

"(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

"(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. . . ."

4. See Maurer v. United States, 284 F.2d 122 (10th Cir. 1960); Killebrew v. United States, 234 F. Supp. 481 (E.D. Tenn. 1964); Morrison v. United States, 230 F. Supp. 989 (E.D. Tenn. 1964); Oppenheimer v. United States, 220 F. Supp. 194 (W.D. Mo. 1963); Hall v. United States, Civil No. 4218, E.D. Tenn., Aug. 22, 1964.

5. See note 3 *supra*.

6. Indeed, to fall within § 1231, a loss *must* first come within § 165, since § 1231(a)(1) provides that "in determining under this subsection whether gains exceed losses, . . . the losses described therein shall be included only if and to the extent taken into account in computing taxable income . . . ." See Treas. Reg. § 1.1231-1(g) Ex. 3 (1957).

7. Section 1231(b) provides in part:

"(1) GENERAL RULE—The term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

"(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

or involuntary conversions of such property, and (3) compulsory or involuntary conversions of capital assets held more than six months. The section stipulates that if the gains exceed the losses, each transaction will be characterized as a "capital" transaction, whereas if the losses exceed the gains, each will be characterized as resulting in an ordinary loss or an ordinary gain.

Petitioners' contention that their loss did not fall within section 1231 is understandable, for a careful analysis of section 1231 leaves unresolved the issue of whether there is a conversion, within the meaning of that section, when the loss is *wholly uncompensated* by insurance or otherwise. First, the language of the statute itself is ambiguous. Section 1231(a) speaks of "the recognized gains from the compulsory or involuntary conversion . . . of capital assets . . . *into other property or money*"[8] and "the recognized losses from such . . . conversions." Subsection (2), however, merely states that "losses upon . . . destruction, in whole or in part, theft or seizure, or requisition or condemnation . . . shall be considered losses from a compulsory or involuntary conversion," omitting the qualifying phrase, "into other property or money." One could logically contend that the use of the phrase "into other property or money" in section 1231(a) was designed to limit the scope of the section to those losses for which there was at least some compensation. On the other hand, it may be argued with equal logic that the omission of the qualifying phrase in subsection (2), which specifically enumerates the losses which are to be considered losses from conversions, is indicative of an intent to extend the definition of conversion, in the case of losses, to those for which there is no *quid pro quo*.

Second, the legislative history of section 1231 is not helpful in determining whether compensation by money or other property is a material element of the definition of conversion, for neither the purpose of the section nor the contemporary explanation for its enactment goes to this question. The predecessor of section 1231[9] was added to the 1939 Code in 1942 to allow taxpayers whose property had been seized, destroyed, or condemned by the government a capital gain rather than an increase in ordinary income, because the involuntary gains which were realized in these transactions were frequently not indicative of an increased ability to replace converted property, and, in addition, because such involuntary gains were subjected to the higher tax rates prevailing during the war years.[10] The

"(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . ."

8. Emphasis added.

9. Int. Rev. Code of 1939, § 117(j).

10. See 3B Mertens, Federal Income Taxation § 22.123 (1958); Surrey & Warren, Federal Income Taxation 714 n.1 (1960).

discussion of "involuntary conversions" in the committee reports accompanying the bill is based on the presumption that the destruction, requisition, or condemnation would be covered by insurance or otherwise,[11] but Congress was then preoccupied with justifying its extension of capital treatment of net gains and not with its continuation of ordinary treatment of net losses. In addition, it should be noted that despite the limited circumstances of, or motivation for, its origin, the section was phrased in general terms which are susceptible to broad interpretation.

The third source of uncertainty stems from an interpretative dispute between the Internal Revenue Service and the federal courts. The Service has consistently maintained that compensation in money or other property is not a prerequisite to the inclusion of a loss within section 1231. Following the enactment of the section, the Regulations noted that losses incurred as a result of destruction, theft, seizure, requisition, or condemnation of capital assets are included "whether or not there was a conversion of such property into money or other property."[12] Although the Regulations construing section 1033, the only other section of the Code dealing with involuntary conversions, adhere to the concept of compensation as a material element of a conversion,[13] these regulations are not inconsistent with those of section 1231, for section 1033 concerns only gains while section 1231 includes both gains and losses. Although compensation must necessarily be received if the transaction is to result in a gain, compensation is not a necessary element when the transaction results in a loss.

The majority of the federal courts, on the other hand, have taken a position contrary to that of the Service.[14] In the leading case of *Maurer v. United States*,[15] the Court of Appeals for the Tenth Circuit held that where a taxpayer does not receive money or other property as compensation for a loss, the loss cannot be considered a "conversion" within the meaning of section 1231. The court noted that section 1231 is "contextually similar to the sections dealing with capital gains and losses"[16] and reasoned that whereas a compensated loss is a "taxable event closely akin to a 'sale or exchange,' albeit an involuntary one,"[17] a wholly uncompensated loss presents a distin-

11. H.R. REP. No. 2333, 77th Cong., 2d Sess. 53-54 (1940), 1942-2 CUM. BULL. 372, 415. Two of the examples which are noted are the gains from the sale of trawlers used in the taxpayer's business and gains from the proceeds of insurance on destroyed property.

12. Treas. Reg. 103 (1939 Code), § 19.117-7 (1943), 1943 CUM. BULL. 314, 327.

13. Treas. Reg. § 1.1033(a)-1 (1957) states: "An 'involuntary conversion' may be a conversion into similar property or into money or into dissimilar property."

14. See cases cited note 4 *supra*.

15. 284 F.2d 122 (10th Cir. 1960), *nonacq.*, Rev. Rul. 61-54, 1961-1 CUM. BULL. 398.

16. 284 F.2d at 124.

17. *Ibid.*

guishable factual situation. This reasoning, however, fallaciously assumes that Congress is bound by the "sale or exchange" rule of section 1222 and would be unable to extend capital-gain treatment unless the transaction were "akin to a 'sale or exchange.' "[18] The court's treatment of the Regulations presents an additional difficulty. The court dismissed the Regulations as being "inapplicable" on the ground that the Regulations deal only with conversions, while the jury had determined that the loss in question was a casualty loss.[19] By distinguishing the Regulations in such a situation, the court in effect declared them invalid, despite its recognition of the presumption of the validity of the Regulations in statutory construction.[20]

Thus, the legislative, administrative, and judicial treatment of section 1231 has failed to produce a rational, consistent articulation of the scope of the section. More recent legislative developments, however, have dealt specifically with this question, and have consistently supported the position taken by the Service. In 1958, Congress amended section 1231 to exclude specifically from the scope of the section uncompensated losses, but *only* with respect to the loss of property used in a trade or business and capital assets held for the production of income.[21] The amendment was enacted to alleviate an undue hardship on business taxpayers who choose, because of special characteristics of their businesses, to be self-insurers;[22] not only are their losses total losses, but, more important, the premiums they would have paid to an outside insurer could have been deducted from ordinary income under section 162 as an ordinary and necessary business expense.[23] Although the self-insurers of *non-business* capital assets also suffer a total loss, their premiums, had they

18. See, *e.g.*, INT. REV. CODE OF 1954, §§ 1232, 1234-35, 1240-41. Moreover, there is some question whether the "sale or exchange" rule is either necessary or desirable. See 3B MERTENS, FEDERAL INCOME TAXATION § 22.91 (1958); SURREY & WARREN, FEDERAL INCOME TAXATION 655-56 (1960).

19. 284 F.2d at 124.

20. The weight to be accorded the Regulations is, of course, open to dispute. Given the ambiguity of § 1231, it is debatable whether the Regulations should be given greater or lesser weight. In addition, it should be noted that the Regulation in question has remained in force, with insignificant modifications, for twenty-two years and was in effect in 1954 when Congress reenacted § 117(j) as § 1231. However appropriate this question may be in this context, the Tax Court's decision in the principal case nevertheless ultimately disposes of the question without significant reliance on the Regulations.

21. Technical Amendments Act of 1958, § 49(a), Pub. L. No. 85-866, 72 Stat. 1606. See INT. REV. CODE OF 1954, § 1231(a). The relationship between this amendment and *Maurer* is quite curious. The loss in *Maurer* occurred in 1954, the amendment was passed in 1958, and the *Maurer* decision was rendered in 1960. The holding in *Maurer* may be strictly limited to its facts since, because of the date of the loss, the court in 1960 was forced to apply pre-1958 law.

22. See S. REP. No. 1983, 85th Cong., 2d Sess., 1958-3 CUM. BULL. 995-96.

23. See INT. REV. CODE OF 1954, § 162: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

chosen to insure their property, would not have been deductible under section 162 or any other provision of the Code.[24] Hence, the underlying rationale of excluding uncompensated business losses is not applicable to uncompensated non-business casualty losses. Thus, since Congress assumed that under pre-1958 law all losses from destruction, requisition, or condemnation were included within section 1231, and since the language of the exclusionary clause is specifically limited to business and income-producing assets, it is clear, at least since the 1958 amendment, that uncompensated non-business casualty losses are within the scope of section 1231.[25]

Moreover, during the past session of Congress the question was raised again, and in August 1965 the House of Representatives passed H.R. 7502,[26] which would amend section 1231(a)(2) to state explicitly that losses, for the purpose of section 1231(a), include wholly uncompensated casualty losses. The committee report on H.R. 7502 notes that the purpose of the amendment is to make it clear, despite *Maurer*, that losses from destruction, theft, seizure, requisition, or condemnation are to be offset against gains treated as capital gains pursuant to section 1231 except to the extent that such losses are explicitly excluded by the 1958 amendment.[27] Although the report concludes with the statement that "no inference should be drawn from this amendment, or its effective date . . ."[28] as to treatment of casualty losses arising prior to the enactment of the bill, the report, read in its entirety, assumes that H.R. 7502 codifies rather than changes the law.[29] Passage of the bill by the Senate would thus be, in effect, an explicit affirmation of the Tax Court's decision in the principal case.

The Tax Court's interpretation of section 1231 is both logical and desirable. The philosophy of the provision is to entitle the taxpayer to the best of two worlds, but not to dispense unwarranted preferential treatment. Absent section 1231, net gains from involuntary conversions would be treated as ordinary income, and net losses would be treated as ordinary losses.[30] With section 1231, net gains are taxed at capital rates while net losses continue to be deducted from ordinary income. Congress could have permitted capital treatment for each gain and ordinary treatment for each loss occurring in the same year, but chose instead to establish a netting provision, thereby indicating its intention to limit the preferential capital-gain

24. INT. REV. CODE OF 1954, § 262.

25. See 1958-3 CUM. BULL., *supra* note 22, at 1124-25.

26. H.R. 7502, 89th Cong., 1st Sess. (1965). The bill was passed by the House on August 3, and referred to the Senate Finance Committee on August 4, 1965.

27. H.R. REP. No. 556, 89th Cong., 1st Sess. 4 (1965).

28. *Id.* at 5. The amendment is to apply to losses sustained after the date of its enactment.

29. *Id.* at 4.

30. See INT. REV. CODE OF 1954, § 1222.

treatment to *net* gains only. Thus, when a taxpayer is subjected to two involuntary conversions during a taxable year, one of which results in a gain and the other in a loss, it is equitable, if the gain exceeds the loss, for the loss to be offset against the gain. Furthermore, the Tax Court's discrediting of the *Maurer* distinction between compensated and wholly uncompensated losses[31] eliminates the need to justify the inclusion within section 1231 of a loss which is only minimally compensated while excluding one which is uncompensated. To exclude the non-insurer while including the partial insurer would be to give discriminatory preference to the non-insurer without any apparent basis for distinguishing between the two.

An analysis of section 1231 indicates that the *Maurer* departure was undesirable, and, if adhered to today, would be an unwarranted precedent. The Tax Court's decision in *Chewning* marks a rational articulation of the scope of the section, consistent with legislative intent. Senate passage of H.R. 7502 can dispel any remaining doubt that uncompensated casualty losses of capital assets neither used in the taxpayer's trade or business nor held for the production of income are losses from an involuntary conversion within the meaning of section 1231.

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31. 284 F.2d at 124.