



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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CONEX-158088-04

Attention:

Dear

This letter is in response to your inquiry to \_\_\_\_\_ dated October 26, 2004, on behalf of your constituents in \_\_\_\_\_. Homeowners in \_\_\_\_\_ asked if they must include in income payments they receive from a corporation as reimbursement for the reduced market value of their homes due to chemical contamination, and, if so, how they should report these payments on their federal income tax returns.

In general, payments from the corporation are not income to individual homeowners, but represent a return of capital to the extent the recovery does not exceed a homeowner's basis in the damaged property. Homeowners must, therefore, reduce their individual bases in the damaged property by the amount of the payment. If, however, the recovery exceeds a homeowner's basis in the damaged property, the law considers any excess capital gain.

Taxpayers may elect to defer gain they receive for the partial destruction of property if they purchase other property similar or related in service or use to the converted property within a specified period, and meet the other requirements of § 1033 of the Internal Revenue Code. If taxpayers make this election, they recognize gain only to the extent that the amount realized exceeds the cost of the replacement property. The IRS has held that damage from chemical contamination that renders property unfit for its intended use is a "destruction" for purposes of § 1033. Thus, taxpayers are eligible to make this election if the chemical contamination caused a partial destruction of the property under § 1033.

In addition, taxpayers may exclude up to \$500,000 of gain on the sale of their principal residences if they meet the requirements of § 121 of the Code. If the chemical contamination results in a partial destruction of the principal residence, taxpayers may exclude gain that they realize on the damage payments under § 121.

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I hope this information is helpful. If you have any further questions, please call  
, Identification Number , at .

Sincerely,

Robert M. Brown  
Associate Chief Counsel  
(Income Tax and Accounting)