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Involuntary Conversions

by

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TAX MANAGEMENT
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Involuntary Conversions

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Involuntary Conversions*, No. 568-5th, analyzes the tax problems that arise in connection with involuntary conversions resulting from the theft, destruction, seizure, requisition, or condemnation of property. Where property is condemned or is lost through theft, fire, or a similar event and the owner receives compensation for such "involuntarily converted" property, taxable gain normally results to the extent the value of the compensation exceeds the basis of the converted property. Section 1033 is a relief provision that allows the taxpayer to defer the recognition of gain.

The basic rules are as follows:

1. Where the taxpayer receives property similar or related in service or use to the involuntarily converted property, no gain is recognized on the involuntary conversion, and the new property takes the same basis as the old property.

2. Where the taxpayer receives cash or other proceeds to compensate for the involuntary conversion of the property, the taxpayer may elect not to recognize the gain if the taxpayer thereafter reinvests the proceeds in property that is similar or related in service or use to the converted property. The basis of the new property normally will be the same as the basis of the old property if all the proceeds are reinvested in the new property.

The Portfolio also discusses business interruption insurance and disaster relief payments, gives examples of involuntary conversions, explains the threat or imminence of condemnation, describes similar property, and reviews severance damages, separate awards, and replacement periods. The relationship between the investment credit, accelerated depreciation and recaptures is also discussed.

For a further discussion of involuntary conversions due to a casualty, see 527 T.M., *Loss Deductions.* See 594 T.M., *Tax Implications of Home Ownership,* for a discussion of the special rules applicable to the condemnation of a residence.

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I. Introduction

A. General Rule of §1033 — Deferral of Gain

Under §1001(c),[1] gain or loss realized from the sale or other disposition of property must generally be recognized. An important exception to this general rule is provided by §1033, which allows gain realized from certain involuntary conversions of property to be recognized or deferred at the taxpayer's election. As used in §1033, an "involuntary conversion" of property results from the property's destruction (in whole or in part), theft, seizure, requisition or condemnation, or sale made under threat or imminence of requisition or condemnation.

When the property is directly converted into property "similar or related in service or use" through an exchange, nonrecognition of gain is mandatory under §1033(a)(1).

When the property is converted into money or property not similar or related in service or use through receipt of insurance proceeds, a condemnation award, or upon qualifying sales, deferral of gain is accomplished if the taxpayer: (1) so elects; and (2) timely purchases qualified replacement property.[2] Qualified replacement property generally is property "similar or related in service or use" to the property converted.[3] However, where certain real property has been involuntarily converted, the replacement property may instead be of a "like kind" to the property converted and still qualify for gain deferral under §1033.[4] Regardless of whether the replacement property is similar in service or use or of like kind to the property converted, complete deferral of the conversion gain is available only when the entire amount of the monetary proceeds received on account of the conversion is reinvested. If only part of the amount of the monetary proceeds is reinvested, gain is recognized to the extent of the nonreinvestment.[5]

Because §1033 defers the recognition of gain, its election is often desirable. Nevertheless, the "price" of §1033 deferral is a lowered basis in the replacement property.[6] This lowered basis reduces subsequent depreciation deductions under §168.

Example: Robert's truck, which he purchased for business use in 20X4 for $15,000, was stolen in 20X9. Robert's insurer, Lo-Reserve Mutual, paid Robert $33,000 in 20X9. The transaction, ignoring §1033 and basis adjustments resulting from depreciation, would produce gain to Robert of $18,000 (proceeds of $33,000 less basis of $15,000). If Robert makes a valid §1033 election and reinvests $33,000 in a new truck, his realized gain will be deferred under §1033(a)(2)(A). Section 1033(b) requires a reduction of his cost basis in the new truck ($33,000) by the deferred gain ($18,000), leaving him a basis of $15,000 in the new truck.

Example: If, on the other hand, Robert reinvested only $25,000 in the new truck, he would have to recognize $8,000 ($33,000 proceeds less reinvestment of $25,000) of his realized gain of $18,000. His basis in the new truck would be his $25,000 cost, less nonrecognized gain of $10,000 (realized gain of $18,000 less recognized gain of $8,000), or $15,000. His recognized gain is subject to §1245 recapture and characterization under §1231.

Example: Assume the same facts as in the first example, except that Robert does not elect §1033 treatment. Upon reinvestment, Robert has a new §1012 cost basis of $33,000, for which depreciation deductions may be taken. His gain realized on the conversion, $18,000, must be recognized currently and is subject to §1245 recapture and §1231 characterization.

B. Losses on Involuntary Conversions Not Affected by §1033

Note: On July 4, 2025, the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, was enacted, making amendments to §165(h)(5). The legislation permanently extends the casualty loss deduction limitation and expands the limitation to include state-declared disasters. The changes apply to taxable years beginning after Dec. 31, 2025. This content is in the process of being updated for the changes. For additional coverage, see the OBBBA, §70109, the OBBBA roadmap, and the OBBBA watch page.

Section 1033, by its literal terms, applies only to "gain" realized from involuntary conversions. Accordingly, §1033 does not apply to losses, and any loss is recognized, or not recognized, under other Code provisions applicable to losses, i.e., §1231 and/or §165, and, possibly, §1211 and §1212.[7] As a gen-

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

[2] §1033(a)(2).

[3] §1033(a)(2)(A). *See also* Rev. Rul. 2005-46 (qualifying business that receives a grant payment under the state's program to reimburse losses that the qualifying business incurred for damage or destruction of real and personal property may elect to defer including in income gain realized from receipt of the grant under §1033 to the extent the grant proceeds (or other funds in lieu of the grant proceeds) are used to timely purchase property similar or related in service or use to the destroyed or damaged property).

[4] §1033(g). *E.g.*, when the converted property is real property held for productive use in a trade or business or for investment.

[5] §1033(a)(2)(A). *See, e.g., Allen v. Commissioner*, T.C. Memo 1998-406 (settlement amounts received from property insurer qualify for nonrecognition because payments were intended to compensate taxpayers for actual damages incurred in involuntary conversion of their property; amounts were used, in substantial part, to restore property to its original condition and any enhancements were de minimis); PLR 201252010 (gain on monetary reimbursement for public utility's removal and relocation of transmission structures eligible for deferral if amounts received are reinvested in similar or related use property within replacement period).

[6] *See* §1033(b).

[7] §165(f); Reg. §1.1033(a)-1(a). Thus, no loss can be recognized on the condemnation of a personal residence. *Seletos v. Commissioner*, 254 F.2d 794

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eral matter, the loss must be taken into account at the time of the disposition and may not be deferred; reinvestment in replacement property is irrelevant.[8]

Example: Gerry owned an investment building that he purchased in January 20X5. Following a fire in February 20X9, when the adjusted basis was $120,000, he recovered $98,000 in insurance proceeds. In September 20X9, he constructs a replacement building for $128,000. Assuming Gerry has no other §1231 transactions (see I.C., below), the $22,000 loss ($120,000 adjusted basis less $98,000 proceeds) is deductible as an ordinary loss under §1231(a) and §165(c)(2). The reinvestment has no effect on the recognition of loss.

Example: Anne owned investment real property for seven months when the Army threatened to condemn it. The property's adjusted basis is $200,000. Anne's best third-party offer is $175,000, which is more than the $168,000 offered by the Army. Anne sells to the third party for $175,000. Because the sale is made under threat of condemnation, recognition of gain could have been deferred under §1033. Anne's loss of $25,000 (adjusted basis of $200,000 less sale proceeds of $175,000) is not within §1231(a) because she held the property for less than one year. The loss is deductible as a short-term capital loss under §165(c)(2), but subject to the annual limits of §1211(b).

Note: The following discussion concerning §165(h) should be read in light of the temporary limitation imposed by §165(h)(5)[9] with regard to taxable years beginning after December 31, 2017, and before January 1, 2026. Under this limitation, any personal casualty loss otherwise deductible is deductible only to the extent it is attributable to a Federally declared disaster as defined in §165(i)(5).

Section 165(h) may impact certain involuntary conversions described in §1033 because if personal casualty gains for a tax year exceed personal casualty losses, then all such gains and losses are treated as arising from the sale or exchange of capital assets.[10] An involuntary conversion subject to §165(h) is one that: (1) arises from fire, storm, shipwreck, or other casualty, or from theft; and (2) affects property other than property connected with a trade or business or a transaction entered into for profit.[11] Such an involuntary conversion is automatically excluded from the reach of §1231 (discussed in I.C., below). Whether some, all, or none of the taxpayer's net personal casualty gain for a particular year will be entitled to long-term capital gain treatment depends on how long the taxpayer held those particular assets before the casualty and on the taxpayer's other capital transactions for the tax year.[12]

If personal casualty losses exceed personal casualty gains, such losses are allowed under a tiered approach. First, the personal casualty losses are allowed to the extent of any personal casualty gains as a deduction in computing adjusted gross income.[13] The effect, of course, is a wash. Generally, personal casualty losses in excess of personal casualty gains are allowed only to the extent net casualty losses exceed 10% of adjusted gross income.[14]

From time to time, Congress modifies the personal casualty loss limitation rules to provide relief to taxpayers affected by a hurricane or other natural disaster. For a detailed discussion of disaster relief legislation, see 597 T.M., *Tax Incentives for Economically Distressed Areas.*

The result of these statutory gymnastics is that personal casualty losses in excess of the applicable floor are fully available to reduce or eliminate personal casualty gains, but once such gains have been eliminated, the remaining personal casualty losses are generally deductible only to the extent they exceed 10% of adjusted gross income:

Example: Taylor's personal use truck (which he owned for two months) is destroyed by a falling tree limb severed in a storm. The insurance on the truck compensates him at a $400 gain. In the same tax year, his personal use furniture is stolen. Taylor purchased this furniture two years before the theft. Unfortunately, the furniture is underinsured and the compensation produces a $4,400 loss. Taylor's bad luck continues, and late in the tax year, his investment real estate is condemned at a $40,000 loss. His adjusted gross income (excluding all §1231 transactions) for the year is $15,000.

Under §165(h), Taylor realizes a deductible loss of $2,400. This loss is determined by netting his personal casualty gain ($400) against his personal casualty loss after reduction for the $100 per loss deductible ($4,400 less $100, or $4,300). Of the $4,300 net personal casualty loss, the amount of loss equal to the personal casualty gains ($400) is deductible against those gains in determining adjusted gross income. The remaining $3,900 ($4,300 less $400) is deductible only to the extent it exceeds $1,500 (10% of adjusted gross income), or $2,400.

The $40,000 loss from the condemnation of real estate does not directly enter into the above calculation because it involves property connected with a transaction entered into for profit and because a condemnation is not an involuntary conversion within §165(c)(3). Instead, the condemnation is subject to §1231. Because §1231 calculations affect adjusted gross income, however, the $40,000 condemna-

(8th Cir. 1958); *Blount v. Commissioner*, 25 T.C.M. 411 (1966). *See Weyerhaeuser Co. v. United States*, 32 Fed. Cl. 80 (1994), aff'd in part, rev'd and rem'd in part, 92 F.3d 1148 (Fed. Cir. 1996), cert. denied, 117 S. Ct. 766 (1997), for an example of how casualties may simultaneously produce losses deductible under §165 and gains deferrable under §1033.

[8] *Pelican Bay Lumber Co. v. Blair*, 31 F.2d 15 (9th Cir. 1929), cert. denied, 279 U.S. 870 (1929); *Wash. Mkt. Co. v. Commissioner*, 25 B.T.A. 576 (1932), acq., XI-1 C.B. 7; *Baer v. Commissioner*, 12 B.T.A. 1060 (1928). *See Guenther v. Commissioner*, 34 T.C.M. 834 (1975). However, where the amount of the loss cannot be determined because the amount of the condemnation award is in litigation, the loss cannot be taken until the litigation is settled. *See Hill v. Commissioner*, 30 T.C.M. 534 (1971), and cases cited therein. *See also Keller Street Dev. Co. v. Commissioner*, 37 T.C. 559 (1961), acq., 1962-2 C.B. 5, aff'd, 323 F.2d 166 (9th Cir. 1963) (obsolescence loss not allowable if potential claim for severance damages exists).

[9] Added by the 2017 tax act, Pub. L. No. 115-97, §11044(a).

[10] §165(h)(2)(B).

[11] §165(h)(3)(A), §165(c)(3).

[12] *See* §1222, §1223.

[13] §165(h)(2)(A)(i), §165(h)(4)(A).

[14] §165(h)(2)(A)(ii).

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tion loss may indirectly affect the amount of adjusted gross income (and thus the 10% calculation) depending on Taylor's other §1231 transactions for the year.

Example: Assume the same facts as in the preceding example, except that Taylor's adjusted gross income (now assumed to include the loss from investment real estate and all other §1231 transactions) is $44,000. While the $4,300 personal casualty loss (after the $100 deductible) is still allowed to the extent of the $400 personal casualty gain, the balance of $3,900 is not deductible because it does not exceed $4,400 (10% of adjusted gross income).

In conclusion, §165(h) may require taxpayers who elect to recognize personal casualty gain (rather than to defer it under §1033) to net such gain with their personal casualty losses for that tax year. The result, as with gains on involuntary conversions subject to §1231, is that increased basis from recognition may be at the cost of lost ordinary income deductions. The 10% adjusted gross income limitation generally applicable to such deductions may make this an acceptable trade-off to obtain a higher basis. Of course, the taxpayer may also find that an increased basis in nondepreciable personal use assets is of little, if any, tax advantage.

For a detailed discussion of the treatment of casualty losses under §165(h), see 527 T.M., *Loss Deductions.* For a discussion of modifications of these rules for taxpayers affected by certain hurricanes or other natural disasters, see 597 T.M., *Tax Incentives for Economically Distressed Areas.*

C. Relationship with §1231

Section 1231 applies to an involuntary conversion described in §1033 if:

(1) Section 1033 is not elected, or if elected, to the extent replacement is not made;

(2) the property involuntarily converted was a capital asset or business property;

(3) the disposition is of a type specified within §1231 and not excluded from its operation; and

(4) the converted property was held for more than the applicable holding period at the time of disposition.[15]

In general, §1231 requires gains from the sale or exchange of business property and gains from involuntary conversions of business property and capital assets held for more than one year to be netted against the recognized losses from such sales, exchanges, and conversions. If gains exceed losses, the net gains are treated as gain from the sale or exchange of capital assets.[16] If losses exceed gains, the net losses are ordinary losses.[17]

Most, but not all, involuntary conversions are within §1231. Examples of conversions not within §1231 include any conversion of property held for less than one year, any conversion described in §165(c)(3) (generally, casualties to or thefts of personal use property), and any conversion of property held for sale.[18] Whether the gain resulting from such non-§1231 conversions is taxed as a capital gain if §1033 deferral is not elected depends on whether the conversion amounts to a sale or exchange of a capital asset. Under *Helvering v. William Flaccus Oak Leather Co.*,[19] insurance compensation for a loss is not a sale or exchange. A condemnation, on the other hand, is a "sale or exchange" within the meaning of relevant provisions.[20] Sales or exchanges under threat of condemnation are by their nature sales and exchanges. The netting of involuntary conversions under §1231 is done in two steps. Step One involves a comparison of (1) recognized losses arising from casualties and thefts of business property and business and investment capital assets held for more than one year with (2) the gains from such occurrences. If losses exceed the gains, the net loss is removed from the §1231 computation and is deductible as an ordinary loss under §165.[21] If such gains exceed losses, the net gains are included in Step Two of the §1231 computation. Step Two involves a netting of all other §1231 gains and losses, with a net gain producing a capital gain, and a net loss producing an ordinary loss.[22] The following examples illustrate the §1231 computation, ignoring any §1245 recapture.

Example: During the 20X9 taxable year, a truck used in Alan's delivery business for two years is destroyed by fire. Through insurance proceeds of $2,500, a gain of $2,100 is realized by Alan. If Alan elects §1033, and purchases a replacement truck in 20X9 for $2,500, the gain of $2,100 will not be recognized. Alan's basis in the replacement truck will be $400 ($2,500 cost less deferred gain of $2,100). If Alan does not elect §1033 deferral but still buys the replacement truck and has no other §1231 transactions, $2,100 will be capital gain under §1231(a) and he will have a basis of $2,500 in the new truck.

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[15] As to casualties, the disposition of the converted property would presumably occur upon the casualty. *See Central Tablet Mfg. Co. v. United States*, 417 U.S. 673 (1974). As to condemnations under state law, local law would have to be consulted; generally passage of title to and right of possession in the condemning authority have been held to be the critical elements. *E.g., 44 West 3rd St. Corp. v. Commissioner*, 39 T.C. 809 (1963), *aff'd sub nom., Wendell v. Commissioner*, 326 F.2d 600 (2d Cir. 1964). As to federal takings, see *Covered Wagon, Inc. v. Commissioner*, 369 F.2d 629 (8th Cir. 1966).

[16] §1231(a)(1).

[17] §1231(a)(2).

[18] *E.g., Young v. Commissioner*, 36 T.C.M. 165 (1977) (ordinary gain on fire destruction of newly constructed house); *Derby Heights, Inc. v. Commissioner*, 48 T.C. 900 (1967) (developer's gain on condemnation of water lines laid in prospective development held to be ordinary). *See also Lakewood Assocs. v. Commissioner*, 109 T.C. 450 (1997) (developer suffered no §1231 involuntary conversion from adverse government land use regulations, even though property value diminished); *Koziara v. Commissioner*, 86 T.C. 999 (1986), aff'd, 841 F.2d 1126 (6th Cir. 1988), cert. denied, 488 U.S. 822 (1988) (unitization order, issued under Michigan law, which permitted oil company to extract oil and gas from under taxpayers' and others' property in return for royalty payments, was not involuntary conversion under §1231 since unitization order was not seizure or requisition or exercise of power of eminent domain but, rather, regulation of extraction of oil and gas to protect parties' interests).

[19] 313 U.S. 247 (1941).

[20] *See Hawaiian Gas Prods., Ltd. v. Commissioner*, 126 F.2d 4 (9th Cir. 1942), cert. denied, 317 U.S. 653 (1942).

[21] The Step One calculation is in §1231(a)(4)(C). *See generally* Reg. §1.1231-1(e)(3).

[22] The Step Two calculation is in §1231(a)(1) and §1231(a)(2). *See generally* Reg. §1.1231-1(a).

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Example: Assume the same facts for 20X9 as in the preceding example, except that Alan's uninsured stamp collection (which he has maintained for several years as a profit-making venture) was stolen, which produces a loss of $2,000. Further, Alan has a $500 loss from the theft of personal use lawn equipment, held two years, a $200 gain from the sale of a car used in the business, and a $300 loss from the sale of certain business furniture, all acquired several years previously. Alan does not elect §1033 and purchases the same replacement truck for $2,500. His basis in the truck is its cost, $2,500. The §1231 computations are as follows:

STEP ONE
NET THEFT AND CASUALTIES

Gain on Truck	$2,100
Theft Loss	($2,000)
Net Step One Gain	$100

Because Step One produces a net gain, the Step One net gain enters Step Two.

STEP TWO
ALL REMAINING §1231 TRANSACTIONS

Net Step One Gain	$100
Car Sale Gain	$200
Furniture Sale Loss	($300)
Net Step Two Transactions	$0

Thus, there would be no offset against Alan's other income from §1231 transactions. Note that the $500 loss on the personal use lawn equipment does not enter either Step One or Step Two of the §1231 calculation.

Example: Assume the same facts as in the preceding example, except Alan elects §1033 deferral for the truck. His basis in the new truck is $400 under §1033(b) (cost of $2,500 less deferred gain of $2,100). Gain on the converted truck is excluded from the §1231 computation by virtue of the §1033 election.

STEP ONE
NET THEFT AND CASUALTIES

Theft Loss	($2,000)

Because Step One produces a net loss, it is an ordinary loss and does not enter into Step Two.

STEP TWO
ALL REMAINING §1231 TRANSACTIONS

Car Sale Gain	$200
Furniture Sale Loss	($300)
Net Step Two Loss	($100)

Because Step Two produces a net loss, it is an ordinary loss.

Under the first of the "Alan examples" above, the absence of other §1231 transactions means that Alan's decision to recognize the $2,100 gain on the converted truck produced a fair-market value basis in the replacement truck at a capital gain cost.[23] The result is altered when Alan has other §1231 transactions. Under the second "Alan example," no §1231 loss is available to offset Alan's other income because the $2,100 gain from the converted truck is netted against the $2,100 loss (theft loss of $2,000 plus Net Step Two loss of $100) from other §1231 transactions. Under the third "Alan example," the full $2,100 loss on the other §1231 transactions is available to offset Alan's other income because the gain on the truck conversion has no impact.

As the previous examples indicate, §1231 is an important factor[24] in deciding whether to elect §1033 deferral. Section 1033 gains, if not deferred, must be offset against any §1231 losses before capital gain is produced. Because §1231 net losses would otherwise offset ordinary income, the recognition of §1033 gains in a year where there are such §1231 losses means the §1231 losses offset potential capital gains rather than ordinary income. Therefore, the decision to recognize potential §1033 gain will not automatically mean increased depreciation deductions at a capital gain cost.[25]

D. Statutory History of §1033

The Code has included, since 1921,[26] a provision providing relief to taxpayers whose property has been taken involuntarily. The Treasury had promulgated regulations in 1919 achieving a similar result under the Revenue Act of 1918.[27] The impetus for both the 1919 regulations and the 1921 statute apparently was concern over items requisitioned during World War I.[28] Initially the statute provided a deduction for the amount of qualified replacement; this was changed in 1924 to a nonrecognition provision.[29] Until 1951, the statute required the conversion proceeds to be traced to the replacement property. That year, the tracing requirement was replaced with one requiring

[23] Again ignoring §1245 recapture. *See* XI., below.

[24] Another factor is whether the recognition of conversion gain increases state and local income taxes. *See* TAM 7934001. While Technical Advice Memorandums provide some guidance in determining the IRS's position on a particular issue, they may not be cited as precedent. §6110(k)(3).

[25] See the Worksheets, below, for a sample client letter outlining the considerations in electing §1033 deferral.

[26] §214(a) of the Internal Revenue Act of 1921, ch. 136, 42 Stat. 227.

[27] Reg. §45, arts. 49, 50 (1919).

[28] *See Am. Natural Gas Co. v. United States*, 279 F.2d 220 (Ct. Cl. 1960), cert. denied, 364 U.S. 900 (1960).

[29] *See* Revenue Act of 1924, §203(b)(5), ch. 234, 43 Stat. 253.

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the replacement property to be purchased.[30] In 1958, Congress added §1033(g), which generally allows converted business or investment real property to be replaced with like-kind property and still qualify for §1033 deferral.[31] The Tax Reform Act of 1976[32] added §1033(g)(4), which allows taxpayers who suffer condemnations of business or investment real property up to three years to replace it and still qualify for §1033 deferral. The Self-Employed Health Insurance Act of 1995[33] added §1033(i), which denies the application of §1033 to some acquisitions of replacement property from certain related parties. The Small Business Jobs Protection Act of 1996[34] substantially revised the rules for determining basis when the replacement property is corporate stock. Over the years, the statute has undergone several other changes of less general importance, but §1033's theme has remained the same: a taxpayer may postpone gain that is forced on him or her if the taxpayer's investment is substantially continued.[35]

[30] Pub. L. No. 82-251.

[31] Technical Amendments Act of 1958, Pub. L. No. 85-866, §46(a).

[32] Pub. L. No. 94-455, §2140(a).

[33] Pub. L. No. 104-7, §3(a)(1). The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1087, expanded the denial of the application of §1033 to any other taxpayer (including an individual) that has aggregate realized gain of more than $100,000 and acquires replacement property from a related party.

[34] Pub. L. No. 104-188, §1610(a).

[35] *See, e.g., Winter Realty & Constr. Co. v. Commissioner*, 149 F.2d 567 (2d Cir. 1945), cert. denied, 326 U.S. 754 (1946); *S.H. Kress and Co. v. Commissioner*, 40 T.C. 142 (1963), acq., 1965-1 C.B. 5; *S. & B. Realty Co. v. Commissioner*, 54 T.C. 863 (1970), acq., 1970-2 C.B. xxi.

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II. What Constitutes an Involuntary Conversion

Application of §1033 requires that property be "compulsorily or involuntarily converted." Section 1033 does not cover all transactions in which a taxpayer is deprived of property without his or her permission; rather, the provision's application is limited to the property's involuntary destruction, theft, seizure, requisition or condemnation, or disposition under threat or imminence of requisition or condemnation.[36] The principal issues regarding these transactions are discussed in this part.

Although most of the case law and rulings discussing involuntary conversions deal with §1033, authority under certain other Code sections has addressed the issue as well. These other Code sections include §165 (dealing with losses generally and especially those from casualties and thefts), §1231 (dealing with involuntary conversions of trade or business properties and capital assets held for more than the applicable holding period), §453(e)(6)(B) (excepting involuntary conversions from the rules requiring acceleration of installment notes upon dispositions to related parties), and former §44(d)(3)(B) (providing an exception to recapture of the former §44 residence credit for involuntary conversions).[37] The following analysis incorporates some of the authority under these other Code sections.

A. Theft or Destruction

1. In General

Ordinarily, we can ascertain without difficulty whether property has been destroyed or stolen. Both the legislative history of §1033[38] and subsequent IRS rulings have analogized "destruction" to "casualty." Examples of §1033 destructions include destruction of livestock by lightning,[39] destruction of livestock by poisoning,[40] and destruction of a wheat crop by hail.[41] Because the destruction need not be sudden, a progressive deterioration will constitute a §1033 destruction even though not a "casualty" within the meaning of §165(c)(3).[42] For example, in *Allen v. Commissioner*,[43] the event of involuntary conversion was the insurance settlements arising from subsidence of a home due to activities occurring on a neighbor's land. In Rev. Rul. 66-334, the IRS ruled that salt water pollution of a water supply was a §1033 "destruction." Presumably, other progressive deteriorations such as those caused by termites,[44] drought,[45] and disease[46] also would qualify as §1033 destructions. In Rev. Rul. 89-2,[47] the IRS ruled that a chemical contamination that rendered property unsafe for its intended use destroyed the property for purposes of §1033(a). However, the development of a hereditary problem, such as dwarfism in breeding cattle, does not qualify.[48]

In *Grant Oil Tool Co. v. United States*,[49] the Court of Claims held that an initial damage deposit paid by an equipment lessee for anticipated tool loss constituted proceeds from an involuntary conversion when the tools were in fact lost.

The "theft" of property is seldom subject to doubt and has a broader meaning than the technical definition of "larceny."[50] In Rev. Rul. 66-355,[51] the taxpayer's employee had wrongfully pledged common stock to secure a personal loan. When default occurred, the employee sold the stock and the taxpayer brought suit. The IRS ruled that the taxpayer could treat settlement proceeds from its suit against the employee as conversion proceeds. In PLR 8947032, a "theft" was found to occur when a publicly traded company fraudulently misrepresented its financial condition to induce two businesses into a tax-free reorganization. The IRS followed the local law defining theft to include larceny by false pretenses.[52]

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[36] §1033(a). *See* FSA 200217001 (amounts received in settlement of lawsuit for breach of contract to buy/sell property and tortious interference with contract to buy/sell property are ineligible for nonrecognition under §1033 because there was no destruction, theft, seizure, requisition, or condemnation); FSA 200049004 ("break-up" or termination fees received due to failed merger do not qualify for nonrecognition because dispositions caused by business necessity or expediency are not involuntary conversions); TAM 200625032 (infringement of trade secrets not considered involuntary conversion; taxpayer must prove that property at issue is no longer available for taxpayer's intended business purpose for property); TAM 200408027 (sale of taxpayer-subsidiary's assets by parent pursuant to FTC consent agreement was not involuntary conversion because sale was voluntary as subsidiary was party to agreement, having been incorporated by reference; purpose of §1033 is not to provide relief from dispositions required by business necessity or expediency). *See also* Notice 2002-67 (buyout of peanut quotas is not involuntary conversion); Notice 2005-51 (buyout of tobacco quotas is not involuntary conversion). However, a sale made by a taxpayer with a reasonable belief based upon official representations and surrounding circumstances that they are under threat or imminence of condemnation or requisition qualifies for the threshold requirement. *See* PLR 201924017 (broadcaster's spectrum-based content distribution rights threatened by FCC policy to force consolidation or "repacking" of frequencies; sale of rights constitutes a disposition under a threat or imminence of condemnation for purposes of §1033). *See also* PLR 201702034. The PLRs merely say that for purposes of the tax position of the transferor of the spectrum rights, to treat it as a sale forced under threat of condemnation. It doesn't require that the actual sale be to the agency forcing condemnation.

[37] Former §44 was repealed by 1984 act §474(m).

[38] *See, e.g.*, H.R. Rep. No. 486, 67th Cong., 1st Sess. (1921), 1939-1 (Part 2) C.B. 206; S. Rep. No. 275, 67th Cong., 1st Sess. (1921), 1939-1 (Part 2) C.B. 181.

[39] Rev. Rul. 195, 1953-2 C.B. 169.

[40] Rev. Rul. 54-395, as *modified by* Rev. Rul. 59-102 (cattle); Rev. Rul. 75-381(honeybees).

[41] Rev. Rul. 59-8.

[42] *See* Rev. Rul. 59-102.

[43] T.C. Memo 1998-406.

[44] Rev. Rul. 63-232.

[45] Rev. Rul. 66-303. *See also* II.D.3., below, regarding §1033(e).

[46] Rev. Rul. 57-599. *See also* II.D.2., below, regarding §1033(d). *See* PLR 8851021 (recently disabled taxpayer's inability to make renovations necessary to make home suitable for continued use did not qualify as destruction or taking within meaning of §1033).

[47] *See also* PLR 199952082 (§1033 destruction existed where taxpayer's plants and fields were rendered commercially unusable by the application of an agricultural chemical); PLR 9615041 (accidental poisoning of plants and plant beds from chemical marketed for use on plants qualifies; chemical manufacturer's denial of liability does not affect application of §1033(a)); PLR 199937050 (same); PLR 8524023 (city's contamination of property with toxic street cleaning chemical is an involuntary conversion).

[48] *See* Rev. Rul. 59-174.

[49] 381 F.2d 389 (Ct. Cl. 1967).

[50] *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956); *Nichols v. Commissioner*, 43 T.C. 842 (1965); *Gerstell v. Commissioner*, 46 T.C. 161 (1966).

[51] *See also* PLR 200239009 and PLR 200239012 (fraudulent conveyance of taxpayer's property interest constitutes involuntary conversion). *Cf. Hutcheson v. Commissioner*, 71 T.C.M. 2425 (1996) (mutual mistake of fact regarding broker's sale of taxpayer's stock was not "seizure" under §1033), TAM 200625032 (in theft of trade secrets case, theft not enough; there must be destruction/disposition of property, not just loss of income).

[52] *See also* PLR 8841019 (theft occurred when brokerage employee converted client's stock for employee's own benefit). For an example in which theft was held not to have occurred under local law, see *Hope v. Commissioner*, 471 F.2d 738 (3d Cir. 1973). *See also Warden v. Commissioner*, 69 T.C.M.

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Taxpayers have taken the position that a third party's tortious interference with a preexisting merger agreement constitutes "theft or destruction" so that the damage award would be deferrable under §1033.[53] It appears from the *Chevron Corp. v. Pennzoil Co.* case that Pennzoil acquired Chevron's stock intending to use it as replacement property for the stock of a third company that would have been acquired had the original merger proceeded. The *Chevron* case does not deal with whether the tortious interference with Pennzoil's acquisition of the third company could be a §1033 involuntary conversion; rather, it deals only with the peripheral issue of whether Pennzoil had made an adequate disclosure under the securities laws of its intent in acquiring the Chevron stock. The securities law being litigated in *Chevron* turned in part on whether §1033 would require Pennzoil to obtain "control" of Chevron before its gain could be deferred, because Pennzoil would have obtained "control" in the original acquisition of the third company. No reported authority decides the underlying question of whether a tortious interference with a preexisting business relationship could be a §1033 involuntary conversion. Accordingly, taxpayers should proceed cautiously until the matter is definitively resolved.

As indicated above, §1033 requires not only that destruction occur, but also that the destruction occur beyond the taxpayer's control. Thus, in Rev. Rul. 82-74, the IRS ruled that §1033 did not apply to a taxpayer who hired an arsonist to burn the taxpayer's building. By contrast, the case law under §165 recognizes that an element of control in the decision to relinquish property does not absolutely preclude the existence of a casualty.[54]

Note that special rules apply for damages to principal residences that occur during federally declared disasters. See VIII.F., below.

2. Partial Destruction

When a partial destruction occurs, the tax treatment of gain is somewhat more complex. If the gain on partial destruction is produced through the receipt of insurance proceeds or other direct reimbursement, there is little problem in applying §1033 to the transaction if it is wholly involuntary. However, where the gain is produced from a sale of the partially destroyed property, an issue presented is whether the subsequent sale is an involuntary conversion.

C.G. Willis, Inc. v. Commissioner[55] is perhaps the leading case in the area. In *Willis*, the taxpayer sold a ship damaged in a collision. Because the vessel could have been repaired and had previously been offered for sale, the Tax Court denied §1033 deferral. The Tax Court found that the choice between sale and repair of the damaged vessel was based on the taxpayer's preference for the replacement vessel. According to the Tax Court, §1033 deferral requires that:

> the taxpayer's property, through some outside force or agency beyond his control, … [must] no longer [be] useful or available to him … .

Because the taxpayer in *Willis* was not forced to obtain replacement property, but only preferred it, the statutory requirement that property be "compulsorily or involuntarily" converted was not met, the court reasoned. Thus, §1033 would not defer recognition of the taxpayer's gain. Similarly, in *Wheeler v. Commissioner*,[56] the taxpayer chose to demolish his building in reliance on certain promised financing. When the financing failed to materialize, the taxpayer sought §1033 deferral as to the damages he obtained in litigation. The Tax Court denied §1033 treatment, indicating that §1033 was limited to circumstances wholly beyond the taxpayer's control. In Rev. Rul. 78-377, the IRS ruled that the gain on a sale of an entire shopping center following a partial fire was not eligible for §1033 treatment because repair was a reasonable alternative to sale.[57]

In Rev. Rul. 80-175,[58] revoking Rev. Rul. 72-372, the IRS ruled that gain on the sale of timber damaged by high winds, earthquakes, and volcanic eruption is eligible for §1033 treatment. The IRS focused on the fact that the timber could not be repaired and was generally no longer useful to the taxpayer. It could be said, therefore, that the damage caused by the hurricane dictated the timber sale.[59] In PLR 8211044 and TAM 8212008, the IRS extended Rev. Rul. 80-175 to deemed timber sales under §631(a) and §631(b) which follow a destructive storm.[60] The IRS applied Rev. Rul. 80-175 in PLR 8928011 to

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2432 (1995) (taxpayer's belated allegations of theft or fraud with regard to court-ordered sale of property were held insufficient to raise colorable issue that involuntary conversion had occurred), *aff'd in unpub. opin.*, 111 F.3d 139 (9th Cir. 1997). In *Gail v. United States*, 58 F.3d 580 (10th Cir. 1995), a mineral interest had been wrongfully appropriated and the issue was whether the resulting damage recovery produced ordinary income or capital gain. The court concluded that the wrongful appropriation produced both capital gain and ordinary (i.e., royalty) income. Presumably, the capital gain portion would be eligible for §1033 deferral, while the royalty portion would not. *Cf. Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960).

[53] *See Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156 (9th Cir. 1992).

[54] *See, e.g., Clem v. Commissioner*, 62 T.C.M. 586 (1991).

[55] 41 T.C. 468 (1964), aff'd *per curiam*, 342 F.2d 996 (3d Cir. 1965).

[56] 58 T.C. 459 (1972).

[57] *Accord Kurata v. Commissioner*, 73 T.C.M. 2929 (1997) ("forced" sale of five rental condominiums was not within §1033 despite alleged soil subsidence because units remained fit for habitation); Rev. Rul. 74-532 (sale gain following continued vandalism is not within §1033). *But see* PLR 9334007 (taxpayer's age and limited financial circumstances were key factors to indicate it would not be economically feasible to replace his dwelling on same site after being destroyed by tornado; land was being redeveloped into high-priced residential subdivisions); PLR 200743010 (inability to restore hurricane damaged or destroyed property to its pre-casualty state because use of such property is no longer either economically or physically viable allows taxpayer to treat voluntary sale as proceeds from involuntary conversion). Willens, *IRS Ruling Offers Economic Viability of Replacement as Consideration in Deferring 'Involuntary Conversion' Gain*, 225 BNA Daily Tax Rpt. J-1 (Nov. 23, 2007).

[58] *See* PRENO-11606-07 (citing Rev. Rul. 80-175, IRS Chief Counsel advised that treatment of proceeds of buyout program arising from settlement of post-Hurricane Katrina oil spill litigation as either elective or qualifying under §1033 must be determined on case-by-case basis).

[59] *Accord* PLR 8040045. *But see* TAM 9209006, where the National Office advised that a taxpayer's decision to cut and remove hurricane-damaged trees was a forest management decision and did not constitute an involuntary conversion. In the TAM, the taxpayer was devoted to the preservation of forests, marshes, and other real estate in their natural state. A hurricane caused extensive damage to the taxpayer's forest. In the most affected areas, the taxpayer cut the damaged trees to allow for restoration and sold the timber. The National Office explained that, because the taxpayer did not intend to use the forest for timber production, but rather managed the forest for preservation purposes, the presence of the timber was incidental to the taxpayer's use of the forest and the taxpayer was, therefore, not compelled to sell it. Citing *Willis*, the National Office concluded that the sale of wood was a voluntary sale and therefore was not an involuntary conversion.

[60] Section 631(a) allows a taxpayer to elect to treat the cutting of timber as a sale or exchange; §631(b) allows a taxpayer to treat a transaction in which an economic interest in timber is retained (or an outright sale of timber is made after 2004) as a sale or exchange. In *Weyerhaeuser Co. v. United States*, 32 Fed.

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an earthquake-damaged hospital. Because the cost of repairs to make the building safe for occupancy exceeded the building's value before the earthquake, the taxpayer had no practical choice to repair. Thus, §1033 could be used to defer gain from the sale of the property.

In *Williamette Industries, Inc. v. Commissioner*,[61] the Tax Court extended the holding of Rev. Rul. 80-175 to a situation in which the taxpayer, a forest products manufacturer, elected to salvage and process damaged trees into end products rather than sell them. Like the taxpayer in Rev. Rul. 80-175, the court reasoned, this taxpayer was forced to salvage or sell its trees before maturity because of damage that occurred outside of its control. Thus, the court held that the taxpayer was entitled to defer the portion of the gain attributable to the difference between its basis and the fair market value of the damaged trees at the time the salvage operation began.

In Rev. Rul. 96-32, the IRS ruled that §1033 nonrecognition treatment applied to the voluntary sale of land upon which the taxpayer's destroyed dwelling had been located. The land's subsequent sale was treated as part of a single involuntary conversion of the dwelling and not as a separate transaction. The IRS relied on Reg. §1.165-7(b)(2)(ii), which provides that in determining the amount of casualty loss for residential real property and improvements thereon, the improvements are considered an integral part of the residential property, so that no separate basis need be apportioned to such improvements.[62]

As pointed out in *Willis*, the critical inquiry as to post-casualty sales is whether the taxpayer has a choice of keeping the property or selling it. If the choice exists, §1033 has no application to sale gain. Whether that choice exists turns in part on whether it is economically feasible to restore or repair the damaged property. A second factor is whether the taxpayer made efforts to sell the property before the casualty. The taxpayer should be particularly wary of selling the undamaged portion if that portion is extensive in relation to the damaged portion. See the discussion in II.B.3.b., below.

B. Seizure, Requisition, or Condemnation

1. Seizure

The term "seizure" within §1033(a) is probably best interpreted as a "confiscation," i.e., when a governmental authority enters into physical possession of property without prior court approval or payment of compensation.[63] Few cases exist that apply §1033 to seizures, presumably because the usual nonpayment of compensation makes §1033 unnecessary, and because sales under "threat or imminence" of seizure are not eligible for §1033 treatment. In Rev. Rul. 54-594,[64] however, the IRS ruled that enemy aliens, whose property had been seized and then sold at a gain during World War II, could defer such gain under §1033 if a proper replacement were made.

2. Requisition or Condemnation

a. In General

Considerably more authority applies §1033(a) to requisitions and condemnations. Over the years, these terms within the context of §1033 have come to mean the compensable acquisition of an estate in property by a governmental or quasi-government entity for a public use.[65] That is, a §1033 requisition or condemnation is a taking that requires the payment of just compensation under the Fifth Amendment.[66] At one point, Rev. Rul. 54-575[67] required that "practically all" of the beneficial interest in a property be taken to defer gain under §1033.[68] Rev. Rul. 72-433 modified Rev. Rul. 54-575 to delete the "practically all" requirement. Thus, over the years, condemnations for §1033 purposes have encompassed the grant of perpetual air rights over property adjacent to an air base,[69] the involuntary grant of a perpetual right to flood property,[70] the grant of an easement and a right of way to an electric utility for transmission lines,[71] the grant of a scenic easement,[72] the involuntary imposition of restrictive covenants preventing the taxpayer from using the land for business purposes,[73] and the acquisition of an easement through the land itself.[74] In PLR 8301042 and

Cl. 80 (1994), aff'd in part, rev'd and rem'd in part, 92 F.3d 1148 (Fed. Cir. 1996), GCM 39152 (Dec. 4, 1981), and PLR 8851034, outright sales of timber damaged by natural disaster were deemed to qualify for nonrecognition treatment under §1033(a) notwithstanding the application of §631(a) and §631(b).

[61] 118 T.C. 126 (2002).

[62] *Cf.* Reg. §1.165-7(b)(2)(i) (loss incurred in trade or business or in any transaction entered into for profit is determined by reference to separate fair market value and basis of each single, identifiable property damaged or destroyed). *See also Weyerhaeuser Co. v. United States*, 32 Fed. Cl. 80 (1994), aff'd in part, rev'd and rem'd in part, 92 F.3d 1148 (Fed. Cir. 1996).

[63] *See* Rev. Rul. 79-269. *See also Recio v. Commissioner*, 61 T.C.M. 2626 (1991) (threat of foreclosure is not "seizure" of property). *See also* Rev. Rul. 72-1 (foreign government's confiscation of U.S. corporation's stock in foreign corporation through nationalization is involuntary conversion); CCA 201002035 (foreign regional electric utility's refusal to agree to terms for connecting power plant project to regional power grid was not seizure); CCA 200246015 (aviation easements considered property involuntarily converted by authority pursuant to seizure under §1033(a) or §1033(g)); PLR 200714002 (escheat of corporate stock by state government under its unclaimed property law and subsequent sale of stock was seizure; seizure was involuntary despite possible negligence by taxpayer). PLR 200946006 (both seizure requirement and involuntary requirement of §1033(a) were satisfied when stock that was left unclaimed escheated to state and was sold, and trustee of entity entitled to stock failed to claim it before escheatment because trustee was not aware of stock's existence).

[64] On the other hand, compensation paid by the German government for property seized before and during World War II is exempt from taxation under the U.S.-German Income Tax Treaty. *See* Notice 95-31.

[65] PLR 200627024 provides an excellent general background discussion of requisitions and condemnations, and contrasts the concept of a "taking" with a valid exercise of "police powers." *See also* PLR 200644019.

[66] *Am. Natural Gas Co. v. United States*, 279 F.2d 220 (Ct. Cl. 1960), cert. denied, 364 U.S. 900 (1960); *Behr-Manning Corp. v. United States*, 196 F. Supp. 129 (D. Mass. 1961); Rev. Rul. 69-254, Rev. Rul. 58-11.

[67] *Modified by* Rev. Rul. 72-433.

[68] *Cf.* Rev. Rul. 38, 1953-1 C.B. 16 (condemnation of only a five-year leasehold is not eligible for §1033 treatment), discussed below in II.B.4.

[69] Rev. Rul. 54-575. See PLR 9148025, where the sale of a mobile home park qualified as an involuntary conversion when a city acquired an aviation easement over the land and imposed restrictive covenants preventing use of land for residential purposes. The IRS explained that the restrictive covenants not only make it impractical for the taxpayer to use the land for business purposes, but specifically prohibit such use and, therefore, it considered the voluntary sale of the land an involuntary conversion.

[70] Rev. Rul. 72-433. *Compare* Rev. Rul. 72-433 *with* Rev. Rul. 70-510 (voluntary grant of right to flood property required recognition of gain). *See also* PLR 200219006.

[71] Rev. Rul. 72-549.

[72] Rev. Rul. 76-69.

[73] PLR 200219006, PLR 9148025.

[74] Rev. Rul. 60-69. In PLR 9248025, the IRS ruled that the taking of a temporary 12-year easement to build a road was within §1033. *See* II.B.4., below.

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GCM 39182,[75] the loss of an exclusive right to use a railroad track was an involuntary creation of an easement that qualified as a taking of property within the meaning of §1033. In PLR 199911048, the enactment and implementation of federal legislation requiring a unilateral change to the price terms of a pre-existing long-term timber cutting contract qualified as a taking within the meaning of §1033. In PLR 200644019, the FCC instituted a spectrum reallocation plan to improve the communication capabilities of the nation's public safety first responders. Under the plan, incumbent broadcast auxiliary services (BAS) broadcasters, including the taxpayer, were required to relocate to different and narrower frequency assignments. That requirement constituted a taking; the relocation necessitated, and the FCC order required, taxpayer to cease using certain of its existing equipment. In FAA 20082803F, the IRS Chief Counsel advised that implementation of FCC policies requiring broadcasters to change frequencies, rendering their broadcasting equipment obsolete and requiring them to replace their equipment, constituted involuntary conversions.[76] In PLR 201609003, at private expense, a government contractor constructed, acquired, and operated various facilities (i.e., public accommodation buildings, retail shops, administrative buildings, and other support buildings) on government agency land. Both the contract between the agency and contractor, and subsequent legislation, recognized the contractor's property rights in the privately funded facilities (a "beneficial ownership interest") and right to just compensation if the agency took the facilities, or if the agency granted a third party the privilege to operate the facilities. The IRS ruled that the taking of the contractor's beneficial ownership interest constituted a condemnation or requisition (i.e., an involuntary conversion).

By way of contrast, exercises of a government's power to regulate and maintain its citizens' health, well-being, and safety (i.e., its police powers) do not require compensation and are not §1033 conversions.[77] Thus, declaring property to be unfit for human habitation does not qualify for §1033 treatment,[78] nor does the failure by a governmental authority to permit zoning or structural variances.[79] Similarly, forced sales or exchanges pursuant to a state corporate statute,[80] state public utility commission order,[81] SEC order,[82] court antitrust order,[83] court divorce order,[84] court partition order,[85] neighbors' complaints to officials,[86] the Chamber of Commerce,[87] delinquent tax obligations,[88] bankruptcy or receivership proceedings,[89] S.B.A. loan requirements,[90] foreclosure of a loan,[91] the insistence of creditors,[92] or general or specific economic conditions[93] are not §1033 involuntary conversions even though the taxpayer has clearly been deprived of the continued use and pleasure from the sold property. Similarly, the forced sale of stock under corporate statutes is not an involuntary conversion.[94]

It is difficult to reconcile PLR 200712006 with the foregoing. In PLR 200712006, the Service concluded that payments by a city to certain low income residents to permit those residents to comply with the city's orders to remove dead and dying trees was held to be an involuntary conversion. The city was not making these payments to acquire anything, but rather to assist the residents in complying with what would appear to be a valid order under the police powers. In reaching the conclusion that the payments were part of an involuntary conversion (presumably, the conversion of the dead and dying trees

[75] GCM 39182 (Mar. 6, 1984).

[76] *See also* PLR 202125006 (FCC's repurposing of portion of electromagnetic spectrum, which requires taxpayers (broadcast service providers) to transmit over different portion of spectrum, results in involuntary conversion (requisition or condemnation) of taxpayers' property), PLR 201821012, PLR 201816008, and PLR 201702034 (the FCC's "repacking" broadcast licenses into a different spectrum was a compensable taking, with the result that affected broadcasters could sell their FCC licenses to mobile broadband providers through an FCC-sponsored auction process, and such sales would be treated as being made under threat of condemnation; such an order "repacking" a license is directed at the acquisition of the underlying property right for a public purpose).

[77] PLR 200644019. *See, e.g.*, *Pa. Coal Co. v. Mahon*, 260 U.S. 393 (1922); *Lucas v. S.C. Coastal Council*, 505 U.S. 1003 (1992). In PLR 200644019, implementation of electric energy deregulation was ruled not to be a §1033 event.

[78] *E.g.*, Rev. Rul. 57-314; PLR 8310057.

[79] *Lakewood Assocs. v. Commissioner*, 109 T.C. 450 (1997); *Gaines v. Commissioner*, 45 T.C.M. 363 (1982). *See also Hay v. Commissioner*, 64 T.C.M. 228 (1992) (California coastal development restrictions are not takings); *Moore v. United States*, 96-2 USTC ¶50,413 (E.D. Va. 1996) (agency declaration that wetlands status precluded building was not necessarily involuntary conversion of affected land).

[80] *Dear Publication & Radio, Inc. v. Commissioner*, 274 F.2d 656 (3d Cir. 1960); *Hitke v. Commissioner*, 296 F.2d 639 (7th Cir. 1961); Rev. Rul. 69-550 (sale of restricted stock when ownership requirements no longer met); Rev. Rul. 55-717 (forced redemption permitted by law).

[81] TAM 200627024 (state enactment of deregulation program with intent to provide for welfare of its residents by significantly reducing cost of purchasing electricity is exercise of its constitutional police power prerogative for public benefit).

[82] *Am. Natural Gas Co. v. United States*, 279 F.2d 220 (Ct. Cl. 1960), cert. denied, 364 U.S. 900 (1960); *see* Rev. Rul. 57-517.

[83] *Behr-Manning Corp. v. United States*, 196 F. Supp. 129 (D. Mass. 1961); Rev. Rul. 58-11. *See* TAM 200408027 (sale of taxpayer-subsidiary's assets by parent pursuant to FTC consent agreement resolving claims of lessened competition did not constitute involuntary conversion; National Office advised that sale was voluntary as subsidiary was party to agreement, having been incorporated by reference and that purpose of §1033 is not to provide relief from dispositions required by business necessity or expediency).

[84] PLR 7930030.

[85] *Roth v. Commissioner*, 36 T.C.M. 82 (1977).

[86] *Piedmont Mt. Airy Guano Co. v. Commissioner*, 8 B.T.A. 72 (1927), acq., VII-1 C.B. 25.

[87] *Davis Co. v. Commissioner*, 6 B.T.A. 281 (1927), acq., VI-2 C.B. 2.

[88] Rev. Rul. 77-370; *see* Rev. Rul. 56-420; TAM 7739003.

[89] Rev. Rul. 79-269 (bankruptcy); *Shields v. United States*, 74-2 USTC ¶9537 (W.D. Tex. 1974) (receivership).

[90] *Dorothy C. Thorpe Glass Mfg. Corp. v. Commissioner*, 51 T.C. 300 (1968).

[91] *Cooperative Pub. Co. v. Commissioner*, 115 F.2d 1017 (9th Cir. 1940); *Recio v. Commissioner*, 61 T.C.M. 2626 (1991); *Woolf v. Commissioner*, 42 T.C.M. 63 (1981).

[92] *Tirrell v. Commissioner*, 14 B.T.A 1399 (1929).

[93] *Callahan v. Commissioner*, 44 T.C.M. 1114 (1982). *See also Lonergan v. Commissioner*, 44 T.C.M. 179 (1982) (house sale occasioned by job-related move not involuntary conversion); PLR 8851021 (house sale occasioned by disability not §1033 event); *Lakewood Assocs. v. Commissioner*, 109 T.C. 450 (1997) (developer suffers no §1231 involuntary conversion from adverse government land use regulations, even though property value diminished); *Koziara v. Commissioner*, 86 T.C. 999 (1986) (oil unitization order under state law was exercise of police power and not §1231 involuntary conversion); *Marshall v. Commissioner*, 56 T.C.M. 1006 (1989) (forced conversion from medical insurance to lump sum payment not §1033 event).

[94] *See Warda v. Commissioner*, 51 T.C.M. 77 (1985) (corporate reorganization); *Carver v. Commissioner*, 50 T.C.M. 929 (1985) (forced redemption in context of management dispute); PLR 8722083 ("freeze out" merger). In PLR 9118005, the IRS ruled that limited partners who unsuccessfully protested the sale of the partnership's assets by the general partners were not entitled to §1033 nonrecognition treatment for the sale gains because the assets were voluntarily disposed of by the partnership. The IRS explained that the sale was not a "requisition or condemnation" because there was no governmental taking.

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into cash), the Service analogized to the treatment of severance payments (for damage to remaining property after a condemnation). *See* X.D., below. The problem with characterizing the payments described in PLR 200712006 as the proceeds of an involuntary conversion is that the payments were intended by the city to be used by the low income residents to pay for tree removal. That is, the city never intended that there would be any leftover funds that could be used to acquire replacement property (such as new trees). Stated more succinctly, payments to a tree service for tree removal would not constitute the acquisition of replacement property that can ever be said to be similar use to the property converted (the dead and dying trees).

PLR 200712006 arose in the context of the city's request for a ruling that the city did not have to issue Form 1099s to the payment recipients. Citing Reg. §1.61-6(b), the Service concluded that no Forms 1099 had to be issued in the context of a §1033 involuntary conversion, because in the §1033 situation recognition of gain ultimately turns upon whether or not the taxpayer meets the timely replacement requirement and is therefore not fixed when the payment is made. *See also* Reg. §1.6041-1(c).

Assuming that the Service's ultimate goal was to conclude that the payments were not income to the recipients (so that the city was not required to issue Forms 1099), one wonders whether the general welfare exclusion should have been the rationale instead of §1033. Under the general welfare exclusion, certain payments made to or on behalf of individuals by governmental units under governmentally provided social benefit programs for the promotion of general welfare are not included in a recipient's gross income.[95] Use of the general welfare exclusion would have avoided the need to distort §1033 to achieve the result that no Forms 1099 had to be issued by the city.

b. Inverse Condemnation

Occasionally, a taxpayer must bring an "inverse condemnation" or "reverse eminent domain" suit claiming that government regulatory actions on an adjoining or related parcel of land have diminished (or "taken") the value of the taxpayer's own land.

The theory of an inverse condemnation suit is different from that of a direct condemnation suit. In a direct condemnation suit, the governmental authority concedes the fact of a compensable taking; at issue is the question of the fair value that must be paid the property owner. In an inverse condemnation suit, the government denies that a compensable taking has occurred. Once the property owner prevails in an inverse condemnation suit that a compensable taking has occurred, the tax treatment is generally the same as for other direct takings.[96] Thus, where a taxpayer prevails in an inverse condemnation case and gain results, §1033 is available to defer the gain's recognition.[97]

There is a subtle difference in the tax treatment of gain on an inverse condemnation and gain on a direct condemnation. In the typical direct condemnation case where a taxpayer disputes the government's view of fair value, the government will be required to deposit funds into the court registry. Assuming those funds are sufficient to produce a gain to the property owner, under §1033(g), the replacement period will end three years after the close of the tax year in which the deposit was made. Thus, in a direct condemnation litigation, the start of the litigation determines the end of the replacement period.

In an inverse condemnation litigation, the governmental authority initially denies a compensable taking has occurred. Thus, no funds are required to be deposited by that governmental authority. Only after the inverse condemnation case successfully concludes for the property owner will compensation be payable. Thus, in an inverse condemnation litigation, the end of the litigation determines the start, and ultimately the end, of the replacement period. Put differently, the taxpayer will usually have three years to make the replacement, measured from the end of the litigation.

Lakewood Assocs. v. Commissioner[98] illustrates another potential tax issue in alleged inverse condemnation cases, which is that the governmental land-use regulations may not amount to a taking for §1231 purposes even though those regulations diminish the value of the property. In many cases, it will not be clear absent a court determination, that particular regulatory action amounts to a compensable taking. Accordingly, taxpayers should be extremely cautious in selling property subject to a putative regulatory taking at a gain and then seeking to defer the resulting gain because the sale was supposedly under threat or imminence of condemnation.

3. Effect of Actual Condemnation on Taxpayer's Other Land

a. Receipt of Severance Damages

Where the taxpayer-condemnee retains land adjacent to the condemned land, the condemning authority may compensate the taxpayer for a decrease in the retained parcel's value. If the severance damages are documented as such, they are applied first against the basis of the retained tract. Any remaining severance proceeds, (i.e., any gain) are eligible for §1033 deferral.[99] The IRS has ruled that the severance proceeds can be used to acquire any property that is similar use property under §1033.[100] This is discussed in more detail in X.D., below.

To obtain severance damage treatment, the condemnation award and/or contract should make a specific allocation to such

[95] Examples of the application of the general welfare exclusion include Rev. Rul. 98-19 (relocation payment authorized by the Housing and Community Development Act and made by a local jurisdiction to an individual moving from a flood-damaged residence to another residence is not includible in the individual's gross income) and Rev. Rul. 74-205 (replacement housing payments to aid individuals displaced from their homes in acquiring decent, safe, and sanitary dwellings of modest standards are not includible in gross income). To qualify under the general welfare exclusion, the payments must (1) be made pursuant to a governmental program, (2) be for the promotion of the general welfare (that is, based on need), and (3) not represent compensation for services. Rev. Rul. 2005-46, Rev. Rul. 82-106, Rev. Rul. 75-246. The requirement of establishing individual need is a part of the general welfare exclusion. *Bailey v. Commissioner*, 88 T.C. 1293, 1300 (1987), acq., 1989-2 C.B. 1.

[96] *See, e.g.*, PLR 8319011 (assumes that proceeds from the settlement of an inverse condemnation action are condemnation proceeds for §1033 purposes).

[97] PLR 200627024.

[98] 109 T.C. 450 (1997). *See also Koziara v. Commissioner*, 86 T.C. 999, 1006–1007 (1986), aff'd, 841 F.2d 1126 (6th Cir. 1988).

[99] *See, e.g.*, Rev. Rul. 83-49.

[100] Rev. Rul. 83-49.

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damages.[101] While there is case authority allowing severance damage treatment where the award makes no allocation but other factors strongly indicate severance damages were paid,[102] the burden of proof is clearly on the taxpayer. Absent such proof, the entire award is deemed to be consideration for the condemned tract only.[103] The effect of finding no severance damages is that the basis of the retained tract does not enter into the determination of realized gain, which produces a larger realized gain.

Under Rev. Rul. 64-183, the requirement that severance damages be documented is met when the condemning authority supplies an itemized statement or closing sheet clearly showing the amount of severance damages.

The tax effects of severance damages are set out in X.D., below. The Working Papers, below, provide an example of contractual language to accomplish the necessary allocation.

b. Voluntary Sale of Adjacent or Related Land

Severance damages will not always be offered or payable. If a taxpayer-condemnee wishes to dispose of a tract related to a condemned tract and still defer the gain under §1033, there are essentially three alternatives. First, if the related tract is itself under threat or imminence of condemnation, §1033 applies to the gain from any sale.[104] Second, efforts can be made to have the related tract condemned directly or through an inverse condemnation suit. Third, if the related tract is part of an "economic unit" with the condemned tract, the related tract may be sold and the gain deferred under the authority of *Masser v. Commissioner*[105] and Rev. Rul. 59-361.[106] In *Masser*, the taxpayer owned a freight terminal and vacant lots directly across the street, which were used for parking. When the government condemned the vacant lots, the taxpayer was unable to secure adequate replacement lots. The taxpayer sold the freight terminal, reinvested the sale and condemnation proceeds in a similar freight terminal with parking lots, and sought §1033 deferral. The Tax Court approved §1033 deferral of all gain, notwithstanding the "voluntary" freight terminal sale, in light of (1) the substantial economic relationship between the lots and the terminal and (2) the taxpayer's significant efforts to replace the condemned lots. Rev. Rul. 59-361 explains the IRS's acquiescence in *Masser* and underscores the need for the taxpayer to document both the economic relationship and the taxpayer's efforts to reasonably replace the condemned property.

The IRS ruled on a common example of a *Masser*-type sale in PLR 8132121, in which the taxpayer owned rental real property in a resort area. Following a gas explosion that destroyed the building, the taxpayer sought IRS approval to sell the remaining land in light of local construction ordinances making rebuilding economically unfeasible. The IRS applied *Masser* and Rev. Rul. 59-361 to allow deferral of the sale gain.[107] In a related vein, in PLR 8208205, the IRS approved §1033 deferral of the gain from a sale of personal property "integrally related" to condemned realty. Similarly, in PLR 8928011, the IRS relied on *Masser* in ruling that gain on the sale of a hospital damaged in an earthquake qualified for §1033 nonrecognition treatment where the cost of repairing the damaged hospital rendered it economically unfeasible to repair the property. In addition, the IRS ruled that gain from the sale of the real property related to the hospital (e.g., parking lots, laundry building, gardens, and walkways) also qualified for nonrecognition treatment since all were integral parts of the property and the earthquake damage and resulting evacuation of all the patients rendered the underlying and surrounding real property unsuitable for its intended purpose. PLR 9334007 carries this analysis one step further. Following a tornado, an elderly taxpayer chose to sell his farm property rather than reinvest the insurance proceeds. The IRS permitted the taxpayer (in light of his age and limited financial resources) to shelter the sale gain under §1033.

The IRS has also applied the economic unit principle of *Masser* and Rev. Rul. 59-361 where the economically related property was a contract. In PLR 199940037, PLR 199940039, PLR 199951037, and PLR 199951038, although the threat of condemnation was aimed at the taxpayers' power cogeneration facilities, the IRS ruled that the taxpayers' "voluntary" termination of power purchase agreements with the condemning authority was an involuntary conversion of both the power purchase agreements and the cogeneration facilities, because the agreements would have been unenforceable and worthless had the facilities been condemned.

IRS approval should not be taken as automatic in all voluntary sales. Rev. Rul. 78-377 and Rev. Rul. 80-175 both indicate *Masser* will not apply where the sale was not "forced" upon the taxpayer.[108] In addition, the rule of *Masser* does not ap-

[101] *See* Rev. Rul. 59-173.

[102] *Compare Vaira v. Commissioner*, 444 F.2d 770 (3d Cir. 1971) (finding severance damages based on parties' actions despite nonallocation in award); *Beeghly v. Commissioner*, 36 T.C. 154 (1961), acq., 1962-1 C.B. 3 (same); *Johnston v. Commissioner*, 42 T.C. 880 (1964), acq., 1965-2 C.B. 5 (same); *Green v. United States*, 60-2 USTC ¶9668 (D.N.J. 1960) (same) *with Vaira v. Commissioner*, 52 T.C. 986 (1969) (finding no severance damages); *Lapham v. United States*, 178 F.2d 994 (2d Cir. 1950) (parties' consideration of severance damages not sufficient); *Estate of Appleby v. Commissioner*, 41 B.T.A. 18 (1940), aff'd on other grounds, 123 F.2d 700 (2d Cir. 1941) (same); *Jamieson Assocs., Inc. v. Commissioner*, 37 B.T.A. 92 (1938), aff'd sub nom., *Seaside Improvement Co. v. Commissioner*, 105 F.2d 990 (2d Cir. 1939), cert. denied, 308 U.S. 618 (1939) (same); *Collyer v. Commissioner*, 38 B.T.A. 106 (1938), acq., 1938-2 C.B. 6 (same).

[103] *See, e.g., Seaside Improvement Co. v. Commissioner*, 105 F.2d 990 (2d Cir. 1939); *Allaben v. Commissioner*, 35 B.T.A. 327 (1937); Rev. Rul. 59-173.

[104] *See* II.C., below.

[105] 30 T.C. 741 (1958), acq., 1959-2 C.B. 5. *See* PLR 9334007 (§1033 treatment allowed for sale of adjacent land to house destroyed by tornado, as replacement with insurance proceeds would put new house out of character with the area in price, size, and quality); PLR 9143056 (where current rental rates in area would not support cost of replacing building destroyed by fire, §1033 treatment allowed for proceeds received from sale of underlying land).

[106] *See* PLR 200743010 (low-income housing complex consisting of destroyed and damaged buildings, clubhouse, tennis courts, and landscaping constituted single economic unit). *See also* Willens, *IRS Ruling Offers Economic Viability of Replacement as Consideration in Deferring 'Involuntary Conversion' Gain*, 225 BNA Daily Tax Rpt. J-1 (Nov. 23, 2007).

[107] *See also* Rev. Rul. 96-32 (following destruction of residence, taxpayer permitted to sell underlying land and defer gain); PLR 9143056 (where current rental rates in area would not support cost of replacing building destroyed by fire, §1033 treatment allowed for proceeds received from sale of underlying land); PLR 7749038 (sale of water company's related properties).

[108] *See also* Rev. Rul. 69-654 (owner's agreement to allow conversion of property in exchange for zoning approval is not condemnation). In TAM 9227002, a sports team and the stadium it used were sold to avoid condemnation proceedings against the stadium. The National Office advised that although the sports team and the stadium were integral parts of a single economic unit,

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ply when the related tract is owned by another taxpayer, even if that taxpayer is related.[109] In some cases, a *Masser*-type analysis has been applied to deny §1033 deferral on the related tract sale gain.[110] Thus, as with "voluntary" sales following destructions or thefts,[111] the advisability of an advance ruling from the IRS should be considered.

c. Special Assessment Against Retained Land

The condemning authority may levy a special assessment against the taxpayer's other property to the extent the retained portion has been benefited by the improvement. In most cases, the special assessment will be withheld from the condemnation proceeds. In such circumstances the effect of the special assessment is to reduce the condemnation award and hence the amount of the taxpayer's required reinvestment.[112] It is not clear whether a special assessment made at the time of the condemnation award but payable later results in the same netting.[113] It is clear, however, that the netting is allowed only when the special assessment relates to the improvement for which the property was condemned.[114]

The tax effects of special assessments are discussed in X.D., below.

4. Temporary Seizures and Condemnations

Occasionally, a public authority will seek to condemn only a leasehold (and not the fee) where the anticipated governmental use is only for a short period. The IRS ruled in Rev. Rul. 38[115] that compensation for a leasehold is ordinary income because such payments are in the nature of rent for the use of the property.[116] That is, although the right to use the property has been lost temporarily to the taxpayer, such a right does not rise to the level of "property" for §1033 purposes. There is no easy way to reconcile the result in Rev. Rul. 38 with that reached in Rev. Rul. 73-477, and the cases discussed in X.F., below, which all generally allow §1033 treatment for insurance proceeds compensating lost use.

Illustrating this tension is PLR 9248025, in which the IRS concluded that: (1) the taking of a temporary 12-year easement was a §1033 event; and (2) the temporary easement could be replaced by a fee interest in real property. In PLR 9248025, the temporary easement was for a haul road for construction purposes. After citing the relevant authorities (including Rev. Rul. 38, *Gillette Motor Transport*, below, and Rev. Rul. 73-477), the IRS ultimately concluded that the facts simply are closer to Rev. Rul. 73-477 than to the other authorities. The difficulty the IRS obviously experienced in PLR 9248025 is not significantly resolved by the principles set forth in that ruling.

The result in Rev. Rul. 38 is similar to that reached by the Supreme Court in *Commissioner v. Gillette Motor Transport, Inc.*[117] In *Gillette*, the government seized the taxpayer's motor vehicles in the closing days of World War II. The taxpayer reported the eventual compensation as capital gain under the predecessor to §1231; the Supreme Court concluded that the right to use the taxpayer's property for a temporary period was not a capital or §1231 asset, but rather was simply an "incident" of the underlying property. The Court held that, because the literal terms of the predecessor to §1231 were not met, the income was taxable under ordinary rates as rent.[118] The IRS applied the *Gillette* reasoning in Rev. Rul. 74-444, to rule that proceeds from use and occupancy insurance were not entitled to §1231 treatment. Use and occupancy insurance proceeds are discussed in X.F., below.

A somewhat different result was reached before *Gillette*, in *Morse v. United States*.[119] In *Morse*, a condemnation award was adjusted to allow the taxpayer to retain possession of the property for three years after the taking. The court in *Morse* held that rentals received during this three-year period were an increase in the condemnation award and thus taxable as capital gain. The logical extension of the *Morse* holding is that the taxpayer could have deferred recognition of the gain on such receipts by a proper §1033 election. Whether *Morse* remains valid in light of *Gillette* is questionable.

C. Threat or Imminence of Condemnation

1. What Constitutes Threat or Imminence

Section 1033(a) conversions include sales made under threat or imminence of requisition or condemnation. That the phrase "threat or imminence" does not relate to seizures, thefts, and destructions is not clear from the statute, but Reg. §1.1033(a)-1(a) takes this approach. The regulation appears correct in light of the statutory predecessors of §1033 such as former §214(a)(12) of the Revenue Act of 1921.

The IRS clearly treats the threat or imminence of condemnation differently from the destruction of property. In Rev. Rul.

deferral of gain on the sports team under §1033(a) was not available because the stadium and the team were not owned by the same taxpayer.

[109] *See* Rev. Rul. 69-53.

[110] *Forest City Chevrolet v. Commissioner*, 36 T.C.M. 768 (1977), aff'd in unpub. opin., 577 F.2d 722 (1st Cir. 1978); *Smith v. Commissioner*, 56 T.C. 1249 (1971), aff'd *per curiam*, 459 F.2d 1043 (4th Cir. 1972).

[111] *See* II.A.1., above.

[112] *See* Reg. §1.1033(a)-2(c)(10).

[113] *Compare Income Syndicate, Inc. v. Commissioner*, 37 B.T.A. 926 (1938), acq., 1938-2 C.B. 17 (allowing netting where no withholding) *with* Reg. §1.1033(a)-2(c)(10) (implying that netting occurs only on withheld special assessments).

[114] *Collyer v. Commissioner*, 38 B.T.A. 106 (1938), acq., 1938-2 C.B. 6.

[115] 1953-1 C.B. 16.

[116] *See also* Rev. Rul. 57-261; PLR 201609003 (agency's buy down of a right to operate a business on agency land, known as a beneficial ownership interest (BOI), was a section 1033 event even though the BOI had been created by contract and legislation and was not *per se* an interest in property because agency owned underlying land). On the other hand, §1033 deferral is available to a lessee who receives condemnation proceeds. Rev. Rul. 71-519. Section 1033 deferral also could be available to a lessor who receives compensation for the entirety of ownership following a reversion from its lessee. *See, e.g.*, PLR 9050007, PLR 9049012, PLR 9049011. However, a distinction exists in most contexts between destruction of the improvements being leased and destruction of the leasehold itself. Thus, reinvestment of insurance proceeds relative to a fire, in fee acquisition of the leased property does not qualify for §1033 deferral, because the property converted was an improvement, and not the leasehold. *Woodall v. Commissioner*, 61 T.C.M. 1682 (1991), aff'd, 964 F.2d 361 (5th Cir. 1992). In PLR 9633029, the IRS ruled that §1033 nonrecognition was available for gains realized by trusts for the sale of leasehold interests pursuant to a state leasehold condemnation law.

[117] 364 U.S. 130 (1960).

[118] *See* Rev. Rul. 72-601 (life interest in real property is only income interest and not real property). *See also Gail v. United States*, 58 F.3d 580 (10th Cir. 1995) (wrongful appropriation of mineral interest is not fully capital gain event); FAA 20115101F (temporary taking of leasehold is rental income to lessor, not capital gain, citing Rev. Rul. 38 and *Gillette Motor Transport*).

[119] 183 F. Supp. 847 (D. Minn. 1959).

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89-2, the IRS ruled that property sold to a governmental authority after passage of an ordinance authorizing eminent domain proceedings was a sale under the threat of condemnation only to the extent that the proceeds represented compensation for the taking of the property by the government, rather than compensation for the destruction caused by the chemical contamination that rendered the property unsafe for its intended use.

According to the IRS, threat or imminence of condemnation exists if the property owner is informed by a reliable source that an entity with authority to condemn has decided to acquire the property for a public use and if there are reasonable grounds to believe the condemnation will be carried out.[120] The "threat or imminence" will not exist if the reliable source merely states that the property is being considered for acquisition, but does not indicate that a decision to condemn has been reached.[121] A taxpayer may defer gain under §1033 on a resale of a property, even if she had knowledge of an existing threat of condemnation when she originally purchased the property.[122]

A threat or imminence was found to exist in *S. & B. Realty Co. v. Commissioner*,[123] where an urban renewal authority threatened condemnation unless the taxpayer improved the property, sold it to the authority, or sold it to a third party who would improve the property. The Tax Court held that these options were sufficiently restrictive so that the taxpayer was realistically faced with two alternatives: sell or suffer condemnation. In a series of private letter rulings, the IRS applied *S. and B. Realty* to the situation where a state agency has the statutory power to condemn a landlord's property upon request by a certain number of tenants.[124] These letter rulings concluded that sale by the landlord to the tenants, in lieu of undergoing proceedings, was a sale under threat or imminence of condemnation. Similarly, notice given to the taxpayer by a state housing authority that house lots had been designated for acquisition through the state's acquisition mechanism constituted notice of imminent condemnation, and sale of the lots by the taxpayer either to the authority or to a third party qualified as an involuntary conversion.[125] In the same way *S. and B. Realty* dealt with nonmeaningful alternatives, in PLR 201702034 the Federal Communications Commission (FCC) implemented a mandate by Congress to repurpose spectrum in a certain bandwidth used by television broadcasts to help meet the nation's accelerating needs for mobile broadband. The FCC mandated that the stations either (1) cease broadcasting, voluntarily move to an inferior spectrum, or agree to share a single channel with other broadcasters, or (2) be subject to a "repacking" process, which would involuntarily reassign the stations to a lower band. The choice for the taxpayer was meaningless; either voluntarily agree to give up the bandwidth or be subject to having it reassigned without compensation. The taxpayer's resulting sale of the spectrum-based content distribution rights and related assets to the FCC constituted a sale under threat of involuntary conversion. A similar result was reached in PLR 201816008 and PLR 201821012.

A threat or imminence may exist even though the condemning authority has not currently appropriated necessary funds.[126] Section 1033 deferral applies to a private sale of personal items integrally related to the condemned real property,[127] and to sales made under the threat of expropriation by a foreign government.[128] Under *Balistrieri v. Commissioner*,[129] it is not necessary that the entity threatening condemnation be a public or quasi-public corporation if the private entity threatening condemnation could require a public authority to condemn the tract for a public use. *Warner v. Commissioner*[130] and Rev. Rul. 74-8 require that the condemning authority be identified to the taxpayer, for without such disclosure, the taxpayer does not have reasonable grounds to believe the condemnation will occur. An often-repeated factor in determining the reasonableness of a taxpayer's belief that condemnation by a quasi-public agency is imminent is whether the taxpayer sought an opinion from legal counsel as to the agency's powers.[131]

A sale to the condemning authority, followed by a leaseback by the taxpayer, may nevertheless be a sale under threat of condemnation.[132]

Often, the taxpayer will be contacted by an entity with condemnation authority seeking to arrange a "voluntary" sale.[133]

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[120] *See, e.g., Tecumseh Corrugated Box Co. v. Commissioner*, 932 F.2d 526 (6th Cir. 1991); *Maixner v. Commissioner*, 33 T.C. 191 (1959), acq., 1963-2 C.B. 5; *Johnson v. Commissioner*, T.C. Memo 1998-448; *Carson Est. Co. v. Commissioner*, 22 T.C.M. 425 (1963); *Dominguez Est. Co. v. Commissioner*, 22 T.C.M. 521 (1963); Rev. Rul. 82-147, Rev. Rul. 74-8, Rev. Rul. 63-221; PLR 9030027 (taxpayer's receipt of letter from government announcing selection of taxpayer's land as site for waste disposal system was "threat" of condemnation under §1033); PLR 8840022, PLR 8226066, PLR 7804098, PLR 200145001. *But see Stone v. Commissioner*, 32 T.C.M. 94 (1973) (taxpayer held to merely have made advantageous sale to willing public buyer). Although the IRS had ruled in Rev. Rul. 58-557 that newspaper articles were not adequate to find a reasonable belief, even when confirmed by the local mayor, the standard adopted in Rev. Rul. 63-221 would find a threat of condemnation on the Rev. Rul. 58-557 facts. *See* PLR 8947023. *See also* PLR 8411097 and PLR 8546016 (notices from county agency constitute threat of condemnation). Threat or imminence was found in a letter from a city announcing its desire to purchase the property in a "voluntary" fashion through a "friendly condemnation," PLR 9450025, PLR 9425018, PLR 9252016, and when taxpayer property was included in a map of a city development project, PLR 200518066. *See also* PLR 200219006 (sale to Army Corps of Engineers). In TAM 200126010, threat or imminence was found when a state agency mandated a switch from the use of one product to another product in the taxpayer's manufacturing facility.

[121] *Forest City Chevrolet v. Commissioner*, 36 T.C.M. 768 (1977), aff'd *in unpub. opin.* 577 F.2d 722 (1st Cir. 1978).

[122] *See, e.g.*, Rev. Rul. 81-181; PLR 9022037, PLR 9050007, PLR 201609003.

[123] 54 T.C. 863 (1970), acq., 1970-2 C.B. xxi.

[124] PLR 8202122, PLR 8108123, PLR 8106029, PLR 7934038.

[125] PLR 8609012.

[126] Rev. Rul. 71-567, Rev. Rul. 69-303.

[127] *See* PLR 8208205.

[128] TAM 8206018; *cf. Edmond Weil, Inc. v. Commissioner*, 150 F.2d 950 (2d Cir. 1945) (no confiscation threatened). *But see* TAM 8115028 (contra).

[129] 38 T.C.M. 526 (1979). *See also* PLR 8012022.

[130] 56 T.C. 1126 (1971), acq., 1972-2 C.B. 3, aff'd, 478 F.2d 1406 (7th Cir. 1973), cert. denied, 415 U.S. 915 (1974).

[131] *E.g., Balistrieri v. Commissioner*, 38 T.C.M. 526 (1979); PLR 8129109. *See also* PLR 8350101, PLR 8350099, and PLR 8349019 (threat of condemnation exists even though constitutionality of enabling legislation was in litigation).

[132] Rev. Rul. 57-70.

[133] *See, e.g.*, PLR 202042002 and PLR 202042003 (FCC procedure to reorganize and reconfigure 39 GHz band spectrum by offering options to current license-holders considered threat of or imminent condemnation where taxpayer chose to relinquish current licenses for incentive payment and eligibility to participate in future auction for new licenses); PLR 8502025 (taxpayer who entered into "voluntary" option contract for sale of property after threat of condemnation was eligible for §1033 deferral of gain from sale of property if option was exercised); PLR 8406048 ("voluntary" sale to city under threat of condemnation qualified as involuntary conversion because taxpayers had reason-

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The taxpayer should, in such a case, ascertain early on whether the entity plans to exercise its condemnation authority. Not only will this allow the taxpayer to determine a more accurate price for the property, but also, it will enable the taxpayer to document the reasonableness of his belief that condemnation will occur. For example, in *Forest City Chevrolet v. Commissioner*,[134] one portion of the taxpayer's property was sold under threat of condemnation. Although the taxpayer sought to defer gain under §1033 on the sale of a second tract, the Tax Court concluded that the evidence (primarily correspondence) showed the public authority wished only a voluntary acquisition for reasons of community relations. Thus, there was no threat of condemnation and §1033 did not apply. Similarly, in *Rainier Companies, Inc. v. Commissioner*,[135] the public authority never actually threatened condemnation even though construction of an expressway in the area was being studied. In *815 Riverside Co. v. Commissioner*,[136] the court determined that the taxpayer's bus terminal was not sold to the city under threat of eminent domain after the city took over the bus service, and also that (1) the taxpayer could have had no reasonable belief that condemnation was likely to take place; (2) the taxpayer was actually desirous of disposing of the property; and (3) the city was the only buyer.

While oral representations of potential condemnation can be the basis of reasonable belief, the IRS has indicated it may require written confirmation of such statements.[137] Because years may elapse between the "sale" and when the dispute with the IRS arises, it is important to obtain the written confirmation during the sale negotiations. Correspondence that sets forth the potential condemnation is adequate for this purpose.[138]

Three further comments are in order concerning proof of the threat or imminence of condemnation.

First, mere conclusory allegations of a threat or imminence in subsequent tax litigation are not likely to survive a summary judgment by the government.[139]

Second, taxpayers (and the professionals advising them) should be mindful of *United States v. Wickersham*.[140] *Wickersham* involved a criminal prosecution for, inter alia, allegedly making false statements on a tax return regarding the threat or imminence of condemnation. The taxpayer apparently had conspired with members of a Texas quasi-governmental authority (a harbor district) to sell the taxpayer's grain elevator to the harbor district at an inflated price. It was undisputed that the harbor district had powers of condemnation. One of the commissioners of the harbor district, himself an alleged co-conspirator, testified in the taxpayer's criminal trial that the commissioner had verbally threatened condemnation to force the sale. Despite the commissioner's testimony, the jury found the taxpayer guilty of making a false statement on a tax return. Apparently the harbor commissioner's "threat" was never reduced to writing, even when the taxpayer's counsel wrote the harbor district after the sale (but before the tax return was filed) requesting the "threat" be put in writing. On appeal, the Fifth Circuit affirmed the taxpayer's criminal conviction, holding that there was an adequate basis upon which the jury could have convicted on this count. The result in *Wickersham* is perhaps explainable by the fact that the commissioner's testimony of a threatened condemnation lacked credibility in view of his alleged participation in the wrongful sale. However, the Fifth Circuit's decision in *Wickersham* indicates that the court was troubled by the fact that the taxpayer, on the advice of tax counsel, had sought the letter formally threatening condemnation after the sale agreement was reached. *Wickersham* thus underscores the importance of documenting the threat before the sale agreement is entered.

Third, in many cases, a taxpayer can convince the public authority to commence an actual condemnation lawsuit. This could be especially helpful in circumstances where the dealings between the parties have left an unclear record whether the condemnation power will be exercised. Of course, this converts the "threat" of condemnation into an actual condemnation.

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able belief that threat to condemn was present, and authority to condemn was readily obtainable); PLR 8840022 (letter from governmental entity stating that farm land would be condemned if not sold to that entity ruled threat of condemnation); PLR 8947023 (sale of apartment building to city after city council authorized purchase of properties in area pursuant to redevelopment plan ruled involuntary conversion because city had authority to condemn and taxpayer was informed orally and in writing that city intended to buy building); PLR 9145011 ("voluntary" sale of property to third-party purchaser, after taxpayer obtained written confirmation from governmental agency that property would be condemned if sale was not negotiated, qualified as involuntary conversion where authority to condemn could readily have been obtained by agency's representative).

[134] 36 T.C.M. 768 (1977).

[135] 61 T.C. 68 (1973), acq., 1974-1 C.B. 2, rev'd in part and rem'd in part, 538 F.2d 338 (9th Cir. 1975).

[136] 54 T.C.M. 886 (1987).

[137] Rev. Rul. 63-221.

[138] *See, e.g., Dominguez Est. Co. v. Commissioner*, 22 T.C.M. 521 (1963). *But see Forest City Chevrolet v. Commissioner*, 36 T.C.M. 768 (1977) (correspondence did not unequivocally threaten condemnation). There appears to be some utility in reciting the course of negotiations (including the threat of condemnation) in the sale documents, although such recitations should not be the sole documentation.

[139] *See McGeary v. United States*, 93-2 USTC ¶50,546 (N.D. Cal. 1993).

[140] 29 F.3d 191 (5th Cir. 1994). *See also United States v. Loeb*, 95 AFTR.2d 1107 (E.D. La. 2005), which was a criminal prosecution that grew out of an alleged involuntary conversion. Mr. Loeb and Mr. Molaison were attorneys who undertook a contingent fee representation of landowners claiming alleged unlawful takings. The attorneys claimed that their contingent fee interest amount to an interest in the underlying land, which could supposedly then be the subject of an involuntary conversion by the Government. Ultimately, when the case was settled, the attorneys reported the cash they received not as fee receipts but instead, as proceeds from an involuntary conversion. The attorneys then acquired replacement property and ultimately, the Government's prosecution for conspiracy to defraud the Government and to commit tax evasion followed. Although in the decision reported at 95 AFTR.2d 1107, the Government's prosecution survived motions to dismiss, the jury ultimately acquitted Mr. Loeb and Mr. Molaison after trial. In parallel proceedings in the Tax Court reported as *Loeb v. Commissioner*, T.C. Memo 2009-6, Mr. Loeb and Mr. Molaison contested tax deficiencies arising from the same alleged involuntary conversion that were asserted more than three years after the returns were filed. Ultimately, the court concluded that although use of §1033 was improper, the deficiencies were time-barred because adequate return disclosure precluded the existence of fraud (with the result that the normal three-year statute of limitations applied). In the final chapter of this saga, Mr. Loeb and Mr. Molaison sued the tax attorney (a Mr. Lukinovich) who had given them advice regarding the possible application of §1033 if the original contingent fee interest amounted to an interest in the land being converted. Mr. Loeb and Mr. Molaison prevailed at trial on a theory that Mr. Lukinovich improperly gave testimony to the IRS and a grand jury and rendered Mr. Lukinovich liable for the damages that flowed from the indictments. However, the Court of Appeal of Louisiana subsequently reversed, citing the importance of such fact-finding inquiries and finding an absolute immunity applied to Mr. Lukinovich. *Molaison v. Lukinovich*, 142 So. 342 (2014). Interestingly, as noted by the Court of Appeal of Louisiana, Mr. Lukinovich was never sued for his advice on §1033, only his testimony to the IRS and the grand jury.

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2. Private or Public Sales Permissible

Once the threat or imminence of condemnation or requisition exists, the taxpayer is free to sell to either the authority in lieu of condemnation or to a private party.[141] If a private party purchases the threatened property, §1033 may also apply to the purchaser's subsequent disposition of the property, even though the purchaser acquired the property with knowledge of the pending condemnation.[142]

D. Other Deemed Involuntary Conversions

1. Section 1033(c): Reclamation Law Sales

Various federal reclamation statutes[143] require landowners within certain irrigation projects to dispose of irrigable land in excess of certain acreage limits. Under §1033(c), such dispositions may be treated as §1033 involuntary conversions, provided proper replacement property is obtained. As with other §1033 transactions affecting real property, replacement property may be either like-kind or similar in use.[144] Reg. §1.1033(c)-1(a) states that the excess lands that are sold may be either: (1) lands that are not receiving water from the project; or (2) lands receiving water only because the owner has executed a valid recordable contract agreeing to sell the lands.

If the disposition includes property other than excess acreage (e.g., where the excess lands alone are not a marketable parcel), §1033 deferral is available only with respect to the excess portion.[145] Such dispositions of excess lands are treated as involuntary conversions for all purposes under Subtitle A of the Code, including §1231.[146]

2. Section 1033(d): Destruction of Diseased Livestock

Section 1033(d) provides generally that the death or disposition of livestock "by or on account of disease" is a potential §1033 transaction. Without §1033(d), the IRS might argue either that the disease was not a §1033 event or that the conversion into money via a "voluntary" sale or exchange was not an involuntary conversion within §1033. Section 1033(d) removes any such doubt on these points, although questions do remain. For example, the scope of the term livestock is uncertain; presumably it includes poultry in light of the express exclusion of poultry from the otherwise parallel provisions of §1033(e). Rev. Rul. 75-381 ruled that honeybees destroyed through a neighbor's use of pesticide were converted within the meaning of §1033(d).[147] Under Reg. §1.1033(d)-1(a), it is enough that the livestock have been exposed to disease and then sold on account of the disease; actual contraction of the disease is not necessary.

As to what constitutes disease, Rev. Rul. 59-174 concludes that dwarfism in cattle is not a disease. For §1033(d) purposes, "disease" is limited to degenerative ailments and does not include hereditary deficiencies. Note further that it is not necessary that the disease be of epidemic portions.[148] It is enough that the disease causes the death of livestock.[149]

An important difference between §1033(d) and §1033(e), discussed below in II.D.3., is that a conversion results under §1033(e) only to the extent that weather-induced sales exceed sales of livestock that normally would have occurred, while a conversion results under §1033(d) to the extent any livestock are destroyed or disposed of on account of disease.

For a further discussion of §1033(d) conversions, see 608 T.M., *Reporting Farm Income*.

3. Section 1033(e): Livestock Sales on Account of Drought, Flood, or Other Weather-Related Conditions

Section 1033(e) allows sales or exchanges of certain livestock "on account of drought, flood or other weather-related conditions" to qualify for §1033 treatment to the extent the number sold exceeds the number the taxpayer would have sold if he had followed his usual course of business.[150] The replacement period is extended to four years, rather than the two years of §1033(a)(2)(B), when the weather-related conditions result in the area becoming designated as eligible for federal assistance.[151]

Under the regulations, the sale or exchange of the livestock need not take place in the drought area, but the sale or exchange must be solely because drought conditions have adversely affected the water, grazing, or other requirements of the livestock so as to require their sale or exchange.[152] Section 1033(e) states that qualifying livestock are those that were held for draft, breeding, or dairy purposes.

Rev. Rul. 66-191 indicates that a taxpayer may come within §1033(e) even though he could have purchased replacement feed for the livestock. It also indicates a taxpayer may attempt to mitigate his losses by placing the livestock in a feed lot for fattening before sale without jeopardizing §1033(e) treatment. Section 1033(e) expressly excludes poultry from its definition

[141] *Warner v. Commissioner*, 478 F.2d 1406 (7th Cir. 1973), cert. denied, 415 U.S. 915 (1974); *Creative Solutions, Inc. v. United States*, 320 F.2d 809 (5th Cir. 1963); *S. & B. Realty Co. v. Commissioner*, 54 T.C. 863 (1970), acq., 1970-2 C.B. xxi; Rev. Rul. 81-181, Rev. Rul. 81-180, Rev. Rul. 69-303. *See also* PLR 200518066, PLR 9706004, PLR 9425018. Permitted transferees include agents for a potential condemnor. *See, e.g.*, Rev. Rul. 74-8; PLR 9145011.

[142] *See* Rev. Rul. 81-181.

[143] 43 U.S.C. §71 *et seq.* (1982).

[144] *See* Rev. Rul. 69-123.

[145] Reg. §1.1033(c)-1(b).

[146] Reg. §1.1033(c)-1(d).

[147] As to other possible definitions of livestock for §1033 purposes, see II.D.3., below.

[148] Rev. Rul. 61-216. Even though hyperkeratosis, a condition caused by contaminated feed pellets and not by infection, is not a disease and does not therefore come within §1033(d), destruction of cattle because of that condition can qualify as an involuntary conversion under §1033(a). Rev. Rul. 54-395, as modified by Rev. Rul. 59-174.

[149] Rev. Rul. 61-216. PLR 9214021 is an example of a ruling that applies §1033(e).

[150] §1033(e)(1).

[151] §1033(e)(2)(A). Further extended replacement periods are authorized under §1033(e)(2)(B) as appropriate if the weather-related conditions which resulted in the involuntary conversion persist for more than three years. The IRS issues an annual list of counties for which exceptional, extreme, or severe drought was reported during the previous 12-month period. *See* Notice 2006-82.

[152] Reg. §1.1033(e)-1(b). These regulations have not yet been updated for the changes to §1033(e) made by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34. Before 1997, §1033(e) applied only to drought.

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of livestock. The IRS ruled in PLR 7903064 that buffalo, despite a "wild" nature, are §1033(e) livestock.[153]

Replacement livestock must be "functionally" the same as those sold or exchanged, i.e., breeding or dairy animals cannot replace draft animals.[154] Similarly, the IRS has ruled that breeding males are functionally different from, and cannot be replaced with breeding females.[155] The proper analysis is whether the replacement property is "similar or related in service or use" to that converted, and not whether the replacement property is identical. See the discussion below at VII.B. Note that §1033(e) is limited to sales and exchanges occasioned by drought, flood, or other weather-related conditions, and does not apply if the livestock perish before they can be sold. If gain is produced as to such perished stock (perhaps through insurance), the gain presumably is eligible for §1033 deferral as gain attributable to the "destruction" of property.[156]

Another relief provision for farmers forced to sell livestock on account of drought, flood, or other weather-related conditions is §451(g), which generally allows the gain on excess livestock sales to be reported in the succeeding taxable year. If property is eligible for the extended replacement period under §1033(e), a cash method taxpayer may make the §451(g) deferral election at any time during the extended replacement period.

For a further discussion of §1033(e), see 608 T.M., *Reporting Farm Income*.

4. *Section 1033(j): Sales and Exchanges Under Certain Hazard Mitigation Programs*

A voluntary sale of property pursuant to §1033(j) is now treated as an involuntary conversion. The sale can be made to a federal, state, or tribal government. Programs include the Federal Flood Mitigation Assistance Program (FMA), the Pre-Disaster Mitigation Program, and the Hazardous Mitigation Grant Program.

5. *Deemed Involuntary Conversions Not Described in Tax Code*

Under §10 of the Maine Indian Claims Settlement Act of 1980,[157] private lands transferred to either the federal government or a particular tribe are deemed to be involuntary conversions under §1033.[158] The provision apparently was included in the federal enabling legislation as part of a negotiated settlement between the federal government, private landowners, and claimant Indians.

Similarly, §103 of the Miscellaneous Revenue Act of 1982 provided that an FCC-ordered sale of broadcast property, followed by a reinvestment in 100% of the stock of a corporation owning a newspaper, qualified for deferral under §1033. While the order of the FCC itself would likely have constituted an involuntary conversion without the express statutory language deeming the FCC sale order to be an involuntary conversion, the replacement of the sold broadcast property with corporate stock would likely not have qualified absent the statutory language. This is because the replacement was stock in a corporation owning a newspaper and therefore was not stock in a corporation owning broadcast property "similar in use" to that subject to the FCC order. Thus, the legislation was necessary to achieve deferral.[159] The provisions of the Indian legislation and the 1982 Miscellaneous Revenue Act impact only a narrow group of taxpayers. Nevertheless, both are useful reminders that Congress may expand §1033 to encompass particular individual situations.

Section 1078 of the Deficit Reduction Act of 1984[160] offers another example of special congressional relief for particular taxpayers. Under this provision, a taxpayer may reinvest equity grants paid by the Forest Service relative to the Boundary Waters Canoe Area.[161] Upon reinvestment, the equity grant is excluded from income. The election to reinvest the equity grant must be made in a manner prescribed by regulations, and should identify the converted property and the reinvestment property. The reinvestment election applies to tax years beginning after 1979, although taxpayers have until the later of two years after the equity grant or the enactment date of the 1984 Act (July 18, 1984) to reinvest. Congress intended this provision to remove any residual doubt about whether the designation of the Boundary Waters Canoe Area as a wilderness area caused an involuntary conversion for §1033 purposes. In Rev. Rul. 82-147, the IRS indicated that it in fact viewed the wilderness designation (including a prohibition on the use of motors with more than a 25 horsepower) as a §1033 involuntary conversion. Rev. Rul. 82-147, in turn, is consistent with several earlier private letter rulings.

The 1989 Ethics Reform Act[162] added §1043 to the Code, to provide that federal government executive branch employees or officers who are required to sell assets after November 30, 1989, to comply with conflict-of-interest divestiture requirements, may purchase "permitted property" (i.e., obligations of the United States or diversified investment funds approved by regulations) within a 60-day replacement period and elect to

[153] For other definitions of livestock, see §1231(b)(3); Reg. §1.1231-2(a)(3); Rev. Rul. 61-42, *rev'g* Rev. Rul. 57-548.

[154] Reg. §1.1033(e)-1(d).

[155] PLR 7903064 (breeding cows and bulls have dissimilar functions within the breeding process).

[156] *See* II.A., above.

[157] 25 U.S.C. §1729.

[158] *See* PLR 8129120. *See also* 25 U.S.C. §1716 (Rhode Island Indian Claims Settlement Act); 25 U.S.C. §1754 (Connecticut Indian Claims Settlement Act).

[159] Compare the result discussed in the text with PLR 201702034, PLR 201816008, and PLR 201821012, which were issued with regard to §6403 of Pub. L. No. 112-96. This legislation authorized the FCC "repurpose" spectrum in the 600 MHz band then being used by television broadcasters, with a goal of converting this band from television to mobile broadband use. To the extent that a television broadcaster did not voluntarily participate in the FCC's efforts, the legislation granted the FCC authority to "repack" (i.e., relocate) the television broadcaster to a different spectrum that might or might not replicate the broadcaster's existing coverage and therefore, might be less valuable. In PLR 201702034, PLR 201816008, and PLR 201821012, the IRS concluded that the right of the FCC to repack licenses was the equivalent of a condemnation (because compensation would be required due to the taking of a valuable property right for a public purpose); sale of the underlying FCC licenses to operate in the 600 MHz band to mobile broadband providers through an FCC-sponsored auction process was therefore a sale under threat of condemnation. Interestingly, PLR 201816008 concluded as well that the acquisition of stock in another broadcaster could constitute similar use property within the meaning of §1033(a)(2)(A). *See also* PLR 202042002 and PLR 202042003, involving similar spectrum auction options when the FCC wished to "repack" the 39 GHz portion of the spectrum under the same statutory authority.

[160] Pub. L. No. 98-369.

[161] *See* Pub. L. No. 95-495.

[162] Pub. L. No. 101-194.

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recognize gain only to the extent that the amount realized from the sale exceeds the permitted property's cost. The permitted property's basis must be reduced by the amount of gain not recognized, but the reduction is allocated in the order the property is acquired rather than according to the assets' fair market values. Note that trustees of trusts may make this election if federal government executive branch employees or officers (or certain immediate family members) have a beneficial interest in the principal or income of the trust.[163]

[163] *See* §1043(b)(5).

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III. Tax Consequences of Conversions into Similar Property Only: §1033(a)(1)

A. What Constitutes "Similar Property"

Section 1033(a)(1) provides for mandatory nonrecognition of gain in the event property is converted directly into property "similar or related in service or use"; i.e., in the event the taxpayer receives similar property as a result of the conversion. Although a more complete discussion of what constitutes similar property is contained in VII.B.1., below, generally "similar property" can be defined as property which is functionally similar to and has the same uses as the property being converted. That is, the replacement property must be physically similar, and the taxpayer's relationship to it must be substantially the same as the taxpayer's relationship to the converted property. The replacement property must substantially continue, and not alter, the nature and character of the taxpayer's investment.

Like-kind property, under §1033(g), can be direct replacement property if the requirements of §1033(a) are met.[164] For example, in PLR 8301042, a railroad's track was condemned, and in exchange, the railroad received rights to use another railroad's track. In PLR 7932062, one of two alternatives offered the taxpayer included construction by the Army Corps of Engineers of a replacement bridge. Although the ruling is not entirely clear, it appears that the other alternative also may have involved some direct replacement property, because the ruling indicates that basis would be determined under the first sentence of §1033(b) [now designated as §1033(b)(1) rather than the last sentence of §1033(b) [now designated as §1033(b)(2)]. However, as illustrated by PLR 9814030, the IRS may decline to rule whether property that purports to be direct replacement property in fact qualifies under §1033.

[164] Section 1033(g), discussed below in VII.B.3., deems like-kind property to be "similar or related in service" to the converted property for §1033(a) purposes when business or investment real property is condemned.

B. Consequences

There are three important consequences for direct conversions of converted property. First, nonrecognition of gain is mandatory.[165] Second, the basis of the replacement property is the basis of the old property, less money received on the conversion that was not expended in the acquisition of the new property, less any loss recognized, plus gain recognized, and plus any additional investment.[166] Third, the holding period of the replacement property includes the holding period of the converted property.[167]

> *Example:* For several years, Sarah owned a cargo aircraft, which, in 2003, the year it was destroyed, had a market value of $15,000,000 and basis of $7,300,000. Pursuant to its insurance policy with Sarah, Kickback Fire and Casualty provided Sarah with another aircraft worth $17,500,000. After two months, Sarah sold it for $17,800,000. On the involuntary conversion, Sarah cannot recognize gain because there has been a direct replacement. The replacement aircraft's basis is $7,300,000 ($7,300,000 − $0 cash + $0 recognized gain − $0 recognized loss + $0 reinvestment). Her holding period for the replacement aircraft includes the holding period for the converted aircraft.
>
> Had Sarah also received $2,500,000 cash, the transaction would not be covered by §1033(a)(1), because there would be a partial conversion into money. The consequences to part similar, part dissimilar conversions are set out in V.B., below.

[165] §1033(a)(1); Reg. §1.1033(a)-2(b).

[166] §1033(b) (first sentence); Reg. §1.1033(b)-1(a). Note that the example in Reg. §1.1033(b)-1(a) is a proper example of §1033(b) (first sentence) because it involves a pre-1951 conversion.

[167] §1223(1)(A); Reg. §1.1223-1(a). There is no doubt as to the application of §1223 inasmuch as the starting point for the direct replacement basis computation is the basis of the converted property.

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IV. Tax Consequences of Conversion into Dissimilar Property Only: §1033(a)(2)

A. What Constitutes Dissimilar Property

Section 1033(a)(2), the heart of §1033, deals with the tax consequences of conversions into "money or … property not similar or related in service or use." Dissimilar property for this purpose includes any property not meeting one of the several definitions of "property similar or related in service or use" contained in §1033. *See* VII.B., below. Section 1033(a)(2) provides for the recognition of gain to the extent that qualified replacement property is not purchased or a proper election is not made. Conversely, if the §1033 election and qualified replacement are made, gain realized on the conversion is not recognized.

B. Effect of No Valid §1033(a)(2) Election

A taxpayer who fails to make a qualified replacement under a §1033 election (whether due to non-election or an unsuccessful election) faces several consequences. First, he or she must recognize gain under the general rule of §1001(c). The character, though, of that gain is determined by an interaction of other Code provisions, e.g., §1221 (definition of capital assets), §1231 (property used in trade or business), §1245 (recapture of depreciation on personal property), and §1250 (recapture of depreciation on real property).[168] Second, under §1012, the taxpayer takes a cost basis in any replacement property. Third, the holding period of any replacement property begins on its acquisition.

C. Direct Effects of a Valid §1033(a)(2) Election

A valid §1033(a)(2) election and qualified replacement produces different tax results than if no election is made.[169] Upon election, realized gain is recognized only to the extent that the cost of replacement property is less than the cash plus fair market value of dissimilar property received for the converted property.[170]

A valid §1033(a)(2) election and qualified replacement have certain basis consequences. The basis of the replacement property is the cost of that property, decreased by any gain not recognized.[171] In addition, for involuntary conversions occurring after August 20, 1996, when the replacement property is corporate stock, not only must the taxpayer's basis in the corporate stock be reduced, but also, the corporation must reduce its basis in its property.[172] In general, the corporation's basis in its assets must be reduced by the same amount as the basis in the corporate stock is reduced. Special rules may apply to limit the amount of the reduction in the corporation's basis in its assets.

Finally, another effect of a §1033(a)(2) election and qualified replacement is that the holding period of the replacement property will include the holding period of the converted property.[173] The concept of tacking the holding period of the converted property onto the holding period of the replacement property is demonstrated in the examples below.

Example 1: Karl owns and uses an expensive camera in his photography business. He purchased his camera in 20X5, and it is now worth $2,500, with a basis of $300. The camera is stolen in 20X8, and Karl receives $2,000 from insurance. Karl decides not to replace the camera, since he has several new ones. Karl must recognize a $1,700 gain ($2,000 proceeds less $300 basis). Part of this gain will be ordinary income depending on his previous depreciation deductions and his other §1231 transactions during the year of theft. In the event Karl decides several years later to replace the camera, he will have a cost basis in the new camera, the holding period of which will begin on the day of purchase.

Example 2: Assume the same facts as in *Example 1*, except Karl's replacement camera costs only $1,500. Because Karl's reinvestment ($1,500) is less than the proceeds received ($2,000), §1033 deferral of gain is permitted only to the extent of the reinvestment ($1,500). Thus, Karl will have to recognize $500 gain, the character of which will be determined under §1231 and/or §1245. Karl's basis in the new camera is its $1,500 cost less $1,200 gain not recognized ($1,700 total gain less $500 recognized), or $300. His holding period in the new camera dates from 2004.

Example 3: Assume the same facts as in *Example 1*, except that Karl purchases for $3,000 all of the stock of a corporation which has as its sole asset a camera with a basis of $3,000. As a result of the theft, both Karl's basis in the corporate stock and the corporation's basis in its camera need to be reduced. The amount of the reduction in the corporate stock basis is always the gain being deferred, $1,700. The amount of the reduction in the basis which the corporation has in its own assets is also usually the gain being deferred, but on occasion may be less. On these facts, Karl's basis in the stock would be $1,300, as would the corporation's basis in the camera.

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[168] *See Wilson v. Commissioner*, 73 T.C.M. 2251 (1997), and *Kurata v. Commissioner*, 73 T.C.M. 2929 (1997), for examples of how such gain would be calculated.

[169] A collateral effect of a §1033 deferral election is that the statute of limitations for assessment of conversion-related deficiencies does not close until three years after the IRS is notified of replacement or nonreplacement. This is discussed in VI.A.5., below.

[170] §1033(a)(2)(A). For an illustration of this situation, see CCA 199919020, where the Chief Counsel's Office bifurcated an urban revitalization grant received by taxpayers into amounts (1) used to remediate flood damage to property and (2) amounts used to pay for improvements to a taxpayer's property. The Chief Counsel's Office advised that grant recipients may treat the former funds as received on account of flood damage and elect, in accordance with §1033, to defer recognition of gain to the extent the taxpayer incurs costs to remediate the flood damage to the property. The Chief Counsel's Office advised that the latter amounts were, in general, gross income to the recipient taxpayers under §61(a). *See also* CCA 199943037 (disaster loan recipients who realized income from partial loan forgiveness could elect under §1033(a)(2) to defer gain recognition to extent of amount of forgiven debt used to purchase qualified replacement property).

[171] §1033(b) (last sentence).

[172] §1033(b)(3).

[173] §1223(1)(A) and §1033(b) (last sentence); Rev. Rul. 72-451; *see also* PLR 7952102.

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Further examples demonstrating basis calculations for replacements made through corporate stock acquisitions are set forth below at VIII.D.

D. Potential Problem if Noncash Dissimilar Property Is Received

Most typically, when dissimilar property is received in a §1033 involuntary conversion, that dissimilar property will be cash. However, §1033(a)(2) still applies if non-cash dissimilar property is received. Because §1033 has no application to a subsequent sale of the dissimilar property,[174] taxpayers as a practical matter must provide the reinvestment funds from another source. This leaves the replacing taxpayer with the dissimilar property and the replacement property.

The basis of the dissimilar property following conversion depends on whether §1033 deferral was elected and a qualified replacement made. If deferral is not elected, gain is recognized to the extent the dissimilar property's fair market value exceeds the converted property's basis.[175] Thereafter, the dissimilar property's basis is its tax cost, i.e., the fair market value when received. If §1033 deferral is elected and qualified replacement property is obtained, only the basis of the qualified replacement property should be determined under §1033(b). Presumably, the basis of the dissimilar property would again be its fair market value, to avoid creating more potential gain than that deferred under §1033.

[174] *Cf.* Rev. Rul. 68-292 (gift to charity of replacement property does not cause recognition of built-in gain).

[175] Reg. §1.1033(a)-2(c)(1).

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V. Tax Consequences of Conversion into Both Dissimilar and Similar Property

A. Ambiguous Legal Standards

The Code and regulations do not address the proper tax treatment when property is converted into both direct replacement property and money. Literally, §1033(a)(1) applies only to direct conversions into similar property and §1033(a)(2) applies only to conversions into dissimilar property. However, when the conversion proceeds are part similar property and part dissimilar property, the transaction is functionally the same as a conversion into dissimilar property, only followed by replacement to the extent of the similar property. Because §1033(a) would allow a taxpayer who receives only cash conversion proceeds and then makes a qualified reinvestment of the entire proceeds to defer the entire realized gain, the result should be no worse when the taxpayer receives some of the qualified reinvestment property directly. Therefore, it appears appropriate to treat the part similar, part dissimilar proceeds as if all dissimilar property were received and then partially reinvested to the extent of the similar use property. Gain would be recognized to the extent of the non-reinvested cash, with the similar use property having a basis of "cost" less the deferred gain. While there is no direct authority on point, this approach (the "deemed cash approach") has the advantage of relative simplicity.

B. Examples of Deemed Cash Approach

Example: Darla purchased an apartment house in 20X2. In 20X8, when the property was condemned, her basis was $140,000, while the fair market value was $750,000. The City paid Darla $300,000 cash and provided her with another apartment house, which Darla will use and hold in a similar manner to the converted one. The replacement apartment house has a fair market value of $450,000. Darla does not reinvest the $300,000 cash.

Analysis: Darla has received total proceeds of $750,000, producing a gain of $610,000. If all the proceeds were treated as cash, followed by a reinvestment to the extent of the building's fair market value ($450,000), the realized gain of $610,000 would be recognized to the extent of the nonreinvestment, or $300,000. The basis of the replacement asset under the deemed cash approach would be $140,000, determined under §1033(b)(2) as follows: the building's cost, $450,000, less deferred gain of $310,000 ($610,000 realized gain less $300,000 recognized gain).

Example: Assume the same facts as in the previous example, except that Darla now purchases a qualified replacement property with the cash proceeds of $300,000.

Analysis: Under the deemed cash approach, Darla's reinvestment of the $300,000 would be sufficient under §1033(a)(2) to avoid recognition of the $610,000 realized conversion gain. This is because the proceeds received ($750,000) equal total qualified reinvestment ($450,000 direct replacement plus $300,000 purchased replacement). As to Darla's basis in the two properties, a total basis of $140,000 is produced for the replacement properties by reducing the aggregate reinvestment cost ($750,000) by the deferred gain ($610,000). This aggregate basis would be allocated between the properties in accordance with their respective fair market values.[176] Thus, basis in the purchased replacement property equals $56,000 ($300,000/$750,000 × $140,000) and basis in the direct replacement property equals $84,000 ($450,000/$750,000 × $140,000).

C. Is Nonrecognition Mandatory?

Even assuming the deemed cash approach is valid, an unanswered question is whether the gain realized through receipt of the direct replacement property may be recognized at the election of the taxpayer. Section 1033(a)(1)[177] provides that nonrecognition of gain upon receipt of direct replacement property is mandatory. Consistent application of the deemed cash approach, however, would allow recognition of gain at the election of the taxpayer.

[176] As to the allocation of basis between multiple replacement properties, see §1033(b)(2) and VIII.B., below.

[177] *See also* Reg. §1.1033(a)-2(b).

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VI. Making the Various §1033 Elections

A. *How and When Regular §1033(a)(2) Election Made: Rev. Rul. 83-39*

1. *On Return for All Years in Which Proceeds Received*

As discussed in IV., above, §1033 deferral results when a timely election is made and qualified replacement occurs. The regulations under §1033 provide that the §1033 deferral is elected to the extent that gain from the conversion is not included on the relevant return. Further, the regulations require a taxpayer to provide "all … details in connection with an involuntary conversion of property at a gain" on the return for the years in which any portion of the gain is realized.[178] These details would include what replacement property was acquired, the date it was acquired, and the cost to the taxpayer.[179] Depending on the purpose for which the converted property was held, its holding period, and the type of conversion, some combination of IRS Form 4684, Form 4797, Schedule C, Schedule D, or Schedule F will be necessary to report the gain. The taxpayer should consult the instructions for these forms for the particular tax year to determine the proper forms to use.

In PLR 8424026, the IRS ruled that where no designations of replacement property were made on the taxpayer's original return (in contrast to the situation in Rev. Rul. 83-39, below), replacement property that was the subject of dispute could be designated on an amended return upon receipt of the settlement agreement resolving the dispute.

In FSA 200147053, the IRS Chief Counsel's Office provided guidance on three issues concerning §1033 elections. First, it advised that a §1033 election is not effective for a taxable year for which a return has already been filed; however, a claim for refund for any year in which gain from the involuntary conversion is realized may be filed within the §6511 period of limitations. Second, it advised that if a return that is filed for a year does not report the details regarding replacement of the converted property, then no property acquired in that year can be qualified replacement property. Finally, it advised, no property can be designated as replacement property unless it was described as such on the *original* return for the year of replacement.

2. *Affirmative Statement Not Required, Only Exclusion*

Having established these general rules, the regulations provide that a failure to include gain shall be deemed a §1033 election even though the details are not reported in such returns.[180] Although this election, by omission, at first appears to favor taxpayers, it is in fact a two-edged sword. Once §1033 is elected, all tax years in which conversion gain is realized will remain open for assessment of conversion-related deficiencies until three years after the taxpayer notifies the IRS of replacement or nonreplacement. As discussed in VI.A.5., below, the result is significantly different from the usual assessment rules relating to omissions from income.

[178] Reg. §1.1033(a)-2(c)(2).

[179] *See Bliss v. Commissioner*, 27 B.T.A. 803 (1933).

[180] Reg. §1.1033(a)-2(c)(2) (fourth sentence).

3. *Changing a Previous Election*

Occasionally, a taxpayer will wish to change a decision regarding the application or nonapplication of §1033.

a. *Revoking a Nonrecognition Election*

Both *McShain v. Commissioner*[181] and Rev. Rul. 83-39 interpret Reg. §1.1033(a)-2(c)(2) to provide three situations in which a valid §1033 election may be changed or revoked:

(1) where the converted property is not replaced within the required time period;

(2) where replacement is at a cost lower than anticipated at the time of the election; or

(3) where a decision is made not to replace.[182]

In the limited circumstances under which §1033 deferral may be revoked, an amended return must be filed for each year in which gain was realized and not previously reported.[183] As the IRS indicated in TAM 7934001, the recognition of gain may require an increase in state income taxes as well. In addition, the IRS may assess interest on the tax due from the previously unreported gain on the amended return.[184]

Comment: Once the nonrecognition election is made, the purchase of any qualifying replacement property makes the §1033 election irrevocable. The purchase of replacement property that is not qualified property does not make a §1033 election final. For example, if a taxpayer purchases replacement property that is not qualifying replacement property, the taxpayer may substitute qualified replacement property, as long as the applicable replacement period has not expired. Although an argument can be made that replacement within the meaning of §1033 does not occur until replacement property is identified to the IRS, neither *McShain* nor Rev. Rul. 83-39 appears to attach much significance to such notification. This may prove to be a trap for the unwary, and taxpayers who have doubts whether §1033 deferral would be advantageous should consider reporting the gain, at least until their mind is made up. If nonrecognition proves more advantageous, that decision can be reversed, as discussed in VI.A.3.b., below.

However, in TAM 8422005, the IRS determined that neither the Code nor the regulations require that the first purchased replacement property be designated as such. Thus, any quali-

[181] 65 T.C. 686 (1976). A related case, *McShain v. Commissioner*, 68 T.C. 154 (1977), deals with whether the particular replacement property was similar in use to that converted.

[182] *Accord* TAM 7809006.

[183] Reg. §1.1033(a)-2(c)(2).

[184] *See Suffness v. United States*, 92-1 USTC ¶50,149 (N.D. Tex. 1992), aff'd, 974 F.2d 608 (5th Cir. 1992), where the court held that the assessment of interest from the due date of the original return to the date the tax on the gain was paid was proper. The court stated that, although §1033 and the regulations are silent as to the imposition of interest if reinvestment is not made during the deferral period, §6601(a) provides general rules for interest calculations and provides that interest be charged on any tax underpayment. Although the parties were not aware of any cases or ruling on this issue under §1033, the court cited Rev. Rul. 122, 1953-2 C.B. 226, dealing with the predecessor to former §1034, which requires interest to be assessed on a tax deficiency that arises when a taxpayer who has sold his or her residence fails to purchase a new residence within the required time period. Moreover, in appropriate circumstances, the existence of a deficiency due to a failure to correctly defer gain under §1033 could cause a late filing penalty to apply. *See* TAM 9548005.

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fying property acquired during the replacement period can be designated as replacement property.

b. Electing Deferral After Recognition of Gain

The regulations provide that a taxpayer may elect to defer conversion gain after a return reporting the gain has been filed, so long as the election is made before the expiration of the period of time within which the converted property must be replaced.[185] To elect §1033 in such circumstances, the taxpayer must purchase replacement property within the statutory period and file a claim for refund or credit for each year in which gain was reported. In Rev. Rul. 63-127, the IRS concluded that the refund claim need not be filed within the replacement period, but only within the normal refund period of §6511. Although favorable to taxpayers, this result is questionable based on the language of the regulations. Taxpayers may therefore wish to make a protective refund claim within the replacement period. The refund claim should be filed in the same place as the original return.

In *Santucci v. Commissioner*,[186] the taxpayer realized gain from an involuntary conversion, and recognized the gain on his return for the conversion year. In the course of an audit after the replacement period had run, the taxpayer sought to make an election and replacement. The Tax Court did not allow the late election and replacement, concluding that an actual election and replacement must occur within the statutory replacement period for nonrecognition to be allowed.

The IRS generally will not extend the time period for electing nonrecognition treatment. In TAM 9138002, the taxpayer argued that the regulations under §1033 should be interpreted to allow requests for an extension of time to elect nonrecognition treatment. Such regulations expressly allow requests only as to an extension of time to replace the converted property. The National Office advised, however, that a taxpayer may not request an extension of time to elect to defer gain on an involuntary conversion under Reg. §1.1033(a)-2(c)(3), reasoning that §1033 is an exception to the general rule that gain or loss must be recognized on the sale or exchange of property, and as an exception must be strictly construed. The National Office explained that when Congress rewrote §1033 in 1951, its intent was that replacement property would generally be purchased within the defined replacement period, and that the IRS would have authority to grant extensions of time to make that purchase. The National Office stated that Congress did not indicate that the extension of time should apply to the election period as well as to the replacement period. The National Office advised that, consistent with Congress's intent, the "period" referred to in Reg. §1.1033(a)-2(c)(3) for which a taxpayer may request an extension is the period within which the converted property must be replaced, and not the period within which an election may be made.

4. Particular Details Required for §1033(c), §1033(d), and §1033(e)

When the involuntary conversion is a sale pursuant to the reclamation laws,[187] the sale or destruction of livestock on account of disease,[188] or the sale of livestock on account of drought, flood, or other weather-related conditions,[189] the taxpayer must report particular details concerning the conversion on the return for the taxable year or years in which any gain from such conversion is realized. The regulations[190] describe these added details, but are silent as to the effect of a failure to include such details. Presumably, a deemed election under Reg. §1.1033(a)-2(c)(2) would still apply if the details were inadvertently omitted.

The details that must be reported on the disposition of excess property within an irrigation project must include (1) "the authority whereby the lands disposed of are considered 'excess lands'" and (2) "a statement that [the] disposition is not part of a plan contemplating the disposition of all or any nonexcess land within the irrigation project or division."[191]

The details that must be reported in connection with the disposition of livestock because of disease include a recital of the evidence that the livestock were destroyed by or on account of disease, or sold or exchanged because of disease.[192]

The details in connection with a sale or exchange of livestock on account of drought must include: (1) "evidence of the existence of the drought conditions which forced the sale or exchange of the livestock"; (2) "a computation of the amount realized on the sale or exchange"; (3) "the number and kind of livestock sold or exchanged"; and (4) "the number of livestock of each kind that would have been sold or exchanged under usual business practices in the absence of the drought."[193] Presumably, similar information must be provided for sales on account of floods and other weather-related conditions.

5. Collateral Effects of §1033(a)(2) Election

Once the taxpayer elects §1033 deferral, the statute of limitations for each gain year remains open for assessment until three years after the IRS is notified of replacement or of failure to replace.[194] This rule operates to extend the period of assessment not only against an electing taxpayer, but in the case of a partnership, against the individual partners who will pay the tax on the conversion gain, even though only the partnership can elect §1033.[195] A similar rule applies to shareholders of S corporations.[196]

Under the deemed election rule discussed in VI.A.2., above, the taxpayer's omission of realized conversion gain keeps the tax year open indefinitely for assessment of related gain, even though §6501(c) would achieve the same result only in cases of fraud, willful attempt to evade tax, or non-filing.

If the replacement property was purchased before the beginning of the last tax year in which conversion gain is realized,

[185] Reg. §1.1033(a)-2(c)(2).
[186] 32 T.C.M. 840 (1973).
[187] §1033(c).
[188] §1033(d).
[189] §1033(e).
[190] Reg. §1.1033(c)-1(c), §1.1033(d)-1(b), §1.1033(e)-1(e).
[191] Reg. §1.1033(c)-1(c).
[192] Reg. §1.1033(d)-1(b).
[193] Reg. §1.1033(e)-1(e).
[194] *See* §1033(a)(2)(C). *See, e.g.*, FSA 200236003 (submission of amended return reallocating insurance proceeds between taxable and nontaxable income started running of special period of limitations for assessment).
[195] *Rosefsky v. Commissioner*, 70 T.C. 909 (1978), aff'd, 599 F.2d 515 (2d Cir. 1979).
[196] Rev. Rul. 79-158.

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related deficiencies for all earlier years may be assessed as long as the last year is open.[197]

In *Cerny v. Commissioner*,[198] taxpayers elected §1033 deferral on a joint return. Subsequently, the taxpayers divorced, with the husband retaining the duty to make any necessary amendments to the couple's tax return. Replacement property was never purchased, and the IRS asserted a deficiency against the couple. The Tax Court concluded that the wife was entitled to innocent spouse relief. Taxpayers should not assume, however, that the innocent spouse relief provision will be so readily applied.

B. Making the §1033(g)(3) Election

1. General Statement of §1033(g)(3) Effect

Replacement property may be "like kind" if business or investment real property is condemned.[199] A taxpayer may elect to treat outdoor advertising displays as real property for purposes of Chapter 1 of Subtitle A.[200] The election, once made, applies to all outdoor advertising displays of the taxpayer, including those acquired or constructed in a taxable year after the taxable year for which the election is made.[201] Three of the more apparent effects of this election are:

(1) to allow the replacement of such signs with any real property interest upon involuntary conversion;

(2) to allow the tax-free exchange of such signs for any real property interest under §1031;

(3) to preclude an election under §179 to expense certain depreciable business assets for any such signs acquired subsequently by the taxpayer.

2. When Election Made; Revocation

The §1033(g)(3) election must be made by the time for filing the return (including extensions) for the first taxable year to which the election is to apply.[202] Because the time for making the election is set by regulation, the IRS's discretionary authority under Reg. §301.9100-1 to allow certain untimely elections may apply.[203]

3. Content of Statement

A statement must be attached to the return clearly indicating that the §1033(g)(3) election to treat advertising displays as real property is being made.[204] The election may be revoked only with IRS consent.[205] Reg. §1.1033(g)-1(b)(2)(ii) sets forth the information to be included with a request to revoke the election.[206]

C. Who Makes a Particular Election

Section 1033(a)(2)(A) and §1033(g)(3) both refer to the "taxpayer" as the one who must make the relevant election. Normally, the person who would otherwise owe the tax from the realized gain is the same person who owns the converted property. Where multiple persons own the property as tenants in common, each is free to make his or her own §1033 election,[207] because the tenancy in common is not a legal entity apart from the tenants.

Note: It is possible that the tenants in common might, nonetheless, be found by the IRS to be a partnership. See VIII.H., below.

From the foregoing, it follows that a corporation, trust, or estate must make its own election apart from its beneficiaries. The converse is also true, viz, that shareholders and beneficiaries generally may not elect for the corporation, trust, or estate. Leaving these rules aside, the taxpayer may be able to assert that true ownership (and thus the ability to replace) lies with someone other than the record owner.[208]

1. Partnership Must Elect

At one point, it was arguable that the "taxpayer" for election purposes was the individual partner, because he or she would owe the tax from a conversion.[209] The IRS has constantly asserted that because the election affects the computation of taxable income derived from a partnership, §703(b) requires the election to be made at the partnership level.[210] Beginning with *Demirjian v. Commissioner*,[211] the courts have adopted the view that only the partnership may make the §1033 election as to partnership property. This result now appears well settled.[212] For example, in *Fuchs v. Commissioner*,[213] the partnership had dissolved for state law purposes when Dr. Fuchs left the partnership. The Tax Court nevertheless required the partnership to make the §1033 election because the partnership continued for tax purposes until it was terminated within the meaning of

[197] §1033(a)(2)(D); Reg. §1.1033(a)-2(c)(6).

[198] 54 T.C.M. 1259 (1987).

[199] §1033(g). See the discussion in VII.B.3., below.

[200] §1033(g)(3). *See* PLR 201450004 (in addition to inherently permanent advertising display, ancillary housing structures and ancillary sign assets that are integral parts of sign structure constitute parts of outdoor advertising display, and thus, §1033(g)(3) election also applies to ancillary housing structures and ancillary sign assets); PLR 201450001 (taxpayer elected to treat its permanently affixed outdoor advertising displays as real property, including digital light-emitting diode displays previously treated as five-year property for depreciation purposes).

[201] Reg. §1.1033(g)-1(b)(1). *See* PLR 200041027 (§1033(g)(3) election would not change 15-year recovery period of signs depreciated under §168, provided §168 alternative depreciation system did not apply to signs and provided that signs were inherently permanent structures for depreciation purposes).

[202] Reg. §1.1033(g)-1(b)(2).

[203] *See, e.g.*, PLR 8322029.

[204] Reg. §1.1033(g)-1(b)(2)(i)(B). See the Bloomberg Tax Elections & Compliance Statements, *Involuntary Conversion: Outdoor Advertising Displays Election to Treat as Real Property (§1033(g)(3)(A))*, for a sample election statement.

[205] *See* Reg. §1.1033(g)-1(b)(2)(ii).

[206] Examples of successful requests to revoke the §1033(g)(3) election include PLR 8325022 through PLR 8325033, and PLR 9017013 (allowing revocation based on unanticipated enactment of §168 (accelerated cost recovery system)).

[207] *See McShain v. Commissioner*, 68 T.C. 154 (1977); PLR 8041060.

[208] *See George v. Commissioner*, 38 T.C.M. 591 (1979).

[209] *See* §7701(a)(14), §701.

[210] *See* Rev. Rul. 66-191.

[211] 54 T.C. 1691 (1970), aff'd, 457 F.2d 1 (3d Cir. 1972).

[212] *E.g.*, *McManus v. Commissioner*, 65 T.C. 197 (1975), aff'd, 583 F.2d 443 (9th Cir. 1978), cert. denied, 440 U.S. 959 (1979); *Fuchs v. Commissioner*, 80 T.C. 506 (1983); *Estate of Goldstein v. Commissioner*, 35 T.C.M. 71 (1976); *Varner v. Commissioner*, 32 T.C.M. 97 (1973), *Myers v. United States*, 72-2 USTC ¶9669 (S.D. Cal. 1972). *See also* PLR 8424099 (purchase and titling of replacement property must take place at partnership level and not partner level since partnership held title to destroyed building and underlying land).

[213] 80 T.C. 506 (1983).

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§708.[214] A partnership-level election presumably would be required also where title to the partnership property has been left in the individual partner's names but the partnership is the true owner.[215] The owner of the property who conveys it to the condemning authority must elect §1033. This is so even though the new owner acquires it with knowledge of the imminent condemnation.[216]

In PLR 8916034, three individuals purchased a parcel of land as tenants in common. However, when the property was later condemned, the condemnation proceeds were deposited into an account that identified the three individuals as partners, and they filed a partnership tax return that year. The IRS ruled that the property was held by the three individuals as partners at the time of the sale and so the partnership was the proper person to elect under §1033 to defer recognition of the gain. Conversely, where a partnership conveys the property to its partners before selling it to the condemning authority, the individual partners make their own separate decisions whether to replace.[217]

2. S Corporations Must Elect

Generally, S corporations are required to make any election affecting the computation of items derived from the corporation.[218] It appears likely that the case law interpreting §1363(c)(1) will follow the rule under §703(b), and thus, the §1033 election should be made with the corporate return.[219]

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[214] *See also* PLR 8015044 and PLR 8947023.

[215] *See* PLR 8006092.

[216] *See* PLR 8527090.

[217] *See* PLR 9022037 (individual partners may independently elect §1033 treatment for condemned property conveyed by partnership to partners as tenants in common before property's sale to condemning authority); PLR 8527090 (same).

[218] §1363(c)(1).

[219] *See also* Rev. Rul. 79-158 (IRS assumed §1033 election made with corporate return valid); PLR 8915013 (same).

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VII. Making the §1033(a)(2) Replacement

The heart of §1033 is the requirement that the taxpayer purchase qualified replacement property within the statutory period. Each of these components is discussed more fully below.

A. Who May Replace

1. General Rule: The Taxpayer

As discussed in VI.C., above, §1033(a)(2) requires that the "taxpayer" acquire the replacement property. When the taxpayer who owns the converted property is still alive or exists, that taxpayer can simply make the replacement subject to the rules discussed here. Thus, a taxpayer who replaces property held as a tenant-in-common with property held as a joint tenant is entitled to defer recognition of gain under §1033, provided the replacement property otherwise qualifies.[220] Considerably more difficulty arises if the replacing taxpayer is not the taxpayer who owned the converted property. For example, in PLR 199909054, replacement property received by an entity that was (1) controlled by the taxpayer, and (2) not respected as an entity separate from the taxpayer, was ruled to have been received directly by the taxpayer. Similarly, in PLR 199945038, the IRS ruled that a single-member LLC's purchase of qualified replacement property for condemned property that was owned by the LLC's member would not preclude elective nonrecognition of gain by the member under §1033(a)(2). By contrast, as discussed below, the replacement of converted property that was owned by a corporation or partnership must be made by that entity rather than by its shareholder(s)/partner(s), and vice versa.

2. Corporations

a. Corporations vs. Shareholders

Because a corporation is a legal entity separate from its shareholders, only the corporation may replace converted corporate property.[221] When a corporation is liquidated following an involuntary conversion, replacement must generally be made by the corporation before complete liquidation.[222] Unless the corporation is liquidated into another corporation under §332, the shareholders cannot make the replacement.[223] Shareholders cannot make the replacement even when a corporation has been involuntarily dissolved for state law purposes at the time of conversion, as long as the corporation continues as a tax entity.[224]

Even if a corporation is liquidated before actual closing of the sale under threat of condemnation, so that the shareholders close the sale, the IRS will likely treat the corporation as the taxpayer that must replace, if it is the corporation that negotiated the sale. In the context of a sale under threat of condemnation, of course, it is the taxpayer who makes the sale that suffers the conversion. Thus the critical question is who has made the sale. In *Court Holding Co. v. Commissioner*,[225] the Supreme Court held that a purported sale by shareholders of distributed property should be disregarded and the transaction reconstructed as a sale by the corporation that actually negotiated the sale. In TAM 9645005, the IRS National Office indicated that an analysis similar to that set forth in *Court Holding* could apply in the context of §1033. Although the entity making the distribution before the sale was a partnership rather than a corporation, TAM 9645005 is a clear indication that the IRS will look to substance rather than mere form. Practitioners who desire to have the shareholders suffer the conversion, so that they, rather than their corporation, make the replacements, would be wise to structure any necessary distribution of property well in advance of the actual sales negotiations, and not just in advance of closing after the parties are already bound.

b. Successor Corporate Entities

Whether a successor corporate entity may replace the converted property depends on the particular relationship between the corporations. Generally, replacement by another corporation does not satisfy the statute, as the difference in corporate entities must be respected.[226] Similarly, where a partial replacement is made by one corporation and the partial replacement and the right to remaining insurance proceeds are sold to another entity, replacement by the purchaser does not suffice.[227] On the other hand, the IRS ruled in PLR 7945077 that a corporation that has been recapitalized within the meaning of §368(a)(1)(E) is the same corporation as the predecessor corporation, and may replace on its own behalf.

Section 381(c)(13) permits certain successor corporations to replace for their corporate predecessors. In general, §381(c)(13) provides that an "acquiring corporation" within the meaning of §381(a) is treated for §1033 purposes as if it were the transferor corporation.[228] PLR 8140045 contains an example of the application of §381(c)(13). A broadcast subsidiary sold its operating assets pursuant to an FCC tax certificate. Thereafter, the subsidiary was liquidated into the parent. The IRS allowed

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[220] *See* TAM 8750001.

[221] Rev. Rul. 73-72. *See Feinberg v. Commissioner*, 45 T.C. 635 (1966), aff'd, 377 F.2d 21 (8th Cir. 1967); Rev. Rul. 56-636; TAM 9051001; PLR 8312014, PLR 7945077. *But see* PLR 19990954 (receipt of replacement property by entity controlled by taxpayer that is not respected as an entity separate from taxpayer is deemed receipt of property directly by taxpayer).

[222] Rev. Rul. 73-72. *Cf.* Rev. Rul. 55-517 (liquidating corporation may replace before liquidation). *See Van Heemst v. Commissioner*, 72 T.C.M. 26 (1996) (shareholder may not replace for liquidating corporation where liquidating corporation suffers involuntary conversion). In PLR 8642039, the IRS ruled that a shareholder who receives property as a distribution during a corporate liquidation can make a §1033 election when the property is later involuntarily converted, as long as the conversion is not deemed to occur at the corporate level under the doctrine of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (liquidation of closely held corporation followed by prearranged sale of its assets by shareholders treated as sale by corporation before liquidation). In recent years though, partnerships, and to a lesser extent S corporations, have presented problems in that neither is a "true" taxpayer.

[223] Rev. Rul. 73-72; *Van Heemst v. Commissioner*, 72 T.C.M. 26 (1996) (shareholder may not replace for liquidating corporation where liquidating corporation suffers involuntary conversion).

[224] *Hill v. Commissioner*, 66 T.C. 701 (1976). *Cf. Fuchs v. Commissioner*, 80 T.C. 506 (1983).

[225] 324 U.S. 331 (1945).

[226] *Vim Secs. Corp. v. Commissioner*, 130 F.2d 106 (2d Cir.), cert. denied, 317 U.S. 686 (1942).

[227] *W. & B. Liquidating Corp. v. Commissioner*, 71 T.C. 493 (1979).

[228] A recapitalized corporation is not within §381(a)/§381(c)(13) because there has been no transfer. *See also Excelsior-Leader Laundry Co. v. Commissioner*, 8 B.T.A. 183 (1927), nonacq., VII-2 C.B. 47 (pre-§381 law; allows replacement by consolidated group member before, but in year of, consolidation).

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the successor parent to obtain §1033 deferral.[229] The §381(a) transfer, however, has no effect on the replacement period.[230] Thus, if the first tax year in which conversion gain is realized is the acquired corporation's year ending on the date of transfer, the acquiring corporation has only two years (or three years if §1033(g)(4) applies) to replace the converted property unless an extension is granted. See VII.E., below, for determination of the replacement period.

PLR 9630010 sets forth another example of §381(c)(13). This letter ruling illustrates both the right way and the wrong way to use a successor corporate entity to make §1033 replacements. The facts of the ruling are: Corporation 1 suffers an involuntary conversion and is owned 70% by Corporation 2 and 30% by Corporation 3. Corporation 2 acquires the replacement property and then proceeds to purchase the 30% stock interest held by Corporation 3 in Corporation 1. Following Corporation 2's acquisition of 100% ownership of Corporation 1, Corporation 1 is liquidated under §332 into Corporation 2. The letter ruling concludes that this fact pattern does not qualify for §1033 deferral because Corporation 1 was liquidated into Corporation 2 after Corporation 2 had acquired the replacement property. PLR 9630010 contrasts this fact pattern with the result if Corporation 2 had accomplished the §332 liquidation and then made the replacement. Although the economics are identical, accomplishing the §332 liquidation before the replacement allows §1033 deferral. The difference turns on the fact that Corporation 2 cannot step into Corporation 1's shoes for §1033 purposes until after the §332 liquidation. Only then does §381(c)(13) permit the acquiror to be the corporation suffering the conversion.

Similarly, a §355(a)(1) spin-off transaction will not affect the status of the spun-off corporation as the proper taxpayer to obtain replacement property since the spin-off affects only the ownership of the corporation, and not its existence.[231]

c. Replacement by Related Corporations

The general rule respecting corporations as independent taxpayers also applies in the context of related corporations. In Rev. Rul. 56-636, for example, the parent corporation was insured against loss to its subsidiary's property. When loss occurred, the parent contributed the insurance proceeds to its subsidiary, which thereafter made the replacement. Rev. Rul. 56-636 indicates that the property owned by the parent was the subsidiary as a whole and not any of the subsidiary's specific properties. Thus, the IRS denied §1033 treatment because the parent suffered no conversion. Similarly, in *Fort Hamilton Manor, Inc. v. Commissioner*[232] and TAM 9051001, the Tax Court held and the IRS advised, respectively, that the purchase of replacement property by an affiliated corporation will not satisfy §1033. In such cases, of course, had the corporation that actually suffered the loss received the insurance proceeds directly because it was the insured and then made the replacement, §1033 would have applied.

3. Estates

The requirement of replacement by the "taxpayer" has also caused problems where the taxpayer dies before making an election or before obtaining replacement property. Under a version of the statute applicable before 1951 (which did not expressly require replacement by the taxpayer), the Third Circuit indicated an estate could make the replacement for the decedent,[233] and the IRS thereafter agreed.[234]

In Rev. Rul. 64-161, the IRS reversed its previous position and concluded that §1033 deferral cannot apply if the taxpayer dies before replacement occurs. Particular emphasis in Rev. Rul. 64-161 was placed on statutory language, applicable after 1951, requiring the "taxpayer" to replace. The essence of Rev. Rul. 64-161 is that §1033 contemplates only an involuntary interruption in a continuing investment. Failure to continue the investment, says the ruling, requires recognition of gain and the rule is no different when the failure occurs through the taxpayer's death. A further factor in Rev. Rul. 64-161 was the step-up in basis accorded the replacement property by §1014, thereby allowing the deferred gain to permanently escape recognition.

In *Estate of Morris v. Commissioner*,[235] the Tax Court rejected Rev. Rul. 64-161. In *Morris*, replacement of the converted property through construction had begun before the decedent's death. The decedent was closely involved with the planning and construction of the replacement structure. The §1033 election was exercised in the decedent's final return, which was filed jointly with his wife. A majority of the Tax Court relied on *Goodman*[236] to conclude that the deferral requirements were met in that the decedent was the architect of the plan of replacement and the testamentary trustees were acting on his behalf in completing the replacement. The Fourth Circuit affirmed,[237] noting that the IRS had consistently followed *Goodman* for the 10-year period before 1964. The IRS nonacquiesced.[238] In *Chichester v. United States*,[239] a district court relied on *Morris* and *Goodman* to conclude that §1033 deferral was appropriate when the decedent had actually made the §1033 election, and had been involved with selection of the replacement property.

The results in *Goodman*, *Morris*, and *Chichester* contrast with the result in *Estate of Jayne v. Commissioner*.[240] In *Jayne*, the proceeds from the conversion of the husband's sole property were placed in joint tenancy bank accounts owned by the husband and his wife. The husband acquired replacement land, but he was unable to satisfactorily improve the land due to zoning problems. Several extensions of the replacement period

[229] *Accord* PLR 8204095 and PLR 8140045. *See also* PLR 8104195 and PLR 8834075 (merger of two subsidiary corporations within §381(c)(13)).

[230] *See* PLR 8834075.

[231] *See* PLR 8521039.

[232] 51 T.C. 707 (1969), acq., 1970-2 C.B. xix, aff'd, 445 F.2d 879 (2d Cir. 1971). *But see Excelsior-Leader Laundry Co.*, 8 B.T.A. 183 (1927), nonacq., VII-2 C.B. 47. *See* PLR 8901031 (property acquired by taxpayer's affiliate does not qualify as replacement property unless and until taxpayer itself, and not its affiliate, acquires property; further, transaction between taxpayer and affiliate must comply with arm's-length standard of Rev. Rul. 73-120 for property to qualify as replacement property); PLR 9546003, PLR 8950029. *Caution:* These authorities should be read in conjunction with §1033(i), discussed below at VII.C.3.

[233] *Estate of Goodman v. Commissioner*, 199 F.2d 895 (3d Cir. 1952).

[234] Rev. Rul. 58-407.

[235] 55 T.C. 636 (1971), nonacq., 1978-2 C.B. 4, aff'd, 454 F.2d 208 (4th Cir. 1972).

[236] 199 F.2d 895 (3d Cir. 1952).

[237] 454 F.2d 208 (4th Cir. 1972).

[238] 1978-2 C.B. 4.

[239] 78-1 USTC ¶9458 (N.D. Ala. 1978).

[240] 61 T.C. 744 (1974).

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were granted, but the husband died before replacement could be made. Following his death, his wife (who was also his executrix) sought to complete the replacement using the proceeds of the joint tenancy accounts. These accounts had passed to her by operation of law outside the probate estate. The Tax Court denied §1033 treatment in that the replacement went beyond mere completion of the decedent's plans; rather, the replacement in *Jayne* involved the wife's use of her own funds which had passed to her without Probate Court supervision, to further her own aims.

Comment: A fair conclusion to be drawn from the cases concerning replacement by estates is that the Tax Court will allow the estate (and/or the late taxpayer's successors at law) to finish, but not start, the taxpayer's replacement. Accordingly, efforts should be made to identify and preserve those facts tending to show decedent's participation in the replacement process. Despite the Tax Court's holdings discussed above, the IRS is continuing to resist §1033 deferral when the taxpayer does not completely replace converted property before death.

If it is the estate, on the other hand, that suffers the involuntary conversion, then the estate must replace and not its beneficiaries. Note that where the possibility of the conversion is known in advance (e.g., a condemnation), it may be possible to restructure ownership of the asset before the conversion. Thus, the estate could distribute land which may be condemned to the beneficiaries in kind. Assuming that distribution is valid under state law, the result should be that the beneficiaries own the asset at the time of the conversion, and thus, they may replace. This is similar to the result where a partnership distributes its property before condemnation to its partners, who then hold as tenants in common.[241]

4. Trusts

Before Rev. Rul. 64-161, a trust could receive §1033 proceeds, terminate, and distribute the proceeds to the beneficiaries, and the beneficiaries could make the replacement.[242] Consistent with the approach taken with regard to estates, Rev. Rul. 64-161 also reversed the IRS's position regarding trusts. The IRS ruled on the replacement of property owned at the time of condemnation as undivided interests by trusts and by beneficiaries of those trusts.[243] In one situation, one beneficiary and his wife had purchased and taken title to replacement property as community property even though the wife had not owned the condemned property. On his tax return, the beneficiary identified the purchased property as his replacement property under §1033. The wife then sold her interest in the purchased property to the husband's trust, which treated that interest as replacement property under §1033. In the other situation, the second beneficiary had purchased and taken title to property in his name but did not identify the purchased property on his return as replacement property under §1033. He then sold the property to his trust, which treated the interest as replacement property under §1033. The IRS ruled that the circumstances of the purchase of the property by each trust did not prevent the purchased property from being qualified replacement property under §1033.

Notwithstanding Rev. Rul. 64-161, Rev. Rul. 70-376, concluded that a grantor who is taxable under the grantor trust provisions (§671 et seq.) on gain from the sale of trust property is able to make the replacement and defer the gain.[244] Presumably, if statutory provisions had not rendered the grantor taxable on sale gain, the application of Rev. Rul. 64-161 would have meant only the trust could make the replacement. The IRS amplified the conclusions of Rev. Rul. 70-376 by ruling, in Rev. Rul. 88-103, that the grantor trust can purchase replacement property without affecting the nonrecognition available under §1033. The theory is that whether the replacement property is purchased by the grantor or the grantor's trust is of no consequence for §1033 purposes since the grantor is treated as the owner of the property. This ruling reflects the IRS's policies previously set forth in PLR 8234048 and PLR 8729023.

In *Estate of Gregg v. Commissioner*,[245] the Tax Court concluded that the trustee of a revocable inter vivos trust could complete replacement, after the grantor's death, of property converted from the trust. Replacement of the property began under the grantor's direction before his death, and the post-death purchases continued the nature and direction of the pre-death replacement. On these facts, the Tax Court held §1033 deferral permissible. Similarly, PLR 8138156 approved an election and replacement by a testamentary trust.

TAM 9232004 illustrates another variation on this pattern. The question was whether the beneficiaries or the trust was the person that suffered the involuntary conversion. The National Office advised that because a valid disclaimer had caused the property to pass directly to the beneficiaries, the beneficiaries were required to replace. Had the property passed under state law to the trust, the trust would have suffered the involuntary conversion, and the trust would have been the taxpayer to elect deferral.

5. Partnerships

Under the cases discussed at VI.C.1., above, the normal rule is that the partnership, and not the individual partners, must elect §1033 deferral and thereafter make the replacement if the partnership actually suffers the conversion.[246] Often, partners will disagree about what the replacement property should be (as well as whether any replacement should actually be made). There are several ways to address this situation.

One way is to distribute the partnership property that is to be converted to the individual partners, to be held following the distribution as tenants in common rather than partners. Care should be taken so that the restructuring occurs well before the event constituting the involuntary conversion so that it is the former partners (in their new capacity as tenants in common)

[241] *See* VI.C., above. *See also* TAM 9645005 (where partnership had already legally bound itself to make sale under threat of condemnation, only it and not its partners could make replacement even though property was distributed to partners before closing).

[242] *See* Rev. Rul. 58-407.

[243] PLR 9649018.

[244] *See also* PLR 8234048 (grantor trust allowed to take title without affecting replacement).

[245] 69 T.C. 468 (1977). PLR 8729023 (also allowed grantor trust to purchase replacement property on behalf of grantor).

[246] *See, e.g., McManus v. Commissioner*, 583 F.2d 443 (9th Cir. 1978), cert. denied, 440 U.S. 959 (1979). *But see* TAM 8750001 (where property is distributed to partners before condemnation, partner may reinvest proceeds in qualified replacement property and take title in that property with unrelated individual as joint tenant).

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who suffer the involuntary conversion.[247] Care should also be taken that if a tenancy in common agreement is entered to control the property, that the provisions are not such as to allow the IRS to argue that the tenancy in common is really a disguised partnership.

Another approach is restructure the old partnership (presumably with only those of the "old" partners who agree on replacement) and to then use the restructured partnership to make the replacement. So long as the restructured partnership is treated for tax purpose as a continuation of the old partnership, PLR 8244124 is authority that the new partnership can make the replacement.

Note: Under the law at the time PLR 8244124 was issued, the resulting partnership would be a continuation of the old partnership only if more than 50% of the partnership interests remained the same. Otherwise, the "old" partnership would technically terminate and the right to make the replacement would be lost. This provision was contained in former §708(b)(1)(B), which was repealed by the TCJA, effective for tax years beginning on or after January 1, 2018.

PLR 200921009 expands upon this approach. In PLR 200921009, a general partnership that had two 50% partners suffered a condemnation and made the §1033 election. Thereafter, two new partnerships were established and carefully structured so that each of the new partnerships' members had previously owned more than 50% of the old partnership's capital and profits. The IRS concluded under §708(b)(2)(B) that each of the new partnerships was a continuation of the old partnership so that both partnerships could make the replacement for the "old" partnership. This allowed each of the new partnerships to choose their own form of replacement property.

Another approach is for the partnership to make the replacement and then distribute the replacement property to the partners. In a situation analogous to Rev. Rul. 55-517 in the corporate area, the IRS ruled that a partnership's subsequent distribution of replacement property to partners who are terminating their interests in the partnership does not prevent the application of §1033(a) to the partnership.[248] In addition, the ruling indicated that the replacement property would be deemed to be purchased by the partnership rather than the individual partners who are leaving the partnership. Even though the departing partners executed purchase contracts on behalf of the partnership, title to the property was deeded to the partnership, which then distributed the property (and transferred title) to the departing partners in their own names in exchange for termination of their partnership interests.

Of course, if it is the partnership that has suffered the involuntary conversion, then it is the partnership that must make the appropriate election on its tax return, while if it is the partners who have suffered the involuntary conversion, they (and not the partnership) must make the election. Only one taxpayer should make the election; making the election on both the partnership return and on the partner returns will leave all taxpayers vulnerable to an IRS audit.

[247] *See, e.g.*, TAM 9645005 (where partnership had already legally bound itself to make sale under threat of condemnation, only it and not its partners could make replacement even though property was distributed to partners before closing).

[248] PLR 8735026.

6. *Cooperatives*

PLR 200439017 deals with the proceeds received relative to an earthquake by a homeowner's association. The IRS reasoned that although the funds were collected by a lawsuit brought by the homeowner's association, the proceeds were nonetheless deemed to be received, for tax purposes, by the homeowner. In reaching this conclusion, the IRS relied on Rev. Rul. 81-152 and Rev. Rul. 75-370.

B. Types of Replacement Property

By far the largest body of rulings and cases under §1033 are those determining whether proper replacement property was acquired. Broadly speaking, there are four different categories of replacement property that may qualify. These are:

(1) similar use property (§1033(a)(1));

(2) stock of a corporation owning similar use property (§1033(a)(2));

(3) property that is like-kind (§1033(g)); and

(4) in certain cases, farm property (§1033(f)).

In determining whether qualified replacement property meets one of the foregoing categories, the ultimate use for the property, intended at the time of acquisition, usually controls.[249] Each of these categories is discussed more fully below.

1. *Property Similar in Use: §1033(a)(1) and §1033(a)(2)(A)*

Over the years, the statutory phrase "similar or related in service or use" has been the subject of numerous (and somewhat conflicting) interpretations. A partial summary of these decisions is contained in III.A., above. The following offers further explanation of whether particular replacement property is similar in use or service to the converted property.

a. *Requirements for Property Similar in Use*

Neither the Code nor the regulations define the all-important and recurring phrase, "similar or related in service or use." The IRS initially sought to apply a "functional use" test to all converted property.[250] Under the test, the replacement property had to have closely similar physical characteristics and end uses to the converted property, but not exact identity or sameness. The functional use test presented relatively few problems as applied to taxpayers who used the converted property, because a comparison of the pre-conversion and post-replacement uses defined the taxpayer's relationship to both properties. However, considerably more problems were presented when the converted property had been leased. The IRS's position for several years was that the tenant's use of the old and new prop-

[249] *See S.H. Kress & Co. v. Commissioner*, 40 T.C. 142 (1963), acq., 1965-1 C.B. 5 (interim use ignored); *Moore v. United States*, 73-2 USTC ¶9789 (S.D. W. Va. 1973) (intent at time of acquisition controls); PLR 9627018 (insurance proceeds used to replace house destroyed by fire with new personal residence qualify, despite brief rental of new residence; both properties were intended to be used as personal residences). *But see* TAM 8341008.

[250] *See, e.g.*, *Liant Record, Inc. v. Commissioner*, 36 T.C. 224, 229 (1961), rev'd, 303 F.2d 326 (2d Cir. 1962); *Steuart Bros., Inc. v. Commissioner*, 29 T.C. 372, 376 (1957).

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erties was to be tested under §1033.[251] Although this position was accepted in the Tax Court, it was rejected on appeal beginning with the Second Circuit's decision in *Liant Record, Inc. v. Commissioner*.[252] According to the Second Circuit's reasoning in *Liant Record*, the critical inquiry in all §1033 cases is whether the taxpayer-owner's relationship to the property has changed; the relevant inquiries are the nature and extent of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risk connected with the properties. Subsequently, the IRS[253] and the Tax Court[254] have accepted the essence of *Liant Record* and its progeny. The IRS's approach is to focus on whether there is "similarity in the relationship of the services or uses which the original and replacement properties have to the taxpayer-owner."[255]

Note that improvements constructed on leased land constitute replacement property if the improvements will be used in the same business and for identical purposes as the converted property.[256] Note further that a lessor who acquires some or all of the property being converted pursuant to express language of a lease is the replacing taxpayer. (This may occur in situations where the lease terminates on the conversion, with an immediate reversion of improvements to the lessor, with the lessor, and not the tenant, entitled to receive the proceeds from the conversion.) The fact that the tenant was the historic owner of the improvements (or even the leasehold) is irrelevant.[257] However, the relationship between tenants and lessors is not always placid when entitlement to condemnation proceeds is concerned.[258]

According to *Maloof v. Commissioner*,[259] the "similar or related in service or use" standard requires that:

(1) reinvestment in "substantially similar" property be made;

(2) reinvestment be a substantial continuation of the prior commitment of capital and not a departure from it;

(3) the replacement property need not duplicate the converted property but that the character of the investment not be changed; and

(4) the entire transaction allows a taxpayer, whose enjoyment of property has been interrupted without his consent, to return as closely as possible to his original position.

It will be inevitable in many circumstances that the similar use property will not be exactly identical to the converted property. *Allen v. Commissioner*[260] applies a percentage test to determine that the cost of the differing expenditures were de minimis relative to the total expenditures and hence insufficient to disqualify the replacement project. Similarly, PLR 200644019 concludes that updated broadcast equipment that employs significant upgrades and enhancement (i.e., digital technology) was nonetheless similar to, and could replace, equipment that had been based on older analog technology.

b. Examples of Similar in Use Property

The following are examples of replacement property which is similar or related in service or use to that converted:

- Breeding cattle replacing buffalo of the same sex;[261]
- Breeding, draft, or dairy livestock replacing breeding, draft, or dairy livestock, respectively;[262]
- The filling of submerged land replacing condemned land;[263]
- Manufacturing plant replacing a long-term leasehold on a similar plant;[264]
- Improvements to retained farm land[265] or purchase of adjacent farm land[266] "using" severance damages or proceeds[267] from an involuntary overflow easement;
- Prune, apricot, and walnut orchards replacing truck and cattle farm;[268]
- Improved property immediately converted into a parking lot replacing a parking lot;[269]
- Substantial repairs to, or rearrangement of, the damaged property or taxpayer's other property to restore lost capacity;[270]

[251] *See, e.g.*, Rev. Rul. 56-347.

[252] 303 F.2d 326 (2d Cir. 1962). *See also Clifton Inv. Co. v. United States*, 312 F.2d 719 (6th Cir. 1963), cert. denied, 373 U.S. 921 (1964); *Loco Realty Co. v. United States*, 306 F.2d 207 (8th Cir. 1962); *Pohn v. Commissioner*, 309 F.2d 427 (7th Cir. 1962).

[253] *See* Rev. Rul. 64-237; PLR 8820055.

[254] *Johnson v. Commissioner*, 43 T.C. 736 (1965), acq., 1965-2 C.B. 5.

[255] Rev. Rul. 64-237. *See also* Rev. Rul. 73-225 (technologically obsolete manufacturing process facility replaced by improved and changed manufacturing process facility met similar or related in service or use test); PLR 200109005 (purchase of leased property used as retail hardware store, as replacement for involuntarily converted property owned and used by taxpayer as retail hardware store, met similar or related in service or use test). The fact that a taxpayer is a lessor of both the converted and the replacement properties alone will not control. *See* PLR 8820055, PLR 9723032 (14-unit motel operated by taxpayer fails to qualify as replacement property for three-unit apartment building owned as rental property).

[256] *See* PLR 9603012, PLR 9026038, and PLR 8509075.

[257] *See* PLR 9050007, PLR 9049011, and PLR 9049012.

[258] See PLR 8915013 for a situation where a dispute between the lessor and lessee delayed receipt (both actual and for tax purposes) of condemnation proceeds.

[259] 65 T.C. 263 (1975).

[260] T.C. Memo 1998-406.

[261] *See* PLR 7903064.

[262] *See* Reg. §1.1033(e)-1(d).

[263] *See* Rev. Rul. 70-265, Rev. Rul. 64-237; PLR 9603012.

[264] *See Davis Regulator Co. v. Commissioner*, 36 B.T.A. 437 (1937), acq., 1937-2 C.B. 7; Rev. Rul. 83-70; PLR 8004133. Compare the authorities discussed below as to whether a leasehold is like-kind to a fee. *See also Woodall v. Commissioner*, 964 F.2d 361 (5th Cir. 1992) (because casualty had occurred as to leasehold improvements rather than leasehold itself, realty could not be replacement property because it was not similar in use to those improvements); FSA 200127001, following *Woodall*; PLR 9248025 (fee interest in land could replace a temporary easement that was taken to permit construction of haul road); PLR 201015015 (same).

[265] *See* Rev. Rul. 271, 1953-2 C.B. 236.

[266] *See* Rev. Rul. 69-240.

[267] Rev. Rul. 72-433.

[268] *Stevenson v. United States*, 64-2 USTC ¶9821 (N.D. Cal. 1964). *See also* S. Rep. No. 1052, 82d Cong., 1st Sess. (1951).

[269] Rev. Rul. 58-245.

[270] Rev. Rul. 67-254; *Allen v. Commissioner*, T.C. Memo 1998-406; *Revez v. Commissioner*, T.C. Memo 1977-13; *Marcal Pulp & Paper v. Commissioner*, 268 F.2d 739 (3d Cir. 1959), cert. denied, 361 U.S. 924 (1959); *Woodall v. Commissioner*, 61 T.C.M. 1682 (1991), aff'd, 964 F.2d 361 (5th Cir. 1992); PLR 8329014.

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• Improvements made to remaining property to prevent recurrence of the conversion;[271]

• An 18-acre tract of unimproved land replacing a 9-acre tract of vacant land adjacent to manufacturing plant;[272]

• "Improved" property, where the improvement had no value, replacing unimproved land;[273]

• Improvements to industrial property replacing agricultural property;[274]

• Leased gas station replacing land and a leased warehouse;[275]

• Leased office and warehouse replacing leased light manufacturing plant;[276]

• Residential apartment development replacing leased industrial warehouse;[277]

• Constructed motel replacing rent-producing improved realty;[278]

• Apartment building replacing leased filling station[279] or office building;[280]

• Improved rental property replacing unimproved land subject to construction contract;[281]

• 20-year leaseback with minimal residual purchase price replacing manufacturing plant;[282]

• One building replacing two buildings used for the same purposes;[283]

• Land held for sale replacing land held for sale;[284]

• Planting new crop,[285] or purchase of standing or harvested crop,[286] replacing standing crop;

• Purchase of all outstanding interests in partnership owning similar property replacing converted property;[287]

• Land that needed some clearing before use as a building site replacing cleared building site;[288]

• Stock in public utility corporations replacing stock in condemned private utility;[289]

• Farm with two residences, one of which taxpayer uses as his home and the other of which is rented, replacing dairy farm with one residence that was rented;[290]

• Rehabilitation of building designated as national historic site to be leased to retail and nonretail tenants replacing commercial building;[291]

• Manufacturing plant producing improved forest product replacing manufacturing plant that produced competing but related product;[292]

• Replacement of destroyed facilities on leased land in one location by construction of similar facilities on leased land in another location;[293]

• Stock of a publicly traded corporation or mutual fund replacing stock of a publicly traded corporation;[294]

• Residential real property replacing same, despite brief rental of replacement residence;[295]

• Timber-cutting contracts with a different party (but not amounts expended as advance royalties, for example, which are normally payable to a lessor as timber is cut) replacing timber cutting contract with the U.S. Forest Service;[296]

[271] Rev. Rul. 60-69, Rev. Rul. 271, 1953-2 C.B. 36; Rev. Rul. 72-433.

[272] *Columbus Die, Tool & Mach. Co. v. Commissioner*, 11 T.C.M. 1053 (1952).

[273] *Scheuber v. Commissioner*, 25 T.C.M. 559 (1966), rev'd on another issue, 371 F.2d 996 (7th Cir. 1967).

[274] *Davis v. United States*, 589 F.2d 446 (9th Cir. 1979). *See also* PLR 7938025 (relining of water company's ditches similar in use to condemned nonexclusive easement over lake).

[275] Rev. Rul. 71-41 (use of condemnation proceeds to construct gas station on land already owned by taxpayer). *See also* PLR 9546003 (proceeds used to acquire replacement land and make improvements to replacement land similar to improvements made to condemned land).

[276] *Loco Realty Co. v. Commissioner*, 306 F.2d 207 (8th Cir. 1962).

[277] *Ponticos v. Commissioner*, 338 F.2d 477 (6th Cir. 1964). *See also* PLR 9326042 (discussing several factors in determining whether apartment building is similar in use to destroyed warehouse).

[278] *Capitol Motor Car Co. v. Commissioner*, 314 F.2d 469 (6th Cir. 1963). *See also* Rev. Rul. 58-396 (taxpayer's purchase of residential house, lot and vacant lot, and his payment of the expenses of moving house from condemned tract to vacant lot, all constituted suitable replacements).

[279] *Pohn v. Commissioner*, 309 F.2d 427 (7th Cir. 1962).

[280] *Liant Records v. Commissioner*, 303 F.2d 326 (2d Cir. 1962).

[281] *Steuart Bros., Inc. v. Commissioner*, 261 F.2d 580 (4th Cir. 1958).

[282] Rev. Rul. 68-642.

[283] *Cotton Concentration Co. v. Commissioner*, 4 B.T.A. 121 (1926), acq., V-2 C.B. 1; *Flaxlinum Insulating Co. v. Commissioner*, 5 B.T.A. 676 (1926), nonacq., X-2 C.B. 86, nonacq. withdrawn and acq. substituted, 1942-1 C.B. 6; *Davis Co. v. Commissioner*, 6 B.T.A. 281 (1927), acq., VI-2 C.B. 2 (1927). *See also* PLR 9603012 (commercial leased property with multi-story buildings replacing commercial leased property with pads).

[284] *Westchester Dev. Co. v. Commissioner*, 63 T.C. 198 (1974).

[285] Rev. Rul. 81-279. *See* GCM 39152 (Mar. 1, 1984) (timber damaged by natural disaster may be replaced by expenditures for following "similar in use" property: (1) capital costs of replanting timberlands already owned or leased by taxpayer, or of new timberlands acquired or leased by taxpayer; (2) costs of acquiring new timberlands for purpose of replanting; (3) costs of purchasing standing timber or land in fee with standing timber; and (4) costs of purchasing stock in order to acquire control of corporations owning timber, timberlands, or both). *See also* PLR 8851034 (uncut timber is part of real property for §1033(g) purposes), PLR 199911048 (timber cutting contract with one person replacing timber cutting contract with another person).

[286] Rev. Rul. 59-8.

[287] Rev. Rul. 70-144; PLR 7933079, as *modified by* PLR 7937052.

[288] *Gaynor News Co., Inc. v. Commissioner*, 22 T.C. 1172 (1954), acq., 1955-1 C.B. 4.

[289] Rev. Rul. 66-355; PLR 200118010, PLR 200022034, PLR 200022029, PLR 199949043, PLR 8233144.

[290] Rev. Rul. 54-569. *But see* Rev. Rul. 79-261.

[291] PLR 8411044.

[292] PLR 8844049.

[293] PLR 9026038.

[294] PLR 8947032 and PLR 8841019; PLR 200714002 (foreign or domestic publicly traded common stock, preferred stock, convertible preferred stock, or mutual fund shares are allowed as replacement property for converted corporate stock; various types of equity securities are not distinguished for §1033 replacement purposes; however, debt instruments are not similar or related in service or use to converted stock). *See also Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156 (9th Cir. 1992) (discussing factors that could be relevant in ascertaining whether replacement stock is similar in use to stock of another public company alleged to have been converted).

[295] PLR 9627018.

[296] FAA 20044102F; PLR 199911048 (timber cutting contract with one person replacing timber cutting contract with another person).

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• Replacement of existing broadcast auxiliary services equipment with comparable facilities used on narrower broadcast spectrum, pursuant to FCC order;[297]

• Beneficial ownership interests in public accommodation buildings, retail shops, administrative buildings, and other support buildings (collectively, privately funded improvements) on government agency property replacing beneficial ownership interests in privately funded improvements at other agency properties;[298]

• Replacement of a technologically obsolete manufacturing process facility with an improved manufacturing process facility, where the new facility was designed to produce an improved version of a finished product, and where the relationship of the manufacturer to the property had not changed;[299]

• Replacement of a condemned potable water facility with water reclamation facility improvements where both the condemned and replacement properties had closely similar physical characteristics and effectuated the same basic processes of water intake, water treatment, and water distribution to customers; the equipment and assets utilized were substantially similar; and the end uses of the properties were closely similar in appearance and were components of the same integrated business;[300] and

• Replacement of existing multi-band satellites used to provide broadcast service over the C-band as part of the satellite business, with new multi-band satellites used to provide broadcast service over the C-band as part of the satellite business.[301]

c. Examples of Property Not Similar in Use

The following are examples of replacement property that is not similar or related in service or use to that converted:

• Improved real estate replacing unimproved real estate;[302]

• Barges replacing a requisitioned tug;[303]

• Reduction in leasehold or mortgage indebtedness "replacing" real property;[304]

• Less than entire partnership interest in partnership owning similar property replacing converted property;[305]

• Interest in real estate investment trust replacing leased commercial building;[306]

• Savings account and bonds replacing investment real estate;[307]

• Bowling facilities leased to related companies replacing bowling center used by taxpayer;[308]

• Artwork replacing artwork in a different medium;[309]

• Billiard facilities replacing bowling facilities;[310]

• Owner-operated motel replacing owner-operated mobile home park;[311]

• Printing company replacing a car wash;[312]

• Commercial building to be leased replacing leased farmlands[313] or leased parking lot;[314]

• Owner-occupied residence replacing leased residence[315] or other rental property;[316]

• Hotel as to which taxpayer was owner-lessor replacing hotel as to which taxpayer was owner-operator;[317]

• Owned and managed hotel replacing owned and managed commercial office building;[318]

• Purchased participation in mortgages replacing realty;[319]

[297] PLR 200644019.

[298] PLR 201609003.

[299] Rev. Rul. 73-225.

[300] PLR 201636034.

[301] PLR 202125006. In PLR 202125006, the IRS ruled that where reimbursement and acceleration payments are the only way for taxpayers (broadcast service providers) to receive compensation for relinquishing their right to broadcast in a portion of the C-band and for the costs related to relocating services into another portion of the C-band, reimbursement payments or acceleration payments received by taxpayers are eligible for nonrecognition of gain under §1033(a)(2)(A) to the extent such amounts do not exceed the cost of property purchased by taxpayers that is similar or related in service or use to the assets being replaced, or otherwise used to provide broadcast services using the C-band during the replacement period. *See also* PLR 202318004 (same).

[302] Reg. §1.1033(a)-2(c)(9)(i). *See also* PLR 9619028 (improvements to previously owned unimproved real estate replacing condemned unimproved real estate). As a similar result when unimproved real estate replaces improved real estate. *See Bratton v. Rountree*, 76-1 USTC ¶9198 (M.D. Tenn. 1976).

[303] Reg. §1.1033(a)-2(c)(9)(iii). *See also Warden v. Commissioner*, 69 T.C.M. 2432 (1995), aff'd in unpub. opin., 111 F.3d 139 (9th Cir. 1997) (yacht never operated in a trade or business is not similar in use to one-sixth interest in abandoned tennis and swim club), *cert. denied*, 522 U.S. 1109 (1998).

[304] Reg. §1.1033(a)-2(c)(9)(ii). Rev. Rul. 70-98, *restating and superseding* I.T. 2700, XII-2 C.B. 73, ruled that the application by the taxpayer of money received from the federal government as a result of the condemnation of one property to reduce a first mortgage on a second property was not an acquisition of other property within the meaning of §1033(a)(2), even though the second property was similar or related in service or use to the first property. While the property is discharged or freed from the encumbrance, the property has always beneficially belonged to the debtor. *See also Murray v. Commissioner*, 24 T.C.M. 762 (1965), aff'd per curiam, 370 F.2d 568 (4th Cir. 1967), cert. denied, 389 U.S. 834 (1967).

[305] Rev. Rul. 57-154, Rev. Rul. 55-351. *But see* Rev. Rul. 70-144. On the other hand, if the replacement property is to be co-owned and not held in partnership, it will qualify. PLR 9352011, PLR 9352008.

[306] *Lakritz v. United States*, 418 F. Supp. 210 (E.D. Wis. 1976).

[307] Rev. Rul. 71-122, updating and restating the position set forth in GCM 14693.

[308] PLR 8130035.

[309] PLR 8127089.

[310] Rev. Rul. 76-319.

[311] Rev. Rul. 76-390.

[312] *Santucci v. Commissioner*, 32 T.C.M. 840 (1973).

[313] Rev. Rul. 76-391.

[314] *McCaffrey v. Commissioner*, 275 F.2d 27 (3d Cir. 1960), cert. denied, 363 U.S. 828 (1960).

[315] Rev. Rul. 70-466, Rev. Rul. 76-84.

[316] *Erickson v. Commissioner*, 598 F.2d 525 (9th Cir. 1979).

[317] Rev. Rul. 70-399.

[318] *Clifton Inv. Co. v. Commissioner*, 312 F.2d 719 (6th Cir. 1963), cert. denied, 373 U.S. 921 (1963). Similarly, an owned and managed motel is not replacement property for a three-unit, three-story apartment building. PLR 9723032.

[319] *Winter Realty & Constr. Co. v. Commissioner*, 149 F.2d 567 (2d Cir. 1945), cert. denied, 326 U.S. 754 (1946).

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• Building used for bank offices replacing office building leased to tenants;[320]

• Office building replacing drive-in theater and farm;[321]

• Shopping center replacing underdeveloped land;[322]

• Breeding and dairy animals replacing draft animals;[323]

• Partnership interests replacing particular assets;[324]

• Leased restaurant replacing operated motel;[325]

• Farm tractor replacing farm truck;[326]

• Shopping mall replacing drive-in theater;[327]

• Fee simple interest in real property replacing leasehold interest in property destroyed by fire;[328] and

• Tangible assets replacing franchise/monopoly rights.[329]

d. Examples of Partially Qualified Replacement Property

The following are examples in which the replacement property qualified only partially:

• Office building that owner partially uses replacing office building that owner leased entirely;[330]

• Fixed assets of manufacturing business replacing import-export business;[331]

• Sea-going seafood processing plant replacing land-based seafood processing plant.[332]

2. Stock of a Corporation Owning Similar Use Property: §1033(a)(2)(A)

Section 1033(a)(2)(A) allows the taxpayer to purchase stock[333] "in the acquisition of control" of a corporation owning similar use property and still qualify for §1033 deferral.

a. Acquisition of Control

"Control" for §1033 purposes is defined as 80% of the total combined voting power of all voting classes of stock, and 80% of the total number of shares of all other classes of stock.[334] Although the 80% test is similar to the test imposed by §1504 for affiliation, §1033 lacks the 80% of value test imposed by §1504. The §1033 test clearly requires that the 80% (or greater) control must be acquired through purchase, but leaves open whether the purchaser can have a pre-existing stake in the corporation (i.e., whether §1033's 80% test can be satisfied by a "creeping acquisition"). Given the focus of §1033(a)(2)(A) on acquisition of 80% control, presumably it is possible for a pre-existing shareholder to obtain 80% or greater control from minority shareholders, although there is no direct authority so holding.[335]

Although it is not authoritative, the reasoning in PLR 200907007 calls into question whether a taxpayer that owns a stake in a corporation before the period for replacement of condemned property can use the previously owned stock to satisfy the control test for §1033 purposes. In PLR 200907007, the IRS ruled that control may be acquired through multiple purchases within the §1033(a)(2)(B) replacement period. The taxpayer made its first purchase of 77% of the target's stock after its replacement period began. It intended to make additional purchases so that it would own 80% of the target corporation's stock before the expiration of the replacement period. The IRS noted that the requirements under §1033 concerning the replacement of converted property are that the property must be acquired within the replacement period, the taxpayer must acquire the replacement property with intent to replace the converted property and the acquisition must be by purchase. The IRS reasoned that no language in either §1033 or the regulations thereunder limits the number of purchases a taxpayer may make within the replacement period to make a valid replacement of converted property. Also, §1033(a)(2)(A), which deals with replacement by stock acquisition, focuses on the acquisition of control of a corporation owning the property, similar or related in service or use to the converted property, and the time limits prescribed in §1033(a)(2)(B). The number of purchases is not mentioned.

A contrasting interpretation of PLR 200907007 is that so long as a proper dollar replacement amount is expended in acquisition of 80% control of the target corporation, the requirements of §1033(a)(2) are satisfied without regard to the amount of the stock that is purchased with that proper dollar replacement amount. That is, it is the completion of the acquisition of 80% control through a purchase during the replacement period that meets the test, even if that equates to the purchase of just one share.

For involuntary conversions before February 7, 1995, a corporation could satisfy the acquisition of control requirement by purchase from a related corporation, or from shareholders, control of a corporation holding similar use assets. In *Kimbell-*

[320] *Lynchburg Nat'l Bank & Tr. Co. v. United States*, 208 F.2d 757 (4th Cir. 1953). *See also* Rev. Rul. 79-261.

[321] *Filippini v. United States*, 318 F.2d 841 (9th Cir. 1963), cert. denied, 375 U.S. 922 (1964).

[322] TAM 8307007.

[323] Reg. §1.1033(e)-1(d).

[324] Rev. Rul. 57-154, Rev. Rul. 55-351. *But see* Rev. Rul. 70-144. In PLR 9451066, the IRS concluded that a converted interest in a partnership owning broadcast property could be replaced with directly owned property. The implication of PLR 9451066 is that a partner's interest in partnership broadcast property is the equivalent of broadcast property that is directly owned by the partner. Since this is contrary to the conclusions reached in Rev. Rul. 55-351 and Rev. Rul. 57-154, the extent to which PLR 9451066 can be relied on is questionable. Caution is clearly warranted.

[325] PLR 7926005.

[326] Rev. Rul. 71-575.

[327] TAM 8341008; GCM 39165 (July 7, 1983).

[328] FSA 200127001.

[329] TAM 200627024.

[330] Rev. Rul. 79-261 (qualified to extent owner didn't use). *But see* Rev. Rul. 54-569.

[331] *Maloof v. Commissioner*, 65 T.C. 263 (1975) (qualified to extent of inventory of new business).

[332] Rev. Rul. 77-192 (qualified to extent of machinery of same type used in land-based plant).

[333] Whether stock warrants satisfy this requirement is not clear; *see* VII.D.2., below.

[334] §1033(a)(2)(E)(i).

[335] *Cf.* §368(a)(1)(B) (containing language expressly allowing pre-existing ownership interests to be counted towards satisfying that statute's 80% requirement).

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Diamond Milling Co. v. Commissioner,[336] the taxpayer corporation sought §1033 deferral through the purchase, from its own shareholders, of control of a sister corporation. The Tax Court allowed §1033 treatment, holding that the taxpayer's pre-existing indirect control of the sister corporation could be ignored. In *Broadview Lumber Co. v. United States*,[337] a subsidiary's acquisition of its parent's stock, where the parent owned similar use assets, followed by a merger of the parent into the subsidiary was held to qualify for §1033 deferral. The results of both *Broadview Lumber* and *Kimbell-Diamond* were legislatively reversed by the enactment of §1033(i).

Another common problem in satisfying the 80% control requirement is whether the taxpayer's stock interest may be aggregated with those of another. In Rev. Rul. 57-454, two corporations with identical stockholders, directors, and officers received condemnation awards for property owned separately. The condemnation proceeds were then used jointly to purchase control of a third corporation owning similar use property. Neither purchaser owned more than 50% of the acquired corporation's stock. The IRS denied §1033 deferral because the statute requires each taxpayer seeking deferral to satisfy the 80% test. The IRS reached a somewhat different result in Rev. Rul. 57-408, in which the taxpayers owned the converted property as tenants in common and took title to the replacement stock as tenants in common. In Rev. Rul. 57-408, the IRS allowed the shareholders' stock interests to be aggregated to meet the 80% requirement. A third variation was presented in *Hofer v. United States*,[338] where the converted property was held as a tenancy in common but the purchased stock was reissued as each taxpayer's individual property in proportion to their interests in the converted property. Although the IRS argued that only a joint owner with an 80% interest in converted property would be able to satisfy the §1033(a)(2) control requirement, the court allowed aggregation, citing Rev. Rul. 57-408 as authority.

Comment: It is unclear whether the IRS will apply the *Hofer* rule. Therefore, it is advisable to issue stock in the same manner and in the same proportion as the ownership of the converted property, and then evaluate the 80% test.

b. Requirement of Purchase

Section 1033(a)(2)(A) also requires that stock vesting 80% control of the corporation be "purchased." As suggested above, it is unclear whether this requirement relates only to the stock by which 80% control is acquired or whether it relates to all stock of the acquired corporation. Leaving this aside, it is arguable that placing the conversion proceeds in a pre-existing wholly owned corporation in exchange for the corporation's stock will not qualify as a purchase, because issuance of the stock does not alter beneficial ownership of the corporation. This point is developed more fully in VIII.E., below.[339] Similarly, payments to a corporation which the corporation reflected as loans for which no stock was acquired do not constitute acquisition of control.[340] Where, in substance, no true sale of stock was contemplated, the transfer of stock will be disregarded.[341]

In *Broadview Lumber Co. v. United States*,[342] the Seventh Circuit concluded that a subsidiary's acquisition of its parent's stock, where the parent owned similar use assets, followed by a merger of the parent into the subsidiary, qualified for §1033 deferral. This conclusion was reached despite the IRS's argument that §304 required the transaction to be treated as a capital contribution by the subsidiary to the parent and not as a purchase.

Section 1033(i) reverses the result in *Broadview Lumber* for involuntary conversions after February 6, 1995.[343]

c. When Similar Use Property Must Be Owned

Both §1033(a)(2)(A) and Reg. §1.1033(a)-2(c)(1) contain the phrase "owning such other property" in referring to the acquired corporation. In Rev. Rul. 77-422, the IRS stated that this phrase requires the acquired corporation to own the replacement property before the taxpayer's purchase of the corporate stock. However, in *John Richard Corp. v. Commissioner*,[344] the Tax Court held to the contrary when the acquired corporation purchased the replacement property as part of the same transaction in which the taxpayer purchased the stock of the corporation.

John Richard Corp. and Rev. Rul. 77-422 are discussed in detail in VIII.E., below.

d. Extent of Similar Use Property

The language of §1033(a)(2)(A) does not impose a requirement as to what percentage of the acquired corporation's assets must consist of similar use property. While a number of approaches are possible, informal discussions with representatives of the IRS indicate that the assets of the corporation must "primarily" be similar use property.[345] This allows each transaction to be viewed on its facts. Under *Malat v. Riddell*,[346] "primarily" for §1231 purposes means "of first importance" or "principally." Not surprisingly, *Templeton v. Commissioner*[347] adopted this approach for §1033 replacements, as well. In *Templeton*, the Tax Court held that §1033 deferral was available only if the acquired corporation's assets consist "principally of similar property" and did not establish any mathematical test for determining whether an acquired corporation owns adequate similar use property. At least one revenue ruling has assumed that the stock's entire purchase price will be similar use

[336] 10 T.C. 7 (1948), acq., 1948-1 C.B. 2.

[337] 561 F.2d 698 (7th Cir. 1977).

[338] 74-2 USTC ¶9690 (D. Or. 1974).

[339] *See Feinberg v. Commissioner*, 377 F.2d 240 (8th Cir. 1967); Rev. Rul. 79-293; *see also Taft Broad. Co. v. United States*, 929 F.2d 240 (6th Cir. 1991).

[340] *Sachs v. Commissioner*, 22 T.C.M. 475 (1963).

[341] *See Am. Truck Rental Corp. v. Commissioner*, 355 F.2d 928 (3d Cir. 1966), cert. denied, 385 U.S. 815 (1966). *See also Templeton v. Commissioner*, 66 T.C. 509 (1976), supplemented by 67 T.C. 518 (1976), aff'd *per curiam*, 573 F.2d 866 (4th Cir. 1978).

[342] 561 F.2d 698 (7th Cir. 1977).

[343] §1033(i).

[344] 46 T.C. 41 (1966), acq., 1967-2 C.B. 3, acq. withdrawn and nonacq. substituted, 1974-2 C.B. 5. *See also Taft Broad. Co. v. United States*, 929 F.2d 240 (6th Cir. 1991).

[345] *See* Rev. Rul. 82-70 (acquired corporation must "primarily or solely" be engaged in broadcasting). *See also* PLR 9211025 (§1033 was satisfied where taxpayer was able to represent that only a de minimis amount of the assets and income of a target corporation were not similar use).

[346] 383 U.S. 569 (1966).

[347] *See* 66 T.C. 509 (1976), supplemented by 67 T.C. 518 (1976), aff'd per curiam, 573 F.2d 866 (4th Cir. 1978).

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property if 75% of the total assets are similar use property.[348] As a practical matter, 75% may be a realistic threshold, for if less than 75% of the corporation's total asset value is similar use property, the taxpayer may have difficulty showing the corporate stock was purchased with an intent to replace the converted property.

In *Kahl v. Commissioner*,[349] replacement property purchased through the taxpayer's wholly owned foreign corporation did not qualify for §1033 nonrecognition treatment because less than 25% of the funds transferred to the corporation was invested in similar use property and, therefore, the taxpayer did not purchase stock in the acquisition of control of a corporation owning similar property. *John Richard Corp.* was distinguished on the grounds that a taxpayer may not ignore a corporation's existence for §1033 purposes if too little corporate property is similar use property.

Citing *Templeton*, the IRS ruled, in PLR 8707022, that stock of a corporation engaged in growing timber and manufacturing wood products qualified as replacement property for timberlands where the taxpayer acquired all of the corporation's stock and its assets consisted principally of property similar or related in service or use to the taxpayer's converted property.

In PLR 200907007, the IRS concluded that where the dissimilar property owned by the acquired corporation constituted less than 10% of the total assets, a controlling interest in the acquired corporation's stock qualified for nonrecognition under §1033. In reaching its conclusion, the IRS noted that Rev. Rul. 69-242 supports the position that a taxpayer's acquisition of a controlling interest in a corporation, the assets of which consist principally, but not entirely, of property similar or related in service or use to the converted property, qualifies as a replacement of converted property under §1033(a)(2)(A). Therefore, the entire purchase price of that controlling interest is taken into account in determining the amount of gain deferred under §1033, even if the acquired corporation owns some property that is not similar or related in service or use to the converted property.

e. Holding Company Stock

Another problem concerning replacement through the purchase of corporate stock is that stock in a holding company, which in turn owns another corporation owning similar use property, will not meet the requirements of §1033(a)(2)(A), which requires that the acquired corporation "own" similar use property. In Rev. Rul. 66-33 the IRS read this language to require the acquired stock to be in a corporation which directly owns the similar use property, *i.e.,* acquisition of control of a holding corporation does not achieve §1033 deferral.

This result should be contrasted with the result in PLR 8512074. PLR 8512074 concluded that acquisition of stock of three corporations operating TV stations, in a reverse cash merger that was then followed by liquidation of the holding company so that the stock of the three television corporations was held by the taxpayer, qualified under §1033 as replacement for the stock of a newspaper publisher, provided a §338 election was made so that the transaction was treated as an asset acquisition. In reaching this conclusion, PLR 8512074 expressly distinguished Rev. Rul. 66-33.

Another approach is illustrated by PLR 200907007. In PLR 200907007, the target holding corporation owned 100% of the stock of a subsidiary which owned the similar use property. By the time the taxpayer finished acquiring (through multiple purchases) the required 80% interest in the target holding corporation, the subsidiary had been liquidated into the target holding corporation, so that the similar use property would be directly owned by the target. The IRS again distinguished Rev. Rul. 66-33 and held that all purchases of the target corporation's stock by the taxpayer during the replacement period would qualify as replacement property within the meaning of §1033(a)(2)(A).

f. Purchase of Partnership Interest Compared

Section 1033 makes no express provision for replacement through purchase of an interest in a partnership. Not surprisingly, the Tax Court and the IRS have concluded that a partner's interest is not similar in service or use to particular assets, even though the partnership may own the identical assets.[350] But in *Magneson v. Commissioner*,[351] the Tax Court held that a transfer to a partnership immediately after a §1031 exchange did not preclude §1031 treatment because the taxpayer's economic interest was "fundamentally the same" before and after the §721 transfer.[352] In affirming *Magneson*, the Ninth Circuit adopted a more limited view of when a prearranged transfer of the like-kind property to a partnership would satisfy the §1031"held for investment" standard. The appellate court held that the prearranged transfer would qualify only if the partnership was a general partnership, the purpose of the partnership was to hold the property for investment, and the total assets held by the partnership were predominantly like-kind to the taxpayer's original investment. The IRS has, at least once, recognized that the direct acquisition of replacement property, followed by a contribution to a partnership, qualifies for §1033 deferral.[353]

Nevertheless, the authorities under §1033 hold that the purchase of a partnership interest will not achieve §1033 deferral. As with most rules, though, there are exceptions. In Rev. Rul. 70-144, a 50% partner purchased the remaining 50% interest in a partnership owning property similar to his condemned property. Thereupon, the partnership terminated and the taxpayer became the sole owner of the property. Consistent with the IRS's view that a corporate acquisition/liquidation amounts to an asset purchase,[354] Rev. Rul. 70-144 concluded that the partnership buy-out amounted to an asset acquisition of the underlying similar use property,[355] thus qualifying for §1033 treat-

[348] Rev. Rul. 69-242.

[349] 41 T.C.M. 1433 (1986).

[350] *See, e.g., M.H.S. Co., Inc. v. Commissioner*, 35 T.C.M. 733 (1976), aff'd, 575 F.2d 1177 (6th Cir. 1978); Rev. Rul. 57-154, Rev. Rul. 55-351. *But see* PLR 9451066 (directly owned property could replace converted partner interest for §1033 purposes).

[351] 81 T.C. 767 (1983), aff'd, 753 F.2d 1490 (9th Cir. 1985).

[352] Moreover, other sorts of subsequent dispositions of the replacement property would not necessarily preclude §1033 treatment. *See, e.g., Cusack v. Commissioner*, 48 T.C. 156 (1967), acq., 1967-2 C.B. 2 (put right not fatal to §1033); PLR 8807029 (same; call right by seller also not fatal); *see also* Rev. Rul. 55-517 (subsequent liquidation does not affect §1033 status).

[353] *See* PLR 9020013 (an equity of 39% in the partnership was adequate control to allow §1033 deferral).

[354] See VII.D.2., below, for further discussion.

[355] *See also* PLR 7933079, as modified by PLR 7937052.

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ment. But the IRS has also determined that the purchase by two partners of the third partner's interest with insurance proceeds received for the destruction by fire of partnership property was not a purchase of qualified replacement property, finding Rev. Rul. 70-144 inapplicable because the partnership still existed after the proposed purchase of the partnership interest.[356]

However, in TAM 8750001, the National Office advised that where real property held by a partnership is distributed to the partners and title is held by the partners as tenants in common, §1033 applies where one partner reinvests the proceeds of a condemnation of the distributed property in qualified replacement property, but for business reasons takes title with an unrelated individual as joint tenants. The National Office reasoned that since this partner was the "legally identical taxpayer" who both suffered the condemnation and purchased the replacement property, there was no obstacle to his changing the form of title on the replacement property, provided the replacement property was otherwise qualified.

Additionally, in PLR 9352008 and PLR 9352011, the IRS ruled that when a co-ownership is not a partnership, the reinvestment qualifies under §1033 as a nonrecognition transaction. In each of these identical PLRs, the taxpayer was a partnership (P) between an individual (J) and a corporation. J owned Blackacre and P owned Whiteacre. Blackacre and Whiteacre were contiguous parcels that were condemned by the state. J and P plan to reinvest the condemnation proceeds in the acquisition of Greenacre as tenants in common. Blackacre and Whiteacre were improved commercial real estate, subject to net leases, that J and P held for investment. Greenacre, also improved commercial real estate subject to a net lease, calls for the lessee to be responsible for all insurance premiums, general real estate taxes and special assessments, most utility costs, and a large portion of the repair costs. J and P plan to hold Greenacre for investment, apportioning the income and expenses they derive pro rata, without special allocations. The IRS determined, citing Rev. Rul. 75-374, that the mere coownership of property without provision by the owners of more than customary services or maintenance and repair and collecting of rents will not amount to a partnership.

g. Basis

A special rule applies when the replacement property is corporate stock.[357] First, the taxpayer's basis in the actual replacement property (the corporate stock) is reduced by the amount of the gain being deferred. This is the result one would expect. Second, the corporation's basis in its property is reduced. Normally, the amount of the reduction in the corporation's internal basis is equal to the amount of the reduction in the basis of the actual replacement property, the corporate stock. The reduction in the internal corporate basis, however, cannot reduce the corporation's internal basis in any asset below zero, nor can it reduce the corporation's internal basis below that of the stock basis. Also, prioritization rules apply, under which the reduction in the corporation's internal bases is to be made first to the similar use property, then to depreciable property, and then to other property.

In PLR 200907007, the IRS analyzed the basis reductions for the target corporation's stock and underlying assets required by §1033(b) where replacement property is acquired before the converted property is disposed of. The IRS noted that §1033(a)(2)(A)(i) allows anticipatory replacement of converted property prior to its disposition. Since the event that determines the deferred gain associated with the disposition of the converted property (and the corresponding basis reductions) is the disposition of the converted property, the deferred gain amount will not be known until that disposition. The IRS noted that, although §1033(b)(3)(A) provides for the reduction in basis of property held by the corporation at the time the taxpayer acquires control, §1033(b)(3)(A) refers to the property to which the basis reduction applies, not to the date on which the basis reduction computations are to be made. Therefore, the IRS concluded that the basis reductions under §1033(b) should be made as of the date on which the converted property is disposed of. In the same letter ruling, IRS noted that §1033(b)(3) makes no mention of liabilities being taken into account in the §1033(b)(3) basis determination. The IRS concluded, therefore, that following the acquisition of the target's stock, the basis of the target's property is not to be reduced by the target's liabilities.

Examples illustrating these rules are set forth at VIII.D., below.

3. Property That Is Like-Kind: §1033(g)

Section 1033(g) allows certain converted real property to be replaced by like-kind property. Not all condemned real property qualifies for §1033(g); only that which is held for productive use in a trade or business or for investment is eligible. The most important types of real property excluded are (i) real property which is stock in trade or otherwise held primarily for sale, and (ii) a taxpayer's residence. Not every conversion qualifies for treatment under §1033(g) either. Section 1033(g) applies only to seizures, requisitions, and condemnations (or sales on account of threat or imminence of seizure, condemnation, or requisition). Also, §1033(g) has no application to the purchase of stock in the acquisition of control of a corporation.

Even with these strictures, the reach of §1033(g) is broad. Most taxpayers' encounters with §1033 involve condemnations of business or investment real property, the event towards which §1033(g) was expressly aimed. Section 1033(g) was intended to achieve a rough parity between the replacement property requirements of §1033 and those of §1031, for the rationale underlying both §1033 and §1031 deferral is that the taxpayer's investment is continued. Accordingly, Congress determined that parallel tests for the requisite continuity should be available under each provision.

a. Interaction with the Similar Use Test

Section 1033(g) does not operate to the exclusion of the similar use rule of §1033(a). Instead, the like-kind rule is merely an alternate means by which §1033 deferral may be achieved. For example, in Rev. Rul. 71-41, the taxpayer's leased warehouse and the land on which it stood were condemned. The taxpayer replaced the condemned property by erecting a gas station on land he already owned. This gas station was thereafter leased. Because land and improvements are not of like kind to improvements only, the IRS ruled that §1033(g) did not provide deferral of the gain on condemnation.

[356] PLR 8424099.
[357] §1033(b).

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It then went on to apply the "similar use" test and eventually concluded that the similar use test was satisfied.[358] In PLR 8852009, the IRS applied the similar use test, but ultimately determined that an office building and its underlying land qualified under §1033(g) as replacement property for condemned farmland since both the building property and the farm were real business properties.

Despite the foregoing authorities, one district court has suggested in dictum that §1033(g) provides the exclusive means to obtain §1033 deferral for property and conversions described therein.[359] The persuasiveness of this case is open to doubt.

In GCM 39783,[360] underlying Rev. Rul. 89-2, the IRS Chief Counsel's Office examined the interplay between §1033(a) and §1033(g) when one property is both destroyed and condemned. The taxpayer sold the buildings and land used in his trade or business after they were chemically contaminated and the government determined that they were unfit for use. However, the taxpayer sold the property to the city only after the passage of an ordinance authorizing eminent domain proceedings. The city's payment to the taxpayer was based on the fair market value of the property before the contamination. The Chief Counsel's Office reasoned that, to the extent the involuntary conversion was attributable to the threat of condemnation rather than to the chemical destruction, the taxpayer is eligible for the generally more liberal like-kind replacement requirements of §1033(g). The Chief Counsel's Office concluded that the taxpayer could treat the entire proceeds received from the city under §1033(a) and replace the property under the similar use rules, or the taxpayer could establish the portion of the proceeds attributable to the government taking (i.e., the fair market value of the property after the chemical contamination) and treat that portion under §1033(g). The proceeds attributable to the destruction of the property must be treated under §1033(a).

b. What Constitutes Like-Kind Property

The regulations under §1033(g)[361] refer the reader to Reg. §1.1031(a)-1(b) in determining whether particular property is like-kind. Reg. §1.1031(a)-1(b) indicates that the words "like-kind" refer to the nature or character of property and not to its grade or quality. Thus, improved real estate is like-kind to unimproved real estate because both improved and unimproved land are the same kind of property: real property. In determining whether property is real property or personal property, state law controls.[362] An important qualification within §1031 expressly repeated within §1033(g)(1) is that each exchanged property must be held either for productive use in the trade or business or for investment. The requirement of proper holding purpose is discussed in VII.D.3., below.

c. Examples of Like-Kind Replacement

The following are examples of like-kind replacement:

• Investment realty replacing condemned business realty, or business realty replacing investment realty;[363]

• Improved city lot replacing condemned mineral rights (which were real property interests under state law),[364] or condemned utility easement;[365]

• Interest in overriding oil and gas leases replacing condemned unimproved real property;[366]

• Perpetual water rights replacing lakefront real estate and permanent nonexclusive management and recreational easement over lake;[367]

• Purchased 30-year leasehold on land already owned by taxpayer replacing condemned unimproved real estate;[368]

• 35-year leasehold interest replacing condemned unimproved real estate;[369]

• Land, greenhouse, buildings, windbreaks, and other improvements replacing condemned nursery and its shrubs and trees;[370]

• Partially completed subdivision replacing condemned housing project, even though subdivision sold within six months;[371]

• Improved real estate leased to related companies replacing condemned improved real estate used in trade or business;[372]

[358] *Accord Westchester Dev. Co. v. Commissioner*, 63 T.C. 198 (1974), acq., 1975-2 C.B. 2; Rev. Rul. 83-70 (like-kind test not met, similar use test met); Rev. Rul. 83-49 (similar use test not met, like-kind test met); PLR 8130035, PLR 8051053. *See also McShain v. Commissioner*, 68 T.C. 154 (1977); Rev. Rul. 76-390 (replacement of mobile home park by construction of motel fails alternate §1033 tests).

[359] *See Lakritz v. United States*, 418 F. Supp. 210 (E.D. Wis. 1976).

[360] (July 26, 1988).

[361] *See* Reg. §1.1033(g)-1(a).

[362] *See, e.g., Morgan v. Commissioner*, 309 U.S. 78 (1940).

[363] Rev. Rul. 72-424.

[364] *Crichton v. Commissioner*, 122 F.2d 181 (5th Cir. 1941).

[365] Rev. Rul. 72-549; *see* Rev. Rul. 59-121 (easement ruled to be real property).

[366] Rev. Rul. 72-117; PLR 8134134; TAM 7741001. *See* Rev. Rul. 68-226 (lessee's interest in oil and gas lease is interest in real property for income tax purposes).

[367] PLR 7938025; *see* Rev. Rul. 55-749. *See also* PLR 202309007 (IRS ruled water rights were like-kind to fee interest in real property under Rev. Rul. 55-749 because rights were perpetual and only state could terminate). *Cf. Wiechens v. United States*, 228 F. Supp. 2d 1080 (D. Ariz. 2002) (water rights that are restricted in priority, quantity, and duration are not sufficiently similar to fee simple interest in farm land to qualify as like-kind property). *But see Fleming v. Commissioner*, 24 T.C. 818 (1955), aff'd sub nom., *P.G. Lake, Inc. v. Commissioner*, 356 U.S. 260 (1958) (oil payment right not like kind to fee interest in real estate); *Clemente, Inc. v. Commissioner*, 50 T.C.M. 497 (1985) (limited gravel extraction rights not like kind to land); TAM 9525002 (right to cut timber during two-year period not like kind to fee timberland).

[368] Rev. Rul. 68-394. *See also* PLR 9543038 (leasehold interests of 35 and 66 years).

[369] *McShain v. Commissioner*, 68 T.C. 154 (1977); *see also* Reg. §1.1031(a)-1(c); *see* Rev. Rul. 78-72 (acquisition of 25-year leasehold interest in improved land, with options to renew for three 10-year periods, qualifies as like-kind to fee interest in unimproved real estate); *compare* Rev. Rul. 83-70 (15-year leasehold not like-kind to fee). *See also Davis Regulator Co.* and other authorities discussed at VII.B.1.b., above, holding that a long-term leasehold may be similar in use to a fee.

[370] *Asjes v. Commissioner*, 74 T.C. 1005 (1980), acq., 1982-2 C.B. 1.

[371] *Ramey Inv. Corp. v. Commissioner*, 26 T.C.M. 17 (1967).

[372] PLR 8130035 (taxpayer's improvement was first partially destroyed by fire and then condemned; IRS denied approval to use insurance proceeds to acquire leased property, because leased property would not be "similar in use" to property used in trade or business).

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• Commercial property replacing condemned agricultural land;[373]

• Constructed building on newly purchased land replacing real estate;[374]

• Purchased life interest in trust holding real property replacing portion of same trust's real property which was condemned;[375]

• Mineral leases and IDC expenditures replacing condemned mineral leases;[376]

• Conservation easement replacing timberland, farm land, or ranch land, provided easement qualifies as an interest in real property under state law;[377]

• Complete possessory interest in land in which taxpayer holds a leasehold interest and improvements to commercial property partially situated on such land replacing condemned commercial property.[378]

d. Examples of Property That Is Not Like-Kind

The following are examples of replacement property that is not like-kind to that converted:

• Constructed motel on land previously owned replacing condemned mobile home park;[379]

• Constructed commercial building on land previously owned replacing condemned real property;[380]

• Personally used residence replacing leased residential property;[381]

• Interest-bearing bonds and a savings account replacing income producing real estate;[382]

• Remainder interest in real property replacing life estate in real property;[383]

• Storm drains, water systems, and roads constructed on previously owned land replacing condemned real property;[384]

• Investment in printing company replacing condemned car wash;[385]

• Fee simple interest replacing 15-year leasehold;[386] and

• Partnership interests in oil and gas properties replacing condemned oil and gas wells.[387]

e. Trade or Business Use or Investment

Section 1033(g) applies only to real property used in a trade or business or held for investment. Section 1033(g) parallels §1221(a)(1), §1231(b)(1), and §1031(a) in its exclusion of "stock in trade or other property held primarily for sale. "Primarily" means "of first importance" or "principally" under *Malat v. Riddell*,[388] and whether particular property is so held is generally regarded as a question of fact. The determination of the taxpayer's intent in holding an asset turns on such diverse elements as:

• the nature and purpose of acquisition and the duration of ownership;

• the extent and nature of the taxpayer's efforts to sell the property;

• whether efforts have been made at subdivision of the property into smaller units; and

• the taxpayer's personal involvement with subdivision and/or sales efforts.[389]

The taxpayer's holding purpose must be determined property by property, as a dealer in real estate may also be holding investment property.[390]

Where the taxpayer would otherwise be characterized as a dealer, an alternate approach is to attempt to come within the narrow provisions of §1237(a). Under §1237(a), land subdivid-

[373] *Braley v. Commissioner*, 14 B.T.A. 1153 (1929), acq., VII-2 C.B. 6; *Hamilton v. Commissioner*, 30 B.T.A. 160 (1934); Rev. Rul. 83-49, Rev. Rul. 72-151. *See also* PLR 9030027, PLR 7838098, PLR 7804098, PLR 7749037, PLR 7741010, PLR 7741003.

[374] PLR 8311027, PLR 8021126. *See also* TAM 9421002 (permitting intended improvements to be of like kind provided other requirements of §1031 for deferred exchanges (e.g., adequate identification of replacement property) are met; presumably, this means that improvements would have to be completed within relatively short period §1031 provides for deferred exchanges).

[375] Rev. Rul. 70-511.

[376] GCM 39572 (Sept. 17, 1984).

[377] PLR 9621012.

[378] PLR 9620010.

[379] Rev. Rul. 76-390. If the taxpayer had used the condemnation proceeds to buy land on which a motel already stood, or if the taxpayer had purchased the land and built the motel, the like-kind test would have been met.

[380] Rev. Rul. 76-391, Rev. Rul. 67-255, Rev. Rul. 71-41 (constructed gas station not like-kind to condemned rental warehouse); *see also* TAM 8307007; PLR 8119029. Cf. PLR 9620010 (complete possessory interest in land in which taxpayer holds leasehold interest and improvements to commercial property partially situated on such land replacing condemned commercial property).

[381] Rev. Rul. 76-84; *Erickson v. Commissioner*, 598 F.2d 525 (9th Cir. 1979).

[382] Rev. Rul. 71-122, updating and restating the position set forth in GCM 14693.

[383] Rev. Rul. 72-601. *But see* Rev. Rul. 78-4 (remainder interests in farm land are like-kind) and PLR 8852009 (property held by father and children in life estate and remainder interests like-kind to replacement property in which same interests and ownerships were continued).

[384] Rev. Rul. 67-255; PLR 9619028 (improvements to previously owned unimproved real estate replacing condemned unimproved real estate). *But see Davis v. United States*, 411 F. Supp. 964 (D. Haw. 1976), aff'd *on other grounds*, 589 F.2d 446 (9th Cir. 1979).

[385] *Santucci v. Commissioner*, 32 T.C.M. 840 (1973).

[386] Rev. Rul. 83-70. *Compare McShain v. Commissioner*, 68 T.C. 154 (1977).

[387] GCM 39572 (Sept. 17, 1984).

[388] 383 U.S. 569 (1966). *Compare Jersey Land & Dev. Corp. v. United States*, 539 F.2d 311 (3d Cir. 1976) and *Turner v. Commissioner*, 540 F.2d 1249 (4th Cir. 1976) (question of law) *with Philhall Corp. v. United States*, 546 F.2d 210 (6th Cir. 1976); *Brown v. Commissioner*, 448 F.2d 514 (10th Cir. 1971); *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184 (8th Cir. 1967); *Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983) (question of fact). *See also* PLR 8851034 (standing timber on condemned timber lot that had been logged only intermittently during 70 years of ownership by taxpayer's family qualified as real property held for productive use in trade or business under §1033(g)(1)).

[389] *See, e.g., Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983). *See also* PLR 200219006 (real property used for recreational and commercial purposes met §1033(g)(1) requirements).

[390] *E.g., Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983); *Casalina Corp. v. Commissioner*, 60 T.C. 694 (1973), acq., 1974-2 C.B. 1, aff'd, 511 F.2d 1162 (4th Cir. 1975).

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ed before sale is deemed to be held not primarily for sale in the ordinary course of business if certain conditions are met.[391]

The purpose for which particular property is held may change,[392] and it is the taxpayer's intent at the time of sale that is critical.[393] Case authority, primarily in the Tax Court, has developed under §1033(g) that property held for sale becomes investment property upon notice of the pending condemnation, even if sold only a short time after the condemnation notice. The theory is that, after condemnation, the property can be sold to or taken only by the condemning authority. Because this is not a sale in the ordinary course of business, the property is no longer held "primarily for sale." The first case so holding was *Tri-S Corp. v. Commissioner*.[394] On appeal, *Tri-S Corp.* was affirmed,[395] but on the ground that the particular property had never been held for sale. *Tri-S Corp.* was followed by the Tax Court in *Ridgewood Land Co., Inc. v. Commissioner*,[396] and in *Juleo, Inc. v. Commissioner*.[397] *Ridgewood* was affirmed per curiam by the Fifth Circuit on appeal,[398] while *Juleo* was reversed by the Third Circuit.[399] An unreported decision of the Federal District Court for Ohio, *Morrison v. United States*, also held that a change in holding purpose occurred upon receipt of the condemnation notice. Although the *Morrison* decision was affirmed by the Sixth Circuit under the name of *Case v. United States*,[400] the rationale was that the property was never held for sale. Further, in *Case*, the Sixth Circuit indicated its disagreement with the notion that a condemnation notice alone could change the holding purpose of property.[401] Subsequent to *Case*, the Tax Court held in *Daugherty v. Commissioner*[402] that the fact of condemnation alone will not convert property held for sale into a capital asset. In so holding, the Tax Court expressly overruled its earlier holdings in *Tri-S Corp.*, *Ridgewood*, and *Juleo*. Under the approach of *Daugherty*, gain from condemnation of development property can be deferred only through replacement with similar use property.[403]

Daugherty does not resolve all issues in this area, however. First, there is still circuit court authority[404] accepting the earlier theory that notice of condemnation will alter the purpose for which property is held. Second, *Daugherty* did not overrule several Tax Court cases that recognized an altered holding purpose when a substantial period had elapsed between the time the developer learned no development would be possible and the actual disposition.[405]

Comment: Until further authority resolves the area, it may be advisable to structure replacements of condemned property held for sale immediately before the condemnation under the similar use rule of §1033(a) rather than under the like-kind rule of §1033(g). For examples of this, see *Westchester Development Co. v. Commissioner*[406] and *Scheuber v. Commissioner*.[407]

f. *Outdoor Advertising Displays Treated as Real Property*

As discussed in VI.B., above, taxpayers may elect to treat outdoor advertising displays as real property. This election allows outdoor displays to be replaced by any real property interest[408] and presumably allows any real property interest to be replaced by an outdoor advertising display.

4. *Farm Property Replacing Livestock: §1033(f)*

Section 1033(f) provides a broader definition of replacement property in the case of livestock involuntarily converted due to environmental contamination. For §1033(f) purposes, "livestock" includes poultry.[409] Under §1033(f), livestock may be replaced by any other property "used for farming purposes" if reinvestment in similar use property is not feasible due to drought, flood, other weather-related conditions, soil contamination, or other environmental contamination. Section 1033(f) expressly includes real property as a permissible replacement for livestock, but only in the case of involuntary conversions attributable to soil contamination or other environmental contamination. Without §1033(f), §1033 would allow only functionally similar livestock to be replacement property. That is, dairy cows would otherwise have to be replaced by dairy cows, not draft or breeding animals.[410]

Nonetheless, on balance, the IRS has taken a narrow view of the circumstances in which §1033(f) will apply. In TAM 8036014, the taxpayer was forced to sell Brucellosis-infected cattle. Brucellosis is a bacterial infection which leaves the land unfit for livestock for a substantial period, and the taxpayer sought to replace the livestock with a horse training facility. The IRS advised that Congress intended §1033(f) to apply only where toxic chemicals were the contaminant. Thus, the provi-

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[391] *See* PLR 8252073 and PLR 8252151. *See also* PLR 9633029 (sales of land from tract under threat of condemnation when taxpayer is making sales from any other tract will not adversely affect treatment of sales from any other tract under §1237).

[392] *See, e.g., Stockton Harbor Indus. Co. v. Commissioner*, 216 F.2d 638 (9th Cir. 1954), cert. denied, 349 U.S. 904 (1955); *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir. 1976), cert. denied, 429 U.S. 819 (1976); *Lomas & Nettleton Fin. Corp. v. United States*, 486 F. Supp. 652 (N.D. Tex. 1980); *Edwards Indus. v. Commissioner*, 33 T.C.M. 596 (1974); *Estate of Dean v. Commissioner*, 34 T.C.M. 631 (1975); *Bush v. Commissioner*, 36 T.C.M. 340 (1977), aff'd, 610 F.2d 426 (6th Cir. 1979); *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278 (1970).

[393] *See, e.g., Eline Realty Co. v. Commissioner*, 35 T.C. 1 (1960), acq., 1961-1 C.B. 4.

[394] 48 T.C. 316 (1967).

[395] *Tri-S Corp. v. Commissioner*, 400 F.2d 862 (10th Cir. 1968).

[396] 31 T.C.M. 39 (1972), aff'd *per curiam*, 477 F.2d 135 (5th Cir. 1973).

[397] 30 T.C.M. 284 (1971), rev'd, 483 F.2d 47 (3d Cir. 1973), cert. denied, 414 U.S. 1103 (1973).

[398] *See Ridgewood Land Co., Inc. v. Commissioner*, 477 F.2d 135 (5th Cir. 1973).

[399] *Juleo, Inc. v. Commissioner*, 483 F.2d 47 (3d Cir. 1973), cert. denied, 414 U.S. 1103 (1973).

[400] 633 F.2d 1240 (6th Cir. 1980).

[401] *See also McManus v. Commissioner*, 583 F.2d 443 (9th Cir. 1978), cert. denied, 440 U.S. 959 (1979).

[402] 78 T.C. 623 (1982).

[403] Before *Daugherty*, the IRS had unsuccessfully argued that the *Tri-S Corp.* rule, which "converted" sale property into investment property, meant that only investment property could be similar in use to that condemned. This position was rejected in *Westchester Dev. Corp. v. Commissioner*, 63 T.C. 198 (1974), acq., 1975-2 C.B. 2.

[404] *Ridgewood Land Co., Inc. v. Commissioner*, 477 F.2d 135 (5th Cir. 1973).

[405] *See Fabiani v. Commissioner*, 32 T.C.M. 941 (1973) (10 years); *Biedermann v. Commissioner*, 68 T.C. 1 (1977) (10 years); *Estate of Knudsen v. Commissioner*, 40 T.C.M. 510 (1980) (14 months).

[406] 63 T.C. 198 (1974), acq., 1975-2 C.B. 2.

[407] 25 T.C.M. 559 (1966), rev'd on other grounds, 371 F.2d 996 (7th Cir. 1967).

[408] *See* S. Supp. Rep. No. 455, 94th Cong., 2d Sess. 25 (1976).

[409] *See* TAM 8041009.

[410] *See* Reg. §1.1033(e)-1(d).

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sion did not apply to the Brucellosis infection. This same approach was taken in *Miller v. United States*,[411] which noted that although the Brucellosis bacteria came to the afflicted cattle "from" the environment, this was simply not the sort of environmental contaminant that §1033(f) was enacted to address.

C. *Replacement Property Must Be Acquired Through Purchase*

1. *In General*

Section 1033(a)(2)(A) requires replacement property to be purchased. Property is not regarded as purchased unless its unadjusted basis is its cost to the taxpayer within the meaning of §1012.[412] A corollary of this rule is that if the basis for the property is determined under any of the exceptions set out in §1012, it does not meet the purchase requirement.[413] Common examples of nonpurchase transactions include gifts where the donor's basis becomes the donee's basis under §1014[414] and tax-free exchanges, where the basis is determined under §1031(d). Thus, in Rev. Rul. 69-639, where like-kind property and cash were used to obtain replacement property following an involuntary conversion, the IRS ruled that the replacement property was purchased (and was thus qualified replacement property) only to the extent of the cash paid.[415] Similarly, in *Real Estate Corp. v. Commissioner*,[416] a taxpayer who repurchased his own property at a tax sale did not make a purchase under §1033. The purchase price would be deductible as taxes and would not give rise to basis under what is now §1012.[417]

In GCM 39742,[418] a subsidiary in an affiliated group sold interests in radio and television stations and proposed to replace the property by transferring the cash proceeds to another member of the affiliated group in exchange for newly issued stock of that member. As a consequence of the attribution of ownership rules applicable to members of an affiliated group filing consolidated returns, the proposed transaction would have constituted a transfer to a controlled corporation governed by §351(a), with the cash treated as the "property" transferred. The Chief Counsel's Office concluded that because the taxpayer's basis in the newly issued stock would be determined by §358(a), and not §1012, the transaction would not qualify as a purchase of replacement property under §1033(a)(2)(A).[419] It further noted that Rev. Rul. 77-422 should be modified to eliminate any implication that a §351(a) transfer qualifies as a purchase.[420]

Comment: GCM 39742 represents an example of literal compliance with the terms of the statute which seems to produce a result arguably contrary to its purpose. Given that the "property" to be transferred was cash, the taxpayer would have had an economic cost basis in the stock, albeit a formal substituted basis under §358(a). Compare the more literal treatment of §351(a) in Rev. Rul. 84-29.[421] GCM 39742 reflects the cautious and not entirely consistent position the IRS has adopted with respect to replacements by the purchase of stock in related corporations. *See* VIII.E.2.a., below.

Replacement purchases also must run the gauntlet of §1033(i), which prohibits taxpayers from making replacement purchases from certain related persons.[422]

2. *Investment in Already Owned Property*

As discussed in VII.B.1.b., above, the IRS has ruled that a taxpayer's expenditure of conversion proceeds on land already owned may qualify as similar use[423] reinvestment in certain circumstances. These circumstances include the filling in of submerged land,[424] repairs to remaining property to prevent recurrence of a casualty, and the replacement of production capacity reduced through the conversion. Similarly, the IRS has allowed the use of severance damages to restore the capacity of severed land.[425] The "purchase" occurs through the expenditures, even though there is no discrete purchase transaction. However, the IRS has also ruled that the purchase requirement is not satisfied if the taxpayer uses the proceeds to reduce mortgage debt on similar property already owned by the taxpayer.[426]

3. *Purchase from a Related Taxpayer*

One problem area not fully resolved is the proper treatment of purchases from related taxpayers. In evaluating whether such a purchase would pass muster from a tax perspective, the transaction needs to be evaluated from two perspectives. The first question is whether §1033(i) applies to prevent the related party purchase from constituting a valid §1033 replacement. The second is whether more general related-party purchase rules, as they read before the enactment of §1033(i), apply.

a. *Section 1033(i)*

Section 1033(i) provides that when replacement property is purchased by certain taxpayers from certain other related taxpayers, §1033(a) deferral is not available. Put differently,

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[411] 615 F. Supp. 160 (E.D. Ky. 1985).

[412] §1033(a)(2)(A)(ii); Reg. §1.1033(a)-2(c)(4).

[413] These exceptions are as provided in subchapter O (§1001–§1092), subchapter P (§1201–§1297), subchapter C (§301–§308), and subchapter K (§701–§761).

[414] *See Dettmers v. Commissioner*, 430 F.2d 1019 (6th Cir. 1970); Reg. §1.1033(a)-2(c)(4).

[415] *See also* PLR 8234048.

[416] 22 T.C.M. 654 (1963).

[417] *Accord* TAM 8205005 (replacement files were not purchased when cost of reconstructing law firm files were expensed).

[418] (Apr. 19, 1988).

[419] *But see* PLR 9211025 and PLR 9252006. In PLR 9211025, the IRS ruled that the purchase of stock of a sister subsidiary holding broadcasting assets qualified as a "purchase" because the sister subsidiary's preferred stock was sold to a partnership that was not a member of the consolidated group and, therefore, the purchasing subsidiary did not control the sister subsidiary within the meaning of §368(c). Thus, the IRS concluded that §351(a) did not apply and the basis of the stock purchased was the cost basis under §1012 rather than a carryover basis under §358. In PLR 9252006, the IRS concluded a purchase had occurred and distinguished Rev. Rul. 79-293 because the stock "purchase" had increased the purchaser's ownership from 80% to 90%.

[420] *See, e.g., Taft Broad. Co. v. United States*, 929 F.2d 240 (6th Cir. 1991), rev'g 685 F. Supp. 1033 (S.D. Ohio 1988). To the same effect is Rev. Rul. 79-293, which concludes that the purported purchase of stock is not a purchase where the replacing taxpayer's corporate family owned 100% of the stock interests before and after the purported purchase.

[421] *See* VIII.E.2.b., below.

[422] *See* §1033(i). *See* VII.C.3., below.

[423] It would not qualify as a like-kind replacement; see the authorities discussed in footnotes at VII.B.3.d., above.

[424] Rev. Rul. 70-265.

[425] *See* authorities cited at VII.B.1.b., above.

[426] Rev. Rul. 70-98; *Murray v. Commissioner*, 24 T.C.M. 762 (1965), aff'd *per curiam*, 370 F.2d 568 (4th Cir. 1967), cert. denied, 389 U.S. 834 (1967).

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when §1033(i) applies, a related party purchase (as described in §1033(i)) does not qualify as proper replacement property.

Section 1033(i) facially applies to all taxpayers. In the case of a taxpayer other than a C Corporation, there is an exception that prevents §1033(i) from applying if the taxpayer has aggregate realized gain of $100,000 or less for the tax year with respect to all converted property with aggregate realized gains. In the case of a partnership (or S corporation), the annual $100,000 limitation applies to both the partnership (or S corporation) and each partner (or shareholder).

If §1033(i) does apply, §1033 deferral is generally denied if the replacement property is acquired from those defined to be a "related person." Those who are "related persons" for §1033(i) purposes are those who would be related persons to the replacing taxpayer under §267(b) or §707(b)(1). However, §1033(i) does not apply (and, therefore, deferral is permitted under §1033(a)) if the replacement property being acquired from the related person is property (including stock) that the related person acquired from an unrelated person during the normal §1033 replacement period.[427]

b. Related Party Replacements Not Controlled by §1033(i)

The authorities are divided on whether related party replacements should be respected[428] or not.[429] Certainly, the provisions of §1033(i) which limit the reach of §1033(i) when the aggregate gain is less than $100,000 presents a strong argument that related party replacements are permitted in these circumstances. To increase the likelihood that the related sale will be respected for tax purposes, the sale should be at arm's length both in price and terms, with appropriate contemporaneous documentation.[430] "Arm's length," of course, is not necessarily the same as "fair market value." In distress sale circumstances, "arm's length" may be a far lower price than a fair market price. Care should be taken, for example, in related party transactions in which the seller will recognize a loss. The IRS can be expected to argue that a "sham" sale has occurred, either to deny loss recognition (by the seller), or §1033 deferral of any gain (by the buyer) or both. Similarly, a highly leveraged transaction which allows the taxpayer to purchase from a related party and yet retain the conversion proceeds for an indefinite or considerable period would seem more vulnerable to IRS challenge than an all-cash purchase transaction.[431]

4. Use of Particular Funds

Until 1951, it was necessary for taxpayers to expend conversion proceeds in acquiring replacement property.[432] Although this tracing requirement was eliminated in 1951,[433] a related problem is present when the taxpayer receives dissimilar property other than cash. To defer recognition, the fair market value of such dissimilar property would have to be used to acquire replacement property. However, §1033 has no application if the dissimilar property is sold to raise funds and any gain must be recognized. As a practical matter, the taxpayer is forced to obtain purchase funds from other sources and then purchase similar replacement property.[434]

5. Purchase Through Construction

Taxpayers occasionally are able to produce their own replacement property. In Rev. Rul. 70-265, the taxpayer sold land, under threat of condemnation, which it had held for productive use. Thereafter, the taxpayer filled in certain acreage submerged under water, for which it received title from the governmental authority. The IRS ruled that the newly acquired land was purchased within the meaning of §1033(a), and that the taxpayer's cost of fill, permits, surveys, and fees were the acquisition costs. The IRS has also concluded that signs manufactured by the taxpayer were "purchased."[435] Taxpayers may also make qualified replacement through erection of new improvements on either previously owned land or leased land.[436]

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[427] §1033(i)(1).

[428] *Gyro Eng'g Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969); Rev. Rul. 73-120; PLR 9548011, PLR 9546003, PLR 9543038, PLR 8312014, PLR 8230108, PLR 8203071, PLR 8138156; TAM 8128010; PLR 8112076, PLR 8020069. Of particular note is PLR 8138156, where the replacing trust was purchased from a trustee/income beneficiary. *See also Broadview Lumber Co. v. United States*, 561 F.2d 698 (7th Cir. 1977) (subsidiary's acquisition of parent's stock followed by merger of parent into subsidiary qualified for §1033 treatment); PLR 8620006 (radio or TV stations can be purchased as replacement property from affiliated corporation at fair market value); PLR 8648052 (IRS, relying on Rev. Rul. 73-120, ruled that an arm's-length purchase of property from an affiliated corporation will not disqualify the purchased property as replacement property under the former version of §1033); PLR 8911034 (broadcasting assets obtained from related corporation constitute qualified replacement property under §1033, provided assets are acquired in an arm's-length transaction); PLR 8949062 (broadcasting assets purchased from wholly owned subsidiary at independently appraised fair market value in arm's-length transaction qualifies as replacement property for §1033 purposes); PLR 8950029 (broadcasting assets purchased by one member of affiliated group from other members at fair market value qualifies as replacement property for §1033 purposes); and PLR 9017007 (corporate parent was permitted to acquire assets from its wholly owned subsidiaries in a §332 liquidation).

[429] *Templeton v. Commissioner*, 66 T.C. 509 (1976), supplemented by 67 T.C. 518 (1976), aff'd *per curiam*, 573 F.2d 866 (4th Cir. 1978); *Am. Truck Rental Corp. v. Commissioner*, 355 F.2d 928 (3d Cir. 1966), cert. denied, 385 U.S. 815 (1966). *See also* GCM 39742 (Apr. 19, 1988), discussed in VII.C.1., above.

[430] *See Feinberg v. Commissioner*, 45 T.C. 635 (1966), aff'd, 377 F.2d 21 (8th Cir. 1967); Rev. Rul. 73-120. *See also* PLR 9548011, PLR 9546003, PLR 9543038, PLR 9224006, and PLR 8803088 (replacement properties purchased from related taxpayers qualify under §1033 where appraisal was conducted by independent appraiser and arm's-length values were assigned to such properties).

[431] Consideration should also be given to the possible impact of §267 (disallowance of losses in related party transactions) and §1239 (gain on related party transaction may be ordinary).

[432] Former Reg. §103, §19.112(f)-1 (1939).

[433] *See also* Rev. Rul. 55-170. *See, e.g.*, PLR 9028046, PLR 9026038. In many situations, in fact, the taxpayer may prefer to keep the cash and leverage the new acquisition through debt. This is entirely consistent with and permitted under §1033.

[434] See the related discussion in IV.D., above.

[435] TAM 7809006.

[436] PLR 9026038 and PLR 8844049. *See also Allen v. Commissioner*, T.C.M. 1998-406 (amounts received from insurance company were used, in substantial part, to restore taxpayers' property to its original condition; to extent any enhancements made, these were *de minimis*); *Rentz v. Commissioner*, T.C.M. 1977-13 (citing Rev. Rul. 67-254, and allowing §1033 treatment of conversion compensation funds that were used to construct property similar to converted property); *Smith & Wiggins Gin, Inc. v. Commissioner*, 37 T.C. 861 (1962), aff'd, 341 F.2d 341 (5th Cir. 1965) (replacement property constructed by partnership and then contributed to corporation); PLR 8509075 (improvements constructed on leased land qualified as replacement property for condemned land and improvements).

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D. Replacement Property Must Be Acquired to Replace Converted Property

1. In General: Intent to Replace

Taxpayers occasionally overlook the requirement of §1033(a)(2)(A) that the replacement property be purchased "for the purpose of replacing the property so converted." This rule provides a trap for those who purchase or acquire the replacement property in the ordinary course of business. The scope of this doctrine is admittedly somewhat uncertain. The IRS made an early pronouncement of the doctrine in Rev. Rul. 59-8, ruling that the taxpayer's planting of a new wheat crop would not qualify for §1033 treatment because the planting would have been made in the regular course of business. Within a few years, the IRS distinguished Rev. Rul. 59-8 in Rev. Rul. 62-161, allowing deferral, following condemnation of an orchard, to the extent of both the purchase of uncultivated land and its replanting. Adding to the doctrine's uncertainty were Tax Court decisions in *Smith & Wiggins Gin, Inc. v. Commissioner*,[437] which allowed deferral even though the replacement property had been ordered under a modernization program before the destruction of the converted property, and *S.H. Kress & Co. v. Commissioner*,[438] which held immaterial the fact that the taxpayer would have acquired the "replacement" property even absent the conversion.

A slightly different aspect of the intent issue was litigated in *Feinberg v. Commissioner*,[439] in which the taxpayer claimed that replacement property was purchased with the requisite intent; the court held the absence of intent was demonstrated by the reporting of condemnation gain and the taxpayer's failure to reduce the basis of the replacement property under §1033(b). Similarly, the National Office advised that a taxpayer, once having filed a return in which replacement property is not designated, may not later designate property acquired during that year as qualified replacement property by amended return. The National Office stated that the intent to replace the involuntarily converted property must be present at the time of purchase of the replacement property. The National Office cited *Feinberg* and advised that when the taxpayer files his return for the year of purchase of the property without reporting that the property is replacement property, the taxpayer rather clearly indicates that the property was not purchased for the purpose of replacing involuntarily converted property. The taxpayer is not permitted hindsight in either electing §1033(a) or in designating replacement property.[440] In Rev. Rul. 81-279, the IRS modified Rev. Rul. 59-8 and amplified Rev. Rul. 62-161 to rule that a taxpayer who elects the crop method of accounting[441] may treat the expenses of planting a replacement crop as a qualified §1033 investment. Rev. Rul. 81-279 did not comment on the intent doctrine set out in Rev. Rul. 59-8, but instead chose to analogize the nondeducted costs to a §1012 cost basis.

Comment: In light of the express language of the statute, it is advisable to document and preserve items showing the acquisition was to replace the converted property as opposed to a preexisting intent and/or obligation to make property purchases in the ordinary course. Furthermore, caution should be exercised relative to binding arrangements whereby the taxpayer will be divested of replacement property or is otherwise protected from the potential for loss normally associated with full ownership.

2. Acquisition/Liquidation Satisfies Intent Requirement

It is reasonably well settled since *Kimbell-Diamond Milling Co. v. Commissioner*[442] that an acquisition of stock followed by a prearranged liquidation is in substance an acquisition of assets. Applying the notion in Rev. Rul. 69-242, the IRS ruled that the assets in a prearranged acquisition/liquidation should be treated as replacement property for purposes of determining whether sufficient replacement has occurred.[443] Similarly, an asset purchase followed by an exchange is in essence a purchase of the exchanged property,[444] and a purchase of stock warrants followed by an immediate conversion into stock has been held to constitute a purchase of the stock.[445] Caution is warranted here, however, in that the *Kimbell-Diamond* doctrine has been statutorily repealed by the enactment of §338.

3. Additional Intent for §1033(g) Replacements

For involuntarily conversions of real property held for productive use or investment, §1033(g) requires an additional element of interest, that the replacement property must be acquired and held for productive use in a trade or business or for investment. The time for determining the holding purpose is the time of the replacement.[446] Thus, property purchased for resale or as a personal residence can never satisfy §1033(g). A continuing problem is whether a taxpayer who transfers replacement property soon after the replacement had the proper intent at the time of replacement.[447] The regulations[448] generally take a

[437] 37 T.C. 861 (1962), aff'd, 341 F.2d 341 (5th Cir. 1965).

[438] 40 T.C. 142 (1963), acq., 1965-1 C.B. 5.

[439] 45 T.C. 635 (1966), aff'd, 377 F.2d 21 (8th Cir. 1967).

[440] FSA 200147053.

[441] Under the crop (or cash) method of accounting, the expenses associated with planting of crops are not currently deductible, but are deductible when gross income from the crop is realized. *See* Reg. §1.61-4.

[442] 14 T.C. 74 (1950), aff'd, 187 F.2d 718 (5th Cir. 1951), cert. denied, 342 U.S. 827 (1951).

[443] *See also Broadview Lumber Co. v. United States*, 561 F.2d 698 (7th Cir. 1977) (subsidiary's acquisition of parent's stock followed by merger of parent into subsidiary qualified for §1033 treatment). Caution is warranted in that §1033(i) reverses the holding in *Broadview Lumber* for involuntary conversions after February 6, 1995.

[444] PLR 8122090.

[445] *Compare* PLR 8122076 (transaction amounts to stock purchase) *with* PLR 8034098 (issue reserved). *See generally Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942) (warrants not same as voting stock).

[446] *Cf.* Rev. Rul. 57-244 (holding purpose determined as of §1031 exchange).

[447] *See, e.g., Ramey Inv. Corp. v. Commissioner*, 26 T.C.M. 17 (1967) (forced sale did not disqualify §1033(g) replacement property); Rev. Rul. 75-292 (subsequent transfer to wholly owned corporation precludes investment intent); PLR 200528011 (termination of testamentary trust and distribution to in-kind beneficiary of replacement property acquired after involuntary conversion of trust property does not preclude §1033(g) treatment where trust's termination is not prearranged plan, and involuntary conversion and attendant acquisition of replacement property are wholly independent from distribution of trust property); PLR 9020013 (contribution of replacement property to partnership not fatal to §1033 deferral); PLR 7838080 (transfer of land trust for financing purposes did not preclude §1033(g) treatment); TAM 7805003 (same). *See also* TAM 9645005 (where distributee partners held former partnership property for only one day, requisite investment intent lacking for §1033(g) replacement).

[448] Reg. §1.1033(g)-1(a).

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restrictive view of subsequent conveyances, although the case law is generally more supportive of taxpayers.[449]

PLR 200528011 is worthy of special note. This private letter ruling involved a testamentary trust that was to terminate on a date certain, with the assets being distributed in kind to the beneficiaries. The trust proposed to acquire certain assets, contribute them to a limited liability company, and then distribute the LLC interests to the beneficiaries as a part of the in-kind liquidation of the trust. In addition, certain real property would be distributed in kind. Overriding all of this was the right of the beneficiary to provide input to the trustees as to the trustees' selection of replacement property. The trustees retained final selection rights, however. Rev. Rul. 71-337 and Rev. Rul. 75-292 were held to be inapplicable, while *Wagensen v. Commissioner*[450] was found to be controlling, and the IRS ruled that §1033 treatment was appropriate. Likewise, in PLR 200812012, the IRS ruled that the termination of an LLC under §708(b)(1)(B) resulting from the distribution of the assets of a testamentary trust did not preclude the replacement property from being held for investment or for the productive use in a trade or business under §1031(a). The point that should be drawn from PLR 200528011 and PLR 200812012 is that the unanticipated reconveyance of property is not fatal per se, i.e., §1033 treatment can be still appropriate when the subsequent conveyance is out of control of the replacing entity.

The concern about transfers of the replacement entity do not apply to a transfer to a "disregarded entity," since the "disregarded entity" does not exist for tax purposes, and hence, the transfer does not have tax significance. That is, after the transfer, the original taxpayer still owns the asset for tax purposes.

E. When Replacement Must Occur

1. Replacement Through Similar Use Property

Section 1033(a)(2)(B) identifies the period within which replacement must occur. A taxpayer wishing deferral under §1033 must pay attention to the earliest date on which replacement can occur, and to the last date for replacement.

Regarding the earliest date for replacement, §1033(a)(2)(B) provides that the replacement may begin on the earlier of (1) the conversion, or (2) the threat or imminence of condemnation or requisition (if applicable).[451] Although §1033(a)(2)(A) is reasonably clear that property acquired before the start of the replacement period cannot be considered replacement property, the language of §1033(a)(2)(A)(i) injects confusion by seeming to allow pre-conversion property to qualify if held by the taxpayer on the date of the "disposition" of the converted property.[452]

Section 1033(a)(2)(A)(i) and §1033(a)(2)(B), however, are in harmony. Section 1033(a)(2)(A)(i) anticipates the situation where the threat or imminence of condemnation allows the taxpayer to purchase replacement property before the actual sale or exchange of the old property. Section 1033(a)(2)(A)(i) and Reg. §1.1033(a)-2(a) provide that the "disposition" of property sold under threat or imminence of condemnation occurs upon the sale or exchange and not the threat or imminence.[453]

The second and often more important aspect of the replacement period is its end. Absent discretionary extension by the IRS, the opportunity for deferral is lost when the replacement period runs beyond two years (or longer in certain specified cases)[454] after the close of the first tax year in which conversion gain is realized.[455] In general, gain is realized as soon as proceeds in excess of basis become available to the taxpayer,[456] even though the gain initially realized may be very small relative to the eventual gain received by the taxpayer,[457] and even though the taxpayer may have a contingent liability to repay the advancement to the condemning authority.[458] Similarly,

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[449] *Compare Black v. Commissioner*, 35 T.C. 90 (1960) (immediate sale precluded §1031 treatment); *Regals Realty Co. v. Commissioner*, 43 B.T.A. 194 (1940) (same), acq., 1941-1 C.B. 9, aff'd, 127 F.2d 931 (2d Cir. 1942); *Griffin v. Commissioner*, 49 T.C. 253 (1967) (pre-existing obligation to sell precluded §1031 treatment); *Click v. Commissioner*, 78 T.C. 225 (1982) (gift within seven months negated investment intent and precluded §1031 treatment); and Rev. Rul. 75-292 (transfer to taxpayer's wholly owned corporation precluded §1031 treatment), *with Magneson v. Commissioner*, 81 T.C. 767 (1983), aff'd, 753 F.2d 1490 (9th Cir. 1985) (transfer to partnership immediately after exchange did not preclude §1031 treatment); *Wagensen v. Commissioner*, 74 T.C. 653 (1980) (gift within nine months did not preclude §1031 treatment); and PLR 8126070 (distribution of exchanged property by nongrantor trust did not preclude §1031 treatment).

[450] 74 T.C. 653 (1980).

[451] *See, e.g.*, PLR 202125006 (written notice to taxpayers of FCC's intent to reassign portion of taxpayers' spectrum usage rights, which would result in involuntary conversion or taking of taxpayers' property, is date of beginning of threat or imminence of requisition or condemnation).

[452] *See also* Reg. §1.1033(a)-2(c)(4).

[453] *See* PLR 7904093 (example of anticipatory replacement). For an example of anticipatory replacement that was held to have occurred before the existence of the threat of condemnation, see *Murray v. Commissioner*, 24 T.C.M. 762 (1965), aff'd *per curiam*, 370 F.2d 568 (4th Cir. 1967). See also PLR 8234048, which discusses the date on which the threat or imminence of condemnation arises when a bond issue is necessary to fund the acquisitions, and PLR 8810054, where property that was purchased before the official action to condemn was ruled not to be qualified replacement property.

[454] Specific situations for which extended replacement periods have been provided are discussed below at VII.E.3. Additional guidance on disaster relief for specific events is available on the IRS's website, and additional guidance on federally declared disasters (including affected counties) is available on FEMA's website.

[455] *E.g., Shipes v. Commissioner*, 74 T.C.M. 2 (1997).

[456] *See Stewart & Co. v. Commissioner*, 57 T.C. 122 (1971); *Feinberg v. Commissioner*, 45 T.C. 635 (1966), aff'd, 377 F.2d 21 (8th Cir. 1967). The interaction of this rule with the installment sales rule of §453 is not clear. However, the IRS can be expected to assert that gain is realized by the taxpayer (even under the installment reporting method) in the year the payments are first made to a cash basis taxpayer. The IRS could base this argument on the fact that all §453 does is "spread" the reporting of gain, not defer its realization or even postpone entirely its recognition.

[457] *E.g., Shipes v. Commissioner*, 74 T.C.M. 2 (1997).

[458] *See Wilson v. Commissioner*, 72 T.C.M. 628 (1996), as supplemented by 73 T.C.M. 2251 (1997); *Stewart & Co. v. Commissioner*, 57 T.C. 122 (1971). *See also Town Park Hotel Corp. v. Commissioner*, 29 T.C.M. 1150 (1970), aff'd, 446 F.2d 878 (6th Cir. 1971); *Conlorez Corp. v. Commissioner*, 51 T.C. 467 (1968); *Aldridge v. Commissioner*, 51 T.C. 475 (1968); *Scolari v. Commissioner*, 32 T.C.M. 803 (1973), aff'd per curiam, 497 F.2d 962 (9th Cir. 1974); *Casalina Corp. v. Commissioner*, 60 T.C. 694 (1973), acq., 1974-2 C.B. 1, aff'd, 511 F.2d 1162 (4th Cir. 1975); *Marco S. Marinello Assoc., Inc. v. Commissioner*, T.C. Memo 1975-78, aff'd per curiam, 535 F.2d 147 (1st Cir. 1976); PLR 8129114. *But see Nitterhouse v. United States*, 207 F.2d 618 (3d Cir. 1953) (fact that taxpayer had no entitlement to sums deposited in court precluded immediate taxation); PLR 200944012 and PLR 200945020 (where taxpayer had right to withdraw condemnation proceeds deposited by city, but withdrawal would have waived taxpayer's right to contest city's right to take condemned property, IRS ruled that taxpayer was not in actual or constructive receipt of such proceeds until settlement of its legal action against city challenging condemnation). In PLR 8915013, the fact that various parties asserted

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although fees and costs paid in subsequent tax years may reduce the overall gain that must be deferred, there is no carryback to eliminate the gain for purpose of §1033(a)(2)(B)(ii).[459] The result is the same even though subsequent proceedings may award additional compensation to the taxpayer, increasing the amount of gain that must be deferred. The fact that the replacement period has long since expired is irrelevant.[460] These rules have caused particular grief to taxpayers who contest the amount of a condemnation award. Generally, despite the contest as to damage amount, condemnation proceeds placed in the appropriate court are available for withdrawals by the taxpayer pending final determination. For tax purposes, these funds generally are constructively received by the taxpayer upon deposit; thus, if the deposited funds produce gain, the replacement period starts upon deposit.[461] All too often, taxpayers have waited until a final determination of the award to make §1033 arrangements, with the result, as mentioned in the cases above, that §1033 deferral is not available. However, the IRS has ruled in some circumstances that the condemnation proceeds were not constructively received by the taxpayer upon deposit, even though they were available for withdrawals by the taxpayer.[462]

Note that the IRS has ruled that a final portion of condemnation proceeds, received after both the acquisition of replacement property and the expiration of the replacement period, qualified for nonrecognition under §1033 when the cost of the replacement property exceeded the total amount realized.[463] The taxpayers had received money as condemnation compensation and acquired replacement property at a cost that exceeded this amount, i.e., an "overreplacement." Following litigation to determine the condemned property's fair market value, and after expiration of the replacement period, the taxpayers received a second payment. The IRS ruled that the second payment related back to the property acquired as replacement property and that any gain realized on the latter proceeds was not recognized because the cost of the replacement property exceeded the total amount realized.

The IRS has also ruled that condemnation proceeds deposited with the state treasurer were not constructively received and gain was not realized until the taxpayer (the property owner) and the lessee of the property settled their dispute as to the proper apportionment of the proceeds. Thus, the replacement period did not begin to run until the dispute was settled.[464]

Comment: As a matter of practice, taxpayers should consider requesting an extension of the replacement period if a protracted condemnation proceeding challenging just compensation is anticipated. Taxpayers should also consider "overreplacing" the property, at least based on the original deposit, when they plan to contest the adequacy of that original deposit.

2. Replacement Under §1033(e)

The general replacement period of two years is automatically extended to four years in the case of a deemed involuntary conversion under §1033(e)(1),[465] *i.e.*, livestock sales on account of drought, flood, or other weather-related conditions.

In addition, the IRS has discretion to further extend the replacement period on a regional basis if the weather-related conditions continue for more than three years.[466] Notice 2006-82 extends the replacement period until the end of the taxpayer's first tax year ending after the first drought-free year. The extension applies only to the counties listed in a further annual publication by the IRS[467] or as portrayed on the U.S. Drought Monitor Maps produced by the National Drought Mitigation Center. The "first drought-free year" is determined based on a 12-month period ending on August 31.

Example: Taxpayer X, a calendar year taxpayer, raises cattle in Keith County, Nebraska. In Year 2, all of X's cattle held for breeding purposes are sold solely on account of drought conditions in Keith County. Under X's normal business practices, only 25% of his cattle would have been sold in Year 2. Keith County was designated as a severe drought area beginning in Year 1. Under §1033(e)(1), the sale of 75% of X's cattle is eligible for §1033 treatment, with the normal replacement period ending December 31, Year 6, pursuant to §1033(e)(2)(A).

Assume further that the designated drought conditions persist through August 31, Year 7 in at least one of the counties contiguous to Keith County, and that no designated drought conditions exist in the 12 months thereafter ending August 31, Year 8. Taxpayer X's replacement period to defer gain on account of the Year 2 cattle sale is automatically extended through December 31, Year 8 (i.e., the last day of X's first tax year ending after the first drought-free year for the applicable region).

3. Extended Replacement Periods for Certain Property

The Code provides longer periods for the replacement of involuntarily converted business and investment real property, principal residences involuntarily converted in federally declared disaster, and property involuntarily converted as a result of the September 11, 2001, terrorist attacks.

In keeping with the more liberal provisions of §1033(g), a three-year replacement period applies to conversions of busi-

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ownership of the deposit prevented taxation of the deposit until the ownership dispute was resolved. Similarly, in PLR 8934049, problems in serving various owners of the subject property prevented any owner from withdrawing the deposit, at least until process service on all owners had occurred. As a bottom line, the notion is one of constructive receipt and/or economic benefit: if the taxpayer has the uncontested right to retain the deposit, it will be taxable to him or her. *See also* PLR 9203022 (analyzing question of when restrictions as to court registry funds had been terminated).

[459] *See* PLR 8041002.

[460] *See, e.g., Shipes v. Commissioner*, 74 T.C.M. 2 (1997) (§1033 does not permit use of multiple replacement periods in connection with single condemnation proceeding); PLR 8934049.

[461] *See* Reg. §1.451-2(a) (constructive receipt doctrine).

[462] *See, e.g.*, PLR 200944012 and PLR 200945020 (although condemnation proceeds were deposited and available for withdrawals by taxpayer, proceeds were not constructively received by taxpayer until settlement of taxpayer's legal action challenging condemnation, because withdrawal of proceeds would have constituted waiver of taxpayer's right to challenge the condemnation), PLR 8934049, and PLR 8915013, discussed in an earlier footnote.

[463] PLR 9028046.

[464] PLR 8915013. *See* PLR 200714002 (replacement period for stock seized and sold by state government under unclaimed property law begins when state sells stock).

[465] §1033(e)(2)(A).

[466] §1033(e)(2)(B).

[467] For the annual IRS list of the affected counties, see Tables, Charts & Lists, *Annual Lists of Drought-Affected Counties under §1033(e).*

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ness or investment real property described in §1033(g).[468] Thus, the replacement period ends three years after the close of the first tax year in which gain from the conversion is realized. The rules for determining the start of the replacement period are not affected.

A four-year replacement period applies to a principal residence (or any of its contents) located in a disaster area that is involuntarily converted as a result of a federally declared disaster.[469]

4. When Replacement Occurs

The taxpayer must complete replacement during the replacement period. Replacement occurs when the taxpayer designates property as replacement property. The first purchased replacement property need not be designated, because any qualifying property acquired during the replacement period can be the replacement property.[470] The taxpayer's unsuccessful good faith efforts to make timely replacement are not enough.[471] Similarly, the nonavailability of replacement property does not stop the replacement period from running.[472]

If replacement consists of construction of a building, construction must be completed by the period's end. Merely paying the contractor for future efforts is not enough.[473] Similarly, improvements must be paid for and actually completed during the replacement period.[474] If a taxpayer purchases items as an act of replacement, the benefits and burdens of ownership must pass to the purchaser during the replacement period. Thus, execution of a binding contract to purchase is not enough if legal title, possession and control do not pass within the replacement period.[475]

If legal title passes under local law to the replacing taxpayer, the existence of an option to reconvey if certain improvements are not made will not negate the §1033 replacement.[476] For example, the IRS ruled that the taxpayer's purchase of replacement property qualified under §1033(a)(2) despite the presence of a put option enabling the taxpayer to resell the property to the person from whom he had purchased it.[477] Similarly, a purchase occurred for §1033 purposes even though in a later year, the seller repossessed the replacement property following default by the purchaser.[478]

5. Discretionary Extension by IRS

The IRS can extend any replacement period upon application of the taxpayer.[479] This application should be made before the expiration of the replacement period;[480] however, Rev. Rul. 60-69 indicates such requests usually will not be granted until the end of the replacement period. Extensions generally are for a period not exceeding one year, and are granted if there is reasonable cause for the failure to make timely replacement. High market value for replacement property, or even its scarcity, are not sufficient grounds on which to obtain an extension.[481] The existence of a sewer moratorium does not present reasonable cause if the moratorium's duration is uncertain,[482] but reasonable cause may be present if a sewer moratorium is likely to be lifted before the requested extension will expire.[483] These results differ primarily because of the reasonableness of the respective taxpayer's waiting for the moratorium to end before reinvesting.[484] Further, the IRS ruled that the nonavailability of conversion proceeds, as where an interim investment became worthless, does not constitute grounds for the extension.[485]

The IRS may extend the replacement period even if the request is filed after the end of the replacement period.[486] However, the taxpayer must show reasonable cause for the late filing as well as for the extension itself. Diligent efforts to secure replacement property before the requested extension should be shown.[487] The question is whether, on all the facts and circumstances, the previous replacement period was adequate.[488] The belated application to extend must be filed within a reasonable time after the replacement period ends.[489]

Generally, a taxpayer cannot demonstrate reasonable cause for filing a late extension request simply by pointing to a tax advisor's failure to make an extension request.[490] Similarly, even if the taxpayer's advisor is inexperienced in tax matters, the taxpayer generally cannot rely on the advisor's conclusion as to whether replacement is necessary.[491] On the other hand, reliance on an experienced attorney and an experienced accoun-

[468] §1033(g)(4); *see* Reg. §1.1033(g)-1(c).

[469] §1033(h)(1)(B). "Federally declared disaster" and "disaster area" are defined in §165(i)(5). *See* Reg. §1.165-11(b)(1), T.D. 9950, 86 Fed. Reg. 31,146 (June 11, 2021) (federally declared disasters include declarations of major disasters under §401 of the Stafford Act and emergencies under §501 of the Stafford Act). Principal residence is defined in §1033(h)(4). *See also Tables, Charts and Lists (Federal), Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions.*

[470] TAM 8422005.

[471] *See Estate of Resler v. Commissioner*, 17 T.C. 1085 (1952).

[472] *Fulliluve v. United States*, 71 F.2d 852 (5th Cir. 1934).

[473] Rev. Rul. 56-543.

[474] *Vaira v. Commissioner*, 52 T.C. 986 (1969), rev'd and rem'd, 444 F.2d 770 (3d Cir. 1971).

[475] *Settmers v. Commissioner*, 430 F.2d 1019 (6th Cir. 1970). *Accord Fort Hamilton Manor, Inc. v. Commissioner*, 445 F.2d 879 (2d Cir. 1971).

[476] *Cusack v. Commissioner*, 48 T.C. 156 (1967), acq., 1967-2 C.B. 2.

[477] PLR 8807029.

[478] *Ruud v. Commissioner*, 28 T.C.M. 1284 (1969). *See* VII.D.1., above.

[479] §1033(a)(2)(B)(ii). A sample application for extension of time to replace is contained in the Bloomberg Tax Elections & Compliance Statements: *Involuntary Conversion: Application for Extension of Time for Replacement of Converted Property (§1033(a)(2)). See, e.g.*, PLR 8840022.

[480] Reg. §1.1033(a)-2(c)(3).

[481] Rev. Rul. 60-69; *Fulliluve v. United States*, 71 F.2d 852 (5th Cir. 1934).

[482] Rev. Rul. 76-488.

[483] *See* Rev. Rul. 76-540, *distinguishing* Rev. Rul. 76-488. Similarly, TAM 9237012 concludes that, where the need for an extension is not the scarcity of property (as in Rev. Rul. 60-69), but instead relates to efforts to acquire a specific property (as in Rev. Rul. 76-540), then an extension may be granted.

[484] *Cf.* Rev. Rul. 60-69 (scarcity of replacement property not grounds for extension).

[485] Rev. Rul. 70-502. In contrast, see PLR 200126010 which concludes that the inability to purchase replacement property within the two-year period due to shelf-life concerns makes an extension appropriate.

[486] Rev. Rul. 56-300.

[487] *Kolstad v. United States*, 276 F. Supp. 757 (D. Mont. 1967).

[488] *Boyce v. United States*, 405 F.2d 526 (Ct. Cl. 1968).

[489] *Ford v. Commissioner*, 35 T.C.M. 253 (1976), aff'd *in unpub. opin.*, 546 F.2d 413 (1st Cir. 1976); *Latimer v. Commissioner*, 55 T.C. 515 (1970); *Miller v. Commissioner*, 32 T.C.M. 1375 (1973); Rev. Rul. 56-300.

[490] *See, e.g., Scolari v. Commissioner*, 32 T.C.M. 803 (1973), aff'd *per curiam*, 497 F.2d 962 (9th Cir. 1974).

[491] *See Casalina Corp. v. Commissioner*, 60 T.C. 694 (1973), acq., 1974-2 C.B. 1, aff'd, 511 F.2d 1162 (4th Cir. 1975); *Marco S. Marinello Assoc., Inc. v. Commissioner*, 535 F.2d 147 (1st Cir. 1976).

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tant that no gain was realized constitutes reasonable cause for failure to file a timely application to extend.[492] In addition, death of the taxpayer's tax advisor may constitute reasonable cause for failure to file a timely extension request.[493]

The application for extension should be addressed to the Internal Revenue Service Center in which the taxpayer's return is filed.[494]

Comment: As discussed in VII.E.1., above, the availability (constructive or actual) of the conversion proceeds starts the limitations period running. When the amount of the total proceeds is still in dispute, the taxpayer does not know the extent of the required reinvestment. Recognizing the dilemma presented such a taxpayer, the IRS has in the past granted extensions in such cases. The IRS also commonly grants extensions when actual purchase negotiations are in progress.

F. Notification of Replacement or Nonreplacement

The final step in the replacement process is proper notification to the IRS. Without notification of replacement or notification that no replacement will be made, each year in which gain is realized remains open indefinitely for the assessment of a deficiency.[495] The notification must be attached to the return for the tax year or years in which replacement occurs and must set forth all details in connection with the investment.[496] The IRS has ruled that replacement property can be designated on an amended return where no designation of replacement property was made on the taxpayer's original return.[497] More recently, however, the National Office has advised that a taxpayer, once having filed a return in which replacement property is not designated, may not later designate property acquired during that year as qualified replacement property by an amended return. The National Office stated that the intent to replace the involuntarily converted property must be present at the time of purchase of the replacement property. Thus, if the taxpayer reports the details of purchase of qualified property in his income tax return for the year of purchase, he shows that he intended to purchase the property as a replacement property. However, when the taxpayer files his return for the year of purchase of property without reporting that the property is replacement property, the taxpayer clearly indicates that the property was not purchased for the purpose of replacing involuntarily converted property.[498]

Regarding notification of an inadequate replacement, the Tax Court held in *Au Hoy v. Commissioner*[499] that a statement attached to the taxpayer's 1965 return concerning a 1964 replacement property was not proper notification to start the statute of limitations. The statement in *Au Hoy* did not identify the replacement property or the converted property and did not state the year of replacement.[500] Similarly, in *James River Apartments, Inc. v. Commissioner*[501] the taxpayer realized gain from an involuntary conversion but did not include this gain in income and also failed to affirmatively elect §1033. In 1964, the IRS assessed a deficiency for 1958, claiming the year was still open under §1033(a)(2)(C)(i). The taxpayer contended that certain information shown on its 1959 return was sufficient to provide the IRS with notice of an intent not to replace and thereby to start the statute of limitations running in tax year 1958. The Tax Court rejected that proposition and held that actual notice of an intention not to replace must be given before the statute of limitations will begin. If denied by the IRS, a request for additional time to replace[502] operates as a notification of nonreplacement.[503]

G. Consequences of Failure to Replace After Election

The various §1033 elections merely operate to defer the recognition of realized gain. Absent a valid election and replacement, the realized gain is recognized in the year(s) of realization.[504] Thus, where a taxpayer elects deferral but fails to replace, the gain that could have been deferred becomes fully recognizable in the years it was realized, and not in the year in which the failure to replace occurs. The tax deficiency arising from such recognition of added income is collected in the same manner as any other tax deficiency, except that a different statute of limitations may apply. Interest is owed on the tax deficiency in the same manner as interest is owed on other tax deficiencies.[505] Moreover, in appropriate circumstances, the existence of a deficiency due to a failure to replace could cause a late filing penalty to be applicable.[506]

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[492] Rev. Rul. 72-27.

[493] *See Lemly v. Commissioner*, 32 T.C.M. 697 (1973).

[494] IRS Pub. 547, *Casualties, Disasters, and Thefts. See also* Reg. §1.1033(a)-2(c)(3).

[495] *See* §1033(a)(2)(C)(i).

[496] Reg. §1.1033(a)-2(c)(5).

[497] PLR 8424026.

[498] FSA 200147053.

[499] 58 T.C. 201 (1972).

[500] *Accord Vaira v. Commissioner*, 52 T.C. 986 (1969), rev'd on other issues, 444 F.2d 770 (3d Cir. 1971).

[501] 54 T.C. 618 (1970), aff'd *per curiam*, 440 F.2d 412 (4th Cir. 1971).

[502] *See* VII.E., above.

[503] *See Rosefsky v. Commissioner*, 70 T.C. 909 (1978), aff'd on other issues, 599 F.2d 515 (2d Cir. 1979). See the Bloomberg Tax Elections & Compliance Statements: *Involuntary Conversion:Involuntary Conversion: Application for Extension of Time for Replacement of Converted Property (§1033(a)(2))*, for sample notices to the IRS.

[504] §1033(a)(2).

[505] *Suffness v. United States*, 788 F. Supp. 304 (N.D. Tex.), aff'd, 974 F.2d 608 (5th Cir. 1992).

[506] TAM 9548005.

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VIII. Special Problems and Planning Opportunities

Section 1033 offers a number of special problems and planning opportunities, which are discussed below.

A. Conversions of Multiple Properties

When there is a disposition of multiple properties, the exact tax treatment depends in part on whether §1245 property, or §1250 property is involved.[507] If such property is involved, the regulations under §1245 and §1250[508] require that the total amount realized on the disposition be allocated between the §1245, and §1250 properties, and the properties not falling into one of the foregoing classes. The effect of this requirement, discussed more fully below in XI., is that taxpayers will achieve complete nonrecognition only if adequate replacement property within each recapture class is purchased. Thus, a de facto allocation applies to many if not most §1033 conversions, and taxpayers usually must replace class by class.

If little or no recapture property is converted, however, the conversion of multiple properties presents the issue of whether §1033 should apply to the transaction as a whole or should apply by asset class. The IRS has advised that, in applying §1033, a business is not a single asset, and §1033 should thus be applied on an asset-by-asset basis.[509]

The following generalizations also may be made:

- If the taxpayer receives payments under separate insurance policies, multiple conversions will be present. Gain or loss, as well as eligibility for §1033 deferral, is determined separately as to each payment.[510]

- If the taxpayer receives a single payment and does not make replacement, an allocation of the proceeds must be made so that gain or loss and character can be determined.[511]

- If the taxpayer receives a single payment, makes some replacement, and there is an adequate basis on which to allocate the award among various asset classes, gain, loss, and §1033 deferral can again be determined separately.[512] Whether such allocation is mandatory is open to some doubt, but the IRS's position is that the allocation is mandatory.[513] However, if it is clear from the amount of the lump sum condemnation amount (because that amount significantly exceeds the fair value of the property), the court will inquire into the circumstances underlying the lump sum condemnation award.[514]

- If the taxpayer receives a single payment and makes some replacement, but there is no basis on which to apportion the proceeds, the taxpayer will not be allowed to supply his own allocation.[515]

Any further generalization is difficult. Where an entire going business is converted, the authorities differ as to whether each item of property must be tested separately to determine whether an appropriate amount has been reinvested.[516]

In another aspect of the same problem, the Tax Court held in *Maloof v. Commissioner*[517] that a shift, upon reinvestment, from a business consisting largely of current assets to a business consisting largely of fixed assets did not satisfy the "similar or related use" test of §1033(a)(2)(A).

Comment: Taxpayers seeking a maximum §1033 deferral in a condemnation setting should, in their negotiations and litigation pleadings: (1) avoid references to lost profits or revenues; (2) focus appraisers on property values, not profits; (3) refer to lost property damages, not lost profits, in the complaint; and (4) ensure that trial testimony refers to lost property damages and minimizes lost profit references.

B. Multiple Replacement Properties

The aggregate cost of replacement properties, as reduced by the gain deferred under §1033, must be allocated to the replacement properties in proportion to their respective costs.[518]

Example: A fire destroys Mickey's barn, which has a basis of $13,000. Mickey receives insurance proceeds of $22,000. Mickey decides to replace the barn with two

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[507] Section 1250 property is generally real property that has been subject to an allowance for depletion and has never been §1245 property. Section 1250 generally recaptures depreciation of §1250 property upon dispositions to the extent that depreciation exceeds straight line depreciation. Since 1986, all real estate has been required to be depreciated under a straight line method, and therefore, recapture of excess depreciation under §1250 is exceedingly rare. The discussion in the text concerning §1250 property is included for completeness and to provide a context in which rulings and decisions concerning, e.g., §1245 property can be understood.

[508] Reg. §1.1245-1(a)(5), §1.1250-1(a)(6)(i).

[509] TAM 9237005.

[510] *See Horowitz Bros. & Margareten v. Commissioner*, 10 T.C.M. 698 (1951). *See also Int'l Boiler Works Co. v. Commissioner*, 3 B.T.A. 283 (1926), acq., V-2 C.B. 2 (1926).

[511] *Lehman Co. of Am. v. Commissioner*, 17 T.C. 422 (1951), acq., 1952-1 C.B. 3.

[512] *See* Rev. Rul. 70-501 (§1033 held applicable to gain from fire, where settlement of single insurance policy was allocated to produce loss on machinery and gain on building); Rev. Rul. 72-424 (allocation between residential and nonresidential portions). *See also* PLR 8347054.

[513] *See* Rev. Rul. 70-465; PLR 7933079. *But see M.I.C. Ltd. v. Commissioner*, 73 T.C.M. 2098 (1997), and related cases, which hold that a lump sum condemnation award may not be allocated among the various items of property involved. *Asjes v. Commissioner*, 74 T.C. 1005, 1010–1011 (1980), acq., 1982-2 C.B. 1; *Kendall v. Commissioner*, 31 T.C. 549, 554 (1958), acq. 1959-1 C.B. 4; *Bymaster v. Commissioner*, 20 T.C. 649, 653–654 (1953); *Allaben v. Commissioner*, 35 B.T.A. 327, 328 (1937). *See also Orders v. United States*, 64-2 USTC ¶9551 (W.D.S.C. 1964) (taxpayer allowed to make favorable allocation to recognize loss over IRS objection); *Massillon Cleveland-Akron Sign Co. v. Commissioner*, 15 T.C. 79 (1950), acq., 1950-2 C.B. 3 (same result); *Lapham v. United States*, 178 F.2d 994, 996 (2d Cir. 1950). See PLR 199942082, which identifies the four factors used by the IRS to allocate condemnation awards: (1) allegations in complaint; (2) defenses asserted; (3) litigation background; and (4) other factors.

[514] *M.I.C. Ltd. v. Commissioner*, 73 T.C.M. 2098 (1997); *Smith v. Commissioner*, 59 T.C. 107 (1972); *Estate of Walter v. Commissioner*, 30 T.C.M. 1051 (1971).

[515] *Bymaster v. Commissioner*, 20 T.C. 649 (1953).

[516] *Compare Massillon-Cleveland-Akron Sign Co.*, 15 T.C. 79 (1950), acq., 1950-2 C.B. 3 (cost of replacement business viewed as a whole) and *Asjes v. Commissioner*, 74 T.C. 1005 (1980), acq., 1982-2 C.B. 1 (same), *with* Rev. Rul. 70-465 (replacement tested asset-by-asset). In Rev. Rul. 89-121, the IRS indicated that for §1031 purposes, an exchange of business assets had to qualify on an asset-by-asset basis. Although Rev. Rul. 89-121 did not cite Rev. Rul. 70-465, it is a strong indication that the IRS position as to §1033 replacement remains asset-by-asset. *See also* TAM 9237005 (aggregate approach is used).

[517] 65 T.C. 263 (1975).

[518] §1033(b) (last sentence); Reg. §1.1033(b)-1(b) *See also* Rev. Rul. 73-18, Rev. Rul. 68-356.

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smaller structures, which will be used for the same purpose as the destroyed barn. Replacement structure number one costs $15,000 and replacement structure number two costs $12,000. Mickey properly elects §1033 and recognizes no gain because his reinvestment ($27,000) equals or exceeds the conversion proceeds ($22,000). His aggregate basis in the new structure is his aggregate cost of $27,000 less his deferred gain of $9,000 ($22,000 proceeds less $13,000 basis), or $18,000. This aggregate basis is then allocated 15/27 (or $10,000) to structure number one, and 12/27 (or $8,000) to structure number two.

C. *Condemnation of Real Property*

1. *Unimproved Real Estate Replaced by Improved Real Estate*

Section 1033(g) allows gain on a condemnation of business or investment real property to be deferred to the extent the condemned tract is replaced with like-kind property. It is immaterial whether the condemned or replacement property is improved or unimproved.[519] When the condemned tract is unimproved and the replacement tract is improved, the IRS has ruled that any gain deferred through replacement must reduce the aggregate basis of the replacement tract.[520] Once this reduced aggregate basis is determined, it is then allocated to the depreciable and nondepreciable portions based on the respective fair market values of the improvements and the land.

Example: Polly owned unimproved investment real property, in which she had a basis of $160,000. In 20X8, that tract was condemned, and she received $400,000 cash. She properly elected deferral with her 20X8 return, and in 20X9, she purchased improved business realty for $800,000. Of this $800,000, $500,000 was allocated to the building and $300,000 was allocated to the land. Under Rev. Rul. 79-402, the $240,000 deferred gain must be used to reduce the basis in the replacement tract as a unit. After this reduction, Polly's basis in the land and improvements is $560,000 ($800,000 cost basis less $240,000 deferred gain). This aggregate basis for the replacement tract is then allocated based on the respective fair market values, viz., $210,000 (3/8 × $560,000) to the land and $350,000 (5/8 × $560,000) to the building (improvements).

Comment: The result in Rev. Rul. 79-402 is consistent with the requirement of §1033(b) and Reg. §1.1033(b)-1(b) that the basis be allocated to multiple properties after the aggregate cost is reduced by deferred gain. The taxpayer in Rev. Rul. 79-402 had sought a ruling that only the unimproved portion of the replacement property had to be reduced by the deferred gain. This would have produced a much more favorable result to the taxpayer, because it would have left the basis of the improvements much higher for depreciation purposes. Rev. Rul. 79-402 properly rejected this approach.

[519] Reg. §1.1031(a)-1(b).

[520] Rev. Rul. 79-402.

2. *Improved Real Estate Replaced by Improved Real Estate*

Less clear is the proper approach when improved real property is converted. An argument can be made, based on the cases and rulings discussed in VIII.A., above, that §1033 deferral should be determined separately for the depreciable and nondepreciable portions of the property.[521] The rationale for bifurcating the §1033 analysis is that the depreciable and nondepreciable portions represent discrete interests in property. A similar rationale requires such allocation when the depreciable portion of §1033 improved property is §1250 property. However, Rev. Rul. 73-18 seems to reject this approach when there is no §1250 property present. Taking a unitary view of the transaction, Rev. Rul. 73-18 provides that the gain deferred under §1033 from the converted property as a whole must be applied to reduce the aggregate replacement cost. This reduced cost basis is then allocated based on respective values of the depreciable and nondepreciable portions. Thus, §1033 deferral is determined based on the replacement property as a whole. The only court decision addressing these issues is *Aschaffenburg v. United States*,[522] in which a district court held that the unitary approach taken by Rev. Rul. 73-18 is correct.

Example: Mary owned a lot with a rental dwelling of negligible value. The city condemned the property, paying Mary $14,000 for the lot and paying her nothing for the improvement. Mary realized gain of $6,000. Mary thereafter purchased another lot with a rental unit for $18,000. The rental unit is worth $12,000, while the lot is worth $6,000. Under Rev. Rul. 73-18, Mary must reduce the aggregate $18,000 replacement basis by the deferred gain of $6,000, leaving a reduced basis of $12,000. This $12,000 is then allocated $8,000 (2/3 × $12,000) to the rental unit and $4,000 (1/3 × $12,000) to the land.

D. *Stock Acquisition vs. Asset Acquisition*

Taxpayers should consider the differences between a direct acquisition of replacement property and the purchase of stock of a corporation owning suitable replacement property. This Portfolio does not discuss the competing concerns of sellers and buyers, but the following comments offer guidance from the buyer's perspective.

In general, when the replacement occurs through the purchase of corporate stock, both the basis of the replacement stock and the basis that the corporation has in certain of its assets must be reduced. Given the potential for two levels of taxation as to any eventual corporate gain, the required reduction in the corporation's basis is a strong incentive to replace through an asset acquisition rather than a stock acquisition.

The buyer needs to evaluate the basis which a corporate seller has in its assets to know whether an asset acquisition or a stock acquisition is preferable. Relevant factors also include the other attributes (e.g., liabilities) of the corporation and the cor-

[521] *See, e.g.*, Rev. Rul. 70-501. *Cf.* Rev. Rul. 74-273 (taxpayer owning undivided half interest and usufructuary interest in other half may elect §1033 as to each interest separately).

[522] 381 F. Supp. 510 (E.D. La. 1974).

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porate seller's willingness to sell only the assets, presumably at a potential cost of two levels of taxation (once to the selling corporation, and a second when the sale proceeds are then distributed to its shareholders).

It may be desirable to acquire the assets, and not the corporation itself, when the underlying replacement assets are heavily encumbered. This allows the purchaser the benefit of the encumbrances in determining the amount of qualified replacement, even though, from an economic perspective, the purchaser only pays the seller the net equity. *See* IX.B., below. If the purchaser pays the equity price for the stock, he or she will not be able to count the asset encumbrances as a cost of replacement. Where there are encumbrances on the assets but a stock acquisition must be arranged for other reasons, it appears the purchaser could require the seller to use a portion of the purchase price to pay off the encumbrances and still treat the encumbrance portion as expended in replacement.[523] While this approach removes encumbrances, the effect of the stock acquisition is to put a higher basis in the nondepreciable corporate stock and leave the basis for the asset unaffected.

Example: Michael's hotel was destroyed by fire in 20X9. He received $150,000 in insurance proceeds, which produced a gain of $50,000. Michael properly elects §1033 and purchases the outstanding corporate stock of a corporation whose sole asset is a similar use replacement hotel for $150,000. The basis of that hotel to the former owner was $245,000. Michael recognizes no gain, as his qualified reinvestment[524] equals the conversion proceeds; Michael's cost basis in the stock is reduced pursuant to §1033(b) by the amount of deferred gain ($150,000 cost less deferred gain of $50,000, or $100,000). The corporation's basis in the hotel is reduced from $245,000 to $195,000 (i.e., by the same $50,000 amount by which Michael's basis in the stock has been reduced). This example illustrates the general rule of §1033(b)(3)(A).

Example: Assume the same facts as in the previous example, except that the corporation's basis in the hotel is $110,000. Michael's basis in the corporate stock is reduced to $100,000. The corporation's basis in the hotel is reduced by only $10,000 from $110,000 to $100,000, which is the amount of Michael's basis in the corporate stock after the basis reduction required by §1033(b). This example illustrates the limitation rule of §1033(b)(3)(B).

Example: Assume the same facts as in the previous example, except that the corporation has two assets, the hotel (basis of $110,000) and unimproved land (basis of $150,000). Michael's basis in the corporate stock is reduced to $100,000. The reduction in the bases of the corporation's assets ($50,000) is applied first to its basis in the similar use property, the hotel. Accordingly, the basis of the hotel becomes $60,000 (original basis of $110,000 less $50,000), and the basis in the unimproved land is unaffected. This example illustrates the prioritization rule of §1033(b)(3)(C)(i).

Example: Assume the same facts as in the previous example, except that the corporation's basis in the hotel is $45,000. Michael's basis in the corporate stock is reduced to $100,000. The reduction in the bases of the corporation's assets ($50,000) is applied first to its basis in the similar use property, the hotel. Accordingly, the basis of the hotel is reduced from $45,000 to zero. The remaining $5,000 of the $50,000 basis reduction is applied against the basis in the unimproved land. Accordingly, the basis in the unimproved land becomes $145,000 ($150,000 basis less previously unallocated basis reduction of $5,000). This example illustrates the prioritization rules of §1033(b)(3)(C)(i) and §1033(b)(3)(C)(iii).

Example: Assume the same facts as in the previous example, except that the corporation's basis in the unimproved land is only $10,000. Michael's basis in the corporate stock is reduced to $100,000. Because the aggregate corporate bases in the corporation's assets, $55,000 ($45,000 in the hotel plus $10,000 in the land) is less than Michael's basis in the corporate stock ($100,000), no reduction in either the hotel's basis ($45,000) or in the unimproved land ($10,000) can occur. This example illustrates the limitation rule of §1033(b)(3)(B).

Example: Assume the same facts as in the previous example, except that the corporation's basis in the unimproved land is $75,000. Michael's basis in the corporate stock is reduced to $100,000. The corporation's basis in the hotel is reduced only by $20,000 to $25,000 and the basis in the unimproved land is not reduced and remains $75,000. This result occurs because: the total basis reduction cannot reduce the aggregate corporate basis below that of Michael's basis in the corporation's stock (§1033(b)(3)(B)); and any basis reduction must first be made to the similar use property owned by the corporation (§1033(b)(3)(C)(i)). Because the corporation's aggregate bases in its assets following these reductions is $100,000 (the same as Michael's basis in his corporate stock) and any basis reduction has been allocated first to the similar use property, these rules have been met.

E. Other Corporate Planning Opportunities

Often, taxpayers will desire to own the replacement assets in corporate form. Historically, this was often due to liability concerns. The availability of limited liability companies in more recent years has lessened the use of corporations to avoid shareholder liability for risky business ventures. Nonetheless, there often will be circumstances when a corporation is the overall choice for the business entity. The following discussion assumes the corporate form is selected.

If a corporate form is desired, one possibility is for the taxpayer to structure the replacement as a stock acquisition. *See* VII.B.2., above. Where this approach is not available, there

[523] *See* PLR 8122076. *But see* PLR 8034098 (ruling reserved on this issue).
[524] *See* §1033(a)(2)(A).

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are two principal methods by which taxpayers have sought to achieve corporate form and still satisfy the replacement rules.

Caution: As discussed in VIII.D., above, special basis rules apply to conversions when the replacement property is corporate stock. These rules provide a disincentive to replacement through stock acquisitions. Taxpayers should proceed cautiously in structuring their replacement transactions in a manner which could be construed by the IRS as a stock acquisition, because the IRS may argue that the recharacterized stock acquisition permits adjustment of the corporation's internal basis in its own assets. The following discussion should be read with this in mind.

Comment: Section 1033(i) imposes restrictions on related-party replacement transactions. See the discussion at VII.C.3., above. The following discussion should be read with §1033(i) in mind.

1. Asset Acquisition Followed by Incorporation

As an alternative, a taxpayer might acquire replacement property directly and then incorporate the assets. A possible flaw in this approach is that the taxpayer ends up with corporate stock rather than the replacement assets. Rev. Rul. 69-242[525] ruled that a stock purchase followed by a prearranged liquidation is a purchase of the underlying assets for §1033 purposes. One might argue that an asset purchase followed by an incorporation of the assets is a purchase of the corporate stock. Because basis of the stock is determined under §358(a) and not §1012, the definition of "purchase" set forth in Reg. §1.1033(a)-2(c)(4) would not be met. To date the IRS has consistently rejected this rationale as to §1033(a) replacement assets and ruled that the subsequent incorporation of the assets has no effect on their status as purchased replacement property if a business reason exists for the incorporation and if the taxpayer maintains effective control over the assets after incorporation.[526] Nevertheless, taxpayers contemplating such an incorporation may wish to obtain their own advance ruling in light of Rev. Rul. 79-293 and related rulings, discussed in VIII.E.2., below. Leaving aside §1033(a) replacements, the IRS position is clear that an incorporation of §1033(g) replacement real property precludes like-kind replacement. This is because the acquired property is not held by the taxpayer for productive use in the trade or business.[527] In light of Rev. Rul. 69-242, one should consider whether the replacement real property could still qualify under §1033(a) if it is otherwise similar use property.

For conversions occurring before August 20, 1996, there was a significant disadvantage to incorporating the replacement assets. To achieve §1033 deferral, the assets (and not the stock) had to be treated as the replacement property. Under §1033(b), then, the basis of the assets (and not the stock) would have to be reduced, and this basis would carry over to the corporation. This produces a lower basis to the corporation for depreciation or cost recovery allowances. While this result would continue to be the result for incorporations of replacement assets as to conversions occurring after August 20, 1996, it is no different than the result if the taxpayer had simply acquired the corporate stock to be replacement property. Thus, there is no longer a disadvantage, per se, to the incorporation of the replacement assets.

In Rev. Rul. 84-29, the IRS ruled that the transfer of assets previously purchased by the taxpayer to the taxpayer's newly organized subsidiary in exchange for all of the subsidiary's stock in a §351 transaction did not disqualify the assets as eligible replacement property. The IRS found that the asset transfer was made "to facilitate the orderly management of the taxpayer's business," and that the taxpayer did not intend to dispose of any of the subsidiary's stock or assets, other than in the ordinary course of business. The IRS reasoned that the taxpayer maintained control of the assets both before and after their transfer. Unlike the transactions in Rev. Rul. 77-422[528] and *John Richard Corp. v. Commissioner*[529] (and assuming a purchase of the subsidiary's stock occurred), the taxpayer in Rev. Rul. 84-29 met the literal requirement of §1033(a)(2)(A) that the purchase of stock as replacement property be "in the acquisition of control of a corporation owning such other property," since he first acquired the qualified replacement assets under §1033 and then transferred them to the new subsidiary under §351.[530]

Comment: Presumably, the IRS concluded in Rev. Rul. 84-29 that the taxpayer continued to control the assets after their transfer by reason of his 100% ownership of the subsidiary's stock.

2. Incorporation of the Conversion Proceeds

Legislative changes beginning in 1995 (and in particular, the related-party rules of §1033(i); *see* VII.C.3., above) have largely rendered incorporation of conversion proceeds and other transactions with a controlled corporation as undesirable from a tax perspective. Thus, although the discussion of these techniques is retained for completeness, extreme caution should be used in employing the strategies described below.

a. Contribution to Subsidiary Already Owning Replacement Properties

If a taxpayer's existing corporation owns qualified replacement property, an option to be considered is whether a purchase of additional shares from the corporation for the amount of the conversion proceeds satisfies the replacement rules of §1033. Initially, in a 1979 technical advice memorandum, the National Office had advised that the purchase of previously unissued shares directly from the corporation was a qualified replacement within the meaning of §1033.[531] The IRS reversed this position in Rev. Rul. 79-293, in which it ruled that a stock purchase from a wholly owned corporation already owning former §1071 replacement property is more akin to a

[525] See also the discussion in VII.D.2., above.

[526] Rev. Rul. 84-29; PLR 8325062, PLR 7838094, PLR 7829130, PLR 7829032. *See also Smith & Wiggins Gin, Inc. v. Commissioner*, 37 T.C. 861 (1962), aff'd, 341 F.2d 341 (5th Cir. 1965) (replacement property constructed by partnership and then contributed to corporation).

[527] Rev. Rul. 75-292; TAM 7805003.

[528] *See* VIII.E.2.b., below.

[529] 46 T.C. 41 (1966), acq., 1967-2 C.B. 3, acq. withdrawn and nonacq. substituted, 1974-2 C.B. 5. For further discussion, see VIII.E.2.b., below.

[530] *See also* PLR 8803091 (transfer of replacement property, consisting of assets of two corporations operating TV stations, to newly formed wholly owned subsidiary in valid §351 transfer, ruled not to disqualify assets as replacement property).

[531] TAM 7902009. *See also* TAM 8034004.

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capital contribution than to a purchase because it does not affect the shareholder's underlying beneficial ownership. The IRS has applied Rev. Rul. 79-293 in several instances where the corporation was 100% owned by the replacing taxpayer.[532] On the other hand, the IRS has ruled privately that the purchase of previously unissued stock qualifies as replacement property if there are other unrelated shareholders whose interests are affected by the purchase.[533] Although none of the cited rulings articulate the particular concerns of the IRS, it may be that the presence of other, unrelated shareholders indicates that the transaction is indeed a bona fide sale. See the cases collected in VII.C.3., above, concerning purchase from a related taxpayer. It would appear, therefore, that the price the replacing taxpayer-shareholder has to pay to achieve §1033 deferral without the normal reduced basis is to share the benefits of that unreduced basis with other shareholders. The IRS's concern may also stem from the fact that the corporation's preexisting ownership of replacement property allows the corporation (and indirectly, the replacing taxpayer) to acquire nonreplacement property without making a new economic investment, a result clearly not available if the taxpayer had purchased the replacement property directly. Moreover, there may even be other factors influencing the ruling posture of the IRS. For example, in PLR 7941040, the IRS denied §1033 treatment despite a representation by the taxpayer that the cash would be used to purchase only replacement property.

If the acquisition of stock from a related corporation constitutes a transfer to a controlled corporation governed by §351(a), the Chief Counsel's Office indicated in GCM 39742[534] that the transaction does not qualify as a purchase because the taxpayer's basis in the stock is not determined under §1012. *See* VIII.E.2.b., below.

As a final matter, any purchase of stock from a corporation even partially owned by a replacing taxpayer would have to run the gamut of §1033(i).

b. Incorporation of the Proceeds in a Newly Formed Subsidiary or Existing Affiliated Corporation

In *John Richard Corp. v. Commissioner*,[535] the taxpayer located appropriate replacement property and decided to incorporate for business reasons. Upon contribution of the insurance proceeds in exchange for its stock, the new corporation immediately purchased the replacement property. The taxpayer claimed §1033 deferral through a §1033(a)(2)(A) stock replacement. Despite arguments by the IRS that §1033(a)(2)(A) requires the corporation to own its similar use property before the taxpayer's stock purchase and that the §1033(b) basis rules had been circumvented, the Tax Court had surprisingly little trouble in concluding that §1033 deferral was available. The Tax Court reasoned that formation of the corporation was but a step in the larger transaction of acquiring replacement property. It may also have been a factor in *John Richard Corp.* that the taxpayer had previously been incorporated for a number of years and that there were business reasons for the new incorporation. Although the IRS initially acquiesced in *John Richard Corp.*, the acquiescence was subsequently withdrawn. In Rev. Rul. 77-422, the IRS clarified its position with regard to *John Richard Corp.* and reiterated its view that the corporation must own the replacement property when control of the corporation is acquired.

The result in *John Richard Corp.* should be contrasted with that in *Templeton v. Commissioner*,[536] where the individual taxpayer formed a new corporation and then transferred certain land he owned jointly with his children to that new corporation. These steps occurred after the taxpayer learned that some of his other land would be condemned. Upon receipt of the condemnation award, the taxpayer transferred the proceeds to the corporation for additional stock (presumably qualifying as a stock replacement). The corporation used the proceeds within a few months to acquire even more land from the taxpayer and his children. Citing *Am. Truck Rental Corp. v. Commissioner*,[537] the Tax Court concluded that the taxpayer had never intended to acquire replacement property when the proceeds were transferred to the new corporation.

Templeton is distinguishable from *John Richard Corp.* on at least two points. First, the taxpayer in *Templeton* sought to satisfy the requirement that the corporation own similar use property by transferring to it property he had owned before the start of the replacement period. This prior ownership of the replacement property would have been fatal under §1033(a)(2)(B) as to direct ownership by the taxpayer, and the result should be no different when formal ownership is in the taxpayer's wholly owned corporation. Second, within a short period after the *Templeton* "replacement," the taxpayer was in direct and actual possession of the bulk of the conversion proceeds due to the corporation's purchase of other land from the taxpayer. The economic result of the *Templeton* transactions is equivalent to the taxpayer having made two separate capital contributions to the corporation while still retaining the conversion proceeds.

Comment: Taxpayers seeking to fit within the holding of *John Richard Corp.* would do well to: (1) have the replacement purchase arranged before the incorporation of the proceeds; (2) arrange the replacement purchase with an unrelated party; and (3) be prepared to show good business reasons for the incorporation.

Taft Broad. Co. v. United States[538] presents another variation on this theme. In *Taft*, the taxpayer negotiated the acquisition of replacement broadcast assets, and then transferred the right to acquire those assets, together with the conversion proceeds, to a newly formed subsidiary. Although the district court relied on *John Richard Corp.* and allowed §1033 deferral,

[532] *E.g.*, TAM 8206018 (100% ownership of subsidiary precludes purchase); PLR 7941040 (same). *See also* TAM 8128010 (issue reserved for further determination).

[533] *See, e.g.*, PLR 9252006 (ownership increased from 80% to 90%); PLR 9211025 (partnership used to prevent §351 transfer analysis); PLR 8230108 (no more than 50% ownership in replacement entity); PLR 8103072 (greater than 50% but less than 100% acquired through purchase); PLR 8044057 (equity of other shareholders reduced).

[534] (Apr. 19, 1988).

[535] 46 T.C. 41 (1966), acq., 1967-2 C.B. 3, acq. withdrawn and nonacq. substituted, 1974-2 C.B. 5.

[536] 66 T.C. 509 (1976), supplemented by 67 T.C. 518 (1976), aff'd *per curiam*, 573 F.2d 866 (4th Cir. 1978).

[537] 355 F.2d 928 (3d Cir. 1966), cert. denied, 385 U.S. 815 (1966).

[538] 929 F.2d 240 (6th Cir. 1991), rev'g 685 F. Supp. 1033 (S.D. Ohio 1988). Note that on remand the district court found that the taxpayer's subsidiary was operating broadcast property at the time the taxpayer acquired its interest. *See Taft Broad. v. United States*, 92-1 USTC ¶50,241 (S.D. Ohio 1992).

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the Sixth Circuit reversed and remanded for a determination of whether the new subsidiary operated a broadcast property at the time the taxpayer acquired its interest. Although the IRS also argued on appeal that the subsidiary's stock had not been acquired through purchase, the court refused to rule on this issue because the issue was inadequately raised in the trial court. *Taft* is authority for the proposition that the IRS will likely continue to attack *John Richard Corp.* fact patterns. Therefore, caution remains warranted.

In contrast to Rev. Rul. 84-29 (discussed in VIII.E.1., above), the IRS has indicated that the acquisition of replacement property through a §351(a) transaction alone does not qualify as a purchase for purposes of §1033(a)(2)(A). In GCM 39742[539] a subsidiary in an affiliated group sold interests in radio and television stations and proposed to replace the property for §1033 purposes by transferring the cash proceeds to another member of the affiliated group in exchange for newly issued stock of that member. As a consequence of the attribution of ownership rules applicable to members of an affiliated group filing consolidated returns, the proposed transaction would have constituted a transfer to a controlled corporation governed by §351(a), with the cash treated as the "property" transferred. The IRS concluded that because the taxpayer's basis in the newly issued stock would be determined by §358(a), and not §1012, the transaction would not qualify as a purchase of replacement property under §1033(a)(2)(A). It further noted that Rev. Rul. 77-422 should be modified to eliminate any implication that a §351(a) transfer qualifies as a purchase.

Note that the IRS ruled in PLR 9020013 that the contribution of replacement property by the taxpayer to a newly formed partnership was permissible by analogy to Rev. Rul. 84-29 and Rev. Rul. 77-422, above. It should be noted that the partnership equity owned by the partner transferor was 39%.

3. Defective Split-Up

PLR 9249017 illustrates another corporate planning opportunity. In this ruling, the FCC had ordered divestment of certain broadcast stations, owned by a corporate taxpayer, due to cross ownership concerns. The stations were placed in a subsidiary (Newco) in a recognition transaction, and the stock of that subsidiary was then distributed to certain of the corporate taxpayer's shareholders in exchange for all their stock in the corporate taxpayer. These shareholders then sold their Newco stock in a prearranged sale. In effect, the transaction was a defective split up, with the following consequences: the corporate taxpayer had no gain under §1033; Newco had no gain under §1032; and redeeming shareholders had no gain or loss depending on their individual bases in the stock.

The planning opportunity inherent in this situation is as follows. First, had the transaction been structured as a split up (i.e., under §355), the redeeming shareholders could not have sold the Newco stock they received (see, e.g., §355(a)(1)(B)) in a prearranged transaction. Similarly, while the corporation could have sold the unwanted stations and distributed the proceeds, the proceeds would have been subject to two levels of tax (once to the corporation and then to the redeeming shareholders). In addition, a direct in-kind distribution of the two stations would have had the same result (see §311(b)). Moreover, the transaction should produce a fair market basis to Newco as to the stations. Thus, the purchaser in essence gets the same basis as it would have had on a direct purchase of the stations.

Critical to the result reached in PLR 9249017 is the conclusion by the IRS that §1033 is effective to shelter both the gain under §1001(c) arising from the original transfer to Newco, as well as the gain otherwise arising under §311(b) from the distribution. Finally, although not abundantly clear from the ruling, the corporate taxpayer arguably satisfied its duty to acquire replacement property by acquiring the stock of Newco (a corporation owning broadcast stations).

4. Shelter of §311(b) Gain

PLR 9437015 and PLR 9438037 (a follow-up private letter ruling issued to the same taxpayer) illustrate the use of §1033 to avoid §311(b) gain. PLR 9438037 concerned the sale of certain broadcast properties. Apparently, it was not feasible to hold the broadcast properties in corporate form until the eventual sale, so the corporation proposed to spin off the broadcast properties into pass-through entities composed of its shareholders, which would then make the eventual sale. The broadcast properties were appreciated so §311(b) would otherwise apply. The IRS ruled in PLR 9437015 and PLR 9438037 that §1033 would prevent recognition of the §311(b) gain to the corporation. However, the PLRs left unanswered the equally critical question of how the eventual sale by the pass-through entities would be taxed. PLR 9437015 and PLR 9438037 probably have only limited future utility, given the fact that in the typical corporate §1033 situation, there is little reason to distribute its converted property to shareholders (since shareholders may not replace for a corporation). *See* VII.A.2.a., above.

F. Conversion of Principal Residence

The basic rules for sales and exchanges of residences are contained in §121. Section 121 provides for a $250,000 exclusion ($500,000 for joint returns) each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years. A widow(er) will still be eligible for the $500,000 exclusion available to joint filers if s/he sells the residence within two years after the spouse's death and both spouses met the requirements for gain exclusion immediately before the death.[540]

Under §121, a principal residence that has been involuntarily converted is treated as a sale of the residence.[541] Allocation issues may be present under §121 when the property upon which taxpayer's residence stands also is used in a business.[542] For purposes of §1033, the amount realized is reduced by the amount of gain excluded under §121(b).[543]

The application of §121 is elective.[544]

An example of when a taxpayer may elect to forego the §121 treatment described above is when a principal residence is damaged or destroyed by a federally declared disaster. If a tax-

[539] (Apr. 19, 1988).

[540] §121(b)(4).
[541] §121(d)(5).
[542] *See, e.g., Wickersham v. Commissioner*, T.C. Memo 2011-178 (2011).
[543] §121(d)(5)(B).
[544] §121(f).

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payer's principal residence or any of its contents is located in a disaster area (defined in §165(i)(5) as an area determined by the President to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act) and is compulsorily or involuntarily converted as a result of a federally declared disaster, no gain is recognized by reason of the receipt of any insurance proceeds for personal property that was part of the contents of the residence and that was not scheduled property for insurance purposes.[545] In addition, in the case of any insurance proceeds (other than those described above) for such residence or contents: (1) the proceeds are treated as received for the conversion of a single item of property; and (2) any property that is similar or related in service or use to the converted residence (or contents of the residence) is treated as property similar or related in service or use to such single item of property.[546] Thus, such insurance proceeds are treated as a common pool of funds that may be used to purchase any property similar or related in service or use to the converted residence or its contents, and the taxpayer recognizes gain only to the extent that the pool of funds exceeds the cost of the replacement property.

A "principal residence," for purposes of §1033(h), has the same meaning as it does under §121, except that renters receiving insurance proceeds as a result of the involuntary conversion of their property in a rented residence also qualify for relief to the extent that the rented residence would be their principal residence if they owned it.[547]

The applicable period for replacement of property involuntarily converted as a result of a federally declared disaster is four years (rather than the normal two) after the close of the first taxable year in which any part of the gain on the conversion is realized.[548]

For purposes of this rule, the term "federally declared disaster" means any disaster subsequently determined by the President to warrant federal government assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.[549]

In Rev. Rul. 95-22,[550] the IRS applied §1033(h) in ruling that a taxpayer whose principal residence was destroyed, along with all its contents, in a federally declared disaster did not recognize gain upon receiving insurance proceeds for the items of destroyed property that were not separately scheduled for insurance purposes. This result remained unchanged even if the taxpayer did not use the specific insurance proceeds to purchase replacement property, the IRS noted. The IRS also ruled in Rev. Rul. 95-22 that the taxpayer did not recognize gain from the insurance proceeds for the destruction of the residence and other items of property that were separately scheduled in the insurance policy. The IRS pointed out that the taxpayer expended amounts to purchase and furnish her replacement residence, which totaled more than the amount in the "common pool of funds" that resulted from the combination of the insurance proceeds for the house and the insurance compensation that the taxpayer received for the destruction of the separately scheduled items of property.

According to PLR 201240006, a failure to report all of the details of such an involuntary conversion as required by Reg. §1.1033(a)-2(c)(2) including as to the acquisition of replacement property will not prevent deferral of gain under §1033(h)(1).

Another aspect of the interrelationship of §121 and §1033 occurs in the context of §121(d)(5)(A), which provides that the destruction, theft, seizure, requisition, or condemnation of property is treated as the sale of the property. In CCA 200734021, the taxpayer's residence was damaged as a result of a natural disaster to such an extent that, as a practical matter, it needed to be rebuilt. The Chief Counsel's Office advised that it considered §121(d)(5)(A) as requiring a complete, rather than a partial destruction, but the lack of feasibility in repairing one's residence was a factor in the determination of whether the damage amounted to a complete destruction. By applying such a test, the Chief Counsel concluded that the taxpayer's residence was completely destroyed under §121(d)(5)(A).

In the application of §121, the Chief Counsel's Office advised that because the taxpayer's gain of $189,000 (excess of $359,000 in insurance proceeds over the basis of $170,000) did not exceed the §121(b) amount of $250,000, the gain from the deemed sale was excluded. Section 121(d)(5)(B) provides that, in applying §1033, the amount realized ($359,000 of insurance proceeds) was reduced by the amount of gain not included in gross income under §121 ($189,000), making the §1033 adjusted amount equal to the taxpayer's pre-catastrophic basis of $170,000. Thus, the taxpayer had no realized gain, and therefore no gain to defer under §1033.

The end result of CCA 200734021 is that the taxpayer's basis in the reconstructed residence will not be decreased by the amount of gain not recognized because §121(d)(5)(A) precludes any realized gain. The taxpayer therefore enjoyed an advantage: the basis in the replacement property is greater than it would have been if the case were controlled by §1033. Therefore, the use of §121 will ultimately result in a $189,000 lower gain when the replacement residence is sold due to the §121(d)(5) deemed sale provision.[551]

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[545] §1033(h)(1)(A)(i).

[546] §1033(h)(1)(A)(ii).

[547] §1033(h)(4).

[548] §1033(h)(1)(B). *See also Tables, Charts and Lists (Federal) > Postponements Due to Combat Zone Service or Federally Declared Disaster Area.*

[549] §165(i)(5).

[550] *See* TAM 200111056 (taxpayer whose principle residence was destroyed in federally declared disaster allowed to exclude gain under §121, or elect to defer gain under §1033 by acquiring replacement property and/or rebuilding, and if gain deferred, treat period of ownership and use of new residence as including period of use and ownership of old residence). Note that the revenue ruling and TAM both were issued before 2008, when the term "Presidentially declared disaster" was replaced in the Code by the term "federally declared disaster." *See also* CCA 200114046 (exclusion of gain resulting from insurance proceeds received for unscheduled personal property applies to property not physically located in residence when it was destroyed).

[551] *See* Willens, *IRS Sheds Light on When Damage to Residence Rises to Level of 'Destruction,'* 185 Daily Tax Rpt. J-1 (Sept. 25, 2007).

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In CCA 200431012, the Chief Counsel concluded that §1033 did not apply to exclude from income grants to property owners to build foundation elevations, which were paid under FEMA's flood mitigation programs (Flood Mitigation Assistance Program (FMA), Pre-Disaster Mitigation Program (PDM), and Hazard Mitigation Grant Program (HMGP)), because the grants were intended to implement a long-term hazard mitigation measure after a major disaster declaration, rather than to compensate the owners for property damaged or destroyed by a major disaster.

G. Interaction with Estate Tax Issues

1. Section 2032A

The provisions of §2032A offer an alternative means of valuing real property used as a farm or in a trade or business for purposes of the federal estate tax. If the special use value is a lower value than the standard "highest and best use" value, the fiduciary of the estate may elect the §2032A valuation.[552] Section 2032A offers two methods to value qualified real property: for valuing farms, a capitalization of rent method is set out in §2032A(e)(7); for valuing business interests other farms, a subjective method that relies on the interplay of five factors is set out in §2032A(e)(8).

The purpose behind §2032A is to encourage continued use of the particular property for the farming or small business use. To qualify for the benefits of §2032A, there must be a "material participation" and a "qualified use" by either the decedent or the decedent's family for at least five out of the eight years before the death and a qualified use on the date of death.[553] In addition, the decedent's heirs must continue the qualified use, material participation, and ownership of the property for 10 years[554] after the death. Failure to satisfy the post-death requirements results in a recapture tax. There are other requirements as well for §2032A treatment. In general, the requirements are aimed at limiting the benefits of §2032A to family farms or other closely held businesses.

There are two common overlaps between §2032A and §1033. First, if otherwise qualified use property is the subject of an involuntary conversion within the meaning of §1033 during the pre-death period, the periods of qualified use and material participation of the involuntarily converted property are added to those of the replacement property in satisfying the pre-death five of eight years requirements.[555] This approach, of course, is consistent with the general tacking rule of §1223(1)(A), discussed in III.B. and IV.C., above. However, tacking does not apply to the extent that the value of the replacement property exceeds the value of the replaced property.[556] Also, where multiple tracts of property are converted before death, only the portion of the replacement property which (with tacking) satisfies the five out of eight years test is eligible for §2032A treatment.[557]

The second overlap concerns conversions during the post-death period. As indicated above, early dispositions of the qualified property generally produce a recapture tax.[558] Under §2032A(h), an involuntary conversion does not trigger the recapture tax if the value of the qualified replacement property equals or exceeds the amount realized on the conversion. To the extent there is not complete reinvestment of the conversion proceeds, the recapture tax is imposed proportionately.[559] Section 2032A(h)(3)(B) defines qualified replacement property as any real property purchased to replace the converted property and which is used for the same qualified use. To the extent the qualified heir is allowed more than the two-year period of §1033(a)(2)(B)(i) to replace, the recapture period of §2032A(c) is extended.[560]

For further discussion of §2032A, see 830 T.M., *Valuation: General and Real Estate* (Estates, Gifts, and Trusts Series) and 833 T.M., *Special Use Valuation (Section 2032A)* (Estates, Gifts, and Trusts Series).

2. Former §2057

Prior to its repeal, former §2057 provided for estates of decedents who died in 1998 through 2003 and the estates of decedents who would die in 2013 and thereafter to deduct up to $675,000 in value attributable to a "qualified family-owned business interest" (QFOBI) when computing the estate tax.[561] One of the consequences of this deduction was that such qualified heir has to assume personal liability for a portion of the reduction in estate tax resulting from the QFOBI deduction. Section 2057 then imposed an additional estate tax on a qualified heir when certain "taxable events" occurred with respect to a QFOBI received by a qualified heir. Section 1033 involuntary conversions of the QFOBI were excluded from this recapture rule by virtue of a cross-reference to §2032A. The qualified heir used Form 706-D to report and pay the additional estate tax, as well as to report certain nontaxable events occurring within 10 years of the decedent's death.[562]

For further discussion of §2057, see 840 T.M., *Estate Tax Deductions — Sections 2053, 2054 and 2058* (Estates, Gifts and Trusts Series).

H. Partnership, Limited Liability Company, and Joint Tenancy Planning

In most cases, limited liability companies are taxable as partnerships. Accordingly, references in the below discussions to "partnerships" should be read to include "limited liability companies."

Conversions of partnership property and presumably, limited liability companies, require the entity, and not the owners, to elect and replace.[563] In some circumstances, it may not be de-

[552] As to the election process generally, see Reg. §20.2032A-8(a)(3).
[553] §2032A(b)(1)(C); Reg. §20.2032A-3(c)(1).
[554] §2032A(c)(1).
[555] *See* §2032A(e)(14)(A); Reg. §20.2032A-3(d); PLR 8104030.
[556] §2032A(e)(14)(B).
[557] Rev. Rul. 81-285.
[558] §2032A(c).
[559] §2032A(h)(1)(B).
[560] §2032A(h)(2)(A).
[561] The section was permanently repealed by the 2014 Tax Increase Prevention Act (2014 TIPA), Pub. L. No. 113-295, §221(a)(97), effective December 19, 2014.
[562] *See generally* Grant, *Comment: Analysis of the Recapture Tax for Qualified Family-Owned Business Interest Deductions*, 26 Ohio N.U.L. Rev. 289 (2000); TAM 200410002.
[563] See the discussion in VII.A.5., above.

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sirable or possible to operate within §1033 at the entity level. Also, application of the partnership tax rules may require individual owners to recognize gain upon a conversion notwithstanding a valid partnership §1033 election.[564] Therefore, when a conversion of partnership property is anticipated, the partners should consider the advisability of a distribution of that property. In PLR 9022037, a partnership was terminated and its real property distributed in anticipation of a condemnation. Following the distribution, the partners held the property as tenants in common, presumably according to their proportionate interests in the former partnership. The IRS ruled in PLR 9022037 that each joint owner could thereafter make an individual §1033 decision.[565] However, because the partnership's investment purpose for holding the realty could not be imputed to the former partners, the realty was not held at the time of condemnation for productive use in the trade or business or for investment. Accordingly, only similar use replacement under §1033(a), and not like-kind replacement under §1033(g), was available.

Nonetheless, taxpayers would do well to consider whether an anticipatory distribution of partnership property would serve their interest rather than the more cumbersome election and replacement by the partnership. However, where taxpayers wait too long to distribute partnership property, it may well be the partnership and not the distributee partners which will be required to replace. In TAM 9645005, where a partnership had already legally bound itself to make a sale under threat of condemnation, the National Office concluded only it and not its partners could make the replacement even though the property was distributed to the partners before closing. TAM 9645005 also indicates as alternative grounds for the conclusion that, because the distributee partners held the former partnership property for only one day, they lacked the requisite investment intent for §1033(g) replacement.

Of course, a separate issue may be present as to whether a particular tenancy in common arrangement amounts to a partnership. For example, in PLR 8041061, the IRS relied on the fact that the partnership was dissolved to conclude that there was no intent to hold the joint property as partners.[566] This circumstance will not always be present, and steps should be taken to ensure the arrangement is not a partnership for tax purposes.[567] The discussion in Rev. Proc. 2002-22, attempts to delineate the difference between a co-ownership and a partnership.

A similar concern is present when taxpayers seek to acquire replacement property jointly. In PLR 9352008 and PLR 9352011, an individual and a partnership in which he held a 53% profits interest jointly acquired improved commercial real estate as replacement property following involuntary conversions of the respective properties each had previously owned. The IRS ruled that no partnership was present as to the replacement property even though the individual and the partnership were related. Citing Rev. Rul. 75-374, the IRS concluded that co-ownership and not a partnership had resulted. The IRS focused on the facts that: (1) the co-owners would not be rendering any services relative to the replacement property other than those typical of a landlord; and (2) the replacement property was already subject to a triple net lease in which most of the normal activities and expenses relative to the replacement would be borne by the unrelated lessee.

To mitigate the risk of a partnership being found, it may be advisable to have a tenancy in common agreement between the property owners. This should make it less likely that a partnership will be found. A triple net lease is also a helpful factor as to the property being owned, since it minimizes the activities co-owners will be taking together. Another possibility is to make a protective election under §761 so that the partnership tax provisions, §701 through §761, will not apply. However, it is uncertain whether a protective election under this provision would control the issues of the §1033 election and replacement if partnership status were otherwise found.[568]

Another approach is to restructure the old partnership to eliminate partners who do not agree on the approach to replacement and to then use the restructured partnership to make the replacement. So long as the restructured partnership is treated for tax purpose as a continuation of the old partnership, PLR 8244124 is authority that the new partnership can make the replacement.

Note: The law has changed somewhat since PLR 8244124 was issued, in that former §708(b)(1)(B) (which had required that more than 50% of the partnership interest remain unchanged between the old and the new partnerships) was repealed by the 2017 tax act, Pub. L. No. 115-97, effective for tax years beginning on or after January 1, 2018. Thus, there is no longer any requirement that a given percentage of partnership interests continue from the old partnership into the new partnership.

Related to this is to restructure the old partnership through a division into two or more new partnerships. So long as the new partnerships have members who had previously owned more than 50% of the old partnership's capital and profits, each of the new partnerships are treated under §708(b)(2)(B) as a continuation of the original partnership and each can make replacement for the "old" partnership.[569] Under this approach, each of the new partnerships can choose their own form of replacement.

Lastly, the co-owners could choose to formally become a partnership, to add certainty to the proper approach to be followed to accomplish deferral. In PLR 8916034, the IRS concluded that a partnership in fact existed for tax purposes, hav-

[564] See the discussion in XI.C., below.

[565] *Accord* PLR 8041061, PLR 7952102, PLR 7952093 (identical to PLR 7952102), PLR 7826012. *Cf.* TAM 8421008 and TAM 8421009 (ownership of replacement property as tenant-in-common will not adversely affect qualification of property under §1033); PLR 8735026 (partnership viewed as acquiring replacement property even though two individual partners executed purchase documents on behalf of partnership which then distributed property to them in exchange for complete termination of their partnership interests).

[566] *See generally* §761; Reg. §1.761-1(a); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953). This issue would appear not to be impacted by the check-the-box regulations designed to give more flexibility to taxpayers in classifying entities for tax purposes. *See* Reg. §301.7701-1(a)(2); PLR 9203022 (partnership for federal tax purposes is broader than state law definition).

[567] *Compare Varner v. Commissioner*, 32 T.C.M. 97 (1973) (partnership found from joint ownership when partnership returns filed) *with McShain v. Commissioner*, 68 T.C. 154 (1977) (no partnership existed).

[568] For an example of replacement at the partnership level rather than the partner level, see PLR 9004018. The PLR also is noteworthy in that the replacement property was purchased by the partnership from its general partner.

[569] *See* PLR 200921009.

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ing come into existence after three co-owners received notice of an intended condemnation and then filed a tax return.[570]

I. Obtaining an IRS Ruling

Taxpayers desiring certainty as to the tax results of a particular involuntary conversion should consider requesting a ruling from the IRS. This, of course, assumes that the IRS has not indicated that the particular issue is one on which it will not rule.[571] The IRS will not issue a ruling on whether or not the replacement or proposed replacement of compulsorily or involuntarily converted property qualifies under §1033(a), if the taxpayer has already filed a federal tax return for the taxable year in which the property was converted.[572] However, the IRS may issue a determination letter in such a case.[573]

If the taxpayer has filed his or her income tax return for the year of the involuntary conversion, revenue procedures issued by the IRS generally require that the request for IRS guidance be addressed to the director or appeals area director who has examination jurisdiction over the taxpayer's return.[574] If issued, IRS guidance would be in the form of a determination letter. If the director or appeals area director concludes a determination letter should not (or cannot) be issued without guidance from the Associate office, a request for technical advice is sent to Washington, D.C.[575] If issued, the IRS guidance will then take the form of a TAM to the director or appeals area director. When technical advice is sought, taxpayers have 10 calendar days to submit a statement of position concerning the request. Although a taxpayer may request the director or appeals area director to obtain technical advice, the taxpayer cannot compel Associate office consideration.

If the return for the year of conversion has not been filed, the request for IRS guidance should be submitted to the appropriate Associate office.[576] If advice is issued, it will generally be in the form of a PLR. If a return is filed before a ruling is received from the Associate office, the taxpayer must attach a copy of the ruling request to the return. If the taxpayer thereafter learns an examination of the return has begun, he must notify the Associate office. If the return is filed after the PLR has been issued, the ruling must be attached to the return when it is filed.

IRS written guidance on a particular transaction represents a ruling by the IRS as to that transaction only. Other taxpayers may not rely on it. Generally, the IRS guidance as to a proposed transaction will not be revoked or modified retroactively as to the requesting taxpayer if the taxpayer has made full and accurate disclosure, the law has not changed, and the taxpayer in good faith relied on the IRS guidance.[577]

A sample request for a determination letter is found in the Worksheets.

J. Special Issues for Property Acquired from Related Persons

Section 1033(i) imposes an additional obstacle to the availability of the §1033(a) nonrecognition provisions if the replacement property or stock is acquired from a related person. Under §1033(i), if the replacement property or stock is acquired from a related person (within the meaning of §267(b) or §707(b)(1)), then the §1033(a) nonrecognition provisions do not apply to an involuntary conversion of property held by:

- a C corporation,
- a partnership or an S corporation in which one or more C corporations owns (within the meaning of §707(b)(3)) more than 50% of the interests, or
- any other taxpayer, if the aggregate of the amount of realized gain on property involuntarily converted during the taxable year exceeds $100,000.

K. Federally Declared Disasters of Business Property

Section 1033(h)(2) provides a special rule as to business property located in a disaster area that is compulsorily or involuntarily converted as a result of a federally declared disaster. Under this special rule, any tangible property held for productive use in any trade or business ("business property") is treated as similar in use to business property that is converted. The result is to broaden the permissible replacement property. A federally declared disaster is one as to which the President determines that relief is warranted under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. A disaster area is the area so determined to warrant such assistance.[578]

Example: Sarah operates two businesses. Certain property in the first business is destroyed in a federally declared disaster. Sarah may use the insurance proceeds she receives from this disaster to purchase any other tangible business property for that business, her second business, or any other business.

In TAM 200111056, the National Office advised that replacement property does not include property held for investment and that the replacement period is two years, not four years. Also, in CCA 200114046, the Chief Counsel advised that §1033 allows deferral of gain recognized on involuntary conversions of inventory, but noted that any gain recognized will

[570] *See* PLR 9352008 and PLR 9352011 (identical to PLR 9352008), in which the IRS concluded that co-ownership of replacement property subject to a triple net lease would not per se cause a partnership to exist. PLR 7904093, however, indicates that the IRS has a "policy" of not issuing advance rulings on the partnership status of a taxpayer for tax years before the current year.

[571] The IRS updates annually the master list of no-ruling areas, and the updated list is always issued as the third annual revenue procedure of the year. *See* 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements.* As the IRS issues additional guidance throughout each tax year modifying the no-ruling list, it is important for taxpayers to check these modifications before each ruling request.

[572] Rev. Proc. 2025-3, §3.01(98).

[573] Rev. Proc. 2025-3, §3.01(98); Rev. Proc. 2025-1, §12.01.

[574] See 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements*, for discussion of the current revenue procedure.

[575] The IRS updates annually the procedures for furnishing technical advice to directors and appeals area directors under the jurisdiction of the Associate Chief Counsel. The applicable revenue procedure is always issued as the second annual revenue procedure. *See* 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements.*

[576] The Associate office address and instructions for requesting a letter ruling or determination letter can be found in Rev. Proc. 2025-1 or the succeeding updated first annual revenue procedure.

[577] Rev. Proc. 2025-1, §11.06. *See* PLR 8034004.

[578] §1033(h)(3) (reference to §165(i)(5)).

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be ordinary gain because §1221(a)(1) excludes inventory from the definition of a capital asset and §1231(b)(1)(A) excludes inventory from §1231 property. Similarly, in TAM 201111004, the Chief Counsel advised that inventory is property held for productive use in a trade or business for purposes of §1033(h)(2).

In CCA 200431012, the Chief Counsel concluded that §1033 did not apply to exclude from income grants to property owners to build foundation elevations, which were paid under FEMA's flood mitigation programs (Flood Mitigation Assistance Program (FMA), Pre-Disaster Mitigation Program (PDM), and Hazard Mitigation Grant Program (HMGP)), because the grants were intended to implement a long-term hazard mitigation measure after a major disaster declaration rather than to compensate the owners for property damaged or destroyed by a major disaster.

L. Depreciation of MACRS Property Acquired in an Involuntary Conversion

Regulations under §168 instruct taxpayers how to determine the annual depreciation allowance for MACRS property acquired in an involuntary conversion in which both the exchanged (relinquished) property and the replacement property are MACRS property in the acquiror's hands, including an involuntary conversion of MACRS property for other MACRS property in a transaction between members of the same affiliated group.[579]

These regulations apply to an involuntary conversion of MACRS property for which both the "time of disposition" and the "time of replacement" (as defined by the regulations)[580] occur after February 27, 2004. Under the regulations, the depreciation treatment of the replacement MACRS property by previous owners is not relevant, and elections made by previous owners in determining depreciation allowances of the replacement MACRS property do not affect the acquiring taxpayer.[581]

The regulations provide that land or other nondepreciable property acquired in an involuntary conversion for MACRS property is not depreciated. If MACRS property, or both MACRS property and nondepreciable property, are acquired in an involuntary conversion for MACRS property, the basis allocated to the nondepreciable property is not depreciated, and the basis allocated to the replacement MACRS property is treated as property placed in service by the acquiring taxpayer in the year of replacement.[582] If MACRS property, or both MACRS and nondepreciable property, are acquired in an involuntary conversion for nondepreciable property, then the basis in the replacement MACRS property that is attributable to the relinquished nondepreciable property is treated as if the replacement MACRS property is placed in service by the acquiring taxpayer in the year of replacement.[583] Also, various convention rules are provided by the regulations.[584]

A taxpayer may elect not to apply the regulations for any MACRS property involved in an involuntary conversion.[585]

For a discussion of the regulations governing the depreciation of MACRS property acquired in an involuntary conversion in which both the relinquished property and the replacement property are MACRS property in the acquiror's hands, see 531 T.M., *Depreciation: MACRS and ACRS.*

M. Tax-Exempt Use Property

A special rule denies the benefit of the involuntary conversion rules to certain conversions involving tax-exempt use property, generally defined as property that is leased to a tax-exempt entity. Congress implemented this rule to curtail the ability of tax-exempt entities to transfer the tax benefit of the involuntary conversion rules to a taxable entity.[586]

Involuntary conversion rules generally will not apply if either: (1) the *converted* property is tax-exempt use property subject to a lease entered into before the effective date of §470 (i.e., before March 13, 2004, except in the case of qualified transportation property) that would not have met §470(d)"safe harbor" requirements described below had those requirements been in effect when the lease was entered into; or (2) the *replacement* property is tax-exempt use property subject to a lease that does not satisfy the §470(d) safe harbor requirements described below.[587] For property acquired by the lessor in a transaction to which §1033 applies, the adjusted basis of the property for purposes of §470 is the lesser of the fair market value of the property at the beginning of the lease term, or the amount that would be the lessor's adjusted basis if §1033 did not apply.[588]

The §470 safe harbor requirements generally are as follows: (1) the tax-exempt lessee does not monetize its lease obligations (including any purchase option) in an amount that exceeds 20% of the taxpayer's adjusted basis in the leased property at the time the lease is entered into; (2) the taxpayer makes and maintains a substantial equity investment in the leased property; (3) the tax-exempt lessee does not bear more than a minimal risk of loss, other than the obligation to pay rent and insurance premiums, to maintain the property, or other similar conventional obligations of a net lease; and (4) for property with a class life of more than seven years, other than fixed-wing aircraft and vessels, under which the tax-exempt lessee has the option to purchase the property, the tax-exempt lessee does not have an option to purchase the leased property for any stated purchase price other than the fair market value of the property (as determined at the time of exercise).[589]

For a further discussion of tax-exempt use property and §470, see 593 T.M., *Real Estate Leases.*

N. Trust and Estate Replacements

Considerable planning should be present when either a trust or estate makes a §1033 replacement. There are pitfalls, as discussed in VII.A.3. and VII.A.4., above. On the other

[579] Reg. §1.168(i)-6.

[580] Time of disposition is defined in Reg. §1.168(i)-6(b)(3). Time of replacement is defined in Reg. §1.168(i)-6(b)(4).

[581] Reg. §1.168(i)-6(c)(2).

[582] Reg. §1.168(i)-6(d)(2)(i).

[583] Reg. §1.168(i)-6(d)(2)(ii).

[584] Reg. §1.168(i)-6(c)(5)(ii)(A), §1.168(i)-6(c)(4)(v), §1.168(i)-6(c)(5)(i)(B), §1.168(i)-6(c)(6) *Ex.* 5.

[585] Reg. §1.168(i)-6(i).

[586] §470.

[587] §470(e)(4)(A).

[588] §470(e)(4)(B).

[589] §470(d).

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hand, there are planning opportunities, as illustrated by PLR 200528011. In PLR 200528011, the testamentary trust was threatened with a condemnation and planned to replace. Under the terms of the testamentary trusts, the trustee was required to allow the beneficiaries input into the trustee's decision of the replacement properties that should be acquired. Moreover, the testamentary trust was to terminate within a relatively short period. As a final matter of note, the trustee was to contribute certain of these replacement properties to a limited liability company and then potentially distribute membership units in the limited liability company to the trust's beneficiaries.

Under these circumstances, the IRS ruled that the trustee's acquisition of replacement property would qualify under §1033, even though there was a significant chance either that the replacement property would be distributed to the beneficiaries within a short period, or that the replacement properties would be held in a newly formed LLC, and the interests in the LLC would be distributed to the beneficiaries.

O. State and Local Law Issues

In many cases, state and local income taxation is based on the taxpayer's federal taxable income (or perhaps, adjusted gross income, in the case of individuals). To the extent this is the case, and absent some state-specific adjustment for §1033 transactions, the federal treatment will be replicated at the state and local levels. However, this is not universally true. Certain states — for example, Texas — in essence ignore the federal §1033 treatment, and instead tax the initial gain transaction without regard to whether a qualified reinvestment occurs for federal purposes. This disparate treatment produces a further difference if the replacement property is disposed of in a taxable transaction. In such a case, gain has to be recognized for federal purposes, but not for state purposes.

P. Malpractice Issues

No one wants to contemplate that the tax advice they have given may be incorrect, although it does happen. In *J.D. Warehouse v. Lutz & Co.*,[590] an accountant incorrectly advised a partnership that gain could be deferred under §1033 if the amount of the *gain* was reinvested in replacement property. The taxpayer followed this advice and reinvested only the gain amount. Following an IRS audit that cost the taxpayer additional taxes and interest, the taxpayer sued the accountant in state court for the additional state and federal taxes, attorney fees, and interest. The defendants were found liable, although the trial court concluded that the amount of additional taxes and related interest were not recoverable because the taxes were incurred from the transaction rather than the accountant's malpractice. Although recognizing that the value of the deferral of these taxes had an important economic value that was lost through the malpractice, the trial court found the period of the possible deferral was too speculative to permit relief. The trial court's conclusions on these points were sustained on appeal by the Nebraska Supreme Court.

Comment: J.D. Warehouse might have been decided differently if the taxpayer could have shown an anticipated future point in time at which a recognized gain would occur as to the replacement property. The problem for most taxpayers, of course, is that they intend to continue to defer the gain indefinitely, either by simply holding the replacement property, or possibly through a subsequent §1031 exchange. While in theory a basis step-up at death will eliminate the gain, in total, for an individual taxpayer, this will still probably not establish the loss with sufficient certainty, because many taxpayers will nonetheless dispose of the replacement property before death in a recognition transaction to provide liquidity. Thus, as a bottom line, providing the certainty as to loss of deferral value sought by the *J.D. Warehouse* court may be virtually impossible to prove for most taxpayers.[591]

Q. Bargain Sales

A taxpayer who owns property that is subject to condemnation proceedings may be confronted with the situation in which the governmental authority offers to purchase the property (in lieu of formal condemnation) at a price beneath the fair market value perceived by the taxpayer. In such cases, the taxpayer can try to negotiate an increased purchase price, which will typically require the taxpayer obtain his or her own appraisal. However, this approach is not always successful because typically the acquiring authority's initial offer will have been based on the authority's own appraisal and the acquiring authority may not have much, if any, latitude or willingness to negotiate the difference between the two appraisals.

An alternative approach, particularly when the acquiring authority is not particularly interested in negotiating the offered purchase price, is for the taxpayer to insist that the acquiring authority proceed to formal condemnation proceedings. This will mean that the acquisition price will at least be determined by a neutral third party, *i.e.*, through the judicial system. However, formal condemnation proceedings will be more expensive for both parties (but especially the taxpayer owning the property because he or she will be forced to use their own resources to hire attorneys and appraisers). Also, there is no guarantee in a formal condemnation proceeding that the judge will accept the taxpayer's position as to the value of the property.

On appropriate facts, a taxpayer may be able to bridge this "value gap" between what is being offered by the acquiring authority and the fair market value perceived by the owner using a "bargain sale" analysis. A bargain sale is an amalgam between a sale and a charitable donation. Assuming that §170 otherwise permits a charitable deduction for the particular sales transaction, §1011(b) requires the selling taxpayer to apportion his or her basis to the sale portion (and thus, indirectly to the donation portion) using the amount realized from the sale portion relative to the fair market value of the property as a whole. The following illustrates the apportionment of basis in a bargain sale as well as the tax consequences when a taxpayer sells a property with a fair market value of $200X to a charity for $50X, assuming the taxpayer has a basis in the property of $125X.

[590] 639 N.W.2d 88 (Neb. 2002).

[591] For a general discussion of tax malpractice, see Todres, *Malpractice and the Tax Practitioner: An Analysis of the Areas in Which Malpractice Occurs*, 48 Emory L.J. 547 (1999); Todres, *Tax Malpractice: Areas in Which It Occurs and the Measure of Damages — An Update*, 78 St. John's L. Rev. 1011 (2004).

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Fair Market Value of Property:	$200X
Amount Paid By Charity:	$50X
Taxpayer's Basis:	$125X
Basis Apportioned to Sale Portion:	$31.25X ($50X ÷ $200X × $125X)[592]
Gain on Sale Portion:	$18.75X ($50X – $31.25X)[593]
Charitable Deduction:	$150X ($200X – $50X)

In bargain sale cases, one of the key inquiries is what is the ultimate fair market of the property being sold, because if the selling taxpayer receives full value from the charity, there is no gift.[594] A related inquiry (even if the fair market value of the property exceeds the price paid) is whether the selling taxpayer has the requisite donative intent.[595] In the context of a condemnation, the acquiring agency will typically qualify to receive a charitable gift pursuant to §170(c)(1) as a "governmental unit."

In *Consolidated Investors Group v. Commissioner,* [596] the Ohio Turnpike Authority ("OTA") sought to acquire property to build a new interchange but was offering very little in the way of compensation based on an initial appraisal of the property and was not willing to negotiate. The owner repeatedly made clear that it fully supported the interchange project and was willing to negotiate with the OTA on the price and to structure the transaction as a part gift part sale. Eventually, the OTA's unwillingness to negotiate in good faith forced the taxpayer to seek a "quick take" of the property through the Ohio state court system. Through the court proceedings the taxpayer discovered that OTA had hid a second appraisal that had placed a far higher value on the property than the first OTA appraisal. Almost immediately after taxpayer learned of the second, higher appraisal by OTA, OTA suspended the court litigation and entered into a settlement agreement with taxpayer. This settlement agreement used as the purchase price the value stated in the appraisal that OTA had hid from the taxpayer, and stated that the property would be acquired in a bargain sale transaction. OTA also agreed in the settlement agreement to provide taxpayer with a Form 8283 (Noncash Charitable Contributions) as is required for charitable donations and that reflected a value higher than the purchase price OTA was agreeing to pay.

Ultimately, on these facts, the Tax Court concluded that the taxpayer was entitled to bargain sale treatment because in part, taxpayer had diligently maintained its willingness to engage in a part gift part sale. Also persuasive was the fact that the taxpayer had negotiated for and received a Form 8283 from OTA. It is clear that the Tax Court thought that OTA had not acted in good faith, and that the Tax Court could therefore disregard the assertions of OTA's trial witnesses (1) that the taxpayer lacked donative intent and (2) that OTA had paid full compensable value for the property. The Tax Court did conclude that taxpayer had not made a proper basis apportionment under §1011(b) (taxpayer had applied its entire basis against the condemnation proceeds) and therefore, the Tax Court found a deficiency in tax.

It should be stressed that the result in *Consolidated Investors Group* turned heavily upon (1) taxpayer's assertions in correspondence throughout the condemnation process that taxpayer intended a part gift part sale; (2) the obvious bad faith of OTA in hiding the second appraisal; and (3) the fact that taxpayer obtained a Form 8283 from the acquiring agency stating a higher fair market value than that actually paid.

The result in *Consolidated Investors Group* should be contrasted with that in *Hope v. United States*.[597] *Hope* has a similar setting to *Consolidated Investors Group* in that *Hope* involved a settlement agreement to establish the purchase price after litigation had been commenced by the Texas Turnpike Authority. The Claims Court in *Hope* had little trouble in concluding that once Hope and the Texas Turnpike Authority established the value of the property by agreement and Hope then received that value as just compensation for his property, there was legally nothing left for Hope to sell on a bargain basis. Moreover, the *Hope* court concluded that such negotiations effectively negated the claim of a donative intent (and there was no promise to Hope that a Form 8283 would be issued showing a higher value in support of an anticipated claim of a charitable deduction). In reaching its conclusion, the Claims Court cited to an earlier Tax Court case, *Maier Brewing Co. v. Commissioner*,[598] which had involved the negotiated sale of property to a school district under threat of condemnation and which the Tax Court had decided adversely to the taxpayer on reasoning similar to that set forth in *Hope*.

The bottom line is that any claim of a bargain sale in the context of a negotiated sale[599] to a condemning authority will likely be too difficult to maintain in the absence of (1) a carefully maintained position by the taxpayer from the outset that it is willing to make a partial donation of the property in question; (2) some form of an acknowledgement by the condemning authority of taxpayer's donative intent and that the fair market value of the property has not been established by the negotiated sales price; and (3) issuance of a Form 8283 by the condemning authority. In most circumstances, it will be difficult to achieve these items so that a taxpayer can fit within the facts of *Consolidated Investors Group.*

[592] In essence in this bargain sale the remaining $93.75X of basis ($125X minus $31.25X) disappears.

[593] Assuming an appropriate replacement is made, this gain can be deferred under §1033.

[594] *United States v. Am. Bar Endowment*, 477 U.S. 105, 118 (1986); *Sklar v. Commissioner*, T.C. Memo 2000-18, aff'd 282 F.3d 610, 612 (9th Cir. 2002).

[595] *United States v. Am. Bar Endowment*, 477 U.S. 105, 117–118 (1986); Rev. Rul. 67-246.

[596] T.C. Memo 2009-290.

[597] 23 Cl. Ct. 776, 68 AFTR.2d 91-5396 (Cl. Ct. 1991).

[598] 56 T.C.M. 1960 (1987).

[599] In the event the question of value proceeds to an actual court determination, the question of whether there is a higher, true value of the property will be effectively negated because the court will be required to determine "fair market value" to satisfy the requirement that just compensation be paid. Stated differently, it is only in the context of a negotiated settlement that the parties could possibly include language that in effect reserves the question of a true fair market value.

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IX. Mortgages and Liens

A. Mortgages and Liens on Converted Property

The regulations under §1033 provide that amounts paid by the condemning authority to a mortgagee or lienor are condemnation proceeds whether or not the condemnee was personally liable for the obligation.[600] Thus, any amount retained by the condemning authority to satisfy liens or mortgages on the condemned property must be taken into account in determining the amount realized on the conversion. The result, of course, is that §1033 reinvestment must be made in an amount equal to the proceeds actually received by the condemnee plus the unpaid mortgage and lien balances.[601] Whether this result is correct law as to nonrecourse debt not incurred by the condemnee has been open to some doubt.[602] However, the weight of authority is that the nonrecourse mortgage is properly counted as proceeds from the condemnation.[603]

> *Example:* Karen owns a building with an adjusted basis of $50,000. The building is subject to a nonrecourse mortgage of $25,000, i.e., Karen has never assumed personal liability on the mortgage. Upon condemnation, the City pays Karen cash of $75,000 and satisfies the mortgage by paying the mortgagee $25,000. Karen must reinvest $100,000 under §1033 to avoid recognition of gain.

Another issue relating to mortgages on converted property is whether the unpaid balance is received when the condemning authority assumes the mortgage or when the mortgagee formally releases the mortgagor from further liability. Some courts hold that the unpaid balance is realized in the year in which the condemning authority assumes liability on the mortgage.[604] The matter is not entirely free from doubt, as *Likins-Foster Honolulu Corp. v. Commissioner*[605] can be read to indicate a formal release is required before gain is realized. Nonetheless, it would appear that the proceeds should be treated as received when the condemning authority agrees with the condemnee to bear the cost of the liability. This is because at this point the condemnee has been relieved of the economic burden of the liability.[606]

B. Mortgage on Replacement Property

Under §1033(a)(2)(A), gain on the conversion of property is recognized only to the extent the amount realized on conversion exceeds the cost of replacement property. A liability incurred by the taxpayer on the acquisition of replacement property counts as an amount expended in replacement, whether or not the purchaser assumes personal liability.[607] An exception to this rule is that an acquisition liability is not included in the §1012 cost basis if payment of the obligation is so speculative as to create a contingent liability.[608] For example, in *American Truck Rental Corp. v. Commissioner*,[609] the replacing taxpayer borrowed funds to acquire replacement property. The length of the loan was so indeterminate that the Third Circuit was convinced that the transaction was a sham designed to leave the taxpayer with the conversion proceeds. A similar result undoubtedly would be reached if the replacement were purchased from a related taxpayer for a price far exceeding the fair market value of the property.[610]

> *Example:* Jefferson's airplane was destroyed by fire. When insurance proceeds of $100,000 are paid, he realizes gain of $80,000. Following a proper §1033 election, he purchases another similar use airplane from his brother for $100,000, paying 10% down and financing the rest. As long as the purchase price is in accord with an arm's-length price and the liability is otherwise genuine, he should recognize no gain from the original conversion.

C. Special Mortgage Problem: Partnership Property

As discussed above in VI.C.1. and VII.A.5., the partnership (and/or limited liability company) is the entity which must elect and generally replace when a §1033 conversion of partnership/limited liability company property occurs.[611] The discussion below refers to partnerships, but applies equally to a limited liability company taxable as a partnership.

In the normal §1033 situation for a partnership, an election in the first gain year postpones recognition of all conversion gain (assuming qualified replacement), including gain attributable to liabilities on the property. However, when encum-

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[600] Reg. §1.1033(a)-2(c)(11).

[601] *Pelican Bay Lumber Co. v. Blair*, 31 F.2d 15 (9th Cir. 1929), cert. denied, 279 U.S. 870 (1929). Cf. *Petit v. Commissioner*, 8 T.C. 228 (1947), acq., 1947-1 C.B. 3. *See also Wala Garage, Inc. v. United States*, 163 F. Supp. 379 (Ct. Cl. 1958); *Ovider Realty Co. v. Commissioner*, 193 F.2d 266 (4th Cir. 1951).

[602] *Compare Commissioner v. Fortee Properties, Inc.*, 211 F.2d 915 (2d Cir. 1954), cert. denied, 348 U.S. 826 (1954) (nonrecourse debt counts as condemnation proceeds) *with Commissioner v. Babcock*, 259 F.2d 689 (9th Cir. 1958) (*contra*).

[603] *Commissioner v. Fortee Properties, Inc.*, 211 F.2d 915 (2d Cir. 1954), cert. denied, 348 U.S. 826 (1954); *Wala Garage, Inc. v. United States*, 163 F. Supp. 379 (Ct. Cl. 1958); *Foster v. Commissioner*, 25 T.C.M. 1390 (1966), modified *and rem'd on other issues sub nom. Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285 (10th Cir. 1969), cert. denied, 397 U.S. 987 (1970); *Harsh Inv. Corp. v. United States*, 323 F. Supp. 409 (D. Or. 1970) (distinguishing the otherwise controlling decision in *Babcock* as turning on pre-1951 law, which referred to a conversion of property "into money"). *See also Tufts v. Commissioner*, 461 U.S. 300 (1983) (nonrecourse debt, even in excess of fair market value, is an amount realized on disposition of encumbered property); Reg. §1.1001-2(a)(4)(i) (same); Reg. §1.1001-2(c) *Ex.* 2 (same).

[604] *Kent Homes, Inc. v. Commissioner*, 55 T.C. 820 (1971), rev'd on other grounds, 455 F.2d 316 (10th Cir. 1972). *See also Smith v. Commissioner*, 324 F.2d 725 (9th Cir. 1963) (gain realized when liability assumed); *Oates v. United States*, 69-2 USTC ¶9658 (N.D. Tex. 1969) (same).

[605] 417 F.2d 285 (10th Cir. 1969), cert. denied, 397 U.S. 987 (1970).

[606] *Cf. Tufts v. Commissioner*, 461 U.S. 300 (1983).

[607] *See Ruud v. Commissioner*, 28 T.C.M. 1284 (1969); Rev. Rul. 68-642; PLR 8021126. *See also Crane v. Commissioner*, 331 U.S. 1 (1947); Rev. Rul. 68-362.

[608] For examples of contingent liabilities not included in the cost basis, see *Denver and Rio Grande Western R.R. Co. v. United States*, 505 F.2d 1266 (Ct. Cl. 1974); *Columbus and Greenville Ry. Co. v. Commissioner*, 42 T.C. 834 (1964), aff'd *per curiam*, 358 F.2d 294 (5th Cir. 1966); *Albany Car Wheel Co. v. Commissioner*, 40 T.C. 831 (1963), aff'd *per curiam*, 333 F.2d 653 (2d Cir. 1964); Rev. Rul. 77-110.

[609] 355 F.2d 928 (3d Cir. 1966), cert. denied, 385 U.S. 815 (1966).

[610] *Cf. Estate of Engelstein v. Commissioner*, 36 T.C.M. 914 (1977) (moral obligation to pay sister for converted property did not increase basis). Also, using the condemnation proceeds to pay down a mortgage on property already owned will not be an adequate §1033 replacement, even though that property is similar to the condemned property. Rev. Rul. 70-98.

[611] *But see, e.g.*, the discussion of PLR 200921009 and PLR 8244124 in VII.A.5. and VIII.H., above.

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bered partnership property is converted, §752 comes into play and may require gain recognition by the partners even though §1033 has been properly elected.

Section 752(b) requires that any reduction in a partner's share of partnership liability be treated as distribution of cash by the partnership. Under §731(a)(1), a partner realizes gain on a distribution of cash to the extent the cash exceeds the partner's adjusted basis in his partnership interest.[612] Thus, when the liability on encumbered partnership property is assumed by a condemning authority in one tax year, the current recognition rule of §752/§731(a) conflicts with the deferral rule of §1033(a) to the extent the partner has inadequate basis to offset the deemed §752 cash distribution. Initially, the IRS ruled in PLR 7948087 that §1033 overrode the current recognition rule of §752/§731(a)(1). This letter ruling relied on Rev. Rul. 79-205,[613] which ruled that the deemed cash distribution under §752(b) is determined after the liability reduction is netted against the liabilities assumed by the distributee in the same transaction. The IRS reasoned in PLR 7948087 that the principles behind §1033 required the conversion replacement process to be treated as one transaction for §752(b)/§731(a)(1) purposes. Only if the liabilities on the replacement property were less than those on the conversion property would §752(b) require recognition of income, the IRS ruled. Thus, the IRS concluded that the §752(b) consequences would be determined on the last day of the taxable year in which replacement was completed.

However, in Rev. Rul. 81-242, the IRS reversed itself, ruling that the conversion transaction is separate from the replacement transaction, and thus, Rev. Rul. 79-205 is inapplicable to §1033 situations. Accordingly, on a liability assumption by the condemnor, §731(a)(1) gain must be recognized to each partner to the extent his share of the deemed §752(b) distribution exceeds the basis in his partnership interest immediately before the distribution. This result occurs, according to Rev. Rul. 81-242, regardless of a valid §1033 partnership level election.[614]

> *Example:* The two partners (Jan and Mary Kay) of J & M Enterprises share all losses and gains equally. J & M owns investment real estate and is a calendar year taxpayer. In 20X8, the City condemns one of J & M's buildings (in which J & M's basis is $52,000) and agrees to pay J & M $50,000 cash and to assume a nonrecourse $80,000 encumbrance on the building. J & M makes a valid §1033 election on its 20X8 partnership return. Jan's basis in J & M immediately before the conversion is $45,000; Mary Kay's is $10,000. J & M makes a qualifying replacement in 20X9, by purchasing another building for $150,000, including encumbrances of $120,000. Rev. Rul. 81-242 allows the partnership's gain of $78,000 to be deferred. However, Rev. Rul. 81-242 requires Mary Kay to recognize gain on the transaction to the extent the $40,000 reduction in her share of partnership liabilities (the reduction being equal to 50% of the $80,000 assumed mortgage) exceeds her $10,000 basis. Thus, Mary Kay will recognize gain of $30,000. Jan will not recognize gain since the $40,000 reduction in her share of partnership liabilities does not exceed her basis of $45,000. After the deemed §752(b) distribution, Jan's basis in J & M is $5,000; Mary Kay's is $0. Rev. Rul. 81-242 does not discuss the consequences of replacement but, presumably, only the partnership's basis in the replacement property is reduced pursuant to §1033(b). The partnership's basis thus would be $72,000 ($150,000 reinvestment less deferred gain of $78,000). Jan's post-replacement basis in the partnership will be $65,000 ($5,000 at the end of 20X8 plus $60,000, her 50% share of the $120,000 encumbrance) even though part of the encumbrance is used as a qualifying reinvestment to defer gain under §1033. Similarly, Mary Kay's basis after the replacement will be $60,000 ($0 at the end of 20X8 plus $60,000, her 50% share of the $120,000 encumbrance).

There are at least two possible ways to avoid the problem of §752 overlapping §1033. First, the property could be distributed from the partnership before condemnation. Assuming the property is distributed jointly among all partners in the same interests as they are partners, the §752 problem should be avoided under Rev. Rul. 79-205 because the increase in each partner's individual liabilities in a nonliquidating distribution washes out the decrease in partnership liabilities caused by the same distribution.[615] Thereafter, the joint owners could defer gain on condemnation under the normal §1033 rules.[616] A risk with this approach is that a partnership might still be found as to the distributed joint property. See discussion in VIII.H., above.

A second possible way to avoid the §752 problem is to make the replacement before a condemnation formally occurs.[617] On this replacement, care should be taken to ensure that the acquisition liabilities are sufficient so that each partner will have sufficient basis immediately before the deemed §752(b) distribution (on the eventual condemnation) to avoid gain under §731(a)(1).

Although Rev. Rul. 81-242 suggests to the contrary, another possibility is that a substantially contemporaneous replacement would be deemed to be part of the same transaction as the conversion. Thus, under Rev. Rul. 79-205, it is arguable that the partner's share of conversion liabilities should be netted against his share of replacement liabilities. This approach would not appear advisable in light of the assertion in Rev. Rul. 81-242 that the condemnation and the reinvestment were "separate transactions that did not occur simultaneously."

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[612] *See generally* 714 T.M., *Partnerships — Allocation of Liabilities; Basis Rules.*

[613] *See also* PLR 8010098.

[614] *Cf. Rosefky v. Commissioner*, 599 F.2d 515 (2d Cir. 1979) (adverse tax consequences to partners required even though partnership level election). Rev. Rul. 81-242 was followed in PLR 9004018.

[615] *See, e.g.*, PLR 8010098.

[616] *See, e.g.*, PLR 7952102 (discussing replacement by tenants in common).

[617] *See* §1033(a)(2)(B). The replacement property would still have to be acquired for the purpose of replacing the converted property.

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A final point of analysis is the effect of PLR 9323010. This ruling letter does not discuss any of the foregoing authorities. It concludes that the taxpayer's proportionate share of the reduction in partnership liabilities is "an amount realized under Section 1001 for purposes of determining the gain that X may elect not to recognize and the amount required to be invested in qualifying replacement property for purposes of Section 1033." This suggests, of course, that if the replacement is in a sufficient amount, gain from the conversion can be deferred notwithstanding Rev. Rul. 81-242.

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X. Miscellaneous Expenses and Payments

A. Acquisition Costs

Costs incurred in connection with the acquisition of a capital asset (such as legal and accounting fees) are capital expenditures and are to be added to basis rather than expensed.[618] Payment of such capitalized items counts toward the total repurchase that must occur. In effect, such capitalized items themselves qualify as replacement property.

If, to defer the recognition of gain, an amount in excess of the proceeds is invested in replacement property, no loss occurs. Instead, the "excess" reinvestment is simply an additional capital expenditure and increases the basis of the replacement property.[619]

> *Example:* Karl's camera (purchased in 20X9 and having a basis of $300) is stolen and he receives $2000 of insurance proceeds. If Karl purchases a replacement camera for $3,000 immediately after the theft, the gain on the conversion will be deferred if he so elects because he has invested at least the total conversion proceeds in replacement property. His basis in the new camera is $3,000 (new cost) less $1,700 gain deferred ($2,000 proceeds less $300 basis in old camera), or $1,300.[620] His holding period for the new camera dates from 20X9.

Occasionally, taxpayers in a stock acquisition will seek to require their seller to use the sale proceeds to reduce underlying corporate debt. It appears that this approach will not reduce the net amount of reinvestment.[621] While this approach removes encumbrances, it has the disadvantage of increasing basis in the purchaser's stock but not the corporation's asset basis. An alternative would be to purchase the assets outright and assume, then pay off, the encumbrances. This should step up the asset basis to market value. See the discussion in VIII.D., above.

B. Conversion Expenses

The rule has long been that the costs of acquiring, transferring, defending or perfecting title to property generally must be capitalized.[622] In determining whether costs must be capitalized, the underlying origin of the transaction in which the costs are incurred controls.[623] The costs incurred in a condemnation proceeding or in the recovery of insurance proceeds arising from other conversions fundamentally relate to the transfer of property and, therefore, must be treated as a part of a capital transaction when a capital asset is involved, regardless of whether the costs are attributable to increasing a recovery or defending against a condemnation.[624] On the other hand, when condemned property is not a capital asset, as for example real property held for sale, there is authority that condemnation expenses give rise to a current deduction from income.[625]

Rev. Rul. 71-476 provides that legal, engineering, and appraisal fees are set off against the condemnation award in determining the amount realized on the conversion.[626] Witness fees are accorded similar treatment.[627] Taxpayers should attempt to pay all such costs no later than the last year in which condemnation proceeds are received; otherwise, the payment may produce a subsequent capital loss and not offset the conversion proceeds.[628] If both severance damages and a separate award for the taken property are made, it appears such expenses should be allocated to each portion of the total award.[629] Normally, there is no basis for allocating a part of such expenses to the interest received.[630] If no actual allocation of costs can be made between the taking and the severance awards, the expenses should be prorated based on the percentage each award bears to the total payable damages. According to the IRS,[631] these expenses reduce severance damages and the condemnation award before consideration is given to any special assessment. Special assessments are discussed in X.D., below.

> *Example:* Dolly's ranch was partially condemned by the state. Her basis in the retained portion is $75,000, and her basis in the taken portion is $55,000. Dolly expends $25,000 in legal fees to obtain severance damages of $20,000 and a taking award of $80,000. Her legal fees relate to the entire transaction and are apportioned $5,000 ((20,000 ÷100,000) × $25,000) to the severance damages and $20,000 ((80,000 ÷ 100,000) × $25,000) to the taking award. These expenses reduce the severance damages to $15,000 and the taking award to $60,000. Applying the $55,000 basis Dolly had in the taken tract against the $60,000 taking award produces realized gain of $5,000, which can be deferred under §1033. Dolly's basis of

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[618] §263; Reg. §1.263(a)-2T(d), effective for taxable years beginning on or after January 1, 2012. For taxable years beginning before January 1, 2012, see former Reg. §1.263(a)-2(a). Reg. §1.263(a)-2T(k). *See also Woodward v. Commissioner*, 397 U.S. 572 (1970); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995); Rev. Rul. 70-265.

[619] Reg. §1.1033(a)-2(c)(12). *See also Pelican Bay Lumber Co. v. Blair*, 31 F.2d 15 (9th Cir. 1929), cert. denied, 279 U.S. 870 (1929).

[620] As an economic matter, this $1,300 represents Karl's old basis of $300 plus his $1,000 investment in addition to the conversion proceeds.

[621] *See* PLR 8122076. *But see* PLR 8034098 (IRS refused to rule on this issue).

[622] Reg. §1.263(a)-2T(d), §1.263(a)-2T(e), effective for taxable years beginning on or after January 1, 2012. For taxable years beginning before January 1, 2012, see former Reg. §1.263(a)-2(a), (c). Reg. §1.263(a)-2T(k). *See Woodward v. Commissioner*, 397 U.S. 572 (1970); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995); *Johnson and Co. v. United States*, 149 F.2d 851 (2d Cir. 1945).

[623] *Woodward v. Commissioner*, 397 U.S. 572 (1970); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

[624] *Madden v. Commissioner*, 514 F.2d 1149 (9th Cir. 1975); *see United States v. Hilton Hotels, Inc.*, 397 U.S. 580 (1970); *Jasko v. Commissioner*, 107 T.C. 30 (1996) (expenses to increase insurance proceeds following casualty are capital expenditures); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995) (partnership's legal fees incurred in appeal of condemnation proceeding are capital expenditures).

[625] *See Scheuber v. Commissioner*, 25 T.C.M. 559 (1966), rev'd on other grounds, 371 F.2d 996 (7th Cir. 1967).

[626] *See Jasko v. Commissioner*, 107 T.C. 30 (1996); *Casalina Corp. v. Commissioner*, 60 T.C. 694 (1973), acq., 1974-2 C.B. 1, aff'd, 511 F.2d 1162 (4th Cir. 1975); PLR 8041002.

[627] *See Vaira v. Commissioner*, 52 T.C. 986 (1969), rev'd and rem'd on other grounds, 444 F.2d 770 (3d Cir. 1971).

[628] *Vaira v. Commissioner*, 52 T.C. 986 (1969), rev'd and rem'd on other grounds, 444 F.2d 770 (3d Cir. 1971).

[629] IRS Pub. 544, *Sales and Other Dispositions of Assets.*

[630] *Johnson and Co. v. United States*, 149 F.2d 851 (2d Cir. 1945); *Casalina Corp. v. Commissioner*, 60 T.C. 694 (1973), acq., 1974-2 C.B. 1, aff'd, 511 F.2d 1162 (4th Cir. 1975); *Marcus v. Commissioner*, 23 T.C.M. 1240 (1964).

[631] IRS Pub. 544, *Sales and Other Dispositions of Assets.*

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$75,000 in the retained tract is reduced to $60,000 ($75,000 basis less $15,000 proceeds).

C. Casualty Loss Expenses

As discussed above, the expenses incurred in a condemnation proceeding are capital expenditures and generally operate to reduce the condemnation proceeds. A different rule has emerged regarding the expenses involved in the collection of insurance proceeds following a casualty. Under *Ticket Office Equip. Co. v. Commissioner*,[632] these expenses are deductible as §162 ordinary and necessary business expenses and are not netted against the proceeds. In *Ticket Office Equip. Co.*, the taxpayer suffered a partial destruction by fire of a building used in the business. The taxpayer's insurer at first refused to pay and the taxpayer hired attorneys to collect the claim. Eventually, the claim was paid at a gain and the taxpayer sought both §1033 deferral and an ordinary deduction under the predecessor of §162 for attorneys' fees. The Tax Court allowed this dual treatment, reasoning that the claim for money damages did not involve title to a capital asset, and also did not involve the improvement, increase in value of, or acquisition of a capital asset. Rather, the insurance claim expenses were akin to the costs of collecting any debt owed the business. In a footnote, the Tax Court drew an analogy to the Supreme Court case *Arrowsmith v. Commissioner*[633] and concluded that it would be "anomalous" if amounts paid to reduce an ordinary loss were themselves not deductible ordinary expenses.

In *United States v. Pate*,[634] the Tenth Circuit relied on *Ticket Office Equip. Co.* to hold that the insurance collection expenses did not have to be netted against the proceeds and were instead deductible separately. The Tenth Circuit concluded that the insurance collection costs were like any other collection expense to the business.[635] However, in *Towanda Textiles, Inc. v. United States*,[636] the Court of Claims refused to follow *Ticket Office Equipment* and *Pate*. The court concluded that because the underlying realized gain was capital, the collection costs incurred to realize that gain could not be deducted as ordinary expenses but reduced the amount of the capital gain instead. Only where insurance proceeds would be taxable as ordinary income could the collection expenses be treated as ordinary business expenses.

The foregoing cases predate the Supreme Court case *Woodward v. Commissioner*.[637] Under *Woodward*, the correct approach is to examine the origin of the claim producing the expense.[638] While not free from doubt, it seems that the underlying nature of insurance collection expenses is more akin to collecting a business debt than it is to improving or transferring property. In the insurance situation, for example, title to the converted property does not usually change hands.[639] If so, the collection expense should produce an ordinary deduction apart from how the proceeds are taxed.[640]

However, in *Jasko v. Commissioner*,[641] the Tax Court determined that legal fees incurred in the collection of insurance proceeds were to be capitalized rather than expensed. The result is generally to reduce the amount of gain which is deferred, as well as to eliminate the deduction. In *Jasko*, the taxpayer's residence had been destroyed by casualty. The Tax Court cited *Towanda Textiles, Inc. v. United States* with approval and questioned whether *Ticket Office Equip. Co. v. Commissioner* remained valid considering the Supreme Court's decision in *Woodward v. Commissioner*.

In view of *Jasko*, the issue should be viewed as undecided. *United States v. Pate* controls for taxpayers residing in the Tenth Circuit, while *Jasko* is controlling authority for other taxpayers who litigate in the Tax Court. Caution is warranted.

D. Severance Damages and Special Assessments

Severance damages may be paid to the taxpayer-condemnee to compensate him for loss to property retained after the condemnation. Conversely, the condemning authority may levy a special assessment against the retained property if that property benefits from the condemnation.

Under Rev. Rul. 68-37, severance damages are applied only against the basis of the retained property. In establishing the basis of the retained portion, the taxpayer may invoke the *Cohan* rule to establish basis indirectly.[642] It is far more advisable, however, to keep detailed records as to basis rather than to rely on the *Cohan* rule, because proof under *Cohan* is always problematic.

Any severance damages in excess of the retained portion's basis is treated as gain. However, Rev. Rul. 83-49 allows this gain to be deferred under §1033 if proper replacement property is acquired. Although previous rulings[643] had ruled or suggested that §1033 deferral was available only if the excess severance damages were reinvested in the retained portion or to acquire adjacent replacement property, the IRS did not prevail in litigation on this point.[644] In any event, Rev. Rul. 83-49 makes clear that the severance damages may be reinvested in any replace-

[632] 20 T.C. 272 (1953), acq., 1953-2 C.B. 6, aff'd on other issues, 213 F.2d 318 (2d Cir. 1954).

[633] 344 U.S. 6 (1952). *Arrowsmith* holds that where an initial transaction is capital, as for example the surrender of stock in a corporate liquidation, a subsequent loss related to that transaction must be characterized the same way.

[634] 254 F.2d 480 (10th Cir. 1958).

[635] *See also Cotton States Fertilizer Co. v. Commissioner*, 28 T.C. 1169 (1957), acq., 1958-1 C.B. 4 (attorneys' fees deductible on conversion; predecessor of §265 relating to expenses on exempt income held not applicable to §1033 transaction); *Petschek v. Commissioner*, 335 F.2d 734 (2d Cir. 1964) (attorneys' fees to obtain recovery for foreign expropriation loss deductible, as transaction more akin to casualty than condemnation).

[636] 180 F. Supp. 373 (Ct. Cl. 1960).

[637] 397 U.S. 572 (1970).

[638] *See generally Wagner v. Commissioner*, 78 T.C. 910 (1982), for a review of the cases applying the origin-of-the-claim test of *Woodward*.

[639] *Compare Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941) (payment of insurance proceeds does not produce sale or exchange) *with Hawaiian Gas Products, Ltd. v. Commissioner*, 126 F.2d 4 (9th Cir. 1942) (condemnation is fundamentally sale or exchange of property), *cert. denied*, 317 U.S. 653 (1942).

[640] *See United States v. Pate*, 254 F.2d 480 (10th Cir. 1958).

[641] 107 T.C. 30 (1996).

[642] Under the rule of *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), a taxpayer may be allowed to claim some tax benefit from expenditures despite inexact records where the evidence is otherwise clear that some amount was spent. *See Stine v. Commissioner*, 35 T.C.M. 1556 (1976).

[643] *E.g.*, Rev. Rul. 80-184, Rev. Rul. 73-35, Rev. Rul. 72-433, Rev. Rul. 69-240, Rev. Rul. 60-69, Rev. Rul. 271, 1953-2 C.B. 36.

[644] *See McKitrick v. United States*, 373 F. Supp. 471 (S.D. Ohio 1974); *Conran v. United States*, 322 F. Supp. 1055 (E.D. Mo. 1971).

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ment property meeting the §1033 standards.[645] Where severance damages are invested in multiple replacement properties, the rules discussed in VIII.B., above, apply.[646]

Example: George, a farmer, purchases agricultural land for $220,000 to be used in his farming operations. Subsequently, the State Highway Department condemned a portion of the land as a right-of-way for a limited access highway. George receives $175,000 from the State as compensation for the property actually taken and additional damages of $135,000 for reduction in value of the retained property. George's basis is allocated $140,000 to the taken portion and $80,000 to the retained portion. Thus, a gain of $35,000 ($175,000 proceeds less $140,000 basis) is produced as to the taken portion, and a gain of $55,000 ($135,000 proceeds less $80,000 basis) results as to the retained portion. Because George has tired of farming, he purchases an apartment house and the land on which it stands for $350,000. Under Rev. Rul. 83-49, George may defer all gain because his reinvestment equals or exceeds the proceeds he received for the land actually taken, $175,000, plus the severance damages in excess of the retained portion's basis, $55,000. His basis in the retained portion is $0, as the first $80,000 in severance damages were applied against his $80,000 basis. His basis in the replacement apartment house is $260,000 ($350,000 cost less $90,000 deferred gain [$55,000 on retained portion plus $35,000 on taken portion]).

As discussed above in II.B.3.c., the effect of a special assessment that relates to a condemnation award is to reduce the gain from the condemnation. The precise effect of a withheld special assessment is determined under the following rules:

- A special assessment is offset first against any severance damage and second against the condemnation award.
- If the special assessment is greater than the total of such awards, the excess is added to the basis of the retained property.
- If the special assessment is less than the severance damages, the severance damages are then applied against the basis of the retained tract. Any excess over the basis is realized gain, but may be deferred under the §1033 rules discussed above. Similarly, any excess of the net condemnation award over the basis of the taken portion may be deferred under the regular §1033 rules.[647]

Example: Tom owns 20 acres of improved farm land that he purchased in 1975. His depreciated basis in the improvements is $15,000, while his basis in each acre is $1,000. The State Highway Department condemns a total of 10 acres (including all acreage with the improvements) for $32,000. In addition, because access to the remaining 10 acres was improved, the State levies and withholds from its payment a special assessment of $200 per acre. Tom's special assessment is applied to reduce the condemnation award because no severance damages are payable. Thus, the total condemnation award of $32,000 is reduced by the $2,000 (10 acres times $200 per acre) special assessment, yielding a total award of $30,000. Applying these net proceeds against his $25,000 basis ($15,000 adjusted basis in improvements plus basis in land of $10,000 ($1,000 an acre times 10 acres)), Tom realizes $5,000 gain. This $5,000 gain is eligible for deferral under §1033.

Example: Assume the same facts as in the previous example, except that properly identified severance damages of $9,000 were paid to Tom in addition to the $32,000 condemnation proceeds. The remaining property is still subject to the special assessment of $2,000. The $2,000 special assessment is offset first against the $9,000 severance damages, yielding net severance damages of $7,000. The net severance damages of $7,000 are then applied against the retained tract's basis of $10,000, reducing it to $3,000. There is thus no gain realized on the severance damage payment. As to the taken tract, realized gain of $7,000 ($32,000 proceeds less $25,000 basis) is produced and may be deferred under §1033(g).

Example: Assume the same facts as in the two examples above, except that severance damages of only $1,500 were paid in addition to the $32,000 condemnation proceeds. The remaining property is still subject to the special assessment of $2,000. The $2,000 special assessment is offset first against the $1,500 in severance damages, yielding $0 net severance damages. The remaining $500 is offset against the condemnation award of $32,000, yielding a net condemnation award of $31,500. As to the taken tract, realized gain of $6,500 ($31,500 condemnation award less $25,000 basis) is produced. Note that the basis of the retained property remains $10,000 because there are no net severance damages.

Example: Assume the same facts as in the three examples above, except that only severance damages of $1,500 and condemnation proceeds of $2,000 were payable. Assume further that the special assessment was $7,000. The $7,000 first reduces the net severance damages to $0 and then the condemnation award to $0. The remaining $3,500 special assessment is added to the basis of the retained tract to yield a basis of $13,500. Also, a loss of $25,000 is produced ($25,000 basis less $0 proceeds) as to the condemned tract. Because Tom has held the condemned tract for longer than the applicable long-term holding period, the character of the loss is determined under §1231.

E. Interest

1. In General

Interest received in a condemnation proceeding is typically taxable to the recipient. However, there are instances where stated interest has been held to be nontaxable. The basis for not

[645] See the discussion in VII.B., above. *See also* PLR 7925097.

[646] *See* Rev. Rul. 80-184.

[647] *See generally* GCM 23698, *declared obsolete by* Rev. Rul. 71-498; GCM 20322, *declared obsolete by* Rev. Rul. 69-45. *See also Carrano v. Commissioner*, 70 F.2d 319 (2d Cir. 1934); PLR 8051053.

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taxing stated interest in a condemnation proceeding involves the §103 exclusion for interest paid on obligations of state or local bonds. The condemnation cases involving §103 are typically the result of a condemnation award that is obtained through a negotiated settlement. It is not entirely clear whether such awards are eligible for the §103 exclusion as there seems to be a split in the circuits.

In a typical condemnation proceeding where a government agency uses its powers of eminent domain to take a piece of property, the taxpayer typically has the option of fighting the government agency's determination as to the value of the property. If the taxpayer contests the value placed on the property by the governmental agency, and the taxpayer prevails in court, the taxpayer is typically awarded the difference in value as well as an amount designated as interest. In these cases, the award of interest is taxable to the recipient.[648]

2. Early Case Law

In *Kieselbach v. Commissioner*,[649] New York City took possession of a piece of property owned by the taxpayer through a condemnation proceeding. The possession took place on January 3, 1933. On March 31, 1937, the Supreme Court of New York entered a final decree stating that the taxpayer was owed $73,246.57 and was stated to be the just compensation which the owners were entitled to receive. Of the $73,246.57, the court stated that $58,000 represented the principal amount owed and $15,246.57, computed at the rate of 6% per annum from January 3, 1933, represented interest.

The taxpayer argued that as part of just compensation, the interest is part of the damages awarded for the property. Therefore, according to the taxpayer, the additional sum paid should be construed as a part of the sale price.[650] The court disagreed. According to the court, the sum paid above the award was paid because of the failure to put the award in the taxpayers' hands on the day. The court stated that this additional payment was necessary to give the owner the full equivalent of the value of the property at the time it was taken. The court went on to state, "Whether one calls it interest on the value or payments to meet the constitutional requirement of just compensation is immaterial. It is income paid to the taxpayers in lieu of what they might have earned on the sum found to be the value of the property on the day the property was taken."

Before the *Kieselbach* decision, two appellate court cases determined that interest awarded pursuant to condemnation proceedings were taxable and not excludible under §22(b) of the Revenue Acts of 1928, 1934, and 1936, the predecessor of §103. In *U.S. Trust Co. v. Anderson*,[651] the Second Circuit held that interest on a condemnation award was taxable. The facts in *U.S. Trust Co.* were similar to the facts in *Keiselbach*. Two pieces of property owned by the taxpayer were condemned by the city of New York. Title to the two pieces of property passed to the city of New York in 1925 and 1926, and the taxpayer received his condemnation award, including 6% interest, in 1927 and 1928, respectively. The court examined §213(b) of the Revenue Act of 1926, which, similar to current §103, provided an exclusion for "interest upon the obligations of a State, Territory, or any political subdivision thereof." In so doing, the court asked, "how broadly the word 'obligations' is to be construed and just when is income covered by the exemption?" The court also noted the use of the word "issued" in connection with "obligations" in the other parts of §213. The court stated, "An award in condemnation, bearing interest, cannot be regarded as 'issued' by a municipality, nor can taxation of the interest received upon such an award in any way affect the borrowing power of the state." The court noted:

> There is no bargaining by the municipality in connection with the matter. The owner of the property condemned is obliged to sell it because of the exercise of the right of eminent domain. There was no competition between the city and other prospective purchasers, for the city had a prior right to the property and one that was subject only to the requirement that it pay a fair price. On the other hand, state and municipal bonds and securities issued to borrow money, if tax exempt, will command a better price in the market than if they are subject to taxation, because the purchaser is not compelled to buy them and, being a free agent, may be induced by the tax exemption feature to prefer them to private bonds for investment. It disregards the whole purpose of the exemption to apply it to interest upon obligations of a state which it can compel a citizen to take in exchange for the fair value of his property. The rate of interest is fixed by law, and neither it, nor the amount of the award adjudged as of the time of taking, is a matter over which he has any control.

In *Holley v. United States*,[652] the Sixth Circuit was faced with somewhat different facts. Unlike *U.S. Trust Co.* and *Kieselbach*, *Holley* involved the negotiated settlement of a potential condemnation proceeding. In *Holley*, the city of Detroit planned to widen certain streets and considered condemnation of the real estate for that purpose. Detroit was having financial difficulty, and "in contemplation of the condemnation proceedings," the taxpayer signed an agreement providing he would receive payments for his property in ten equal installments with interest on the unpaid balance at 4.25%.[653] Thereafter, the taxpayer began to receive yearly payments, including interest. The taxpayer argued that the interest should be excluded under §22(b) of the Revenue Acts of 1934 and 1936, the predecessor of current §103. The Sixth Circuit disagreed. According to

[648] *See, e.g., Kieselbach v. Commissioner*, 317 U.S. 399 (1943); *Fulks v. Commissioner*, T.C. Memo 1989-190.

[649] 317 U.S. 399 (1943). *See also Tiefenbrunn v. Commissioner*, 74 T.C. 1566 (1980); *Ferreira v. Commissioner*, 57 T.C. 866 (1972); *Leonard v. Commissioner*, 96-2 USTC ¶50,404 (9th Cir. 1996) (prejudgment interest on reverse condemnation award is ordinary income, not compensation for taking); *Fulks v. Commissioner*, T.C. Memo 1989-190; *Wilson v. Commissioner*, T.C. Memo 1996-418. The interest component of a condemnation award amounting to $600 or more which is paid to any person in a taxable year and does not meet the criteria of §6049 is reportable on Form 1099-INT. *See* CCA 200012080. 1099-INT may be furnished electronically to any recipient who has consented to the electronic provision of the statement.

[650] The taxpayer seemed to concede that the amounts were not "interest upon the obligations of a state" pursuant to §22(b)(4) of the Revenue Act of 1936, the predecessor to current §103.

[651] 65 F.2d 575 (2d Cir. 1933).

[652] 124 F.2d 909 (6th Cir. 1942).

[653] It is unclear whether condemnation proceedings had begun. Pursuant to the analysis in *Holley*, this factor would be of no significance. However, later courts have looked to this factor in analyzing §103.

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the court, "while the contract to defer payments was voluntary, the taking was not, all the proceedings being under the power of eminent domain and necessarily compulsory." The court further stated, "the statute does not exempt interest paid on every type of contract or legal liability incurred by a municipal corporation." According to the court, the exemption provided in §22(b), was established to aid in the flotation of government bonds and securities by making them tax free, and therefore more attractive to investors. Finally, the court stated that the fact the city of Detroit was in acute financial difficulty was irrelevant in this instance.[654]

According to both the Second Circuit in *U.S. Trust Co.* and the Sixth Circuit in *Holley*, virtually any case involving interest in the context of a condemnation proceeding would be taxable as the government entity does not typically "issue" a bond or security in such cases. Both the Second Circuit and the Sixth Circuit construed the term "obligation" narrowly, making it virtually impossible for any interest awarded in the context of a condemnation proceeding to be excludible.

3. Later Circuit Court Cases

In *Drew v. United States*,[655] the Fifth Circuit addressed the issue. In *Drew*, a government agency decided that it needed certain real property held by the taxpayer to build a reservoir. The taxpayer owned part of the land that the agency needed. The agency began negotiations with taxpayers to purchase the property, however the parties were unable to reach an agreement. At this point, condemnation proceedings were instituted.[656] Payments for the land were initially made in cash. However, at the suggestion of certain landowners, the agency devised a plan whereby the purchase price could, at the option of the seller, be spread over a period of time, giving the taxpayers the tax benefits of installment reporting. All landowners were offered one of the following three choices for accepting payment: (1) cash for the total purchase price; (2) interest-bearing warrants under the deferred-payment plan; or (3) a combination of cash and warrants. The taxpayer in *Drew* elected to receive his payment through a combination of cash and warrants. The taxpayer did not include the interest payments in income, claiming that the interest was excludible under §103.

Citing *Holley* and *Anderson*, the Fifth Circuit held that §103 was not applicable because the taxing of the interest paid had no effect upon the borrowing power of the governmental entity. The court also distinguished the case of *Commissioner v. Meyer*[657] by noting that the land sale in *Meyer* wasn't compulsory. The court noted that in both the present case and *U.S. Trust Co.*, the land transfer was compulsory, and the interest paid "was payable not by virtue of any contract under which credit was obtained but because required by law as part of the just compensation for what was condemned and taken *** for public use."[658] However, instead of just relying on the fact that *Drew* involved an involuntary conversion, the *Drew* court went further and stated that the transaction imposed no burden on the governmental entity as it was not in need of funds to purchase the land involved.[659] The court went on to state, "[t]he fact that [the governmental entity] allowed them and other landowners to elect to receive compensation on a deferred basis … did not convert the transaction into a voluntary one."

In 1983 and 1984, two opinions were issued by the Ninth Circuit involving the same taxpayer. In *Stewart v. Commissioner* (*Stewart I*),[660] the city of Phoenix offered the taxpayers approximately $2.4 million for a piece of property owned by the taxpayers. The taxpayers believed that the property was worth more. The city of Phoenix then brought a condemnation proceeding. Under Arizona law, the city of Phoenix could obtain immediate possession by depositing an amount equal to double the probable damages with the court. However, after the condemnation action was filed, the parties entered into an agreement which gave the city immediate possession of the property, and required the city to pay the taxpayer $2.45 million. To the extent that the court in the condemnation proceeding awarded the taxpayers any additional money for their property, the taxpayers would receive interest on that additional money at the statutory rate of 6% from the original date that the city took possession. The court later determined that the value of the taxpayers' property was $3.4 million, and the city paid the taxpayers an additional $1,180,162, of which $239,137 was interest as required by the earlier agreement. The taxpayers took the position that the interest was excludible under §103. The Tax Court, relying on *U.S. Trust Co.*, held that the interest paid did not fall within the scope of §103.[661] The Ninth Circuit affirmed.

According to the Ninth Circuit, where a government's obligation to pay interest arises solely by operation of law, taxing the recipient on such interest does not adversely affect the government's ability to borrow money. The court also cited *U.S. Trust Co.*, *Drew*, and *Holley* for the proposition that an award in a condemnation case which bears interest cannot be regarded as being "issued" by a municipality as there is no bar-

[654] It should be noted that while the Sixth Circuit found this factor to be irrelevant, later courts held that this factor was relevant in the analysis. *See Drew v. United States*, 551 F.2d 85 (5th Cir. 1977); *Stewart v. United States*, 739 F.2d 411 (9th Cir. 1984); *DeNaples v. Commissioner*, 674 F.3d 172 (3d Cir. 2012).

[655] 551 F.2d 85 (5th Cir. 1977).

[656] It should be noted that the Fifth Circuit stated, "when [the governmental agency] was unable to reach an agreement with the landowner condemnation proceedings were instituted," which seemed to suggest that the case involved a condemnation proceeding. However, the district court opinion specifically stated that the case was "not a condemnation case and the court does not so hold." *See* 394 F. Supp. 340 (S.D. Texas 1975).

[657] 104 F.2d 155 (5th Cir. 1939). The *Meyer* case did not involve the condemnation of property. It simply concerned the sale of property from a taxpayer to a political subdivision of the State of New York. However, taxpayers claiming the §103 exclusion often cite the *Meyer* case for the proposition that interest received in a case which involves a negotiated settlement under the threat of condemnation should also be afforded the interest exclusion under §103. The Fifth Circuit similarly distinguished *Kings County Dev. Co. v. Commissioner*, 93 F.2d 33 (9th Cir. 1937) by quoting language from the *Anderson* case indicating the involuntary nature of the transaction: "[T]here was no bargaining, nor any possibility of bargaining, between the taxpayer and the City of New York." It should be noted that although neither *Meyer* nor *Kings County* involved condemnations, other taxpayers later cited those cases for the proposition that an interest obligation does not have to be in some particular form such as municipal bonds, to be excludible under §103.

[658] As noted above, the district court in *Drew* stated that this case was "not a condemnation case and the court does not so hold." Therefore, according to the Fifth Circuit, just the threat of condemnation means that any transfer is not voluntary.

[659] Note that in the *Holley* case, the Sixth Circuit held that the fact that the city of Detroit was having financial difficulties was irrelevant to the analysis.

[660] 714 F.2d 977 (9th Cir. 1983).

[661] T.C. Memo 1982-209.

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gaining and the owner of the property condemned is obliged to sell it because of the exercise of the right of eminent domain. The Ninth Circuit then distinguished the *Kings County* and the *Meyer* cases on the basis that those cases were based on contractual relationships and not condemnations.

A year later, the Ninth Circuit addressed this issue again with the same taxpayer with a different fact pattern.[662] In *Stewart II*, the taxpayer owned a utility located just outside the city limits of Phoenix, which the city of Phoenix sought to buy from the taxpayers. The city of Phoenix and the taxpayers agreed on a price which the city agreed to pay over five years with interest payments due at the rate of 6%. Again, the taxpayers excluded the interest from income pursuant to §103.

Pursuant to cross motions for summary judgment, the district court held that the interest was excludible under §103.[663] Citing *Kings County*, the court held that an interest obligation of a city does not have to be in some particular form to be excludible under §103. The district court also distinguished both the *Holley* and *U.S. Trust Co.* cases due to the fact that both of those cases involved interest on payments for property that was actually condemned. The court further noted that the *Holley* case distinguished the *Kings County* case because the purchase agreement in the *Kings County* case was completely voluntary, unlike *Holley* and *U.S. Trust Co.* situations where the taxpayer had no choice. The district court also distinguished the *Drew* case because, according to the court, a condemnation proceeding was instituted in the *Drew* case.[664] The court also noted that in *Drew* the local government had already raised the money necessary to pay a condemnation award, where as in *Stewart II*, "there is no evidence that the City of Phoenix could have paid a condemnation award without credit."[665]

On appeal, the Ninth Circuit vacated the district court's grant of summary judgment and remanded the case. According to the Ninth Circuit, the joint stipulation of facts upon which the summary judgment order was issued did not address whether the city of Phoenix agreed to the credit arrangement as an exercise of its borrowing power and, therefore, a material issue of fact was not addressed and summary judgment was improper for either party. However, before making this ruling the Ninth Circuit seemed to indicate that the taxpayer would be denied the §103 exclusion. The court noted that this case was factually different from *Stewart I* because no condemnation proceedings were ever instituted. Therefore, according to the court, the city was under no legal obligation to pay interest as it was in *Stewart I*. However, the court noted that in the *Drew* case, the taxpayer sold property to a governmental agency under the threat of condemnation, although condemnation proceedings were never actually begun. Accordingly, because the sale was made under the threat of condemnation and therefore involuntary, the governmental agency did not use its "borrowing power" to obtain credit, rather it agreed to the arrangement solely for the seller's benefit. After indicating that it was going to follow the *Drew* rationale, the court stated, "a sale made under the threat of condemnation is indistinguishable from one in which condemnation proceedings are actually begun."

At this point, it seemed as though the taxpayer had lost. However, as noted above, the Fifth Circuit in *Drew* partly based its holding on the fact that the governmental agency was not in need of funds to purchase the land involved. The Ninth Circuit in *Stewart II* stated that there is no evidence showing whether the installment agreement was made because the taxpayers wanted the tax benefits of installment reporting or because the city of Phoenix wanted credit.[666] Therefore, the Ninth Circuit remanded the case back to the district court to determine whether the arrangement was made because the city of Phoenix needed the credit.

It difficult to reconcile *Stewart I* and *Stewart II*. In *Stewart I*, the Ninth Circuit seems to suggest that any interest received pursuant to a condemnation proceeding would be ineligible for the exclusion provided for in §103. In *Stewart II*, decided a little over one year later by the same court, the Ninth Circuit states for purposes of §103, a sale made under the threat of condemnation is indistinguishable from one in which condemnation proceedings have actually begun. It would seem that under the rationale of *Stewart I*, even though there was no condemnation in *Stewart II*, §103 would not be applicable. However, the court in *Stewart II* remanded the case back to the district court to determine if the city of Phoenix needed the credit. Presumably, if the taxpayer could have shown that the negotiated sale was structured using installment payments because the city of Phoenix needed the credit (even though the court had already held that the sale was indistinguishable from a condemnation), the taxpayer would have prevailed and the interest payments would be excludible pursuant to §103.

The Third Circuit addressed the issue in 2012 in a case that involved two different types of interest payments. In *DeNaples v. Commissioner*,[667] the state of Pennsylvania sought to acquire property in order to build a highway and initiated condemnation proceedings. Three years later, the parties settled. Pursuant to the settlement agreement, the taxpayers would receive $40.9 million, of which $24.6 million was allocated to principal and $16.3 million was allocated to interest ("settlement interest"). The state could not pay the full amount, so the taxpayers agreed to take payment over five installments. Additional interest would be due at the interest rate for tort suits ("installment interest").

[662] *Stewart v. United States*, 739 F.2d 411 (9th Cir. 1984) (*Stewart II*). In *Stewart I*, the taxpayer brought an action in the Tax Court to challenge the IRS's determination. However, in *Stewart II*, the taxpayer challenged the IRS's determination in federal district court.

[663] *Stewart v. United States*, 83-2 USTC ¶9580 (D. Ariz. 1982).

[664] There is some confusion as to whether a condemnation proceeding was instituted in the *Drew* case. The district court stated, "this is not a condemnation case and the court does not so hold." However, the Fifth Circuit seemed to imply that a condemnation suit had been initiated when it stated, "[w]hen [the governmental entity] was unable to reach an agreement with a landowner condemnation proceedings were instituted." However, the Fifth Circuit did not state that the taxpayer in *Drew* was "a" landowner whose property was subject to a condemnation proceeding.

[665] As noted above, part of the Fifth Circuit's rationale in the *Drew* case was that the transaction in *Drew* imposed no burden on the governmental entity as it was not in need of funds to purchase the land involved. However, in the *Holley* case, the Sixth Circuit held that Detroit's financial problems were irrelevant. As will be discussed, on appeal, the Ninth Circuit does place an emphasis on this factor in *Stewart II*.

[666] The district court seemed to put the burden on the government to prove that the city of Phoenix did not need the credit when it stated, "there is no evidence that the City of Phoenix could have paid a condemnation award without credit."

[667] 674 F.3d 172 (3d Cir. 2012).

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As to the "installment interest," the taxpayers received $1.9 million, $3.8 million, $2.2 million and $2.7 million in 2002, 2003, 2004 and 2005, respectively. The taxpayers excluded all installment interest from their gross income pursuant to §103. As to the "settlement interest," the taxpayers received approximately $4.3 million for the tax years 2002 through 2004, and approximately $8.7 million for 2005. The taxpayer excluded from their gross income any interest received above 6%, contending that anything above this rate was exempt as an obligation of the state pursuant to §103.[668]

The IRS claimed that all of the interest was includible in the taxpayers' gross income because the exclusion provided for in §103 was inapplicable. The Tax Court agreed with the IRS.[669] As to the settlement interest, the Tax Court held that the taxpayers had failed to demonstrate that they received interest income above and beyond what was legally required and therefore the settlement interest was not an obligation of the state of Pennsylvania because it did not invoke the state's borrowing power. As to the installment interest, the Tax Court held that none of it was excludible under §103 because the taxpayers were entitled to it as part of their just compensation.[670]

On appeal, the Third Circuit reversed the Tax Court's decision as to the installment interest. However, as to the settlement interest, the Third Circuit held that the taxpayers failed to meet their burden of excludibility under §103 and upheld the Tax Court's decision to refuse to reopen the record to include evidence which may have aided the taxpayers in meeting their burden.

With respect to the installment interest, the court looked to whether Pennsylvania's interest obligation arose by operation of law or by voluntary bargaining. According to the court, Pennsylvania and the taxpayers negotiated a complete arms-length settlement of Pennsylvania's claims, and because the taxpayers agreed to a lower, variable interest rate for the purpose of extending credit to Pennsylvania, the court held that Pennsylvania's obligation arose by voluntary bargaining, not by operation of law. The court noted that while the settlement negotiations between the state and the taxpayers were done in the shadow of an ongoing condemnation proceeding, the parties crafted a settlement and the taxpayers agreed to tax installment payments because the state needed credit.[671] As to the voluntary versus involuntary nature of the transaction, the court stated that while the taxpayers were going to be obligated to sell their property, the taxpayers had a choice over the terms by which to do so.

The court did note that in most condemnation proceedings the state's obligation to pay interest arises by law, and therefore, would be outside the scope of §103. The court then stated:

> [The taxpayers] could have proceeded to judgment and obtained a judicially mandated just compensation award with statutory interest. Instead, they voluntary bargained with the State because the State needed an extension of credit to pay any award.[672]

Finally, the court clarified its holding by stating that "we do not hold that any interest payment made pursuant to a voluntary settlement agreement is automatically excludable under §103. Rather, it is excludable here because, given the nature of how and what the parties agreed to in the settlement agreement, it is clear that the obligation to pay interest … arose not by operation of law but through the voluntary, arms-length negotiations between the DeNaples and Pennsylvania."[673]

As to the settlement interest, the court noted that the taxpayers excluded any delay interest in excess of 6%, reasoning that Pennsylvania was only required to pay 6%, and anything above that was the result of the state's voluntary bargaining. The court did not address the merits of the taxpayers' claim. Instead, the court held that there wasn't sufficient evidence in the record for the Tax Court to calculate the prevailing commercial rate at the time of the settlement agreement. In so doing, the court upheld the Tax Court's refusal to open the record and found that the taxpayers did not meet their burden.

4. Tax Court Cases

As indicated in the discussion above, the Tax Court has consistently interpreted case law to hold that interest awarded in any sort of condemnation proceeding is not excludible under §103, even where the government agency hasn't begun condemnation proceedings.[674] As the *DeNaples* case illustrates, the rationale of the Tax Court is that taxpayers in condemnation proceedings are not eligible for the §103 exclusion because the interest is not an obligation of the governmental entity and taxpayers are entitled to the interest as part of their just compensation.

5. Planning for Condemnation Awards Involving Interest

As the discussion above illustrates, there are planning opportunities that a taxpayer can use in order to attempt to treat the interest component of a condemnation proceeding (whether instituted or settled) as coming under the exclusion provided for in §103(a). First, to the extent possible, a taxpayer should attempt to work out a negotiated settlement with the governmental agency. Some courts have held that a negotiated settlement before, or under a threat of, a condemnation proceeding is indistinguishable from an actual condemnation proceeding, however, working out a negotiated settlement at its earliest point would seem to give the taxpayer the best argument under §103. Second, if possible, the taxpayer should document the

[668] The installment rate that Pennsylvania paid for tax years 2002 through 2006 were 5.75%, 5.25%, 5.00%, 6.25%, and 8.25%. *DeNaples v. Commissioner*, 674 F.3d at 175 n.2.

[669] T.C. Memo 2010-171.

[670] The taxpayers filed a motion for reconsideration in which they sought to introduce evidence of the prevailing commercial rate to show that some of the settlement interest was excludible. The Tax Court denied the taxpayers' motion and reaffirmed its original decision. T.C. Memo 2011-46. The Tax Court also refused to open the record because it would require opening the proceeding, which according to the Tax Court was inappropriate at that stage.

[671] T.C. Memo 2010-171. The court also noted that in *Stewart II*, the Ninth Circuit found that whether a governmental entity needs credit is a material fact that altered the application of §103.

[672] *DeNaples v. Commissioner*, 674 F.3d.

[673] 674 F.3d at 179.

[674] *See Tiefenbrunn v. Commissioner*, 74 T.C. 1566 (1980); *Ferreira v. Commissioner*, 57 T.C. 866 (1972); *Fulks v. Commissioner*, T.C. Memo 1989-190; *Wilson v. Commissioner*, T.C. Memo 1996-418; *DeNaples v. Commissioner*, T.C. Memo 2010-171, rev'd, 674 F.3d 172 (3d Cir. 2012).

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fact that any installment agreement worked out between himself and a government agency is being done at the behest of, and for the benefit of, the government agency. While some courts have held that a government agency's financial predicament is irrelevant, some of the more recent decision have stressed this factor. Finally, a taxpayer in a potential condemnation proceeding should look to engage in a "give-and-take" arrangement with the government agency, whereby the taxpayer might accept a larger or smaller interest rate. Some courts have stressed the "statutory rate" nature of interest in denying the §103 exclusion. Varying the interest rate from the statutory amount and negotiating other terms may convince a court that the negotiated terms are not something that the taxpayer is entitled to under state law.

Editor's Note: With respect to litigation, taxpayers should avoid the Tax Court, if possible. In some of the more recent cases, the Third and the Ninth Circuits have allowed the §103 exclusion.[675] Unless the taxpayer in those circuits can show that his facts are similar to those in *Stewart II* or *DeNaples*, thereby invoking the *Golsen* rule,[676] they also would be wise to avoid the Tax Court. Some district courts have been more taxpayer friendly.[677]

F. Business Interruption Insurance

Taxpayers frequently purchase insurance to protect against interruption of their business. Commonly, such policies are known as "use and occupancy insurance" or "business interruption insurance."[678] The tax treatment of the proceeds from these policies turns on what the payments compensate.[679]

The analysis begins with Reg. §1.1033(a)-2(c)(8), which provides that the proceeds of a policy insuring against lost profits are not proceeds from an involuntary conversion. Instead, the proceeds are ordinary income, just as the profits they replace would be.[680] On the other hand, if the policy insures against the loss of the right to use property, then the weight of authority is that §1033 applies.[681] In *Shakertown Corp. v. Commissioner*,[682] the Sixth Circuit held that insurance proceeds determined on a per diem basis, but subject to a limitation whenever the insured's net profits fell below a certain level, nevertheless were proceeds from a policy compensating use loss. Thus, §1033 applied to allow deferral of the resulting gain.[683] Rev. Rul. 73-477[684] endorsed the general proposition that the gain produced by the proceeds of an insurance policy compensating use loss could be deferred under §1033, but indicated the IRS's view that a profit limitation of the sort litigated in *Shakertown Corp.* transformed a use loss policy into a profit loss policy. However, in Rev. Rul. 74-444, the IRS ruled that the proceeds of a valued use and occupancy insurance policy were not entitled to §1231 capital gain treatment. In reaching this result, the IRS relied on the holding of *Commissioner v. Gillette Motor Transport, Inc.*,[685] that the right to use property is itself not a capital or §1231 asset. It remains to be seen whether the IRS will extend Rev. Rul. 74-444 to deny §1033 treatment to such use loss policies. One indication that the IRS may still allow §1033 deferral for gain realized from use loss policies is TAM 8315007. In TAM 8315007, the National Office advised that gain produced through a use loss policy could be deferred under §1033 notwithstanding Rev. Rul. 74-444. Rev. Rul. 73-477 was cited as authority for this result. According to the TAM, §1033 applies to involuntary conversions "without limitation," whereas §1231 applies only to conversions of certain business and investment property. The TAM did not discuss Rev. Rul. 38,[686] which ruled that compensation for a temporary loss of the right to use property was not within §1033. See the discussion in II.B.4., above.

If the foregoing were not confusing enough, in GCM 35193,[687] the IRS indicated its belief that there is a substantial litigation risk in dual purpose costs because of *Shakertown*.

Assuming that the current IRS view is consistent with Rev. Rul. 73-477 and that gain from use loss policies may be deferred under §1033, correct tax treatment turns on whether a policy compensates use loss or profit loss. In *Marshall Foods, Inc. v. United States*,[688] the court relied on the following factors to conclude that the policies were designed to compensate for profit loss:

> (1) In addition to the business interruption insurance policies, additional insurance contracts compensated losses sustained from direct damage to physical properties in the taxpayer's plants.
>
> (2) Suspension of business, not destruction of the asset, was the event that triggered payment.

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[675] *See Stewart v. United States*, 739 F.2d 411 (9th Cir. 1984) (*Stewart II*) and *DeNaples v. Commissioner*, 674 F.3d 172 (3d Cir. 2012).

[676] Under the *Golsen* rule, the Tax Court follows a court of appeals decision squarely on point where an appeal from the Tax Court decision lies to that particular court of appeals. *See Golsen v. Commissioner*, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).

[677] *See, e.g., Stewart v. United States*, 83-2 USTC ¶9580 (D. Ariz. 1982).

[678] The issue is also presented by third party liability insurance payments. *See* TAM 200322017.

[679] A similar issue is present with regard to statutory indemnity payments. So long as the payments compensate for property and equipment lost, the payments are within §1033. Rev. Rul. 2005-46; IRS Info. Ltr. 2002-0074.

[680] *See Maryland Shipbldg. & Drydock Co. v. United States*, 409 F.2d 1363 (Ct. Cl. 1969); *Miller Hocking Glass Co. v. Commissioner*, 80 F.2d 436 (6th Cir. 1935); *Mellinger v. United States*, 54-1 USTC ¶9197 (S.D. Tex. 1953); *Oppenheim's, Inc. v. Kavanagh*, 90 F. Supp. 107 (E.D. Mich. 1950); *Int'l Boiler Works Co. v. Commissioner*, 3 B.T.A. 283 (1926), acq., V-2 C.B. 2 (1926). *Cf.* Rev. Rul. 75-381 (portion of indemnification payments upon honeybee loss is taxable as loss of income and not eligible for §1033 deferral). Any policy compensating lost profits produces income in the year of receipt or accrual and may not be spread over the period to which the loss of profits relates. *See Cappel House Furnishing Co. v. Commissioner*, 244 F.2d 525 (6th Cir. 1957). *See also* TAM 200322017 (third-party commercial general liability policy payments received pursuant to claims made by taxpayer for environmental cleanup costs at its operating sites were amounts received as compensation for third-party liabilities, not for involuntary conversion of taxpayer's property).

[681] *See Flaxlinum Insulating Co. v. Commissioner*, 5 B.T.A. 676 (1926), nonacq., X-1 C.B. 79, nonacq. withdrawn and acq. substituted, 1942-2 C.B. 6; *Piedmont-Mt. Airy Guano Co. v. Commissioner*, 3 B.T.A. 1009 (1926), acq., 1942-2 C.B. 15.

[682] 277 F.2d 625 (6th Cir. 1960).

[683] *See also Williams Furniture Corp. v. Commissioner*, 45 B.T.A. 928 (1941), acq., 1942-1 C.B. 17.

[684] *See also* GCM 35266, 1973 IRS GCM Lexis 286 (explaining rationale behind Rev. Rul. 73-477).

[685] 364 U.S. 130 (1960). The *Gillette* decision is discussed in II.B.4., above. *Cf.* PLR 9248025.

[686] 1953-1 C.B. 16.

[687] 1973 IRS GCM Lexis 345.

[688] 393 F. Supp. 1097 (D. Minn. 1974), aff'd per curiam, 75-2 USTC ¶9536 (8th Cir. 1975), cert. denied, 423 U.S. 928 (1975).

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(3) The policy was extended to cover another plant that supplied material to the taxpayer's plant, which could only mean coverage for a loss of the plant's earnings from failure to have a market for its production.

(4) The insurance was written on underwriting information based totally on gross earnings.

(5) On the business interruption worksheet requested by the insurer, the actual loss sustained figures were to be equated with the loss of net profits.

The foregoing factors should be contrasted with those relied on by the National Office in TAM 8315007 in reaching its conclusion that the policy there in question compensated for lost use. First, the amount payable under that policy roughly approximated replacement cost. Second, the per diem rate was fixed in advance and contained no limitation based on profitability. Third, a related policy expressly covered lost profits and there was no indication this related coverage did not approximate the profit loss.

In Rev. Rul. 86-12, the IRS indicated that the written terms of a use and occupancy contract are not the sole basis to determine whether insurance proceeds from the contract qualify as proceeds of an involuntary conversion under §1033. Instead, the IRS examines the underwriting and actuarial criteria and other information used in writing the insurance policy to determine whether the insurance proceeds are designed to reimburse for a loss of profits. In Rev. Rul. 86-12, the written terms of a business interruption insurance policy provided for protection from and reimbursement for loss of the use and occupancy of the taxpayer's building and machinery resulting from fire or other casualty. The contract provided for a fixed payment of 200x dollars per day, but did not specify how the amount of coverage or the premium was computed. In fact, the premium and coverage were arrived at by application of underwriting and actuarial criteria and were based exclusively on the profits and fixed charges experience of the taxpayer. Thus, the insurance proceeds received by the taxpayer did not qualify for nonrecognition treatment as proceeds of an involuntary conversion, but instead were treated as ordinary income.

Comment: From the foregoing, it would appear that the conservative advice in structuring insurance protection is to have the taxpayer purchase loss value coverage to the extent value loss would result. To the extent remaining potential losses are to be insured, the policy should compensate on a flat per diem basis, perhaps as adjusted for inflation. Neither type of policy should make reference to, or be limited by, historic profits. Even on this basis, of course, Rev. Rul. 86-12 is an indication the IRS may challenge such flat per diem amounts to the extent those amounts arguably compensate for loss of profit.

An alternative is to refer to rental cost of replacement property. In any event, any claim should avoid references to "lost profits."

G. Reimbursements for Relocation Costs, Living Expenses, and Other Payments

When persons are displaced on the conversion of property, compensation may be paid apart from the property's market value. Whether such payments are taxable, and if taxable, eligible for §1033 deferral, depends on several factors.

1. Temporary Living Expenses

Temporary living expenses do not give rise to a deduction because they are personal expenses within the meaning of §262 and no deduction is allowed for personal, living, or family expenses.[689] However, under §123, insurance proceeds that reimburse a taxpayer for temporary living expenses following a casualty to the taxpayer's principal residence are includible in income only to the extent excess reimbursement occurs. That is, amounts received under an insurance contract are excludible from income only to the extent the amounts received do not exceed the amount by which the actual temporary living expenses incurred exceed the taxpayer's normal living expenses that would have been incurred during the period. Thus, to this extent, §1033 is irrelevant. If the conversion is a condemnation rather than a casualty, the reimbursement would be includible in income unless it is otherwise made exempt or is a part of just compensation for the property under state law. *See* X.G.2. and X.G.3., below.

When a lawsuit is resolved through a settlement, the tax consequences will usually turn on exactly what is being settled. Where the settlement document is unhelpful or ambiguous, the courts look to the circumstances surrounding the settlement to determine the tax consequences.

For an example of how to compute the amount of insurance proceeds includible in income and the timing of that inclusion, see Rev. Rul. 93-43.

2. Certain Federal Acquisitions

Under the provisions of the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970,[690] certain types of compensation[691] may be paid to persons required to vacate business or farm real property if such property is acquired pursuant to a federal or federally funded program. Payments under the act are exempt from federal taxation by virtue of 42 U.S.C. §4636. In *Nielson v. Commissioner*,[692] the Tax Court held that a condemnation award needs to be treated separately from payments under the Relocation Act. The court reasoned that only payments expressly authorized by the Relocation Act and in excess of the just compensation paid for taken property are exempt from taxation under the Relocation Act. *Strogoff v. United States*[693] interprets the statutory exclusion to apply only to those payments actually made by a federal agency; it does not apply to sales to private parties even though the proceeds from such sales may operate to reduce the federal agency payments and hence the excludible payments. To the extent funds are exempt under the act, application of

[689] *See* Rev. Rul. 59-398.

[690] Pub. L. No. 91-646 (1970), *codified at* 42 U.S.C. §4601–§4655 (1990). Certain states also have their own relocation statutes, and these should be reviewed as well for the tax impact of payments thereunder.

[691] *See* PLR 201617002. Payments received for relocation (including land purchase and to construct improvements) and equipment replacement and installation, as well as relocation-related costs (professional and service fees related to the relocation) from a state agency under Title II of the Uniform Relocation Assistance and Real Property Acquisitions Policies Act, Pub. L. No. 91-646 (as amended by the Uniform Relocation Act Amendments of 1987, Title IV of Pub. L. No. 100-17) ("Relocation Act"), 42 U.S.C. §4601–§4665 are not includible in gross income under § 61.

[692] 114 T.C. 159 (2000).

[693] 86-2 USTC ¶9616 (Cl. Ct. 1986).

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§1033 need not be considered. However, no deduction may be claimed for amounts reimbursable under the act.[694]

3. *Moving Expenses Reimbursement and Other Payments*

Occasionally, taxpayers receive other forms of compensation when their property is converted. In determining the proper tax treatment of these other forms of compensation, the threshold question is whether these other forms of compensation are a part of the compensation for the value of the underlying property. If so, §1033 deferral will typically be available; if not, the amounts are fully includible in income under §61, absent express exclusion or deferral.[695]

In *Estate of Resler v. Commissioner*,[696] the Tax Court concluded that the course of negotiations and court documents precluded a characterization of part of the condemnation award as rent. Accordingly, the entire proceeds were eligible for §1033 treatment. Similarly, in *Kendall v. Commissioner*,[697] the Tax Court rejected the IRS's argument that part of the award compensated for lost profit and found instead that the award was partially for moving expenses, which under the applicable law were compensation for the value of the property and thus were §1033 payments.[698] And, in *Sturgill Motor Co. v. Commissioner*,[699] a certain payment was held to represent compensation for property taken rather than a payment made simply to avoid litigation.[700] If the other compensation is paid in one year and reimbursement occurs in another, the IRS has asserted that the reimbursement is not part of the property's compensation and must therefore be included as ordinary income.[701]

Where a lump-sum award is found to compensate for something other than the converted property, ordinary income may be generated. In *Graphic Press v. Commissioner*,[702] the Tax Court accepted the IRS's argument that part of the lump-sum condemnation award was consideration for a waiver of the taxpayer's state law right to compel the state to purchase certain machinery that the state did not want. The condemnation award to this extent was held not eligible for §1033 deferral. On appeal, however, the Ninth Circuit reversed.[703] Such an allocation would be proper, according to the Ninth Circuit, only if the condemnation award so provided. Since the award did not so provide, the Tax Court allocation was in error and §1033 deferral was available. In *South Bay Corp. v. Commissioner*,[704] the Second Circuit held that, because part of the award compensated previously paid real estate taxes, that portion of the award was includible in income in the year of receipt and could not be deferred.

As indicated above, moving expenses may be reimbursed as a part of the condemnation proceeding. If the moving expenses are a part of the compensation of the property under state law, they normally can be deferred under §1033.

In *E.R. Hitchcock Co. v. United States*,[705] the Second Circuit found Connecticut state law to require that reimbursement for moving expenses be considered as an element of the taken property's fair market value. Accordingly, the reimbursement was eligible for §1033 deferral, whether or not the moving expenses were separately stated. Importantly, the Second Circuit indicated the total award was received "economically and substantively" because of the conversion and thus the entire award was within the purview of §1033.

In *Graphic Press*,[706] the Ninth Circuit relied on *Hitchcock* to reject the IRS's argument that nondeferrable moving expenses were present. The Ninth Circuit instead concluded that the entire award was deferrable under California law as compensation for the taken property.

In *Buffalo Wire Works Co. Inc. v. Commissioner*,[707] the Tax Court was again presented with the issue of §1033 deferral of moving expenses. The Tax Court concluded that because its decision would be appealable to the Second Circuit, the *Golsen* rule[708] required the Tax Court to follow the *Hitchcock* decision and hold for the taxpayer, thus allowing §1033 deferral of the reimbursed moving expenses. In light of the IRS's nonacquiescence in *Buffalo Wire*,[709] taxpayers should anticipate continued opposition from the IRS when §1033 deferral of moving expenses is sought. It is uncertain whether the Tax Court will adhere to its *Graphic Press* decision in cases not appealable to the Second or Ninth Circuits. This issue, therefore, remains unsettled.

If the moving expense reimbursement is not a part of the compensation for the value of the property taken it will normally be includible in gross income under §61, unless the reimbursement is excludible under the federal Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, as amended. If so, the exclusion of the reimbursement amount will not give rise to a deduction. *See* X.G.2., above. If the federal Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, as amended, does not apply, and the amount is included in income, the question becomes whether a deduction may be claimed relative to the reimbursement (be-

[694] *See also Wolfers v. Commissioner*, 69 T.C. 975 (1978) (interaction with §362(c)); Rev. Rul. 78-388 (accrual taxpayer's moving expenses not deductible to extent reimbursable under Relocation Act); PLR 8949057 (citing *Wolfers*, IRS noted that relocation expenses reimbursed under Act are excludible by the recipient and therefore do not produce a deduction under §162 and cannot become part of taxpayer's basis in assets purchased with payments); PLR 201617002 (same).

[695] *See Smith v. Commissioner*, 59 T.C. 107 (1972). *See also Vaira v. Commissioner*, 444 F.2d 770 (3d Cir. 1971).

[696] 17 T.C. 1085 (1952), acq., 1952-1 C.B. 3.

[697] 31 T.C. 549 (1958), acq., 1959-1 C.B. 4.

[698] *See also* PLR 200445004.

[699] 32 T.C.M. 1336 (1973).

[700] *See also Nat'l Publ'g Co. v. Commissioner*, 24 T.C.M. 1470 (1965) (award did not compensate moving expenses).

[701] As an alternative theory, the IRS has argued that the tax benefit rule requires the reimbursement to be included in income. See the discussion of *Buffalo Wire Works Co. v. Commissioner* in X.H., below.

[702] 60 T.C. 674 (1973), rev'd, 523 F.2d 585 (9th Cir. 1975).

[703] 523 F.2d 585 (9th Cir. 1975).

[704] 345 F.2d 698 (2d Cir. 1965).

[705] 514 F.2d 484 (2d Cir. 1975), aff'g 382 F. Supp. 236 (D. Conn. 1974).

[706] 523 F.2d 585 (9th Cir. 1975). *See also* PLR 200445004 (taxpayer may elect to defer gain under §1033 on payments for equipment moving costs, land, and rights-of-way, provided taxpayer neither deducts nor capitalizes any such relocation costs and that taxpayer uses payments to invest in other property similar or related in service or use to property converted and to relocate affected property or equipment).

[707] 74 T.C. 925 (1980), nonacq., 1982-1 C.B. 1, aff'd in unpub. opin. (2d Cir. 1981).

[708] Under *Golsen v. Commissioner*, 54 T.C. 742 (1970), the Tax Court follows controlling precedent in the circuit to which the Tax Court decision would be appealable, even though the Tax Court may have its own contrary precedent on the issue.

[709] 74 T.C. 925 (1980), nonacq., 1982-1 C.B. 1.

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cause the taxpayer will have presumably expended amounts to which the reimbursement relates).

In the context of a business move, the relevant provision is §162. For the accrual taxpayer, the IRS may also assert that a future potential reimbursement precludes accrual of the moving expense deduction (but presumably, the deduction under §162 is permitted once the amounts are expended and the reimbursement is received).[710] As an alternative theory, if the deduction is permitted prior to the reimbursement, the IRS has argued that the tax benefit rule requires the reimbursement to be included in income. See the discussion of *Buffalo Wire Works Co. v. Commissioner* in X.H., below.

4. Statutory Indemnity Payment

Various state and federal statutes authorize payments to taxpayers who suffer certain types of calamities. Section 139 excludes from income any "qualified disaster relief payment." This can include statutory indemnity payments, if paid in conjunction with a "qualified disaster." "[Q]ualified disasters" include those resulting from (1) terrorist or military action; (2) a federally declared disaster; (3) those of a "catastrophic nature" as determined by IRS; or (4) a situation that has been found by an applicable agency to trigger statutory indemnity payments. To the extent a statutory payment would not be within §139, a tax treatment will be determined under the rules discussed for business interruption insurance, at X.F., above. That is, a payment for lost *property* is a §1033 payment, while a payment for lost *profits* is generally ordinary income.

H. Tax Benefit Rule

Another limitation on §1033 is the tax benefit rule. Under the tax benefit rule, a taxpayer who recovers an amount he or she has deducted in a prior year must report the recovery as income when recovered except to the extent the previous deduction did not reduce the amount of income subject to tax. Before the revision of §111 by the 1984 act, this formulation of the rule found its greatest support in the case law rather than the statutory provisions of §111.

The revisions made by the 1984 act were designed primarily to conform §111 with existing case law and did not substantively change the tax benefit rule as it related to involuntary conversions. The 1986 TRA further revised §111 to require a taxpayer to include a tax benefit item in income only if the taxpayer's tax was reduced in the prior taxable year by reason of the tax benefit item. This amendment, however, also did not effect a substantive change in the tax benefit rule as it relates to involuntary conversions.

In Rev. Rul. 74-206,[711] the IRS took the position that the tax benefit rule overrides §1033 where a §165(c)(3) deduction on account of a flood loss to a residence was properly claimed in one year, and the property was condemned thereafter because of the flood at the entire pre-loss value. Rev. Rul. 74-206 has been extended to §1231 property by Rev. Rul. 80-65. On facts similar to those of Rev. Rul. 74-206, the court in *Mager v. United States*,[712] concluded that the tax benefit rule did indeed override the deferral rules of §1033.[713]

However, the Tax Court reached a contrary conclusion in *Buffalo Wire Works Co., Inc. v. Commissioner*,[714] where the taxpayer deducted moving expenses incident to a condemnation. As an alternative theory, the IRS asserted that to the extent the eventual compensation reimbursed the moving costs, the tax benefit rule overrode §1033. Although the Tax Court rejected application of the tax benefit rule and allowed §1033 treatment in *Buffalo Wire*, it was compelled to do so under its *Golsen* rule.[715] Thus, it is uncertain whether the Tax Court would otherwise have applied the tax benefit rule. *Buffalo Wire* was later affirmed in an unreported decision by the Second Circuit. The IRS's nonacquiescence in *Buffalo Wire*[716] indicates that the IRS will continue to contest the tax benefit issue, at least with regard to the reimbursement of moving expenses.

Leaving aside *Buffalo Wire*, it is questionable whether the tax benefit rule should operate where the later recovery does not arise from the same transaction as the earlier deduction. *Hillsboro Nat'l Bank v. Commissioner*[717] requires the later recovery to be "fundamentally inconsistent" with the earlier deduction before the tax benefit rule applies. For example, in *Byrd v. Commissioner*,[718] the court held that the value of plant inventory which had previously been expensed by an S corporation owning a nursery and later distributed in liquidation to the buyer of the corporation's stock was includible in the former shareholders' income under the tax benefit rule. The court concluded, in applying the *Hillsboro* test, that the distribution of the plants in liquidation was fundamentally inconsistent with the purpose behind the §162 deduction. Similarly, the regulations dealing with losses[719] require inclusion when the later payment is a "reimbursement" of the earlier loss. These standards suggest that there must be a relationship between the transaction producing the deduction and the transaction producing the recovery. Thus, if a later involuntary conversion (e.g., a condemnation to build a highway) has no relation to a basis-reducing deduction claimed in a prior year, the conversion proceeds should all be eligible for §1033 deferral. In Rev. Rul. 72-528, insurance proceeds reimbursing pilot model costs that were previously expensed were tax benefit items. However, in Rev. Rul. 85-186, the IRS reconsidered Rev. Rul. 72-528 under the "fundamentally inconsistent" rationale of *Hillsboro Nat'l Bank* and revoked the ruling. Rev. Rul. 85-186 concluded that a subsequent disposition of property with respect to which amounts had been expensed under §174 had independent sig-

[710] *See Baloian Co., Inc. v. Commissioner*, 68 T.C. 620 (1977), nonacq. on other issues, 1978-2 C.B. 3; Rev. Rul. 78-388. *But see Elec. Tachometer Corp. v. Commissioner*, 37 T.C. 158 (1961), acq., 1962-2 C.B. 4 (where amount of reimbursement was sufficiently uncertain to allow deduction's accrual); *Best Universal Lock Co., Inc. v. Commissioner*, 45 T.C. 1 (1965), acq., 1966-2 C.B. 4 (same).

[711] *See also* CCA 200016019 (Chief Counsel advised that under tax benefit rule, recipients of state grants intended to help state residents repair flood-damaged homes had to include in their gross incomes, in year they received grant money, amount of any deduction previously taken on account of flood losses for which grants compensated).

[712] 499 F. Supp. 37 (M.D. Pa. 1980), aff'd in unpub. opin. 636 F.2d 1209 (3d Cir. 1980).

[713] *Accord Birnbaum v. Commissioner*, 37 T.C.M. 1775 (1978).

[714] 74 T.C. 925 (1980), nonacq., 1982-1 C.B. 1, aff'd. (2d Cir. 1981).

[715] *See Golsen v. Commissioner*, 54 T.C. 742 (1970).

[716] 74 T.C. 925 (1980), nonacq., 1982-1 C.B. 1.

[717] 460 U.S. 370 (1983).

[718] 87 T.C. 830 (1986).

[719] Reg. §1.165-1(d)(2)(iii).

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nificance and was not fundamentally inconsistent with the prior §174 deductions.

I. Other Impacts of §1033

Section 1033 has occasionally been cross-referenced by Congress in other provisions of the Code. For example, §453(e)(6) provides an exception to the acceleration rules applicable when there is a disposition of installment notes between related persons. The §453(e)(6) exception applies (and the acceleration rules do not) if the note's disposition to the related party occurs following "[a] compulsory or involuntary conversion (within the meaning of Section 1033). …"[720]

Similarly, legislative proposals have surfaced from time to time to substitute restrictive "similar in service or use" standard for replacement property for the more liberal "like kind" standard of §1031. Other examples of cross-referencing include §121 (discussed in VIII.F., above) and former §44.

Also, qualification of an event as an involuntary conversion may have other federal law impacts beyond the tax field.[721]

J. Lawsuit Settlements

Settlements often produce tax characterization problems, especially where the settlement documents are not clear on what the parties intend the tax treatment to be.

PLR 199952082 identifies the four factors used by the IRS to allocate lump sum condemnation awards: (1) allegations in the complaint; (2) defenses asserted; (3) litigation background; and (4) other factors. *Nielsen v. Commissioner*[722] concerned characterization of a lump sum condemnation award. In *Nielsen*, an initial amount was paid for the property loss; thereafter, additional amounts were paid. Although the taxpayer tried to characterize the subsequent amounts also as a §1033 payment, the court concluded otherwise because of the extrinsic evidence surrounding the second payment, including the tenor of the parties' negotiations.

Allen v. Commissioner[723] illustrates the characterization problem as to settlement payments arising from a casualty that constituted a §1033 event. In *Allen*, it was undisputed that the taxpayer had suffered a §1033 event when their home was damaged by subsidence ultimately attributable to activities on their neighbor's lands. Since the Allens had to bring a "bad faith" lawsuit seeking, inter alia, punitive damages against their own insurance carrier (Allstate) to obtain full payment of their damages, the IRS argued that a portion of the resulting settlement could not be deferred under §1033. Stated differently, the IRS argued in *Allen* that the payments from Allstate were not for the actual property damage the Allens had suffered, but rather were for a breach of the *insurance* relationship. The Tax Court found it important that the settlement payments did not exceed the costs of repair, and that the bad faith/punitive damage allegations were not a predominant part of the settlement negotiations, and it concluded that the settlement payments were within §1033.

Comment: The Allens would have been well advised to have included language in the settlement agreement that the payments were attributable to the property loss claim, and/or to have included language to the effect that little or none of the payment was for the punitive damage/bad faith claims.

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[720] *See Tecumseh Corrugated Box Co. v. Commissioner*, 932 F.2d 526 (6th Cir. 1991) for an example of how §453(e)(6) and §1033 interrelate.

[721] *See, e.g.*, 42 U.S.C. §411 and 20 C.F.R. §404.1084 (definitions relative to Social Security Act); §1402(a)(3)(C) (gain from certain involuntary conversions excluded from "net earnings from self-employment").

[722] 114 T.C. 159 (2000).

[723] T.C. Memo 1998-406.

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XI. Conversions of §1245

A. General Rules of §1245 Recapture

By its terms, §1245 overrides all other income tax provisions of the Code, including §1033, except as set out in §1245 itself. Taxpayers contemplating gain deferral from conversions of §1245 property must review §1245 to ensure that deferral is achieved. The general rule imposed by §1245(a) is that ordinary income is to be recognized upon the disposition of §1245 property. Section 1245 property is generally tangible personal property disposed of after 1962 and subject to the allowance for depreciation.[724] The amount of recaptured ordinary income under §1245 is generally the extent to which the lesser of (1) the amount realized, or (2) the recomputed basis, exceeds the adjusted basis of the property. The recomputed basis for §1245 property is the adjusted basis of the property plus all deductions allowed or allowable to the taxpayer for depreciation or amortization. As a practical matter, the recapture on §1245 property is the lesser of the gain realized or the depreciation deductions previously taken.

B. Section 1245 and Involuntary Conversions: §1245(b)(4)

Under an exception to the §1245(a) rules that deals with like-kind exchanges and involuntary conversions, the gain recognized under §1245(a) shall not exceed the sum of the gain recognized (determined without regard to §1245), plus the fair market value of property acquired which is not §1245 property but which qualifies for gain deferral under the §1033 rules.[725] The essence of these rules is that §1245 will not require any recognition if the requirements of §1033 are met and if the conversion proceeds attributable to §1245 property are reinvested entirely in §1245 property. Moreover, in the event both §1245 property and §1250 property are converted and §1250 property is acquired in replacement, the allocation rules of Reg. §1.1250-3(d)(6) apply.[726]

Example: Elaine owns certain machinery that is destroyed by fire. Her adjusted basis in the machinery (which has been owned since 20Y6) is $88,000; the recomputed basis is $212,000. In 20X8, she receives insurance proceeds of $150,000. Under the normal §1245(a) rules, Elaine would have to recognize $62,000 ordinary gain, which is the lesser of the gain ($62,000) or post-1961 depreciation ($124,000). If Elaine properly elects §1033, her reinvestment of $175,000 in either replacement machinery or in controlling stock of a corporation owning replacement machinery will allow deferral under §1033. If Elaine purchases the replacement machinery directly, recapture under §1245(b)(4) is $0 ($0 gain recognized under §1033 plus $0 reinvestment in non-§1245 property). If she purchases the stock, all her §1245(a) gain of $62,000 will be recognized to the extent of gain recognized under §1033 ($0) plus reinvestment in non-§1245 property ($175,000) (i.e., the entire $62,000 will be recognized).

As the foregoing example illustrates, §1245 recapture has a pronounced effect on reinvestment practice. Even if the case law under §1033 would not require precise replacement of each class of property, §1245 does.[727] Thus, a de facto allocation occurs on conversions of multiple properties if the taxpayer wishes to minimize or eliminate §1245 recapture.

C. Basis and §1245 Taint in Replacement

The basis of replacement property in a §1033 involuntary conversion is to be determined under the §1033(c) rules.[728] Thus, the basis is the cost of the replacement property, less any deferred gain. To the extent gain is recognized under §1245, this gain is treated as recognized gain and thus does not reduce the cost basis of the replacement property.

Unrecognized §1245 gain is transferred to the replacement property.[729] Immediately after the replacement, the potential §1245 recapture is equal to the post-1961 depreciation in the property disposed of less the gain recognized under §1245 upon the involuntary conversion.

Example: Sally's machinery (in which she has an adjusted basis of $30,000 and post-1961 depreciation of $14,000) is destroyed through vandalism. Insurance proceeds of $40,000 are received. Sally invests all $40,000 in a corporation owning similar use property. Section 1245(a) would require her to recognize $10,000 ordinary income (lesser of $14,000 depreciation or $10,000 gain); §1245(b)(4) requires her to recognize this $10,000 to the extent of gain recognized under §1033 ($0) plus reinvestment in non-§1245 property ($40,000), or all $10,000. Sally's basis in the stock is her cost, $40,000, less the deferred gain, $0, or $40,000. The §1245 taint in the replacement property is $14,000 (post-1961 depreciation of old property) less gain recognized, $10,000, or $4,000.

[724] §1245(a).

[725] §1245(b)(4). For an example of §1245 recapture in the §1033 context, see *Santucci v. Commissioner*, 32 T.C.M. 840 (1973). The limitation of recognized gain rule is similar to that employed by the regulations under §1254 (disposition of geothermal properties) and by §1351 (treatment of recoveries of foreign expropriation losses).

[726] Reg. §1.1245-4(d)(7).

[727] Reg. §1.1245-1(a)(5). Compare the discussion in VIII.A., above.

[728] Reg. §1.1245-5(a).

[729] Reg. §1.1245-2(c)(4).

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Example: Assume the same facts as in the previous example, except that Sally invests $39,000 in machinery and only $1,000 in stock. The §1245(a) computation produces the same $10,000 of §1245(a) ordinary income (lesser of $14,000 depreciation, or $10,000 gain). The §1245(b)(4) computation limits recognition of this $10,000 to the sum of gain under §1033 ($0) plus reinvestment in non-§1245 property ($1,000), or $1,000. Thus, $1,000 of the potential §1245 gain is recaptured. To the extent the purchase of controlling stock in a corporation causes §1245 gain to be recognized, the basis of the stock is equal to its cost.[730] The basis of the replacement machine is its cost, $39,000, less the deferred gain, $9,000 ($10,000 realized gain less $1,000 recognized gain), or $30,000. Reflected in this adjusted basis is potential depreciation of $13,000 ($14,000 post-1961 depreciation less $1,000 recapture).

[730] Reg. §1.1245-5(a)(2).

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XII. Section 1033 and the Rehabilitation Credit

With the repeal of the regular 10% investment tax credit by the 1986 TRA,[731] the investment credit rules, which are now contained in §46 through §50,[732] are of substantially diminished significance. The only type of investment credit that may continue to be of benefit to a broad variety of taxpayers is the rehabilitation credit.[733] The rehabilitation credit may be available for buildings which are certified historic structures (provided the rehabilitation is certified by the Department of Interior).[734]

If a taxpayer elects to defer gain under §1033 attributable to the receipt of insurance or condemnation proceeds and the replacement property is substantially rehabilitated property otherwise qualifying for the rehabilitation credit, the taxpayer's rehabilitation credit will be reduced to account for the basis reduction occurring as a result of the §1033 election. For example, in PLR 9145019, following extensive fire damage to the taxpayer's historic buildings, the taxpayer substantially rehabilitated the buildings in a rehabilitation certified by the Interior Department. The rehabilitation costs were substantial; a portion of the costs were funded by insurance proceeds received by the taxpayer as a result of the fire damage. The taxpayer elected to defer the gain attributable to the receipt of the proceeds under §1033. The IRS ruled that the rehabilitation costs qualified for the rehabilitation credit but that the qualifying basis for credit computational purposes must be reduced by the gain not recognized under §1033(a)(2).

If the property qualifying for the rehabilitation credit is involuntarily converted before the expiration of the five-year credit period set forth in §50(a), a portion of the credit will be recaptured even though the taxpayer elects to defer any resulting gain from the conversion under §1033.[735]

For a more complete discussion of the rehabilitation credit, see 586 T.M., *Rehabilitation Tax Credit.*

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[731] *See* pre-1990 RRA §49(a).

[732] The so-called "deadwood provisions" of the 1990 RRA deleted all rules pertaining to the repealed 10% regular investment credit and renumbered the remaining investment credit rules.

[733] §47. The other components of the post-1990 RRA investment credit are the energy credit, the qualifying advanced coal project credit, the qualifying gasification project credit, and the qualifying advanced energy project credit. The investment credit is discussed in 583 T.M., *Cost Segregation and the Former Investment Tax Credit.*

[734] §47.

[735] *See Webber v. Commissioner*, 47 T.C.M. 32 (1983), aff'd *on other grounds*, 790 F.2d 1463 (9th Cir. 1986); *Fortin v. Commissioner*, 57 T.C.M. 1017 (1989). Although these cases interpret the recapture rules applicable to the now-repealed 10% regular investment credit, their rationale should apply equally to the rehabilitation credit.

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