Which Property Qualifies for Involuntary Conversion Tax Relief?

by Robert W. Wood

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In this article, Wood explains how section 1033 offers big benefits in many destruction and conversion contexts, and he examines the reach of the term "property" under section 1033.

If your property is condemned for a freeway, school, park, or some other public use, it is treated as a sale for tax purposes. You may have been *compelled* to sell, but it is still taxable. That usually means taxes on the difference between your basis and the sale price. However, if you qualify, section 1033 offers a way out, allowing you to plow your sale proceeds back into other property and not pay current taxes on the sale.

Other events are covered, too, such as sales under threat of condemnation, destruction by fire, etc. Section 1033 applies to property that is involuntarily converted from complete or partial destruction, theft, seizure, or requisition or condemnation. The condemnation need not actually occur, but there must at least be a threat or imminence of it when you sell. If you purchase other property that is "similar or related in service or use," you can elect to recognize gain only if the amount you receive exceeds the cost of the replacement property.[1]

In other words, if you reinvest all but $1,000, you should have to pay current tax on only the $1,000. Section 1033 is pretty flexible, so your purchase might look quite different from what you gave up. For example, if you hold a deed to an apartment building that is converted, you could buy stock in a corporation that owns another apartment building. Section 1033 is explicit that you can qualify by purchasing a controlling stock interest in a corporation that owns the qualifying replacement property.[2]

Timing Matters

Timing is important. In general, you must purchase qualifying replacement property during the period that begins at the *earlier* of the date of disposition of the property or the threat of its condemnation and ends two years after the close of the year in which you realize gain from the conversion.[3] For the involuntary conversion of real property held for investment or for use in a trade or business, the replacement period is extended for an additional year.[4]

Section 1033 only delays taxes; it does not avoid them. The gain will eventually be taxed when the replacement property is sold. Your basis in the replacement property is calculated by subtracting the amount of gain that was deferred on the condemned property.[5]

[1] Section 1033(a)(2)(A).

[2] *Id.*

[3] Section 1033(a)(2)(B).

[4] Section 1033(g)(4).

[5] Section 1033(b)(2).

Limits on Property

Section 1033 is available only for compensation for property. Thus, if any portion of an award or settlement is attributable to a claim other than the condemned property, the tax deferral is not available for that part. The amount of the required reinvestment can also vary significantly depending on how a lump sum award is allocated. These rules can be confusing and dangerous.

Indeed, at the time the taxpayer is fighting or negotiating the condemnation action by the government, the taxpayer is simply trying to maximize the amount the government will pay. Especially when the condemnation is difficult and there have been major expenses, inconvenience, and ancillary consequences of the condemnation, why wouldn't the taxpayer list as many items as possible, seeking to recover for them all? It can be easy to put off thinking about the tax and allocation issues until later.

However, the taxpayer may end up several years later trying to sort out what portion of a negotiated (or litigated) payment from the government is really for the property and what portion is for something else. The taxpayer's documents, correspondence, pleadings, and discovery may suggest that some large-dollar items were really not for the value of the property.

Rent and Lost Profits

Rent is taxable. For example, in Rev. Rul. 57-261, 1957-1 C.B. 262, the IRS ruled that compensation the taxpayer received for the use of property under a lease in conjunction with the involuntary conversion did not constitute a part of the condemnation proceeds. That was taxable rent.

In other cases, the issue is not as clear. In comparison to cases involving interest, the IRS has generally been less successful in reallocating lump sum condemnation awards to other income items. For example, in *Asjes*,[6] the Tax Court addressed whether the entire condemnation proceeds of the taxpayer's nursery business were eligible proceeds for deferral under section 1033. After years of negotiation and the filing of a condemnation action, the taxpayer was awarded a lump sum, without any allocation of the award among land, buildings, and vegetation.

The taxpayer reinvested its entire net award in replacement property. The IRS argued that a part of the proceeds was allocable to trees, shrubs, and other plants that the taxpayer raised for sale. The IRS said that portion was taxable and could not be deferred. The court disagreed, noting that when a lump sum condemnation award consists entirely of compensation for property, the award should not be reallocated after the fact among the various items of property involved.

Only the portion of an award representing compensation for non-property items is ineligible for deferral under section 1033. The pivotal question, in the court's view, was whether the taxpayer's vegetation was an item of property. Because the trees and shrubbery were part of the land until severed, the court concluded they were properly treated as property. The court was not bothered by the fact that many of the trees and shrubs were ultimately to be sold to customers.

The IRS met a similar defeat in *Kendall*.[7] In that case, the taxpayer owned a restaurant that was threatened with condemnation. In negotiations with the state, the taxpayer submitted an appraisal, which noted a recent reduction in revenue. Based on newspaper reports, some customers believed the restaurant had already closed. The taxpayer ultimately settled with the state for a lump sum, reinvesting the entire proceeds in replacement restaurant property.

The IRS seized on the appraisal report's determination that the taxpayer had lost income in the amount of $24,000, arguing that the condemnation award should be taxable in this amount as compensation for lost business profits. The Tax Court disagreed, finding that the parties did not discuss any amount of lost profits in their negotiations. According to the court, a lump sum purchase price should not be reallocated after the event based solely on hypothetical factors.

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

[7] *Kendall v. Commissioner*, 31 T.C. 549 (1958), *acq.*

Interest

Interest is a prime example of a non-property item. A separate award of interest does not qualify for nonrecognition under section 1033.[8] The same rule applies whether that extra compensation is called "detention damages," "delay damages," or "payment for delay in compensation."[9] Thus, any portion of a condemnation award or settlement attributable to interest is ordinary income that cannot be rolled over to a replacement property. In some cases, interest is easy to identify.

For example, in *Tiefenbrunn*,[10] the taxpayer's property was taken by condemnation. Upon judicial review of the compensation to which the taxpayer was entitled, the taxpayer received a judgment award consisting of the value of the condemned property, plus a specific amount of interest from the date of the condemnation. Rejecting the argument that the interest award was simply a part of the fair compensation to which the taxpayer was entitled, the Tax Court held that the interest was properly considered separately as ordinary income.

The court in *Tiefenbrunn* reasoned that the interest did not represent gain from the property itself. Instead, it was compensation for delay in paying the sale price. In other cases, a lump sum can be recharacterized as interest, even though no specific allocation was made to it. That was the result in *Smith*,[11] in which the settlement agreement provided for a lump sum payment but expressly stated that "said sum shall include therein any amount claimed for interest or detention damages."

In *Smith*, the Tax Court agreed that the taxpayer's lump sum award included interest. That result seemed clear in light of a Pennsylvania statute that presumed that a condemnee is entitled to interest as a matter of right. Further, an opinion from the state attorney general had concluded that the taxpayer was in fact entitled to interest.

A more difficult case reaching the same conclusion was *Walter*.[12] In *Walter*, the taxpayer and the government reached a settlement of condemnation proceedings. Under the settlement agreement, the taxpayer sold the property for a lump sum, without any specific allocation being made to interest.

Nevertheless, the Tax Court agreed with the IRS that the taxpayer could not defer the entire gain under section 1033. The court noted that the taxpayer's right to compensation accrued as of the date the taxpayer was deprived of possession of the property. As a result, the court believed that a portion of the settlement *necessarily* included an interest component.

Moving Costs

Sometimes the settlement of a threatened condemnation may provide for additional cost reimbursements or releases. The question may arise whether, and to what extent, a lump sum payment is allocable to these separate costs or releases rather than the condemned property itself. Many taxpayers assume that the entire condemnation payment must be for the property, so it all must qualify for reinvestment.

For example, in *Graphic Press*,[13] California notified a printing business of its intent to acquire property to widen the San Bernardino Freeway. The taxpayer's plant contained massive printing presses and other machinery classified as fixtures, all of which the state was required to include in its condemnation. However, the state recognized that it was likely to obtain only 10 percent of the machinery's value if it were condemned and then sold at auction.

Rather than condemn the machinery and realize little value, the state paid the business an additional $407,192 to cover the costs of removing and transporting it to a new location. Although these costs were discussed and incorporated into the lump sum settlement, the state was actually prohibited by law from reimbursing a condemnee for moving costs exceeding $3,000. Thus, the settlement between the taxpayer and the state was

[8] *Tiefenbrunn v. Commissioner*, 74 T.C. 1566 (1980).

[9] *See Smith v. Commissioner*, 59 T.C. 107 (1972).

[10] *Tiefenbrunn*, 74 T.C. 1566.

[11] *Smith*, 59 T.C. 107.

[12] *Estate of Walter v. Commissioner*, T.C. Memo. 1971-244.

[13] *Graphic Press Inc. v. Commissioner*, 523 F.2d 585 (9th Cir. 1975).

for a single lump sum, without any breakdown among components.

Facing a later tax dispute with the IRS, the taxpayer argued that the entire lump sum was its amount realized under section 1033, and that no gain needed to be recognized because all proceeds were reinvested in replacement property. However, the Tax Court agreed with the IRS. Because state law did not permit an award of moving expenses, the payment exceeding the property's value was a severable award. The court labeled the separate award as compensation for the business's waiver of its statutory right to require condemnation of its entire property, including the equipment.

The Ninth Circuit reversed. As a preliminary matter, the court noted that an award for lost profits, rents, or interest cannot be deferred under section 1033 as the proceeds of property. However, the Tax Court had previously found that none of the taxpayer's award was attributable to lost profits. The appellate court agreed in principle with the Tax Court that the moving expense award was severable.

Nevertheless, the Ninth Circuit held that moving costs were also compensation for property and were properly considered part of the condemnation award. As long as the condemnee reinvests the entire award into property that is similar in use within the prescribed time, both the language and spirit of section 1033 are met. The Second Circuit reached a similar conclusion in *E.R. Hitchcock*.[14]

Compensation for Destruction of Property

Even if a condemnation award relates solely to a taxpayer's lost property, that does not necessarily mean that the entire gain can be deferred. The IRS has taken the position that compensation for destruction may be treated differently from a taking of the property itself. In Rev. Rul. 74-206, 1974-1 C.B. 198, a taxpayer's residence was destroyed by a flood. Because the residence was uninsured, the taxpayer claimed a casualty loss deduction.

In the following year, the taxpayer's land was condemned, and he received an award equal to the pre-flood fair market value of his property. Thus, the award compensated the taxpayer not only for the value of the land but also for the value of his destroyed residence. The taxpayer reinvested the entire condemnation award in replacement property. The IRS ruled that because the taxpayer had previously claimed a loss, the portion of the award compensating him for the flood damage was taxable.

Only the remaining gain could be deferred. Notably, the IRS maintained that the entire condemnation award, including the compensation for flood destruction, needed to be reinvested to defer the taxpayer's realized gain. Yet the IRS announced an even stricter view in Rev. Rul. 89-2, 1989-1 C.B. 259. In that ruling, a portion of a condemnation award was allocable to compensation for the environmental contamination and destruction of the taxpayer's property. The IRS ruled that only the gain attributable to the remaining proceeds, representing compensation for the taking of the property, could be deferred.

Separate Covenants

A challenge to the condemnation of business property can involve multiple claims, not all of which relate to the property's value. A settlement agreement that resolves all those claims for a lump sum, without any specific allocation among the claims, can invite challenges by the IRS. In *M.I.C. Ltd.*,[15] the Tax Court considered such a lump sum settlement.

In resolution of a condemnation proceeding involving an adult business establishment, the settlement agreement resolved all the taxpayer's claims for a single lump sum. The issues resolved included claims regarding the value of the real estate, going concern value, and covenants by the business owners not to operate an adult business in the area. Although the agreement failed to set forth a value for any specific claim, the taxpayer was advised that the covenants had little value.

The taxpayer purchased other property similar to or related in use to the condemned property and elected to not recognize the gain under section 1033. The IRS contested the

[14] *E.R. Hitchcock Co. v. United States*, 514 F.2d 484 (2d Cir. 1975).

[15] *M.I.C. Ltd. v. Commissioner*, T.C. Memo. 1997-96.

taxpayer's treatment, arguing that the condemnation award included damages for going concern value and the additional covenants. To the IRS, the payment of those amounts did not qualify for nonrecognition of gain.

The Tax Court disagreed with the IRS and declined to allocate any part of the award away from the taxpayer's real property. After analyzing competing expert testimony about the property's actual value, the court concluded that the value of the condemnation award was "not significantly in excess of the fair market value of the property." However, the court reached that conclusion only after it heard competing expert testimony on the property's appraised value.

In many cases, the taxpayer's case could be considerably strengthened if the settlement agreement had provided specific allocations of value to each claim. As with other language in settlement agreements, the IRS is free to go behind those allocations and make its own assessment of the nature and value of the claims resolved. Fortunately, as a practical matter, the IRS often accepts the agreement of the parties.

Charitable Contributions

A government authority is generally not inclined to be generous in determining the FMV of condemned property. As a result, some taxpayers have claimed the uncompensated "true" value of the property as a charitable contribution. However, this strategy is likely to be successful only if it is well documented in a settlement agreement.

This strategy may be especially difficult if the taxpayer's property is actually taken in a condemnation proceeding, as occurred in *Hope*.[16] In that case, after the taxpayer filed suit to obtain additional compensation for his property, the parties reached a settlement for a lump sum. The settlement agreement contained a recital that the settlement amount did not constitute an agreement that the amount represented the FMV of the taxpayer's property.

Instead, the amount was understood to be a negotiated settlement of the parties' litigation. The taxpayer probably thought these provisions left him room to argue that the purchase price was below actual market value. In fact, the settlement was for a much lower amount than the taxpayer's own appraisals.

The taxpayer chose to characterize the condemnation transaction as a bargain sale. Because the taxpayer believed he received less than FMV in settlement of the condemnation proceeding, he claimed he was entitled to a charitable contribution deduction for the excess. The Claims Court disagreed, finding that a plaintiff in a condemnation proceeding who voluntarily accepts an agreed-upon amount as full compensation for the property cannot claim a greater value for the property for income tax purposes.

The IRS's theory seems simple: Once the condemnation is complete and the taxpayer has negotiated the best terms available, the taxpayer retains no property rights in the land for which he can claim a charitable contribution deduction. However, better documentation sustained a charitable contribution deduction in *Consolidated Investors Group*.[17] Unlike the post hoc character of the taxpayer's reporting position in *Hope*, the donor's charitable intent in *Consolidated Investors Group* was well documented.

In fact, the taxpayer had offered to structure the acquisition as a part-contribution/part-sale consistently throughout the negotiations. Further, the Tax Court found it significant that condemnation proceedings were initiated at the taxpayer's suggestion, after it became clear that the state was not negotiating in good faith. Condemnation did not negate the taxpayer's donative intent because the taxpayer simply desired a neutral determination of the property's value.

Finally, the parties' settlement agreement expressly acknowledged that the taxpayer would file a Form 8283, "Noncash Charitable Contributions," with its income tax return. That form clearly indicated that the taxpayer had made a charitable contribution in connection with the settlement. The state also agreed that it would execute the donee acknowledgment section of that form.

[16] *Hope v. United States*, 23 Cl. Ct. 776 (1991).

[17] *Consolidated Investors Group v. Commissioner*, T.C. Memo. 2009-290.

Allocations Between Property, Severance Damages

In cases in which only a part of the taxpayer's property is condemned, the owner may be entitled to compensation for damage that the condemnation caused to the remaining property. This type of award is referred to as severance damages. A taxpayer who receives severance damages must reduce his basis in the retained property by a corresponding amount and must realize gain only to the extent the award exceeds his basis.[18]

The realized gain is eligible for deferral under section 1033.[19] In cases in which a settlement does not specify the portion of an award that is allocable to severance damages, the courts have been called on to determine the tax consequences. Of course, severance damages do not trigger gain unless they exceed basis. As a result, a taxpayer may have an incentive to allocate as much of his award as possible to severance damages to reduce the realized gains on the condemned portion.

In the past, the IRS and the courts were generally unreceptive to allocating any portion of a lump sum settlement to severance damages unless there was strong supporting evidence. For instance, the Second Circuit in *Lapham*[20] addressed whether a taxpayer who sold a portion of her property under threat of condemnation could allocate any portion of the lump sum to severance damages. The court denied the taxpayer's attempt to do so, even after she presented evidence that the state highway department, without informing her at the time, took severance damages into account in determining the purchase price it was willing to pay.

The court believed the lump sum settlement simply reflected the purchase price for the particular parcel conveyed. The Board of Tax Appeals earlier reached the same conclusion under similar circumstances.[21] Indeed, in an early ruling, the IRS took the position that a condemnation award may be considered as having been received as severance damages only when that designation has been stipulated by both parties.[22]

However, later rulings and cases have proven more generous. In Rev. Rul. 64-183, 1964-1 C.B. 297, the IRS permitted the allocation of a lump sum condemnation award when the property owner was furnished an itemized statement or closing sheet by the condemning authority indicating the specific amount of the total contract purchase price that was for severance damages. The courts have since found extrinsic evidence to be persuasive.

For example, in *Vaira*,[23] the Third Circuit recognized that when a taxpayer receives a lump sum condemnation award, that award will be presumed not to constitute severance damages. However, the court found that the taxpayer overcame this presumption by introducing evidence that the state reviewing board had taken severance damages of $12,000 into account in determining the taxpayer's award.

Similarly, in *Johnston*,[24] the taxpayers were able to show that throughout the condemnation proceedings and negotiations, both sides had acknowledged that the bulk of the award was attributable to severance damages rather than the condemned property itself. Because the taxpayers had sufficient basis in their retained property, this meant that they were required to recognize capital gain only on the property they conveyed. The IRS's acquiescence to the *Johnston* decision may have signaled an end to the debate over whether a lump sum award can be reallocated to severance damages based on extrinsic evidence.

Attorney Fees

A related issue in the context of a condemnation proceeding is the treatment of attorney fees and other expenses. To fully defer realized gain, a taxpayer must reinvest at least as much as the amount realized on the condemnation. A key issue in this determination is whether attorney fees and related expenses are subtracted directly from the gross proceeds realized, or are instead included in the gross

[18] Rev. Rul. 68-37, 1968 C.B. 359.

[19] *See* Rev. Rul. 83-49, 1983-1 C.B. 191.

[20] *Lapham v. United States*, 178 F.2d 994 (2d Cir. 1950).

[21] *Allaben v. Commissioner*, 35 B.T.A. 327 (1937).

[22] Rev. Rul. 59-173, 1959-1 C.B. 201.

[23] *Vaira v. Commissioner*, 444 F.2d 770 (3d Cir. 1971).

[24] *Johnston v. Commissioner*, 42 T.C. 880 (1964), *acq*.

proceeds realized and only *then* subtracted as basis.

In other words, the question is whether a taxpayer must reinvest the gross proceeds including expenses, or only the proceeds net of expenses. Fortunately, this issue appears to be well settled in the taxpayer's favor. In Rev. Rul. 71-476, 1971-2 C.B. 308, the IRS ruled that in determining the amount realized from a condemnation award for purposes of section 1033, the award is reduced by legal, engineering, and appraisal fees incurred in obtaining the award.

Thus, although these expenses must be capitalized,[25] they are not adjustments to basis for purposes of section 1033. Instead, they are treated as selling expenses.[26] This favorable rule permits a taxpayer to invest only the net proceeds to fully defer gain.

Conclusion

It may not be possible or practical to negotiate tax-driven (or even tax-savvy) allocations of monies in every legal settlement of a threatened or actual condemnation proceeding. However, it can be very helpful indeed to take advantage of this opportunity when there is time. Fortunately, the courts, apparently recognizing that not every taxpayer will be thinking ahead on such matters, have adopted presumptions that are generally in the taxpayer's favor.

That seems only fair. After all, section 1033 was expressly designed to provide relief to taxpayers who experience a sale-like event that is not of their own choosing. However, the IRS still appears eager to argue for tax-inefficient allocations of lump sum settlements or awards. That should serve as a warning.

In some cases, the IRS's position seems overly aggressive. A taxpayer who wants to avoid being forced to expend money in an audit or tax controversy should try to address the allocation issues upfront. IRS disputes on these issues can be expensive and may involve factual and valuation questions. In general, the best indication of value is what is agreed between two parties dealing at arm's length.

A well-advised taxpayer can strengthen his position by documenting in advance the key factors supporting his reporting position. Ideally, helpful allocation language should be inserted in the judgment award, settlement agreement, closing statement, or other contemporaneous acknowledgments by both parties. That is hardest in a judgment, because the court will ultimately decide on its final wording.

However, it is rarely impossible to include that language in a settlement agreement. Even though there may be impediments to negotiating it, a settlement seldom is derailed over such issues. Whenever possible, insist on settlement language with an eye on the tax return position that the taxpayer may ultimately take. It is usually worth the effort and the small additional expenditure of time to do so. ■

[25] *See Marcus v. Commissioner*, T.C. Memo. 1964-206.

[26] *See also* LTR 8041002, LTR 200239012, and LTR 200239009.