



GINSBERG
JACOBS^{LLC}

CONDEMNATION ROLLOVERS
STEP-BY-STEP

Darryl P. Jacobs

djacobs@ginsbergjacobs.com

312.660.9615

CONDEMNATION ROLLOVERS STEP-BY-STEP

As a general rule, the sale or exchange of property gives rise to gain or loss.¹

A sale or exchange includes a disposition by way of an involuntary conversion, which includes destruction by theft, seizure or condemnation.

The gain which otherwise results from condemnation can be deferred if the taxpayer receives money for the condemned property and reinvests that money in replacement property. Code Section 1033.

The principal issues under Code Section 1033 are:

1. The type of property in which the condemnation proceeds must be reinvested.
2. The time by which condemnation proceeds must be reinvested.
3. The amount of condemnation proceeds that must be reinvested.

CODE SECTION 1033 IS GENERALLY ELECTIVE

The benefit of Code Section 1033 is elective as long as the taxpayer receives money for his condemned property.² Procedures for election are set out in Treasury Regulations Section 1.1033(a)-2(c) (2).

THE SAME TAXPAYER MUST MAKE THE ELECTION

The taxpayer that realized the gain is the taxpayer that must make the election.

The Internal Revenue Service has ruled that a partnership (which would include a LLC) is eligible to make the election. Partners cannot make the election. Revenue Ruling 66-191, 1966-2 C.B. 300. This is so even where a partnership dissolved for state law purposes. Fuchs v. Commissioner, 80 T.C. 506 (1983). A partnership-level election is also required where title to partnership property has been left in an individual partner's name, but the partnership is the true owner. See Private Letter Ruling 8006092.

A corporation, trust or estate must make its own election. Shareholders and beneficiaries may not elect for the corporation, trust or estate.

WHAT IS QUALIFIED REPLACEMENT PROPERTY?

In general, condemned property must be replaced with property that is "similar or related in service or use" to the condemned property. This is a strict requirement that is often times difficult to satisfy. 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 condemned property. The replacement property must substantially continue and not alter the nature and character of the taxpayer's investment. Thus, for example, property subject to a net lease is not

necessarily similar or related in service or use to property which is subject to gross lease.

But in the case of real estate, the rule is relaxed. Replacement property need only be of like-kind, as that term is defined in Treasury Regulations Section 1.1031(a)-1. Treasury Regulations Section 1.1033(g)-1(a). That means virtually any real estate interest will be of like-kind to any other real estate interest. Thus, raw land can be replaced with an improved shopping center. An industrial use building can be replaced with farmland, an office building or a shopping center. In all events, a specific analysis of prospective replacement property should be made.

IMPORTANT NOTE: The more liberal “like-kind” test is only available in the case of real estate that is held for investment or for productive use in a trade or business. It is not available for real estate that is part of the taxpayer’s inventory or is held primarily for sale.

WHEN MUST REPLACEMENT PROPERTY BE ACQUIRED?

In general, the time period within which condemned property must be replaced begins with the date of disposition of the condemned property and ends three years after the close of the first taxable year in which any part of the gain is realized. Code Section 1033(a) (2) (B), as modified by Code Section 1033(g) (4).³

Thus, if there was a taking in 1989, and gain was realized in that year, the time within which replacement property must be acquired ends on December 31, 1992 (three years after the close of the first taxable year in which any part of the gain was recognized).

Note that three-year period begins to run in the year in which gain was first realized. This is not necessarily the same as the year in which the first proceeds of condemnation are paid. If the proceeds of condemnation are received in the year of taking are less than property’s adjusted tax basis, no gain is realized in that year (assuming that the final amount to be received is not then known and there are no constructive receipt issues). If, in a subsequent year, the taxpayer receives proceeds which (together with proceeds previously received) exceed the taxpayer’s basis, gain will be realized in that year, and the three-year period begins to run as of the last day of that year. See, Casalena Corp. v. Commr., 60 T.C. 694 (1973), acq. 1974-2 C.B. 1, aff’d 511 F. 2d 1162 (4th Cir.1975).

In Casalena, the taxpayer’s property was condemned in 1953. In that year, the taxpayer received (constructively) \$7,500.00, which exceeded the taxpayer’s adjusted basis in the property. In 1968 (15 years later), the U.S. District Court entered final judgment and awarded the taxpayer \$171,900.00 in respect of the condemned parcel.

The Tax Court held that the replacement period began to run in 1953, and the reinvestment of proceeds received in 1968 could not be rolled-over to defer gain. This apparently harsh result, in the Court’s opinion, could be mitigated by a timely request for an extension of the replacement period. (see footnote 3, supra).

A similar result was reached in Conlorenz Corporation v. Commr., 51 T.C. 467 (1968) (taxpayer’s argument that it received proceeds in excess of basis under a claim of right, subject to the possibility of return upon final determination of condemnation proceeds, not sufficient to postpone the running of the replacement period).

Similarly, see Aldridge v. Commr., 51 T.C. 475 (1968) (taxpayer found to be in constructive receipt of proceeds in excess of basis, thus starting the running of replacement period).

HOW MUCH MONEY MUST BE REINVESTED?

The amount that must be reinvested in replacement property is determined by looking to the amount realized from the condemned property and comparing it to the cost of the replacement property. Revenue Ruling 71-476, 1971-2 C.B. 308, provides that legal, engineering and appraisal fees are set off against the condemnation award in determining the amount realized. Thus, such expenses effectively reduce the amount of money that must be reinvested to postpone gain.⁴

To the extent that the amount realized (after reduction for legal, engineering and appraisal fees) exceeds the cost of replacement property, gain is recognized up to the amount of the difference (but not more than the amount of gain that would be recognized under general tax rules).

Severance Awards. Where the taxpayer retains land adjacent to the condemned land, the condemning authority may compensate the taxpayer for a decrease in the retained parcel's value. If these "severance" damages are documented as such, they are applied first against the basis of the retained land. (The idea is to reduce the amount realized on the condemned land by treating it as a reduction of the basis of the retained property.) Any remaining severance proceeds are eligible for Code Section 1033 deferral. To obtain severance treatment, the condemnation award should make a specific allocation to such damages. Revenue Ruling 59-173, 1959-1 C.B. 201. There are other ways of establishing an allocation, but the burden of proof weights heavily on the taxpayer.

MISCELLANEOUS POINTS

1. Interest paid on involuntary conversion proceeds is includible as ordinary income and is not eligible for Code Section 1033 deferral.
2. When multiple parcels are condemned, the exact tax treatment will follow an allocation of basis among the several properties. In general, the determination is made on a parcel by parcel basis.
3. Code Section 1033(a) (2) (A) requires that the replacement property be purchased "for the purpose of replacing the property so converted." This rule may provide a trap for those who purchase or acquire the replacement property in the ordinary course of business. This is basically an intent test. And in the case of real property, Code Section 1033(g) requires further that the replacement property be acquired and held for productive use in a trade or business or for investment.

In connection with this purchase requirement, the ability to purchase replacement property from a related property is limited. Under Code Section 1033(i), for some taxpayers, property acquired from a related party will not qualify as replacement property unless the replacement property was acquired by the related party during the normal Code Section 1033 replacement period. Code Section 1033(i) applies to

C corporations, partnerships in which one or more C corporations own, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership, and any other taxpayer if the taxpayer has aggregate realized gain from converted property exceeding \$100,000 for the tax year.⁵

4. Constructed property can qualify as replacement property, but construction must be completed by the end of the replacement period. Merely paying the contractor for future efforts is insufficient. Revenue Ruling 56-543, 1956-2 C.B. 521.

5. In certain situations, it may be possible to acquire replacement property by purchasing a controlling stock interest in the corporation which owns the property. Code Section 1033(a) (2) (A). However, the replacement period is only two years in that event, and certain other restrictions apply.

I:\djacobs\Condemnation Rollovers Step-by-Step.doc