

BUS 225H – Taxation of Property Transactions

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Weeks 7 & 8 Reading – Special Exclusion and Deferral Rules for Certain Exchanges, Conversions and Sales

- §121 sale of a principal residence
- §1031 like-kind exchanges
- §1033 involuntary conversions
- §1041 transfers incident to divorce
- Other tax-deferred transactions

In addition to the items in this reading packet, also read at the Bus 225H Website:

- IRC Sections 121, 1031, 1033 and 1041
- Section 121 regulations (and preambles): TD 9030 and TD 9152
- Overview of Section 1031 like-kind exchanges from the IRS + link to Form 8824

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Introduction

There are several provisions in the federal income tax law that allow a realized gain or loss to be deferred. For example, if a person transfers appreciated property into a partnership in exchange for an interest in the partnership, no gain is realized. While these types of transactions are often referred to as “tax free,” they are really just “tax deferred.” The deferral of the gain or loss is handled through the basis of the new asset. For example, if the individual transferred land with a FMV of \$100,000 and basis of \$20,000 to a partnership in exchange for an interest worth \$100,000, his basis in the partnership interest would be \$20,000 (carryover basis from the asset transferred). The rationale for tax deferred transactions is usually:

1. The taxpayer did not have a significant change in what they owned. For example, the individual in the earlier example still have an ownership interest in the land, it is that it is now through a partnership rather than direct ownerships.
2. Wherewithal to pay. In the exchange, the taxpayer did not generate cash and so might have to sell the asset in order to pay tax on any realized gain. Typically, if the taxpayer does receive some cash (such as to equalize the fair market values of both sides of the exchange), that much of the gain must be recognized (under the assumption that the person does have wherewithal to pay some tax since they got some cash). The cash is usually referred to “boot” in these situations

The deferral provisions are not all the same. Key differences:

- Some only defer gains and not losses while others defer both realized gains and losses.
- Some have strict dates that must be followed.
- Some are elective (such as §1033 on involuntary conversions) and others are mandatory (such as §351 on transfers to a corporation and §1031 on like kind exchanges)

There are several tax deferral provisions scattered throughout the IRC. Following are ones categorized into a part of the code on tax deferred provisions in Subchapter O --Gain or Loss on Disposition of Property (§§1001-1092).

Part III – Common Nontaxable Exchange

§1031 – Exchange of property held for productive use or investment

§1032 – Exchange of stock for property

§1033 – Involuntary conversions

§1035 – Certain exchanges of insurance policies

§1036 – Stock for stock of same corporation

§1037 – Certain exchanges of United States obligations

§1038 – Certain reacquisitions of real property

§1040 – Transfer of certain farm, etc., real property

§1041 – Transfers of property between spouses or incident to divorce

§1042 – Sales of stock to employee stock ownership plans or certain cooperatives

§1043 – Sale of property to comply with conflict-of-interest requirements

§1044 – Rollover of publicly traded securities gain into specialized small business investment companies

§1045 – Rollover of gain from qualified small business stock to another qualified small business stock

§121

Gain Exclusion on Sale of a Principal Residence

The current gain exclusion of §121 was created in 1997. Prior to this change, there were two rules on the treatment of gain on sale of a principal residence:

1. §121 – lifetime exclusion of up to \$125,000 on sale of a principal residence if the taxpayer was age 55 or older
2. §1034 – rollover of gain on the sale of a principal residence. To the extent the taxpayer timely reinvested the sales proceeds in a new principal residence, the gain could be deferred (with a basis adjustment to the replacement residence). Gain would be recognized to the extent of the sales price of the old home that was not reinvested in the replacement residence.

IRC §1034 has been repealed, but it is still relevant for at least two purposes:

1. The definition of a principal residence: There are many rulings under §1034 and some may still be of value in defining a principal residence.
2. In determining the basis of a home for which a gain was rollover into under old §1034 (and there are plenty of homeowners in this situation). Many homeowners (and perhaps even their tax advisers) may have forgotten that the gain rolled over under old §1034 continues to reduce basis.

Example: Mr. and Mrs. Green purchased their first home in 1980 for \$25,000. In 1994, they sold the home for \$125,000, rolling over their \$100,000 realized gain under IRC §1034. They purchased a new home costing \$220,000. In 2007, they sold that home for \$1 million. With the new exclusion rules added in 1997, the Greens may believe that their realized gain upon sale of the home is \$780,000 (\$1 million less \$220,000) with \$500,000 excludable under IRC §121 and \$280,000 taxable as a capital gain. However, their basis is not \$220,000, but instead is \$120,000 (cost of \$220,000 less previously deferred gain of \$100,000). Thus, their taxable gain is \$380,000, not \$280,000.

IRC §121 Basics:

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Question 1 – Sam and his grandfather are equal owners of a home in which they have both resided for 10 years. The basis is \$100,000 and the FMV today is \$700,000. What is the tax treatment to each of them if they sell the home today.

Question 2 – The Smiths have lived in their home for ten months. Mrs. Smith has been asked by her employer to relocate to another state so the Smiths sell their home realizing a \$40,000 gain. They owned the home for 11 months and it is their first home. What is the tax effect of the \$40,000 realized gain?

Question 3 – What is the proper tax treatment of a \$360,000 sales price for a principal residence that was sold with the washer, dryer and special draperies?

Question 4 – On 2/2/09, Samantha purchased a home for rental purposes for \$400,000. After renting it out for 5 years, she moved into it making it her principal residence. After living in the home for 3 years, she sold it for \$750,000. She claimed \$40,000 of depreciation on it before selling it. What is the tax effect to Samantha?

Question 5 – Joe and Jane are married, but live and work in different cities. Each owns a residence that is used as their principal residence. In 2008, they retire and decide to sell their homes and purchase a new one in a new city. Both homes are owned by the spouses as joint tenants. In 2008 they sell both homes, realizing a \$100,000 gain on Jane's home and a \$300,000 gain on Joe's home. What is the tax effect? What planning advice would you have offered if they had come to you before selling either house?¹

¹ Based on example in ABA Tax Section comment letter of 3/31/98.

Question 6 - What arguments exist for removing the dollar limit at §121?

Question 7 - What arguments exist for lowering the dollar limit of §121?

§1031

Like-Kind Exchanges

Purpose: “It is the purpose of Section 112(b)(5) [now §1031] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, or closed out a losing venture.” *Portland Oil Co.*, 109 F2d 479 (1st Cir. 1940)

Question 8 - Without §1031, do you think businesses and investors would typically exchange property rather than selling and buying?

Reporting Form: Form 8824

Like-Kind: The term like-kind is quite broad with respect to real property even including improved real property exchanged for unimproved real property. For personal property, the determination of whether property is like kind involves more considerations. For intangibles, trademarks and goodwill cannot be like kind property.

§1.1031(a)-1(b) “Definition of “like-kind.” As used in section 1031(a), the words “like kind” have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. For additional rules for exchanges of personal property, see §1.1031(a)-2.”

PLR 200901020

“Under state law, the Development Rights constitute interests in real estate.” ...

“Not all interests defined as real property interests for state law purposes, are of like kind for purposes of §1031. Although the Service generally looks to state law in determining what property rights constitute real property interests, such classifications are not necessarily determinative of what real property interests are of like kind to other real property interests under federal income tax law. That determination is a matter of federal, not state, law. For example, even if a short-term lease (any lease having a term of less than 30 years with extensions) is an interest in real property under state law, it is not of like kind to a fee interest in real estate. However, [per] §1.1031(a)-1(c)(2), long-term leasehold interests in real estate with 30 or more years to run are of like kind to other real estate.” ...

“The Development Rights to be transferred by Taxpayer as relinquished property are of like kind, for purposes of § 1031 of the Code, to a fee interest in real estate, a leasehold interest in real estate with 30 years or more remaining at the time of the exchange and land use rights for hotel units.”

§1.1031(a)-2 provides additional rules for when personal property may be like kind. Some personal property is considered like kind if it is like class to other property. For example, a computer and printer are like kind because they are in the same Rev. Proc. 87-56 depreciation class. The following approach can be used to determine if personal property is like kind to other personal property.

(1) Is it depreciable tangible personal property? (Does the property fall into a Rev. Proc. 87-56 category 00.11 through 00.28 or 00.4?)

YES – match it with property received that falls into the same asset class.

NO – does the property fall into an NAICS product class (6 digit code) other than one ending in “9”?

YES – match the property received that falls into the same 6 digit class

NO – the property is not of “like class” but may still try to show it is of “like kind” (§1.1031(a)-2(a))

(2) Intangible personal property and non-depreciable personal property (such as collectibles) – see §1.1031(a)-2(c) – since there are no “like classes”, you must show it is like kind for §1031 to apply. Whether the property is “like kind” depends on the nature or character of the rights involved and the nature and character of the underlying property. Goodwill and going concern value are not like kind to any other property.

Rev. Rul. 82-166 – Gold and silver bullion held for investment are not like kind. “In this case, the values of the silver bullion and the gold bullion are determined solely on the basis of their metal content. Although the metals have some similar qualities and uses, silver and gold are intrinsically different metals and primarily are used in different ways. Silver is essentially an industrial commodity. Gold is primarily utilized as an investment in itself. An investment in one of the metals is fundamentally different from an investment in the other metal. Therefore, the silver bullion and the gold bullion are not property of like kind.”

Question 9 – For each of the following assets, give an example of like kind §1031 property. Guidance on “like kind” for personal tangible and intangible assets is at §1.1031(a)-2.

a. office building

b. truck used in taxpayer’s business

c. SUV used in taxpayer's vehicle leasing business²

d. computer used in taxpayer’s business

² See PLR 200912004.

e. land in England held for investment

f. truck held as inventory

g. gold Krugerrands

h. copyright on a song

i. trademark³

j. FCC license for a radio station⁴

k. office building in California for office building in Nevada⁵

Holding Purpose: Section 1031 only applies to property held for “productive use in a trade or business or for investment,” assuming it is not excluded from §1031. Thus, a taxpayer may not apply §1031 to her principal residence.

Rev. Proc. 2008-16

1. Purpose

This revenue procedure provides a safe harbor under which the Internal Revenue Service (the “Service”) will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment for purposes of § 1031.

2. Background

.01. Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business

³ CCA 200911006 which modifies TAM 200602034.

⁴ IRS Coordinated Position paper Media Industry - Like-Kind Exchanges Involving Federal Communications Commission Licenses (4/07); <http://www.irs.gov/businesses/article/0,,id=139358,00.html>.

⁵ SB 1316 (2010) had proposed to deny §1031 treatment under California tax law if a taxpayer exchanged California property for property located in another state.

or for investment (replacement property). Under § 1.1031(a)-(1)(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment, and property held for investment may be exchanged for property held for productive use in a trade or business.

.02. Rev. Rul. 59-229, concludes that gain or loss from an exchange of personal residences may not be deferred under § 1031 because the residences are not property held for productive use in a trade or business or for investment.

.03. Section 2.05 of Rev. Proc. 2005-14, states that §1031 does not apply to property that is used solely as a personal residence.

.04. In *Moore v. Commissioner*, T.C. Memo. 2007-134, the taxpayers exchanged one lakeside vacation home for another. Neither home was ever rented. Both were used by the taxpayers only for personal purposes. The taxpayers claimed that the exchange of the homes was a like-kind exchange under § 1031 because the properties were expected to appreciate in value and thus were held for investment. The Tax Court held, however, that the properties were held for personal use and that the “mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence.”

.05. In *Starker v. United States*, 602 F.2d 1341, 1350 (9 Cir. 1979), the Ninth Circuit held that a personal residence of a taxpayer was not eligible for exchange under § 1031, explaining that “[it] has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment.”

.06. The Service recognizes that many taxpayers hold dwelling units primarily for the production of current rental income, but also use the properties occasionally for personal purposes. In the interest of sound tax administration, this revenue procedure provides taxpayers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under § 1031 even though a taxpayer occasionally uses the dwelling unit for personal purposes.

3. Scope

.01. In general. This revenue procedure applies to a dwelling unit, as defined in section 3.02 of this revenue procedure, that meets the qualifying use standards in section 4.02 of this revenue procedure.

.02. Dwelling unit. For purposes of this revenue procedure, a dwelling unit is real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities.

4. Application

.01. In general. The Service will not challenge whether a dwelling unit as defined in section 3.02 of this revenue procedure qualifies under §1031 as property held for productive use in a trade or business or for investment if the qualifying use standards in section 4.02 of this revenue procedure are met for the dwelling unit.

.02. Qualifying use standards.

(1) Relinquished property. A dwelling unit that a taxpayer intends to be relinquished property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the “qualifying use period”); and

(b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

- (ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

(2) Replacement property. A dwelling unit that a taxpayer intends to be replacement property in a § 1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

- (a) The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the “qualifying use period”); and
- (b) Within the qualifying use period, in each of the two 12-month periods immediately after the exchange,
 - (i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and
 - (ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.

.03. Personal use. For purposes of this revenue procedure, personal use of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under § 280A(d)(2) (taking into account § 280A(d)(3) but not § 280A(d)(4)).

.04. Fair rental. For purposes of this revenue procedure, whether a dwelling unit is rented at a fair rental is determined based on all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account.

.05. Special rule for replacement property. If a taxpayer files a federal income tax return and reports a transaction as an exchange under § 1031, based on the expectation that a dwelling unit will meet the qualifying use standards in section 4.02(2) of this revenue procedure for replacement property, and subsequently determines that the dwelling unit does not meet the qualifying use standards, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange under § 1031.

.06. Limited application of safe harbor. The safe harbor provided in this revenue procedure applies only to the determination of whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under § 1031. A taxpayer utilizing the safe harbor in this revenue procedure also must satisfy all other requirements for a like-kind exchange under § 1031 and the regulations thereunder.

5. Effective Date

This revenue procedure is effective for exchanges of dwelling units occurring on or after March 10, 2008. No inference is intended with respect to the federal income tax treatment of exchanges of dwelling units occurring prior to the effective date of this revenue procedure.

Question 10 – Sarah exchanged her single family residence rental property for another rental property, realizing a \$240,000 gain. She held the exchanged property as rental for over ten years. Sarah would like to make the new property her principal residence. What do you recommend that Sarah do?

Question 11 – What is the likely tax effect to a client who exchanges rental property for a farm and gifts the farm to his son two months later? Why?

Answer - First – always be cautious when related parties are involved in a transaction. There are special rules at §1031(f) for exchange between related parties. That rule doesn't seem to apply here unless the exchange is between related parties.

The concern with the taxpayer gifting the farm to his son two months after the exchange is whether the exchanger met the qualified use requirement (is both the property exchanged and received “held for productive use in a trade or business or for investment.” Was the farm held for trade or business or investment purposes? There are cases that can help answer this question. This fact pattern is similar to the *Click* case (78 TC 225 (1982)) where the court held: “On July 9, 1974, petitioner exchanged her farm for two residential properties, cash, and a note. On the same day, her two children and their families each moved into the residences. Approximately 7 months later, petitioner transferred the residences by gift to her children. *Held*, the July 9, 1974, exchange does not qualify for nonrecognition treatment under sec. 1031(a), I.R.C. 1954, because petitioner did not intend to hold the property received for productive use in a trade or business or for investment.”

There are several other cases dealing with this issue including ones where a corporation does the exchange but then transfers the property to a shareholder. The qualified use by the corporation can't necessarily be attributed to the shareholder. For example, see Rev. Rul. 77-337. However, *Bolker*, 760 F2d 1039 (9th Cir. 1985) reached an opposite conclusion. Also, *Maloney*, 93 TC 89 (1989).

Question 12 – Client exchanges an apartment building worth \$1,100,000 (adjusted basis \$600,000) for another apartment building worth \$1,000,000 + \$100,000 cash.

a. What are the client's realized and recognized gains?

b. What is the client's basis in the new building?

c. How would your answer change if the client's building had a mortgage of \$200,000 on it which the other party assumed and the property client received was only worth \$900,000 and no cash was exchanged?

d. Must Form 8824 be filed for this exchange? If yes, by whom and by when?

Question 13 – What is a deferred exchange and what special rules apply to them under §1031(a)(3)?

§1033

Involuntary Conversions

Purpose of §1033: “The purpose of the statute is to relieve the taxpayer of unanticipated tax liability arising from involuntary *** [conversion] of his property, by freeing him from such liability to the extent that he re-establishes his prior commitment of capital within the period provided by the statute. The statute is to be liberally construed to accomplish this purpose. On the other hand, it was not intended to confer a gratuitous benefit upon the taxpayer by permitting him to utilize the involuntary interruption in the continuity of his investment to alter the nature of that investment tax free.” [*Filippini v. US*, 318 F.2d 841, 844 (9th Cir. 1963)]

“Involuntary conversion” Typically, an involuntary conversion is condemnation or some type of destruction. But sometimes it might be a voluntary sale, such as because of the threat of condemnation (assuming there is a real threat).

Rev. Rul. 74-532 [minor editing]

Advice has been requested whether, under the circumstances described below, property sold at a gain qualifies as an involuntary conversion under section 1033.

X corporation was organized in 1967 to provide rental housing for low income families. X purchased rental properties, renovated these properties, and then mortgaged the renovated properties to finance the purchase of more rental units. Since 1967 vandalism of the properties had been extensive and recurring. The properties had been repaired as quickly as possible but the constant vandalism had not been curtailed. As a result of the continued vandalism X sold the properties in 1971 and realized a gain.

Section 1033(a)(3) provides, in part, that if property as a result of its destruction in whole or in part is involuntarily converted into money, and the disposition occurred after December 31, 1950, the gain shall be recognized except as provided in section 1033(a)(3)(A). Section 1033(a)(3)(A) provides, in part, that if the taxpayer, during the period specified in section 1033(a)(3)(B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property.

Section 1.1033(a)-2(a) defines the term “disposition of the converted property” to mean the destruction, theft, seizure, requisition, or condemnation of the converted property or the *sale or exchange of such property under threat or imminence of requisition or condemnation*. (Emphasis added)

Section 1.1033(a)-2(c) provides, in part, that if property as a result of its destruction in whole or in part is compulsorily or involuntarily converted into money, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of replacement property purchased by the taxpayer that is similar or related in service or use to the property so converted.

Rev. Rul. 72-372 holds that the voluntary sale of timber uprooted by a hurricane does not qualify for the nonrecognition of gain provisions of section 1033(a) even though the proceeds were used to purchase other standing timber. The holding was based upon (1) the fact that there was no direct conversion into money as contemplated by section 1033(a)(3) and (2) the sale of the timber was not under threat or imminence of condemnation or requisition.

In *C. G. Willis, Inc.*, 41 T.C. 468 (1964), *aff'd per curiam*, 342 F. 2d 996 (3rd Cir. 1965), the Tax Court held that the sale of a damaged ship was not an involuntary conversion within the meaning of section 1033(a). In that case the sale of the unrepaired ship was held to be the result of a business decision by the owner that the money equivalent of the unrepaired ship would serve its own business interests.

In the instant case, similar to Rev. Rul. 72-372 and the *C. G. Willis, Inc.* case, (1) there was no direct conversion into money as prescribed by section 1033(a)(3) of the Code and (2) the sale of the property was not made under threat or imminence of condemnation or requisition. The decision by X to sell the property was the result of a voluntary business decision to serve its own business interests.

Accordingly, in the instant case, it is held that the sale of the properties was not an involuntary conversion within the meaning of section 1033 and the taxpayer is not entitled to elect the nonrecognition benefits of section 1033.

Question 14 – When is §1033 mandatory?

Question 15 – When is §1033 elective?

“Similar in service or use” standard: Generally this is a stricter standard than “like kind.”

Rev. Rul. 64-237

The Internal Revenue Service has reconsidered its position with respect to replacement property that is “similar or related in service or use” to involuntarily converted property within the meaning of section 1033(a) in light of the decision of the United States Court of Appeals for the Second Circuit in the case of *Liant Record, Inc. v. Commissioner*, 303 Fed. (2d) 326 (1962), and other appellate court decisions.

In previous litigation, the Service has taken the position that the statutory phrase, “similar or related in service or use,” means that the property acquired must have a close “functional” similarity to the property converted. Under this test, property was not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties were closely similar. Although this “functional use test” has been upheld in the lower courts, it has not been sustained in the appellate courts with respect to investors in property, such as lessors.

In conformity with the appellate court decisions, in considering whether replacement property acquired by an investor is similar in service or use to the converted property, attention will be directed primarily to the similarity in the relationship of the services or uses which the original and replacement properties have to the taxpayer-owner. In applying this test, a determination will be made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what such properties demand of the taxpayer in the way of management, services and relations to his tenants.

For example, where the taxpayer is a lessor, who rented out the converted property for a light manufacturing plant and then rents out the replacement property for a wholesale grocery warehouse, the nature of the taxpayer- owner's service or use of the properties may be similar although that of the end users change. The two properties will be considered as similar or related in service or use where, for example, both are rented and where there is a similarity in the extent and type of the taxpayer's management activities, the amount and kind of services rendered by him to his tenants, and the nature of his business risks connected with the properties.

In modifying its position with respect to the involuntary conversion of property held for investment, the Service will continue to adhere to the functional test in the case of owner-users of property. Thus, if the taxpayer-owner operates a light manufacturing plant on the converted property and then operates a wholesale grocery warehouse on the replacement property, by changing his end use he has so changed the nature of his relationship to the property as to be outside the nonrecognition of gain provisions.

Rev. Rul. 72-433.

Advice has been requested whether, under the circumstances described below, the gain resulting from condemnation proceeds may be postponed under section 1033.

In 1970 under threat of condemnation in connection with a flood control project of the United States Government, A granted the Government a perpetual overflow easement that gave the Government the perpetual right to flood his farm when necessary to the government's program. It was expected that the property would be flooded once every 6 years. The easement provided that no structure for human habitation should be constructed or maintained on the land.

A retained legal title to the property and specifically reserved all rights and privileges that could be used and enjoyed without interfering with the flood control project or abridging the easement conveyed. A continued to operate the farm and grew crops on it except when it was flooded.

The money paid A by the government for the easement was in excess of A's basis in the property. In order to continue his farming operation at its former capacity in spite of the anticipated periodic flooding of his retained land, A immediately invested the entire amount in other farm property.

Section 1033(a) provides for the nonrecognition of gain when property is involuntarily converted as a result of condemnation and the taxpayer, within the prescribed period of time, purchases other property similar or related in service or use for purposes of replacing the condemned property.

In Revenue Ruling 69-240, it is held that the expenditure of severance damages by the taxpayer to acquire adjacent farmland to permit him to continue his farming operation as before the condemnation constitutes an acquisition of property similar or related in service or use for purposes of the nonrecognition of gain provisions of section 1033(a).

In Revenue Ruling 271, the taxpayer's farm was bisected when land was condemned for highway purposes and, as a consequence, his cattle were denied grazing land and water. The taxpayer used severance damages to dig wells, clear wooded area, plant shade trees, etc., to restore the usefulness of his remaining property. The Revenue Ruling holds that the taxpayer was entitled to defer the recognition of his gain under section 1033.

There can be a close similarity between the nature of proceeds from the involuntary grant of an easement and the severance damages for the loss in value of retained land resulting from a condemnation. In both situations a property owner retains property that has been affected in some way by the condemnation of related property

Accordingly, in the instant case, since the taxpayer invested the proceeds received for the flowage easement on his farm for farmland, the use of which would restore him to his volume of production before granting the easement, he may defer the recognition of the gain under section 1033, if he otherwise meets the requirements of that section.

Revenue Ruling 54-575, holds that when proceeds are received for granting an air rights easement that deprived the taxpayer of practically all the beneficial interest in his land the gain realized was subject to the relief provisions of section 112(f) of the Internal Revenue Code of 1939 (section 1033 of the 1954 Code). It further holds that when such proceeds are received and the taxpayer retains a beneficial interest in his land such proceeds reduce the cost or other basis of such land and any excess of the payment over the cost or other basis is taxable gain and any recognizable gain is considered as having been realized in connection with an involuntary conversion and is subject to the limitations provided by section 1231 of the 1954 Code. Revenue Ruling 54-575 is modified to the extent that it holds the application of section 1033 is limited to a situation in which the taxpayer is deprived of practically all his beneficial rights in property. Compare Revenue Ruling 70-510, which holds that when proceeds are received from the Federal Government for a "flowage deed," the grant of which was discretionary on the part of the taxpayer, the consideration was measured by the estimated diminution in value of the property caused by the burden of the easement, and such proceeds are in excess of the taxpayer's basis for determining gain or loss on the properties affected by the easement, such excess is recognized gain for the taxable year in which the payment was received or accrued.

PLR 9117030 - the IRS held that a bridge constructed to connect two land parcels after land was condemned was similar in service or use to the condemned and severed parcel under §1033(a)(2)(A), but was not like kind.

Treatment of costs incurred in obtaining condemnation proceeds:

Rev. Rul. 71-476

The taxpayer upon obtaining an award for a piece of its property which was condemned realized a gain. The taxpayer in obtaining the award incurred expenses for legal, engineering and appraisal fees. Section 1033(a) (3)(A) provides, in part, that where property is replaced within the specified replacement period, the taxpayer may elect to have gain recognized only to the extent that the amount realized upon such conversion exceeds the cost of the replacement property.

Held, in determining the "amount realized upon . . . conversion" as that phrase is used in section 1033 (a)(3)(A), the legal, engineering and appraisal fees are offset against the amount of the total award.

Question 16 – On October 2, 2009, Mr. A's shoe store is condemned by the State. The State gives him \$240,000 for the store and land. Mr. A's basis in the property was \$150,000.

a. what is Mr. A's realized gain?

b. What is the latest date by which Mr. A must reinvest the condemnation proceeds in order to defer any gain?

c. What, if anything, may Mr. A do if he is unable to find replacement property by the time indicated in your prior answer? §1033 (a)(2)(B) & §1.1033(a)-2(c)(3)

d. What type of replacement property must Mr. A acquire in order to apply §1033?

e. Mr. A buys a new shoe store the next year for \$170,000. What is his recognized gain and when must he report it and how? What is his basis in the new shoe store? §1033(a)(2)(C) and §1.1033(a)-2(c)

f. When Mr. A gets the money from the State, he decides to retire and now reinvest the proceeds, so you report his gain on his 2009 tax return. In December 2010, Mr. A Tells you he has changed his mind and wants to buy another shoe store. Is it too late for Mr. A to use §1033? What is the authority for your answer?

g. How would your answers to (b) and (d) change if Mr. A's store had instead been destroyed by fire and he received \$240,000 from his insurance company?

Rev. Rul. 80-175

ISSUE

Reconsideration has been given to Rev. Rul. 72-372 which deals with the application of the nonrecognition of gain provisions of section 1033(a) with respect to the proceeds from a sale of timber downed by high winds.

FACTS

In Rev. Rul. 72-372 the taxpayer was the owner of timberland. As a result of hurricane, a considerable number of trees were uprooted. The timber was not insured, and once downed, was subject to decay or being rendered totally worthless by insects within a relatively short period of time. The taxpayer was, however, able to sell the damaged timber and realized a gain from such sale. The proceeds of the sale were used to purchase other standing timber.

Rev. Rul. 72-372 holds that a gain from a voluntary sale of such timber under these circumstances does not qualify for nonrecognition of gain under section 1033(a) of the Code because there was no direct conversion into money nor was such sale precipitated by the threat or imminence of requisition or condemnation.

LAW AND ANALYSIS

Section 1033(a)(1) provides rules under which no gain is to be recognized where property is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted. Section 1.1033(a)-1(a) provides that an involuntary conversion may be, among other things, the result of the destruction of property in whole or in part.

Section 1033(a)(2)(A) provides for the nonrecognition of gain if property is involuntarily converted into money and that money is invested within a specified period of time, in other property similar or related in service or use to the property so converted.

Section 1033(a)(2)(B) states the time period within which converted property must be replaced. That time period commences with the date of the disposition of the converted property. The term "disposition of the converted property" is defined by section 1033(a)(2)(E)(ii) to mean the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation. Thus, the term "disposition of the converted property" is defined for the purpose of establishing the beginning of the replacement period and not for the purpose of defining the term "involuntary conversion." Section 1.1033(a)-1(a) of the regulations

defines the latter term to include the destruction of property. In the present case, the taxpayer's property was destroyed by a hurricane.

In *S. H. Kress and Co. v. Commissioner*, 40 T.C. 142, 153 (1963), *acq.*, 1965-1 C.B. 4 the Tax Court of the United States stated that the basic purpose of section 1033 of the Code is to allow the taxpayer to replace his property without realization of gain “where he is compelled to give up such property because of circumstances beyond his control.” In *S & B Realty Co. v. Commissioner*, 54 T.C. 863, 871 (1970), *acq.*, 1970-2 C.B. xxi the court stated that “When Congress enacted sections 214(a)(12) and 234(a)(14) of the Revenue Act of 1921 [the predecessors of section 1033] it obviously intended to grant a measure of tax relief to those who were compelled by the specified circumstances to convert their property into cash.” The involuntary conversion provisions allow recognition of gain to be postponed on the theory that the taxpayer was compelled to dispose of property and had no economic choice in the matter. The taxpayer in the instant case was compelled by the destruction of the timber to sell it for whatever the taxpayer could or suffer a total loss. Consequently, the facts of this case place it within the ambit of those circumstances contemplated by the provisions of section 1033.

Both the Internal Revenue Service and the Tax Court have considered this application of section 1033(a) to sales of property not threatened by requisition or condemnation. Rev. Rul. 54-395, holds that any gain from the sale of poisoned cattle at salvage value or in settlement of damage claims against manufacturers of contaminated feed pellets was subject to the involuntary conversion relief provisions. In *Masser v. Commissioner*, 30 T.C. 741 (1958), *acq.*, 1959-2 C.B. 5 the court considered this application of section 1033 to a sale of property that was part of an economic unit, a portion of which was sold under threat of condemnation. It found that the sale of both pieces of property constituted an involuntary conversion because it was no longer practical to use the remaining property for the purpose intended.

The present case and *Masser* share three common features. First, an event specified by the statute as one that may result in an involuntary conversion occurred. Second, that event rendered the property unfit or impractical for its intended use. Third, the property was sold and the proceeds invested in similar property. Furthermore, the argument for applying section 1033 to the instant case is stronger than in *Masser*. In the instant case, the property sold was the very property directly affected by the casualty while in *Masser* the property sold was only indirectly affected by the condemnation.

In *C. G. Willis, Inc. v. Commissioner*, 41 T.C. 468 (1964), the court considered the application of section 1033 to the proceeds from the sale of a partially damaged ship. The ship was repairable; however, the owners chose to sell the ship (at a gain) rather than make the necessary repairs. The proceeds from the sale, along with the insurance proceeds for the repair cost, were invested in a barge that would cover the same ports and carry the same kind of cargo as the damaged ship. The ship owners claimed nonrecognition treatment for this transaction under the provisions of section 1033(a).

In denying the claim for nonrecognition treatment, the court stated that “Involuntary conversion, within the meaning of section 1033(a), means that the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes.” The court concluded that “It cannot be said that the sale of the unrepaired ship was a result of its partial destruction. The sale was the result of a business decision by the owner that the money equivalent of the unrepaired ship would serve its business interests better.”

In the present case, the downed timber was not repairable and was generally no longer useful to the taxpayer in the context of its original objective. The destruction caused by the hurricane forced the taxpayer to sell the downed timber for whatever price it could get. Unlike the situation in *Willis*, the sale of the downed timber was dictated by the damage caused by the hurricane.

HOLDING

Upon reconsideration of Rev. Rul. 72-372, and in light of the court decisions cited above, it is now the Service's position that the nonrecognition of gain provisions of section 1033(a) of the Code are applicable with respect to the proceeds received from the sale of timber downed by high winds. The same treatment

would be accorded if, for example, the timber in question was downed as a consequence of an earthquake or a volcanic eruption.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 72-372 is revoked.

Question 17 – Hurricane Hugo partially destroyed timber lands of Taxpayers X and Y. X and Y sold timber that was destroyed and salvaged in the clean up. X was in the business of selling timber. Y's land was a preserve of the flora and wildlife on the land. Y did not normally cut and sell timber. Y realized that it could leave the damaged timber and let nature take its course or clear it to aid the reforestation process. Can X and Y apply §1033 to the proceeds from the sale of the damaged timber?⁶

One economic unit theory: The one economic unit theory has been applied in several cases and rulings to find that a voluntary sale of property that is indirectly affected by the condemnation or destruction of adjoining property is also entitled to deferral of gain under §1033.

Rev. Rul. 59-361

Further consideration has been given to the position taken in Revenue Ruling 57-117, in the light of the decision of the Tax Court of the United States in the case of *Harry G. Masser, et ux. v. Commissioner*, 30 T.C. 741, acquiescence page 5 of this Bulletin.

Revenue Ruling 57-117, *supra*, holds that the sale of property which had lost its value to the taxpayer as a golf course when a portion of it was condemned for a public highway could not be treated as an involuntary conversion.

In the *Masser* case, the salient facts were that the petitioner owned a freight terminal and eight vacant lots directly across the street which were used for storing his semi-trailers when not in use. Because of the shortage of loading docks at the freight terminal, it was necessary to move the semi-trailers frequently between the parking lots and the freight terminal in order to transfer the contents to delivery trucks. The availability of parking space nearby to the freight terminal was a substantial determinant of profit from the business. The parking lots were condemned and the petitioner, being unable to secure adequate replacement lots, sold the freight terminal. The proceeds of the sale, together with the proceeds of the condemnation of the parking lots, were expended for a similar terminal and parking facilities suitable for the petitioner's business operation.

⁶ PLRs 9131034 and 9209006 and *Willamette Industries, Inc.*, 118 TC 126 (2002).

The Tax Court permitted involuntary conversion treatment of the proceeds of sale of the terminal, as well as the proceeds from the sale of the condemned lots. It cited the inadequacy of the available lots for use in the petitioner's business; that the properties were "practically adjacent to each other;" and that they "were acquired for the purpose of being used and were used *** as an economic unit."

Accordingly, where all the facts and circumstances show a substantial economic relationship between the condemned property and the other property sold by the taxpayer, so that together they constituted one economic property unit, such as existed in the *Masser* case, involuntary conversion treatment for the proceeds of the voluntary sale will be permitted. The taxpayer must show the unavailability of suitable nearby property of a like kind to that converted and the proceeds of the voluntary sale must be expended in acquiring property of a like kind.

Revenue Ruling 57-117, revoked.

Question 18 – For which of the following would §1033 apply, assuming the time period requirements are met?

- a. condemned vacant land replaced with an apartment building
- b. theft of a ring replaced with a watch
- c. destroyed principal residence replaced with a new principal residence
- d. destroyed apartment building replaced with an office building
- e. use of condemnation of land proceeds to make improvements to farm land already owned⁷
- f. proceeds from sale of rental housing because the area it is in has become an area plagued with vandalism, reinvested in rental housing in another part of town
- g. billiard center destroyed by fire replaced with a bowling alley
- h. damages received for copyright infringement reinvested in stock of a company with copyrights⁸

⁷ Rev. Rul. 67-254 and Rev. Rul. 67-255.

⁸ TAM 200625032.

IRC §1041

Transfers of property between spouses or incident to divorce

Legislative history to §1041:

Transfers of property between spouses or incident to divorce. ('84 TRA, PL 98-369, 7/18/84)

House Explanation

Present Law

The Supreme Court has ruled that a transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims results in the recognition of gain to the transferor (*United States v. Davis* (370 U.S. 65(1962))). The spouse receiving the property receives a basis in the asset transferred equal to its fair market value. These rules do not apply in the case of the equal division of community property, and the IRS has ruled that this rule does not apply to the partition of jointly held property.⁴ The tax treatment of divisions of property between spouses involving other various types of ownership under the different State laws is often unclear and has resulted in much litigation.⁵ Several states have amended their property law in an attempt to avoid the result in the *Davis case*.

⁴ See Rev. Rul. 74-347, 1974-2 CB 26.

⁵ See e.g., *Commissioner v. Collins*, 412 F.2d 211 (10th Cir. 1969) U.S. v. *Wallace*, 439 F.2d 757 (8th Cir. 1971); *Commissioner v. Wiles*, 499 F.2d 255 (10th Cir. 1974); U.S. v. *Imel*, 523 F.2d 853 (10th Cir. 1975); *W.W. McKinney*, 64 T.C. 262 (1975); U.S. v. *Bosch*, 590 F.2d 165 (5th Cir. 1979).

In addition, under present law, losses are not allowed with respect to the transfer of property between spouses (sec. 267), and capital gains treatment and installment sales reporting are not allowed on the sale or exchange of depreciable property between spouses (secs. 1239 and 453(g)). These limitations do not apply to transfers between former spouses.

Reasons for Change

The committee believes that, in general, it is inappropriate to tax transfers between spouses. This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single economic unit.

The current rules governing transfers of property between spouses or former spouses incident to divorce have not worked well and have led to much controversy and litigation. Often the rules have proved a trap for the unwary as, for example, where the parties view property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property upon divorce triggers recognition of gain.

Furthermore, in divorce cases, the government often gets whipsawed. The transferor will not report any gain on the transfer, while the recipient spouse, when he or she sells, is entitled under the *Davis* rule to compute his or her gain or loss by reference to a basis equal to the fair market value of the property at the time received.

The committee believes that to correct these problems, and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and former spouses should be changed.

Question 19 – Provide an example of where §1041 would apply and the effect to the spouses.