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Involuntary Conversions I.R.C. Section 1033

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INVOLUNTARY CONVERSIONS

I.R.C. SECTION 1033

By

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I. NON-RECOGNITION OF GAIN

a. General Rule.

i. Under §1001(c) of the Internal Revenue Code, gain or loss realized from the sale or other disposition of property must be recognized.

ii. An exception to this general rule is provided by §1033, which allows non-recognition of gain realized from certain involuntary conversions of property.

b. Property Directly Converted Through an Exchange.

i. Under §1033(a)(1), when property is directly converted into property "similar or related in service or use" through an exchange, non-recognition of gain is mandatory.

c. Property Converted Through Receipt of Insurance Proceeds, Condemnation Award or Qualifying Sales.

i. Under §1033(a)(2), when 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, non-recognition of gain is accomplished if the taxpayer:

1. Elects non-recognition, and
2. Timely purchases qualified replacement property.
   a. Qualified replacement property generally is property "similar or related in service or use" to the property converted. §1033(a)(2)(A).
   b. Where certain real property has been involuntarily converted, the replacement property may instead be "like-kind" to the property converted and still qualify for non-recognition of gain. §1033(g).

ii. Complete non-recognition of the conversion gain is available only when the entire monetary proceeds received are reinvested. If only part of the proceeds is reinvested, gain is recognized to the extent of the non-reinvestment. §1033(a)(2)(A).

d. Section 1033 non-recognition of gain lowers the basis in the replacement property, which reduces subsequent depreciation deductions under §168.

e. Section 1033 does not apply to losses. Generally, a loss must be taken into account at the time of the disposition and may not be deferred. Reinvestment in replacement property is irrelevant.

II. INVOLUNTARY CONVERSION

a. Destruction.

i. Destruction of property for purposes o f §1033 is analogous to casualty under §165 as an involuntary conversion of property arising from fire, storm, shipwreck, or other casualty. Examples include:

1. Destruction of livestock by lightning or poisoning; and
2. Destruction of a wheat crop by hail.

ii. Progressive deterioration qualifies as destruction (destruction need not be sudden). Examples includes:

1. Salt water pollution of a water supply; and
2. Other progressive deteriorations such as termites, drought and disease.

iii. Destruction must be beyond taxpayer's control.

1. Destruction is voluntary where an owner hires an arsonist to burn down his building.
2. Demolition of a building is also a voluntary conversion, as is the sale of property that was the target of repeated vandalism.

b. Theft.

i. The term "theft" encompasses any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and other forms of fraud.

1. In Rev. Rul. 66-355, the taxpayer's employee 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.

c. Seizure.
    i. Occurs when a governmental authority takes physical possession of property for a public purpose without prior court approval or payment of compensation.
    ii. Few cases exist which apply §1033 to seizures. The usual nonpayment of compensation renders §1033 moot. The "threat or imminence" eligibility language in §1033(a) does not apply to seizures. Treas. Reg. §1.1033(a)-1(a).
d. Requisition or Condemnation.
    i. Occurs when governmental or quasi-governmental agency legally takes private property for public use, without property owner's consent, but upon the award and payment of just compensation.
    ii. Exercises of the government's police powers do not require compensation and are not §1033 conversions.
        1. Declaring property to be unfit for human habitation does not qualify for §1033 treatment, nor does the failure by a governmental authority to permit zoning or structural variances.
        2. Forced sales or exchanges mandated by legislation, court order or other circumstances are not involuntary conversions.
        3. Payments received from the USDA in termination of the tobacco marketing quota program under Title VI of the American Jobs Creation Act of 2004 are not involuntary conversion payments. Notice 2005-51 and Notice 2005-57, Q&A 10.
    iii. Threat or Imminence of Requisition or Condemnation.
        1. Involuntary conversions include sales made under "threat or imminence" of requisition or condemnation. Threat or imminence of requisition or condemnation exists if:
            a. The property owner is informed, orally or in writing, by a governmental body or public official authorized to acquire the property for public use, that it intends to acquire the property; and

b. The information conveyed to the owner gives him reasonable grounds to believe that the property will be condemned if a voluntary sale is not arranged.

2. An owner who sells property before actual notice must demonstrate a reasonable belief that disposition was required because of the impending consequences. In S. and B. Realty Co. v. Comr., 54 T.C. 863 (1970), 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 these options were sufficiently restrictive so that the taxpayer was realistically faced with two alternatives: sell or suffer condemnation.

3. The IRS may request written confirmation to support any oral statement relied on by the owner.

4. Property subject to threat or imminence of condemnation need not be sold to the condemning authority. It may be sold to a third party willing to cooperate with the condemning authority.

   a. If property is sold to third party who subsequently sells to the condemning authority, both transactions qualify as involuntary conversions.

e. Partial Destruction or Condemnation.

   i. If property is partially destroyed, the owner may decide to sell the remainder of the property and move elsewhere.

   ii. If a portion of real estate is condemned, the owner may decide to sell the remainder.

   iii. The gain may be non-recognized if the proceeds are timely reinvested in eligible property and the following conditions are met.

      1. Involuntarily converted property cannot be reasonably or adequately replaced. In C.G. Willis, Inc. v. Comr., 41 T.C. 468 (1964), aff'd per curiam, 342 F.2d 996 (3d Cir. 1965), 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 non-

recognition. 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.

2. There must be a substantial economic relationship between the condemned property and the property sold so that together they constitute an economic unit. Non-recognition treatment applies where a freight operator sells a building located next to his condemned parking lots. The operator needs parking lots to conduct his freight business.

f. Other Involuntary Conversions.

i. Property sold pursuant to reclamation laws. §1033(c).

1. Federal reclamation statutes 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 involuntary conversions, provided proper replacement property is obtained.

ii. Certain dispositions of livestock. §1033(d) and (e).

1. Death or disposition of livestock "by or on account of disease" is a potential §1033(d) transaction.

2. Sales or exchanges of certain livestock (on or after January 1, 1997) "on account of drought, flood or other weather-related conditions" 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.

iii. Property sold under FCC order. §1033(j).

III. ELECTING NON-RECOGNITION

a. Non-recognition is elected if the full gain is not included in gross income in the year in which it is realized. Treas. Reg. §1.1033(a)-2(c)(2).

i. All the details of the conversion (including description of the property, date and type of conversion, computation of gain, decision to replace) must be reported in a statement attached to the return for each year in which gain is realized.

ii. 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.

b. A election may be changed or revoked:

   i. Where the converted property is not replaced within the required time period;

   ii. Where replacement is at a cost lower that anticipated at the time of election; or

   iii. Where a decision is made not to replace.

   iv. If deferral is revoked, an amended return must be filed for each year in which gain was realized and not previously reported.

c. Taxpayer may elect to defer 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.

IV. MAKING THE REPLACEMENT

a. The taxpayer must purchase qualified replacement property within the statutory period.

b. Who may replace.

   i. Taxpayer.

      1. Section 1033(a)(2) requires that the "taxpayer" acquire the replacement property.

   ii. Corporations.

      1. Because a corporation is a legal entity separate from its shareholders, only the corporation may replace converted corporate property.

         a. When a corporation is liquidated following an involuntary conversion, replacement must generally be made by the corporation before complete liquidation.

      2. Section 381(c)(13) permits certain successor corporations to replace for their corporate predecessors. In general, an "acquiring corporation" is treated as if it were the transferor corporation.

      3. In Fort Hamilton Manor, Inc. v. Comr., 51 T.C. 707 (1969), aff'd 445 F.2d 879 (2d Cir. 1971), the Tax Court held that the purchase of replacement property by an affiliated corporation (i.e. subsidiary of parent corporation) would not satisfy §1033. Section 1033 would have

applied had the corporation which actually suffered the loss received the insurance proceeds directly (because it was the insured) and then made the replacement.

iii. Estates.

1. An estate may complete the taxpayer's replacement.

iv. Trusts.

1. Generally, the trust (not the beneficiaries) must elect deferral and make the replacement.

v. Partnerships.

1. The partnership (not the individual partners) must make the replacement if the partnership incurs a conversion.

c. Types of Replacement Property.

i. Property Similar or Related in Service or Use. §1033(a)(1).

1. Replacement property must be "similar or related in service or use" to the converted property to qualify for deferral under §1033.

2. In Maloof v. Comr., 65 T.C. 263 (1975), the Tax Court articulated the "similar or related in service or use" standard:

a. Reinvestment be made in "substantially similar" property;

b. Reinvestment be a substantial continuation of the prior commitment of capital and not a departure from it;

c. Character of the investment should not be changed (although replacement property need not duplicate the converted property); and

d. Transaction should allow a taxpayer to return as closely as possible to his original position.

3. Examples of Similar in Use Property.

a. Improved rental property replacing unimproved land subject to construction contract.

b. One building replacing two buildings used for the same purposes

c. Planting new crop or purchase of standing or harvested crop replacing standing crop.

d. Replacement of destroyed facilities on leased land in one location by construction of similar facilities on leased land in another location.

e. Stock in public utility corporations replacing stock in condemned private utility.

4. Examples of Property Not Similar in Use.

   a. Improved real estate replacing unimproved real estate.

   b. Reduction in leasehold or mortgage indebtedness replacing real property.

   c. Interest in real estate investment trust replacing leased commercial building.

   d. Shopping center replacing underdeveloped land.

   e. Partnership interests replacing partnership assets.

ii. Special Rule for Eligible Property That is Like-Kind. §1033(g).

   1. Section 1033(g) allows certain converted real property to be replaced by "like-kind" property.

      a. Section 1033(g) does not operate to the exclusion of the similar use rule. It is an alternate means by which §1033 non-recognition may be achieved.

   2. Not all converted real property qualifies for §1033(g).

      a. Section 1033(g) is applicable only to real property that is held for productive use in a trade or business or for investment.

         i. Taxpayer's intent in holding a particular asset turns on the following elements:

            1. The nature and purpose of acquisition and the duration of ownership;

            2. The extent and nature of the taxpayer's efforts to sell the property;

            3. Whether efforts have been made at subdivision of the property into smaller units; and

4. The taxpayer's personal involvement with subdivision and/or sales efforts.

ii. Real property excluded from §1033(g) are:

1. Real property which is stock in trade or otherwise held primarily for sale, and
2. Taxpayer's residence.

b. Section 1033(g) is applicable to seizures, requisitions or condemnations (but not destruction) of property, or the sale or exchange of property under threat or imminence of seizure, requisition or condemnation. Treas. Reg. §1.1033(g)-1(a). Cf. Treas. Reg. §1.1033(a)-1(a).

3. "Like-kind" refers to the nature or character of property and not its grade or quality.
   a. Improved real estate is like-kind to unimproved real estate because both improved and unimproved land are the same kind of property (real property).
4. Examples of Like-Kind Replacement Property.
   a. Investment realty replacing condemned business realty, or business realty replacing investment realty.
   b. Water rights replacing lakefront real estate and permanent nonexclusive management and recreational easement over lake.
   c. Partially completed subdivision replacing condemned housing project, even though subdivision sold within six months.
   d. Commercial property replacing condemned agricultural land.
   e. Conservation easement replacing timberland, farm land or ranch land, provided easement qualifies as an interest in real property under law.
5. Examples of Property That is Not Like-Kind.
   a. Constructed motel on land previously owned replacing condemned mobile home park.
   b. Personally-used residence replacing leased residential property.

c. Interest-bearing bonds and a savings account replacing income producing real estate.

d. Fee simple interest replacing 15-year leasehold.

e. Partnership interests in oil and gas properties replacing condemned oil and gas wells.

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

1. Section 1033(a)(2)(A) allows the taxpayer to purchase a controlling interest in a corporation owning similar use property and still qualify for §1033 non-recognition. This option is available if the following conditions are met:

    a. Taxpayer must acquire a controlling interest in the corporation by purchase.

        i. Control 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.

        ii. Stock vesting 80% control of the corporation must be purchased.

        iii. If control exists prior to conversion, further purchases of stock do not qualify.

    b. Corporation must directly own the replacement property.

    c. Property owned by the corporation must be similar or related in service or use to the converted property.

        i. In Templeton v. Comr., 66 T.C. 509 (1976), the Tax Court held that §1033 non-recognition 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.

2. When replacement occurs through the purchase of corporate stock (for conversions occurring after August 20, 1996), both the basis of the

replacement stock and the basis which that corporation has in certain of its assets has to be reduced.

a. Generally, the corporation's basis in its assets must be reduced by the same amount as the basis in the corporate stock is reduced.
b. Given the potential for two levels of taxation on any eventual corporate gain, the required reduction in the corporation's basis is an incentive to replace through an asset acquisition rather than a stock acquisition.

iv. Farm Property. §1033(f).

1. 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 soil contamination or other environmental contamination.

d. Purchase of Replacement Property.

i. Section 1033(a)(2)(A) requires replacement property to be purchased.

ii. Under §1033(a)(2)(A)(ii) and Treas. Reg. §1.1033(a)-2(c)(4), property is not regarded as purchased unless its unadjusted basis is its cost to the taxpayer within the meaning of §1012.

1. If the basis for the property is determined under any of the exceptions set out in §1012, it does not meet the purchase requirement. See <u>Real Estate Corp. v. Comr.</u>, 22 T.C.M. 654 (1963). 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 §1012.

iii. A taxpayer's expenditure of conversion proceeds on land already owned may qualify as similar use reinvestment in certain circumstances. Examples include:

1. The filling in of submerged land, repairs to remaining property to prevent recurrence of a casualty, and the replacement of production capacity reduced through the conversion.
2. The purchase requirement is not satisfied if the taxpayer uses the proceeds to reduce mortgage debt on similar property already owned by the taxpayer.

e. Replacement Period.

  i. When Replacement Period Begins.

    1. Destroyed or stolen property – begins on date of destruction or theft

    2. Condemnation or seizure – earliest of the following three dates triggers the start of the replacement period:

      a. Date on which the property was condemned or seized;

      b. Date on which the property was first subjected to threat or imminence of condemnation or seizure; or

      c. Date on which the property was sold or exchanged under threat or imminence of condemnation or seizure.

  ii. When Replacement Period Ends.

    1. Two Years – the replacement period normally ends two years after the close of the first tax year in which any part of the gain on the conversion is realized. §1033(a)(2)(B).

    2. Three Years – for business or investment real property converted by seizure, requisition or condemnation (or threat or imminence), the replacement period normally ends three years after the close of the first tax year in which any part of the gain on conversion is realized. §1033(g)(4).

    3. Four Years – for principal residences and their contents damaged by Presidentially declared disasters, the replacement period normally ends four years after the close of the first tax year in which any part of the gain on the conversion is realized. §1033(h)(1)(B). Also for livestock converted as a result of certain weather conditions. §1033(e)(2)(A)

  iii. Extension of Replacement Period. The replacement period may be extended if special permission is obtained from the IRS. §1033(a)(2)(B).

f. Notification.

  i. 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 deficiency. Notification must be attached to the return for the taxable year or years in which replacement occurs.

a. Notification should include what replacement property was acquired, the date acquired, and the cost to the taxpayer.

V. MORTGAGES AND LIENS

a. Under Treas. Reg. §1.1033(a)-2(c)(11), the amounts paid by a condemning authority to a mortgagee or lienor are condemnation proceeds whether or not the condemnee was personally liable for the obligation.

   i. 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.

b. Section 1033 reinvestment must be made in an amount equal to the proceeds actually received by the condemnee plus the unpaid mortgage and lien balances.

   i. The weight of authority is that the nonrecourse mortgage is properly counted as proceeds from the condemnation.

VI. CONVERSION OF MULTIPLE PROPERTIES

a. When there is a disposition of multiple properties, the tax treatment depends on whether §1245 (recapture of depreciation on personal property) or §1250 (recapture of depreciation on real property) property is involved.

   i. If such property is involved, the total amount realized on the disposition must be allocated between the §1245 and §1250 properties and properties not falling into those classes.

   ii. Taxpayers will achieve complete nonrecognition only if adequate replacement property within each recapture class is purchased. Thus, taxpayers must usually replace class-by-class.

b. In applying §1033, a business is not a single asset and §1033 should thus be applied on an asset-by-asset basis.

c. 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.

d. 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 the §1033 deferral can again be separately determined.

e. 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.

VII. POST CONVERSION

a. Direct Conversion into Qualifying Property.
    i. The basis of the replacement property is the basis of the old property, less money received on the conversion which was not expended in the acquisition of the new property, less any loss recognized, plus gain recognized, and plus any additional investment.
    ii. The holding period of the replacement property includes the holding period of the converted property.
b. Conversion into Money or Dissimilar Property.
    i. No Election.
        1. Taxpayer who fails to make a valid election or qualified replacement:
            a. Must recognize gain under the general rule of §1001(c).
            b. Under §1012, taxpayer takes a cost basis in any replacement property.
            c. Holding period of any replacement property begins on acquisition.
    ii. Election.
        1. Taxpayer who makes a valid election and qualified replacement:
            a. Basis of the replacement property is the cost of that property, decreased by any gain not recognized. §1033(b).
            b. When the replacement property is corporate stock (conversion occurring after August 20, 1996), not only must the taxpayer's basis in the corporate stock be reduced, but also, the corporation must reduce its basis in its property.
            c. Holding period of the replacement property will include the holding period of the converted property.

(Note: Katherine L. Martin, a summer associate with Kaufman & Canoles, assisted in the preparation of this outline.)

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