TAX PROBLEMS & OPPORTUNITIES IN

Real estate

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Planning for real estate condemnation awards in light of recent favorable Rulings

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The Service has recently promulgated two Rulings which clarify the reinvestment of condemnation proceeds received for a leasehold and liberalize reinvestment alternatives for severance damages. The authors examine the impact of the Rulings on existing law and explore the tax planning possibilities that may now arise.

As soon as a taxpayer learns that his real property used in a trade or business or held for investment is the subject of possible condemnation proceedings, he needs to begin planning immediately for the condemnation award and possible reinvestment. The Service has recently promulgated two Revenue Rulings, *Rev. Rul.* 83-49, IRB 1983-12, 8 and *Rev. Rul.* 83-70, IRB 1983-17, 10,[1] which provide new guidance for the taxpayer and his tax advisor. Further, the IRS internal response, General Counsel's Memoranda (GCM), to these Rulings, before they were issued, provides useful insight in applying the principles set forth in the Rulings.

Treatment of condemned property

When property is condemned, it is treated as an involuntary conversion under Section 1033. Section 1033(a)(2)(A) permits a taxpayer who receives money (the usual form of a condemnation award) to elect not to recognize any gain on the condemnation of his property to the extent the proceeds are invested in property "similar or related in service or use" to the property converted. A purchase of a controlling interest in a corporation which owns such property also qualifies. Section 1033(a)(2)(B)(i) gives the taxpayer two years after the close of the first taxable year in which any part of the gain upon conversion is realized to make such reinvestment.

A special provision, Section 1033(g), permits a taxpayer to invest the proceeds of a condemnation award in "like kind" property and still come under the nonrecognition election of Section 1033(a)(2)(A). This special rule applies only to real property held for productive use in a trade or business or for investment. Section 1033(g)(4) extends the two year reinvestment period to three years for a taxpayer who qualifies under Section 1033(g).

The definition of what constitutes "property similar or related in service or use" may depend upon whether the owner is a direct user of the property or an investor/lessor of the property. The IRS and the Tax Court for many years focused on the physical characteristics and end uses of the converted property. Thus, a condemned gas station had to be replaced by another gas station. This approach was rejected by the Second Circuit in *Liant Record, Inc.*, 303 F.2d 326 (CA-2, 1962), where the court determined that the "similar or related in service or use" test should be applied differently to owners of condemned property who were end users from those who were investor/lessors. In the first instance the same traditional standard is to be applied. However, in the latter case, the court looked at the investor/lessor's economic relationship to the condemned property.

Thus, an investor/lessor who leased a farm to a riding club that was condemned was permitted to elect nonrecognition treatment when he invested the condemnation award in a gas station of which he also was the lessor.[2]

The impact of the *Liant* decision has been reduced by the enactment of Section 1033(g) which permits the reinvestment of the proceeds in "like kind" property. The "like kind" standard is drawn from Section 1031(a) which applies to exchanges of property. Unlike the end use test (or the more generous "economic relationship" standard for investor/lessors), the "like kind" standard as articulated in Reg. 1.1031(a)-1(b) focuses on the nature or character of the property. Specifically, improved real property may be replaced by unimproved real property, whereas such a replacement under the "similar or related in service or use" test cannot be made unless the taxpayer is an investor/lessor with regard to both properties.[3]

Revenue Ruling 83-70

The promulgation of *Rev. Rul.* 83-70 is, at first blush, instructive and interesting, but not startling. What the Ruling does not state is that: (1) the conclusion initially reached by the Service was opposite the conclusion of the published Ruling and (2) the IRS altered its position only after the advice of its General Counsel in GCM 38975, 6/15/82.

The Ruling concerns a domestic corporation which leased a warehouse in its business of hauling, handling, and storage of furniture. The lease was a net lease, which at the time of condemnation, had 15 years to run. The land was condemned, and the taxpayer received some of the proceeds for its unexpired leasehold term. The entire amount of the proceeds would have been treated as a gain absent the application of Section 1033. The taxpayer purchased a fee simple interest with the proceeds, and used the property in the same capacity that it had used the condemned property.

The IRS concluded that the property did not qualify as "like kind" for purposes of Section 1033(g), because under Reg. 1.1031(a)-1(c), a leasehold in exchange for a fee does not constitute

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"like kind" property unless the leasehold has 30 years or more to run. Under the facts of the Ruling, the leasehold condemned had only 15 years to run.

While the properties failed the "like kind" standard, the Service determined that the fee was "similar or related in service or use" to the leasehold interest since the taxpayer used the property for identical purposes. Hence, no gain was recognized to the taxpayer.

The IRS had originally concluded that the acquisition of the fee interest did *not* constitute "similar or related in service or use" property. Although GCM 38975 agreed that the properties were not "like kind," the General Counsel concluded that a holding that the properties were not "similar or related in service or use" was inconsistent with the current published IRS positions, and recommended that this position be sustained for the present:

"The proposed revenue ruling concludes that under section 1033 a fee simple property interest does not qualify as replacement property similar or related in service or use to an involuntarily converted 15-year leasehold interest. We believe that this conclusion is inconsistent with *Davis Regulator Co.*, [36 BTA 437 (1937), *acq.* 1937-2 CB 7], as well as with several analogous cases in which the Service has acquiesced. Since we now believe that it is inadvisable to modify these acquiescences, we recommend that the proposed revenue ruling be revised to reflect the Service's longstanding acquiescences."

Prior authorities

The disagreement with the proposed holding stems from the case of *Davis Regulator Co.* There, the taxpayer had a leasehold interest condemned, and reinvested the condemnation proceeds in the construction of a building on land already owned by the taxpayer. After construction, the taxpayer used the building for the identical purpose that it had used the condemned property. The Board of Tax Appeals concluded that under Section 112(f) of the Revenue Act of 1928 (the forerunner of Section 1033),[4] the taxpayer could elect nonrecognition treatment for the amount reinvested. The Board found that the statute required "a replacement in the character of the service or use." In holding for the taxpayer, the Board held that the reinvestment did meet this standard.

The proposed Revenue Ruling attempted to distinguish *Davis* by focusing on the fact that the taxpayer in *Davis* held a leasehold which was extendable at will, and which thus more closely resembled a fee interest than a leasehold interest. The taxpayer in the proposed Ruling clearly held a leasehold interest. The General Counsel found this to be irrelevant, because the *Davis* case had not considered this point in holding for the taxpayer.

Apparently, the proposed Ruling focused on the fundamental differences between a leasehold interest and a fee interest. The GCM states, "The proposed ruling reasons that the extent of the taxpayer's rights to use the converted and replacement properties has changed. Moreover, the taxpayer has altered the nature of its capital investment through involuntary conversion." The GCM does indicate that the Service is uncomfortable with the *Davis* holding, and flatly states, "Thus, the argument can be made that the rationale of *Davis Regulator* is not legally correct."

In fact, the Service had previously recommended that the acquiescence in *Davis* be changed to an acquiescence in result only.[5] This rejection of the BTA's reasons for its holding in *Davis* can be found in the Service's position in *Rev. Rul.* 64-237, 1964-2 CB 319, where the physical characteristics and end uses of the converted and replacement properties must be very similar. The GCM states, "The proposed revenue ruling states that this test requires that the extent of the taxpayer's right to use the converted and replacement property be considered." Reducing this still further, the GCM finds the central issue to be—as to whether property is "similar or related in service or use"—"whether in all circumstances it represents a substantial continuation of the taxpayer's prior commitment, or a departure from it."[6]

Taken together, what the IRS seems to be saying is that the burdens and benefits of a leasehold interest and a fee interest can never constitute property "similar or related in service or use" unless the term is 30 years or more, or perhaps, unless the leasehold is a triple net lease.[7] While such a conclusion may be technically correct, it would appear that such an application is inconsistent with the purpose of the statute. The theory behind the nonrecognition of gain under Section 1033 is that the taxpayer has not converted his property to cash for purposes of recognizing the inherent gain or loss. Rather, he has continued his investment by reinvesting the proceeds, or some part thereof, in such form that the taxpayer is not in a materially different position after the transaction. Certainly, the conversion of a leasehold interest for a fee interest alters some of the taxpayer's responsibilities, liabilities and equities. However, such a concern seems less significant where a taxpayer continues to use the "new" property in the same manner as he did the "old" property. The application of the "similar or related in service or use" test to the investor/lessor recognizes this fact.

The conclusion of the GCM is that a change of position was inadvisable in view of the *Davis* acquiescence, and the long standing published position of the IRS.

[1] See *Leasehold replaced with fee meets similar use test*, 59 JTAX 6 (July 1983).

[2] *Johnson*, 43 TC 736 (1965), *acq.* 1965-2 CB 5.

[3] The investor/lessor would still be required to show that his economic relationship regarding the two properties was unchanged.

[4] While Section 112(f) did not exactly correspond to Section 1033, the similarities are substantial. Section 112(f) read: "INVOLUNTARY CONVERSION—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat of imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended."

[5] An acquiescence in result only indicates that the IRS disputes some or all of the reasons given by the Tax Court (the successor to the Board of Tax Appeals) for its conclusion.

[6] The proposed Ruling cited *Filippini*, 318 F.2d 1841 (CA-9, 1963), for this proposition.

[7] A similar view has been taken regarding the retention of a leasehold interest and the sale of the reversion in real property transactions, or in the sale and leaseback of an interest. See generally *Alstores Realty Corp.*, 46 TC 363 (1966); *Ellison*, 80 TC 378 (1983); *Rev. Rul.* 77-413, 1977-2 CB 298. A triple net lease might qualify since it remains the lessee's duty to maintain the property and pay taxes and insurance. Thus, the lessee's responsibilities are closely akin to a fee interest.

[8] *Allaben*, 35 BTA 327 (1937); *Rev. Rul.* 59-173, 1959-1 CB 201; *Rev. Rul.* 64-183, 1964-1 CB 297.

[9] See *Beeghly*, 36 TC 164 (1961), where the taxpayer was successful.

[10] *Rev. Rul.* 73-35, 1973-1 CB 367, and *Rev. Rul.* 271, 1953-2 CB 36, state that severance damages are analogous to property insurance, and are paid as compensation for the property damaged. Thus, only the basis of the property damaged may be considered in determining the gain or loss from such damage.

[11] *Rev. Rul.* 80-184, 1980-2 CB 232.

[12] See *Rev. Rul.* 78-377, 1978-2 CB 209.

Rev. Rul. 83-70 does not seem to be an irrevocable endorsement of this position, but it does add support and consistency to the previous IRS pronouncements. Further, since the published Ruling does not attempt to distinguish *Davis* on its facts, it is doubtful that the IRS, having had the opportunity to confine the *Davis* holding, would now see fit to publish a contrary Ruling. Indeed, the published Ruling seems to implicitly support *Davis*. Thus, it would appear that condemnation awards for leasehold interests may receive nonrecognition treatment if they are reinvested in fee interests, where the taxpayer uses the property in an identical or nearly identical fashion to the property condemned.

Revenue Ruling 83-49

A taxpayer may receive, as part of the condemnation proceeds, an award for the damage to any real property retained. The IRS has stated in *Rev. Rul.* 271, 1953-2 CB 36, that severance damages are "compensation for conversion of the taxpayer's right to use his property in the manner and for the purpose for which it was acquired. Such damages are analogous to the proceeds of property insurance; they represent compensation for damages to the property."

Severance damages can be paid to compensate an injured realty owner for various reasons, *e.g., Rev. Rul.* 271 (damages to restore grazing land); *Rev. Rul.* 69-53, 1969-1 CB 240 (remaining land no longer suitable for type of farming previously practiced); *Rev. Rul.* 72-433, 1972-2 CB 470 (easement gave Government perpetual right to flood remaining land); and *Rev Rul.* 73-35, 1973-1 CB 367 (condemnation made manufacturing complex unusable). Whenever there is a condemnation that causes damages to the remaining real property, either through the taking or the use of the condemned portion, severance damages are appropriate.

Severance damages must be separately stated in the condemnation award or in subsidiary documents. If severance damages are not separately stated, the taxpayer may be precluded from taking advantage of significant tax planning opportunities. Generally, where severance damages are not clearly shown, it is presumed that all proceeds received are for the property condemned.[8] While taxpayers have occasionally been successful in convincing the courts that severance damages could be ascertained in the absence of a clear designation, the great weight of authority is against such a finding.[9] Where a taxpayer sells his land under a threat of condemnation, he should be able to have the contract of sale specify the amount of the severance damages that would have resulted had the land been condemned. This may take some negotiation on the part of the taxpayer with the purchaser, since a purchaser may not want to bifurcate the award, but such insistence on the taxpayer's part may give greater flexibility later.

When a taxpayer receives a sum as severance damages, careful planning is needed. The taxpayer must consider the amount of the award for severance damages, the amount of the award for the real property taken, the damage done to the remaining tract of land, the adjusted basis of the real property damaged, the adjusted basis of the real property taken, and the investment posture of the client. Several alternatives are available.

1. The proceeds can be retained by the owner and used for unrelated activities. In this situation, gain is realized and recognized by the amount received over the adjusted basis of the real property affected. This is similar to any other sale of property under the Code. Where severance damages are paid because only a part of the remaining tract of land is affected, only that portion of the basis that pertains to that portion of the land affected is used in determining any gain or loss.[10]

2. The proceeds may be used to restore the damaged real property to its original state.

3. Where an owner retains land that is irrevocably damaged by the condemnation, he may reinvest the proceeds under Section 1033.

4. Where a taxpayer could restore the real property damaged but chooses to reinvest the proceeds in other real property, he can now defer recognition of gain. Prior to the promulgation of *Rev. Rul.* 83-49, the IRS would not permit this choice.[11] However, there appears to be a change of philosophy. Until the release of *Rev. Rul.* 83-49, the IRS took the position in *Rev. Rul.* 80-184, 1980-2 CB 232, that severance damages must be first expended to restore the damaged property, if possible, before the reinvestment of the proceeds would qualify under Section 1033. In GCM 38968, 4/29/82, which was the IRS internal response to *Rev. Rul.* 83-49, the Chief Counsel stated that such a restrictive interpretation is without legal justification. This apparent shift is premised on the conclusion, first expressed in *Rev. Rul.* 271, that severance damages are similar to property insurance. The Chief Counsel concluded that "it follows that a taxpayer may elect to defer recognition of gain in respect of severance damages if the requirements of section 1033 are otherwise satisfied." Since Section 1033 requires only that money be reinvested in "other property similar or related in service or use to the property converted" (or "like kind" property where appropriate), the election by a taxpayer to use insurance proceeds to purchase other property rather than to restore the damaged property should likewise apply to severance damages.[12]

Assuming this position is not reversed, the taxpayer who receives severance damages will be able to reinvest the entire award, to bifurcate the award between reinvestment and retention, or retain the entire amount of the severance damage proceeds.

In addition to providing more flexibility in the reinvestment of proceeds for severance damages, *Rev. Rul.* 83-49 and GCM 38968 have adopted a new rule for calculating: (1) the basis for the property replaced or restored, and (2) gain for the retention of any proceeds. This rule, which is consistent with Section 1033(b), can be set forth as follows:

1. Any portion of the proceeds received and not reinvested in qualifying property will cause gain to be recognized up to the amount of the proceeds not reinvested.

2. Any proceeds reinvested in qualifying property will cause the restored or replaced property to have a cost basis reduced by the amount of gain not recognized.

3. In determining gain or loss, only the basis of the real property actually affected is used.

Example. The taxpayer owns a tract of 120 acres. Of this amount, 20 acres are condemned, and the taxpayer receives $50,000 in severance damages for damages done to ten of the remaining 100 acres. The basis of the land affected and for which severance damages are paid is $10,000 (ten acres). He reinvests $10,000 in restoring the damaged property and $30,000 for "like kind" property, and he keeps $10,000 to take a

vacation. His tax consequences would be as follows:

1.	Amount realized from severance damages	$50,000
2.	Basis of land affected	10,000
3.	Gain from severance damages	40,000
4.	Amount realized (line 1)	50,000
5.	Restoration cost	10,000
6.	Purchase of like-kind property	30,000
7.	Total reinvested (lines 5 and 6)	40,000
8.	Amount recognized (line 4 less line 7)	10,000
9.	Amount not recognized (line 3 less line 8)	30,000
10.	Basis of qualified reinvestment (line 7 less line 9)	10,000
11.	Basis of restored property (line 10 times line 5 divided by line 7)	2,500
12.	Basis of purchased property (line 10 times line 6 divided by line 7)	7,500

The promulgation of *Rev. Rul.* 83-70 clarifies how condemnation proceeds received for a leasehold interest may be reinvested in order to come within the scope of the nonrecognition rule of Section 1033. The issuance of *Rev. Rul.* 83-49 provides new and more liberal reinvestment alternatives for amounts received as severance damages. In either case, planning must be done as soon as possible to give the taxpayer all the flexibility that the law and new liberalized treatment permits. ☆

RECENT TAX LITERATURE

Lifetime and Testamentary Estate Planning (Tweed and Parsons), Ninth Edition, by William Parsons, 228 pages, hardcover, $40. Discusses the tax and nontax factors in planning inter vivos and testamentary disposition of estates. Included are forms of wills and trust instruments, cross-referenced to the text. Tables, index. ALI-ABA, 4025 Chestnut St., Philadelphia, Pennsylvania 19104.

Federal Income Taxation of Corporations, Fifth Edition, by Herrick Lidstone and Albert Powers, 506 pages, hardcover, $55. Covers tax nature and organization of corporations, fiscal year and accounting methods, gross receipts v. gross income, deductions, credits, deviation from treatment of corporations as separate entities, special and punitive taxes, tax-free exchanges, distributions and liquidations. The main text is updated by an addendum based on TEFRA, the Miscellaneous Revenue Act of 1982, the Subchapter S Revision Act of 1982 and the Technical Corrections Act of 1982. Tables of cases, statutes and Regulations; index. ALI-ABA, 4025 Chestnut Street, Philadelphia, Pennsylvania 19104.

Tax-Exempt Charitable Organizations, Second Edition, by Paul E. Treusch and Norman A. Sugarman, 726 pages, hardcover, $95. Reports and analyzes developments in tax-exempt charitable organizations, beginning with a history of tax aspects of philanthropy and covering the qualifications of charitable organizations, tax on unrelated business income, the Tax Reform Act of 1969, general rules and restrictions on private foundations and public charities. Appendix, tables and index. ALI-ABA, 4025 Chestnut Street, Philadelphia, Pennsylvania 19104.

Obtaining IRS Private Letter Rulings, A Manual of Forms and Procedures from Touche Ross & Co., by Gerald W. Padwe, Donald C. Wiese and Isaac W. Zimbalist, not consecutively paginated, looseleaf, $100. Provides basic information and procedures to obtain rulings or determinations from the Service. The thrust is directed to rulings concerning changes in methods and periods of accounting and rulings in the area of reorganization and corporate acquisitions. Oceana Publications, Inc., 75 Main Street, Dobbs Ferry, New York 10522.

Note, *Independent Auditor's Tax Accrual Workpapers Shielded from IRS Summons Power by Accountant Work-Product Privilege,* U.S. v. Arthur Young & Co. *(2d Cir. 1982),* pages 434-450, *Villanova Law Review,* Vol. 28, No. 2, 1982-1983. Analyzes several pertinent cases affecting tax accrual workpapers, and suggests that the Supreme Court should resolve the issue. Single issue $4.50. Villanova Law Review, School of Law, Villanova University, Villanova, Pennsylvania 19085.

Comment, *Retroactive Taxation: A Constitutional Analysis of the Minimum Tax on IDCs,* pages 107-118, *Oklahoma Law Review,* Vol. 36, No. 1, Winter 1983. Argues that the minimum tax on IDCs and its effect on the noncorporate oil and gas producer is unconstitutional. Single issue $7. Oklahoma Law Review, 300 Timberdell Road, Norman, Oklahoma 73019.

Tax Shelter Opinions—Securities and Tax Liabilities after TEFRA, by Mark J. Gimenez, page 25-46, *Baylor Law Review,* Vol. 35, No. 1, Winter 1983. Reviews and evaluates TEFRA's sanctions on lawyers who write tax opinions to be included in and distributed to investors as part of a securities offering. Single issue $6. Baylor Law Review, B.U. Station, Box 6262, Waco, Texas 76706.

Note, *Start-up Cost Treatment Under § 195: Tax Disparity is Disguise,* pages 449-466, *Oklahoma Law Review,* Vol. 36, No. 2, Spring 1983. Examines the lack of tax parity between a new or prospective venture and an established business for investigatory expenses and start-up costs. Single issue $7. Oklahoma Law Review, 300 Timberdell Road, Norman, Oklahoma 73019.

Tax Planning for Real Estate Transactions, by Robert M. Weiss and Robert E. Dallman, 368 pages, hardcover, $39.95. Designed as a practical guide to be applied at each stage of the life of a real estate project. Divided into three sections which consider the best form of business to utilize to purchase and operate the project; problems which arise during ownership; and dispositions. Index and tables. Prentice-Hall, Inc., Englewood Cliffs, New Jersey 07632.