

1959

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### Recommended Citation

Keith Miller, *Land Condemnation—Federal Income Tax Consequences*, 38 Neb. L. Rev. 507 (1959)

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## LAND CONDEMNATION—FEDERAL INCOME TAX CONSEQUENCES

Keith Miller\*

*In the following article, the author examines an oft-forgotten phase of condemnation—the Federal income tax consequences which the condemnee-landowner must face after receiving compensation from the condemner. The author takes the reader through the relevant sections of the Internal Revenue Code of 1954, examining the problems of “gain or loss”, “severance damages”, etc. He emphasizes that the attorney for the condemnee must consider this problem if he is to adequately advise a condemnee-client.*

*The Editors*

### I. INTRODUCTION AND SCOPE

A tax-wise landowner may realize more net proceeds from the condemnation of his land than one who is not well advised. Varying federal tax consequences, often depending upon form or upon technicalities, behoove a landowner to consult his lawyer even in advance of negotiation for voluntary sale of his land to the state.

Generally speaking, it makes no difference tax-wise whether one voluntarily sells and deeds his land to the government, or whether his land is taken by the government under statutory condemnation procedure. Thus, for purposes of the following discussion, property “condemned” includes property voluntarily sold under threat or imminence of condemnation. Either transaction is an “involuntary conversion” of the property, within the meaning of the Internal Revenue Code of 1954.<sup>1</sup>

This article is intended to deal only with tax consequences of condemnation of real estate. The term “real estate” is intended to include land and improvements which are affixed to the land; it is contemplated that all real estate will fall into one of four

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<sup>1</sup> Int. Rev. Code of 1954, § 1033. Hereinafter cited as Code.

property held primarily for sale by a real estate dealer, or the categories for tax purposes. It is either property held for productive use in a trade or business, property held for investment, residence of the taxpayer. The article attempts to illustrate the tax consequences of the condemnation of each such class of real estate.

Discussions herein concerning involuntary conversion rules are not necessarily applicable, and should not be relied upon, where property is converted as a result of some transaction or event other than a condemnation or sale under threat or imminence of condemnation.

## II. GAIN OR LOSS

### A. ELEMENTS OF NET PROCEEDS

Although a landowner may be interested only in the total net proceeds he is paid by the condemning authority as "just compensation," as many as four separate elements of the net proceeds may be factors in determining his income tax consequences. These are: (1) the consideration or damages paid for the land actually taken; (2) the consequential or severance damages to abutting real estate retained by him; (3) the amount of special assessments he must pay the condemning authority on account of the improvement; and (4) his expenses incurred in connection with the condemnation.

### B. GAIN OR LOSS REALIZED

A condemnation of land is a sale or exchange within the meaning of the Internal Revenue Code of 1954.<sup>2</sup> Aside from two statutory exceptions, gain or loss on land condemned is realized and recognized for income tax purposes just the same as if the land had been sold voluntarily to a purchaser other than a governmental agency. The exceptions, hereinafter discussed, are found in sections 1033 and 1231 of the Internal Revenue Code of 1954.<sup>3</sup> Gain or loss realized is always measured by the difference between the net consideration received and the adjusted basis of the land condemned.

<sup>2</sup> G.C.M. 23646, C.B. 1943, p. 372; *Comm. v. Kieselbach*, 127 F.2d 359, 29 AFTR 270 (1942).

<sup>3</sup> § 1033 pertains to the election of the taxpayer not to recognize gain in certain cases; § 1231 prescribes different treatment of gains and losses on "capital assets."

### C. RECOGNITION OF LOSSES

The involuntary conversion rules deal only with non-recognition of gains in certain cases, but there is no such provision providing for non-recognition of losses. Without exception, (a) losses on residential property may not be deducted;<sup>4</sup> (b) losses on real estate held by a dealer primarily for sale are deductible from ordinary income; (c) losses on real estate used in a trade or business, held for six months or less, are deductible from ordinary income; and (d) losses on investment real estate (capital assets), held for six months or less, are deductible only as short-term capital losses, subject to the limitations of section 1211 of the Internal Revenue Code of 1954.

Losses on real estate used in a trade or business, and held for more than six months, and on investment real estate held for more than six months, are treated as section 1231 losses. Thus, the first exception applies to recognition of losses on capital assets held for more than six months. Such a loss resulting from an ordinary sale or exchange is offset against capital gains and is subject to the limitations of section 1211; however, such a loss resulting from condemnation will receive section 1231 treatment, and will be fully deductible as an ordinary loss except to the extent that it is offset against gains from other section 1231 assets. This exception points up the necessity of wise planning on the part of a landowner whose land is about to be condemned. If he has other gains or losses in the current taxable year, he might find it advantageous to stall negotiation or actual condemnation, when possible, so that the effective date of the sale will not occur until the next taxable year. Or, if the land to be taken is a capital asset held for less than six months, he may find it advantageous tax-wise to stall until the six-month holding period has expired.

### D. RECOGNITION OF GAINS

All gains from property condemned, or sold under threat or imminence of condemnation, are realized and recognized the same as if the sale were voluntarily made to a purchaser other than the condemning authority, except that long-term capital gains become section 1231 gains, and except that the taxpayer may elect not to recognize all or any part of the gain from a condemnation by complying with section 1033 and Regulations 1.1033.

Although it is generally advantageous to the taxpayer to receive section 1231 treatment with regard to losses on capital

<sup>4</sup> Code, § 165(c).

assets held for more than six months, section 1231 treatment on gains may be disadvantageous. Assume, for example, that a calendar-year taxpayer has a \$1,000 loss in 1959 by reason of the voluntary sale or exchange of a truck which he uses in his business. In the same year, he realizes a gain of \$1,000 by reason of the condemnation of a vacant lot he had held for investment for more than six months. He has no other gains or losses except profit from his business operation. Had he sold the lot voluntarily for the same price, the gain would have been long-term capital gain, subject only to the alternative tax,<sup>5</sup> or includible in taxable income only to the extent of \$500,<sup>6</sup> whichever would produce the lesser tax, and the loss on the truck would have been entirely deductible from ordinary income. By treating the condemnation gain as a section 1231 gain, however, the gain and the loss offset each other. In the one situation, a net deductible loss of \$500 is effected voluntarily, but where condemnation occurred, no deduction is effective. In such situations, the taxpayer might well find a buyer for a capital asset about to be condemned. It is doubtful at best that a voluntary sale to the condemning authority could be treated as a long-term capital gain rather than as a section 1231 gain, since section 1231 clearly pertains to property converted as a result of "condemnation or the threat or imminence thereof".

When an entire parcel of land is taken by the condemning authority, neither severance damages nor special assessments are a factor in computing the gain or loss realized by the taxpayer. When only a portion of the owner's land is taken, however, the following rules apply:

(1) The severance damages<sup>7</sup> merely reduce the basis of all the abutting land owned by the taxpayer whose land was taken, hereinafter referred to as the "remaining land". No gain is realized except to the extent that the severance damages exceed the basis of the remaining land. To the extent of the gain so realized, payment of severance damages constitutes an involuntary conversion within the meaning of section 1033. Unless the taxpayer elects non-recognition under that section, the gain will be taxable. If the

<sup>5</sup> Code, § 1201.

<sup>6</sup> Code, § 1202.

<sup>7</sup> It is assumed that damages exceed special benefits to the remaining land, and the term "severance damages" is taken to mean only the net amount paid to the landowner on account of change in value of the remaining land. Should special benefits exceed damages, then the entire amount paid would constitute consideration for the land taken.

land has been held for more than six months and is not held primarily for sale, then the gain will receive section 1231 treatment.<sup>8</sup> Otherwise, the gain will be taxable as ordinary income.<sup>9</sup>

(2) Only the part of the owner's "just compensation" which constitutes consideration for the land taken will be used in determining gain or loss realized and recognized. If the evidence clearly segregates the consideration for land taken and severance damages, then the tax consequences with regard to the land taken are the same as if an entire parcel was taken.<sup>10</sup>

(3) Expenses of negotiation, appraisals, title conveyance, and condemnation proceedings may be deducted in computing gain or loss realized upon the taking of the land, according to several decisions.<sup>11</sup> It would seem to be reasonable and proper, however, that such expenses should be allocated between the sale and the acquisition of severance damages; the writer recommends such an allocation where the facts and the benefit to the taxpayer justify it. Where interest, constituting ordinary income, has been paid on a condemnation award, the taxpayer has not been allowed to deduct expenses of the condemnation against such interest.<sup>12</sup>

(4) Any special assessments against remaining land on account of the improvement must be applied, first, against severance damages, and to the extent the assessments exceed severance damages, to reduce the consideration received for the land taken.<sup>13</sup>

<sup>8</sup> Rev. Rul. 271, C.B. 1953-2, p. 36.

<sup>9</sup> It is doubtful that a sale or exchange occurs by reason of payment of severance damages. Thus, where the land has been held for six months or less, the gain qualifies neither as a § 1231 gain nor as a short-term capital gain.

<sup>10</sup> G.C.M. 20322, C.B. 1938-2, p. 167; G.C.M. 23698, C.B. 1943, p. 340; I.T. 3203, C.B. 1938-2, p. 233.

<sup>11</sup> Washington Market Co., 25 B.T.A. 576 (1932); Connally, 32 B.T.A. 920 (1935); Johnson & Co. v. U.S., 33 AFTR 1472, 149 F.2d 851 (2d Cir. 1945); Burton-Sutton Oil Co. v. Commissioner, 150 F.2d 621 (5th Cir. 1945), 34 AFTR 68 (reversed on other issue), 328 U.S. 25, 34 AFTR 1017 (1945).

<sup>12</sup> Johnson & Co. v. U.S., 33 AFTR 1472, 149 F.2d 851 (2d Cir. 1945).

<sup>13</sup> Central & Pacific Improvement Corp. v. Commissioner, 92 F.2d 88 (9th Cir. 1937), 20 AFTR 227 (Reversing 34 B.T.A. 208); Christian Ganahl Co. v. Commissioner, 91 F.2d 343 (9th Cir. 1937), 19 AFTR 1114 (Reversing 34 B.T.A. 126); Carrano v. Commissioner, 70 F.2d 319 (2d Cir. 1934), 13 AFTR 976 (Reversing 33,199 P-H Memo B.T.A.). The writer is informed that there are no instances wherein adjoining landowners in Nebraska will be assessed for improvements in connection with the Interstate Highway.

## III. EVIDENCE OF SEVERANCE DAMAGES

The Internal Revenue Service recognizes the general rule that severance damages are applied to reduce the basis of remaining property, but such application has been denied the taxpayer where proof of the specific portion of the award representing severance damages has been held to be insufficient. The evidentiary requirements thus far set up by the Internal Revenue Service and the courts seem to be especially strict and inconsistent with other rules of tax law, but the wise taxpayer nevertheless should heed the rules to receive the maximum tax benefit.

Where property is sold voluntarily after negotiation, the Internal Revenue Service will deny treatment of any part of the award as severance damages unless the contract clearly distinguishes between such damages and consideration for the property taken. In a late ruling on the subject, the Service states: "Remuneration may be considered as having been received for damages only where such designation has been stipulated by both contracting parties."<sup>14</sup> The leading Tax Court<sup>15</sup> and Circuit Court<sup>16</sup> cases on the subject both involve Connecticut taxpayers. In both cases, the State Highway Engineer testified that he considered severance damages in a fixed sum as part of the total amount paid the taxpayer, but that such sums were not discussed in the negotiations. In one case the state purchase voucher, and in the other case the contract, simply showed the total payment as the "purchase price" of the land taken. The Tax Court stated that "a lump sum purchase price is not to be rationalized after the event as a combination of factors which might properly have been separately stated in the contract if the parties had seen fit to do so."<sup>17</sup>

The writer finds no cases where the contract states that a lump sum price was paid in consideration of both land taken and consequential damages to the remaining land. It would seem logical and reasonable, in such a case, that the taxpayer could separate the purchase price from the severance damages by proving either the relative value of each, or by oral proof that the separate amounts were mutually agreed upon. Cases are numerous where lump sum payments, recognized by the parties

<sup>14</sup> Rev. Rul. 54-575, C.B. 1954-2, p. 145.

<sup>15</sup> Marshall G. Allaben, 35 B.T.A. 328.

<sup>16</sup> Lapham v. U.S., 178 F.2d 994 (2d Cir. 1945), 38 AFTR 1255.

<sup>17</sup> *Supra*, note 15.

as consideration for more than one asset, have been allocated among the assets acquired, as, for example, in transactions where all assets and the good will of a going business have been sold for a lump sum price.

One form of right-of-way contract used by the Nebraska Department of Roads provides five separate lines on which various elements of consideration are to be stated. Where such a form is used, only the stated purchase price for the acreage taken should be considered in determining gain or loss realized on the taking of the land; however, the taxpayer should insist on a clear-cut statement in the contract describing the other elements of the total proceeds.

Some Nebraska taxpayers presently are being affected by condemnation of land along the Missouri River by the Federal Bureau of Reclamation. The form of contract used by that Bureau, and possibly by other federal agencies, does not provide for itemization of the total consideration. In cases already processed by the office of the District Director of Internal Revenue in Nebraska, the entire payment has been treated as consideration for the land taken, even where the government engineers and negotiators had agreed orally with the taxpayer as to the amount of severance damages.

When there is no voluntary sale by a landowner, then the award determined in the condemnation proceedings will be conclusive as to the treatment of severance damages. When a New York court entered judgment in a condemnation proceeding, separately stating the amount awarded for land taken and the amount awarded for consequential damages to remaining land and improvements, the Tax Court recognized the latter as severance damages.<sup>18</sup> Conversely, should the Court's award be stated as a lump sum, then the taxpayer will meet resistance from the Internal Revenue Service if he attempts to treat any part of the total award as severance damages.

In Nebraska condemnations, the condemnee's initial forum is the county court, the award being determined by appointed appraisers. The statute requires only that they ". . . shall assess the damages that the condemnee has sustained or will sustain by the appropriation of the property . . ." <sup>19</sup> Under this statute, it is doubtful that the appraisers could be forced to separate a

<sup>18</sup> Pioneer Real Estate Company, 47 B.T.A. 886.

<sup>19</sup> Neb. Rev. Stat., § 76-710 (Reissue 1958).

condemnation award into two sums, one for land taken and the other for severance damages. The condemnee's only apparent hope of tax relief is a prayer based on sympathy that the county judge will instruct the appraisers to state the severance damages separately. Should the appraisers make only a lump sum award, then tax consequences might dictate an appeal to the district court, even if the total amount of the award is sufficient.

The Iowa Legislature solved a similar dilemma by amending its eminent domain statute. The statute now directs the condemnation "commissioners" to divide the damages into the value of the land and improvements being condemned and the consequential damages, when requested by the condemnee.<sup>20</sup> Similar legislation is recommended to the Nebraska Legislature.

Once a Nebraska condemnation proceeding is appealed to the district court, the condemnee should request that the jury or court render separate verdicts or findings with regard to the two elements of the total award. The form of verdict rendered in *Schulz v. Central Nebraska P. P. & I. Dist.*,<sup>21</sup> listing separate damages for land taken and for consequential damages to remaining land, certainly should be satisfactory from a tax standpoint. However, a special verdict or finding is not a matter of right to a litigant,<sup>22</sup> and specific legislation certainly should be considered.

#### IV. NON-RECOGNITION OF GAIN

A condemnation or a sale under threat or imminence of condemnation is an "involuntary conversion" within the special meaning of that term in the Internal Revenue Code.<sup>23</sup> Recognizing the inequity of forcing a taxpayer to pay tax on a gain realized only under compulsion, Congress provided relief by allowing the taxpayer to escape tax on the gain from condemned property where the proceeds are used to replace the property taken. The rules were liberalized to take effect as of January 1, 1951<sup>24</sup> and broadened to include residential property as of January 1, 1954.<sup>25</sup> The relief provisions were further broadened with regard

<sup>20</sup> Iowa Code, § 472.14.

<sup>21</sup> 138 Neb. 529, 293 N.W. 409 (1940).

<sup>22</sup> Neb. Rev. Stat., § 25-1121 (Reissue 1956).

<sup>23</sup> Code, § 1033.

<sup>24</sup> Section 112(f), Internal Revenue Code of 1939; 65 Stat. 733 (1951).

<sup>25</sup> Code, § 1033(b).

to dispositions occurring after December 31, 1957, with regard to the nature of replacement property and with regard to treatment of gain on condemnation of a residence.<sup>26</sup>

#### A. EXTENT OF NON-RECOGNITION

The taxpayer may elect not to recognize gain realized from condemned real estate if the proceeds received for the land taken are reinvested in the requisite "replacement property," within specified time limits. If the entire proceeds are reinvested, no gain need be recognized; if only a portion of the proceeds are reinvested, then the gain must be recognized to the extent that such proceeds are not reinvested.

Under rules effective after December 31, 1950, it is not necessary to trace specific funds into the replacement property, the only factor being the amount of money invested in the replacement property.

Assume, for example, that a strip of a taxpayer's unimproved farm is condemned. He owns forty acres, having a basis of \$20,000, of which ten acres having a basis of \$5,000 is taken. He receives an award of \$30,000 for the ten acres, plus \$4,000 damages to the remaining land. He has realized a gain in the amount of \$25,000 on the ten acres, and the basis of the remaining thirty acres is reduced to \$11,000. If he elects nonrecognition of gain and purchases other farm land costing at least \$30,000, then he need not recognize nor pay tax on any gain. If the other farm costs him only \$22,000, then he must recognize and pay tax on \$8,000, that portion of the proceeds of the converted land not reinvested.

#### B. TIME FACTORS

Contrary to the usual real estate sale, both title to and possession of condemned property may, and often do, pass to the condemner without any voluntary act of the condemnee. In such situations, it is probable that the condemnee taxpayer will not receive any proceeds from the condemnation until some later time. Both the date of passing title and the date of receipt of proceeds may be extremely important in tax planning.

The date that the condemning authority is vested with title and possession is normally the effective date of condemnation and thus of "disposition." Disposition of the property is the key event which determines which law is applicable, i.e., pre-1951,

<sup>26</sup> Regulations 1.1033.

post-1950, 1954 Internal Revenue Code, or the 1958 amendments. Disposition is also the effective act which terminates one's holding period, for purposes of determining whether the transaction results in a short-term or long-term gain or loss.<sup>27</sup>

For example, if a Nebraska taxpayer purchased land on July 1, 1950 and condemnation proceedings were commenced in October, 1950, resulting in the deposit with the county court on December 1, 1950 of the appraiser's award, the pre-1951 law would apply, and the resulting gain or loss would be short-term because the property would have been "held" for only five months. These results would follow even though the proceedings were appealed both to the district court and the Nebraska Supreme Court, and even though no gain or loss were realized until 1958, when the awarded damages finally became payable to the taxpayer.

No gain or loss is realized until such time as an accrual basis condemnee becomes entitled to awarded damages, by reason of the damages becoming fixed.<sup>28</sup> Under Nebraska statutes, this would be the date following the last day for appeal of an award, since no part of an award becomes certain until neither party may appeal.<sup>29</sup>

A cash basis taxpayer realizes gain or loss at such time as the condemnation award actually is paid to him, where the entire sum becomes payable at one time, as under the Nebraska statute.<sup>30</sup> Assume that a Nebraska taxpayer's land is condemned through statutory procedure in the county court and the last day for appeal is December 30, 1958; that no appeal is taken, and the award is paid to the taxpayer on January 2, 1959. If the taxpayer's taxable year ends December 31, he realizes gain or loss in 1958 if he files on an accrual basis, or in 1959 if he is a cash basis taxpayer.

Under some statutory condemnation procedures, a minimum award becomes fixed and certain even though the condemnee taxpayer may appeal in the hope of obtaining a greater award. If such an award exceeds the taxpayer's basis for the property taken, gain is realized by an accrual basis taxpayer when the

<sup>27</sup> *Comm. v. Kieselbach*, 127 F.2d 359, 29 AFTR 270 (1942).

<sup>28</sup> *Koppers Co. v. Commissioner*, 3 T.C. 62; affirmed on this issue, 151 F.2d 267, 34 AFTR 151 (1945).

<sup>29</sup> Neb. Rev. Stat. § 76-719 (Reissue 1958).

<sup>30</sup> *Keneipp v. U.S.*, 184 F.2d 263, 39 AFTR 1039 (1950).

award of such minimum amount is paid into the court,<sup>31</sup> or by a cash basis taxpayer when such amount is paid to him.<sup>32</sup>

### C. ACQUISITION OF REPLACEMENT PROPERTY

In order that a taxpayer may avoid recognition of gain, he must reinvest the proceeds of property taken in replacement property within specific time limits, if the disposition occurred after 1950. The replacement property may have been purchased prior to disposition, but not sooner than the earliest date of threat or imminence of condemnation. There seems to be no helpful authority for determining the precise time when "threat or imminence" first occurs, but it is suggested that the taxpayer have some official notice in writing that his property is about to be condemned prior to the time of buying replacement property. The last date that the replacement property may be acquired is one year after the last day of the taxable year in which any part of the gain is first realized, provided, that the District Director of Internal Revenue for the district in which the taxpayer files his return may extend the time within which such property may be acquired. The application of the taxpayer should be filed prior to the stated deadline for replacement, showing reasonable cause for failure to acquire replacement property prior to the deadline,<sup>33</sup> but even a delinquent application may be granted if the delinquency was due to reasonable cause.<sup>34</sup>

With regard to dispositions occurring prior to 1951, replacement property had to be acquired "forthwith"<sup>35</sup> — construed as meaning "within a reasonable time" — and could not be acquired prior to receipt of the proceeds of the conversion<sup>36</sup> since it was necessary to trace the specific funds into the replacement property.<sup>37</sup>

<sup>31</sup> *Supra*, note 28.

<sup>32</sup> *Nitterhouse v. U.S.*, 207 F.2d 618, 44 AFTR 527 (1953); *Cert. denied*, 347 U.S. 943 (1954).

<sup>33</sup> Code, § 1033(a)(3)(B); Regulations 1.1033(a)-2(c)(3).

<sup>34</sup> Rev. Rul. 56-543, C.B. 1956-2, p. 521.

<sup>35</sup> *Winter Realty & Construction Co. v. Commissioner*, 149 F.2d 567, 33 AFTR 1411 1945, affirming 2 T.C. 38; *George Herder Estate*, 106 F.2d 153, 23 AFTR 322 (1939), affirming 36 B.T.A. 934.

<sup>36</sup> *Twinboro Corp. v. Commissioner*, 149 F.2d 574, 33 AFTR 1418 (1945); *Cameron Machine Co.*, 24 T.C. 394; I.T. 3827, C.B. 1946-2, p. 57.

<sup>37</sup> *Commissioner v. Flushingside Realty Co.*, 149 F.2d 572, 33 AFTR 1416 (1945); *Frischkorn Development Co.*, 88 F.2d 1009, 19 AFTR 244 (1937), affirming 30 B.T.A. 8.

## D. NATURE OF REPLACEMENT PROPERTY

In order to elect nonrecognition of gain on condemned real estate, the replacement property purchased must be "similar or related in service or use"<sup>38</sup> to the property condemned, except for dispositions of business or investment real estate occurring after 1957, in which event the replacement property must be "of a like kind"<sup>39</sup> as the property condemned.

The phrase "similar or related in service or use" has been construed quite narrowly, thus greatly restricting the benefit intended by the involuntary conversion rules. It has been held that improved property is not similar or related in use to unimproved property, and vice versa.<sup>40</sup> Property which was used in a trade or business is not similar to property held for rent,<sup>41</sup> and property held for rental and used by the tenant for a specific purpose has been held not similar to replacement property held for rental, but used by the tenant for a different purpose.<sup>42</sup> Thus in order to assure himself of non-recognition of gain on property condemned prior to 1958, the taxpayer must be careful to acquire replacement property which is held and used in the same manner as the property condemned.

Where a strip of farm land was condemned and the owner used the proceeds to make capital improvements on the remaining portion of the farm, such as fences, sheds, trees, and wells, the proceeds were held to be invested in property similar and related in service or use.<sup>43</sup> Even though severance damages are paid specifically because such improvements will be necessary, the taxpayer may elect non-recognition of gain on the property taken if the severance damages so invested exceed the damages paid for the land taken.

The 1958 amendment<sup>44</sup> to the statute was intended to give the same benefit to a taxpayer with regard to condemned property as he might have received had he voluntarily exchanged the condemned property for other property of a "like kind." The

<sup>38</sup> Code, §§ 1033(a)(2) and 1033(a)(3); Regulations 1.1033(a)-2.

<sup>39</sup> Code, § 1033 (g), added by § 46(a), Technical Amendments Act of 1958, 72 Stat. 1641.

<sup>40</sup> I.T. 1617, C.B. June, 1923, p. 119; Regulations 1.1033(a)-3(g).

<sup>41</sup> Collins, 29 T.C. 670.

<sup>42</sup> Rev. Rul. 56-347, C.B. 1956-2, p. 517; Steuart Bros, Inc., 29 T.C. 372.

<sup>43</sup> Rev. Rul. 53-271, C.B. 1953-2, p. 36.

<sup>44</sup> Code, § 1033(g).

liberalized rule applies only to property held for use in business or for investment, and, thus, is inapplicable to the taxpayer's residence or to property held for sale by a real estate dealer.<sup>45</sup> The old property and the new property are of a like kind if held either for productive use in business or for investment, and it is immaterial whether the real estate is improved or unimproved. Thus, proceeds of condemned farm or ranch land may be invested in city rental real estate, or in real estate to be used in a trade or business. A leasehold interest in real estate having at least thirty years to run is deemed to be an interest in real estate, and may be replaced by a fee simple interest in real estate, or vice versa.<sup>46</sup>

#### E. REPLACEMENT THROUGH CORPORATE CONTROL

The condemnee is deemed to have acquired replacement property if he acquires at least eighty per centum of the total combined voting power of all classes of voting stock and at least eighty per centum of all other classes of stock of a corporation, and if the corporation owns the requisite replacement property.<sup>47</sup> This special provision does not apply, however, to "like kind" replacements.<sup>48</sup> Thus, the replacement property owned by the corporation, stock of which is acquired by the condemnee, must be similar or related in service or use to the condemned property.

A question apparently never litigated is whether the other assets of the corporation, stock of which is acquired, have any bearing on whether or not the condemned property has been properly replaced. Assume, for example, that a strip of farm land is condemned and the condemnee receives \$200,000 for the land taken. If he then buys control of a corporation for \$200,000, the statute is literally complied with if the corporation also owns farm land. However, if the corporate assets consist of a farm worth \$10,000 and other assets worth \$190,000, it seems logical that only \$10,000 of the condemnation proceeds could be treated as having been used to acquire replacement property.

<sup>45</sup> Code, § 1031; Regulations 1.1031; S. Rep. No. 1983, 85th Cong., 2d Sess. 72 and 202 (1958).

<sup>46</sup> Regulations 1.1031(a)-1(b) and 1.1031(a)-1(c).

<sup>47</sup> Code, §§ 1033(a)(3)(A) and 1033(a)(2), as amended by 72 Stat. 1641, § 45 (1958).

<sup>48</sup> Code, § 1033(g)(2)(A)

## F. BASIS AND HOLDING PERIOD OF REPLACEMENT PROPERTY

The basis of replacement property is its cost, decreased by the amount of any gain realized but not recognized upon the condemned property. It appears that the same result will obtain whether the condemnation of the old property occurred before or after January 1, 1951, but the statutory formula is stated differently with regard to pre-1951 dispositions. The statute requires using the basis of the condemned property, adding thereto the gain recognized upon the conversion, and subtracting therefrom the portion of the net proceeds of the conversion not expended in acquiring the replacement property.<sup>49</sup>

It seems that the change in statutory language was intended only as a simplification, but it poses a definite problem with regard to the holding period of the replacement property. Under the pre-1951 rule, the replacement property clearly takes the basis of the old property, with adjustments. Under the basis rule applying to dispositions after 1950, the replacement property clearly takes a new basis—its cost, with adjustments. The result is that the holding period of property acquired to replace property condemned prior to 1951 begins with the date of acquisition of the condemned property, but the holding period of property condemned acquired to replace property condemned after 1950 begins with the date of acquisition of the replacement property.<sup>50</sup>

Assume, for example, that a Nebraska farm owner became advised in June, 1950, that a portion of his farm was about to be taken for a new highway. Had he sold the strip of land at a gain voluntarily, after negotiation, on December 31, 1950, and reinvested the total proceeds in farm land on January 1, 1951, the holding period of the new land would have commenced with the date of acquisition of the old farm. On the other hand, had the land been condemned through statutory procedure, and had the title and right to possession not become effective until after December 31, 1950, then the holding period of the replacement property, whether acquired before or after December 31, 1950, would have commenced with the date of acquisition.

<sup>49</sup> Code, § 1033(c); Regulations 1.1033(c)-1.

<sup>50</sup> Code, § 1223(1); Regulations 1.1223(1)(a).

## V. PARTICULAR PROBLEMS

## A. CONDEMNATION OF RESIDENCE

Tax consequences of condemnation of a residence may vary considerably depending upon the date of disposition, as the Congress has continually attempted to alleviate hardship on a taxpayer whose residence is involuntarily taken. Whether sold voluntarily, or sold under threat of condemnation, or actually condemned, the sale or disposition of a residence will result either in a non-deductible loss, or in a capital gain. Any gain from a condemnation sale or award, however, will receive section 1231 treatment, taxed as capital gain only to the extent it exceeds section 1231 losses, if the residence had been held for more than six months.

With regard to the disposition of a residence prior to 1951, the taxpayer could elect non-recognition of gain only if the residence was involuntarily converted, and if the replacement residence was acquired pursuant to the strict pre-1951 rules.<sup>51</sup> Effective January 1, 1951, Congress adopted specific legislation to provide for non-recognition of gain on any sale or disposition of a residence, including condemnations.<sup>52</sup> The rules provided substantially the same relief with regard to a residence as was effective with regard to involuntary conversions of other property. This statute was re-enacted in 1954;<sup>53</sup> except that condemnations and other involuntary conversions occurring after December 31, 1953, were excluded from the operation of the section.<sup>54</sup>

Condemnations of residences occurring in the years 1954 through 1957, inclusive, were involuntary conversions, and gain thereon was subject to non-recognition under the rules effective for condemnations of other real estate at such time.<sup>55</sup> Final liberalization of the statute came with the Technical Amendments Act of 1958. Effective with regard to condemnation of a residence occurring after December 31, 1957, the taxpayer may elect non-recognition of gain by complying with the replacement requirements of either the specific statute dealing with sale of a residence or the involuntary conversion statute.<sup>56</sup>

<sup>51</sup> Internal Revenue Code of 1939, § 112(f)(2)

<sup>52</sup> *Id.*, § 112(n).

<sup>53</sup> Code, § 1034.

<sup>54</sup> Code, § 1034(i).

<sup>55</sup> Code, § 1033(b)

<sup>56</sup> Code, § 1034(i)(2).

**B. METHOD OF ELECTING NON-RECOGNITION OF GAIN<sup>57</sup>**

The Commissioner requires that full details of any condemnation be reported on the taxpayer's income tax return filed for the fiscal year in which any gain is realized. Such return should set out a computation of gain realized, but should not include such gain in gross income to the extent that non-recognition is elected. It is suggested that a positive statement be made on the return to the effect the taxpayer is making his election under section 1033 of the Internal Revenue Code of 1954, even though the regulations specifically state that a failure to include any such gain in gross income will be deemed to be an election.

If the taxpayer includes gain from condemned property in gross income on his return for the taxable year in which gain was incurred, he may later file either an amended return or a refund claim, making the election at such time, if the statute of limitations has not run.

If the taxpayer shall have elected non-recognition, but failed to acquire replacement property within the requisite time, he is required to file an amended return and pay the additional tax on the gain. In any event, complete details of acquisition of replacement property must be reported to the District Director of Internal Revenue by separate notice or on the taxpayer's return filed for the taxable year in which any such property is acquired, whether or not any gain from the condemnation was realized in that year.

Where residential property is condemned in 1958 or thereafter, the taxpayer must carefully decide whether he wishes to elect non-recognition of gain under the sale of residence statute<sup>58</sup> or under the involuntary conversion statute.<sup>59</sup> Although present regulations do not so specify, obviously the taxpayer should clearly state his election on the return filed for the year in which gain is first realized.

**C. EFFECT ON STATUTE OF LIMITATIONS<sup>60</sup>**

The Commissioner normally may assess an income tax deficiency within three years after the due date or date of actual

<sup>57</sup> Regulations 1.1033(a)-2(c)(2).

<sup>58</sup> Regulations 1.033(a)(2)(c)(5) and 1.1033(a)(2)(c)(6).

<sup>59</sup> Code, § 1034.

<sup>60</sup> Code, § 1033.

filing of an income tax return, whichever is later. An election under section 1033 automatically extends the statute, and the period of limitation becomes three years after the date the taxpayer first notifies the District Director of Internal Revenue of the details of acquisition of the replacement property, or of taxpayer's intention not to replace the converted property, or of taxpayer's failure to replace the converted property. In addition, where the condemnation or other involuntary conversion results in realization of gain in more than one taxable year, which is not likely under Nebraska statutes, a deficiency for any such year may be assessed within the period of limitations which applies to the last such year.

The extension of the period of the statute of limitations only allows the Commissioner to assess any deficiency arising out of gain incurred upon the conversion with regard to which non-recognition of gain has been elected, and the normal periods of limitations will apply to a deficiency assessed by reason of any other transaction.

The requisite notice with regard to replacement property obviously should be in writing; it may be filed with taxpayer's regular income tax return, or may be a separate instrument or letter. The notice must be filed with the District Director for the same district in which the return or returns, on which non-recognition was elected, were filed.

#### D. INTEREST ON CONDEMNATION PROCEEDS

Nebraska statute expressly provides for the payment of interest to a condemnee in cases where the condemnation award is appealed and the award is increased in the appeal proceedings. Interest is paid on the total award at six per cent per annum from the date of deposit of the original award with the county judge.<sup>61</sup> Any such interest paid is taxable as ordinary income to the condemnee,<sup>62</sup> and has no effect on gain realized or recognized under rules hereinabove discussed.

<sup>61</sup> Neb. Rev. Stat. § 76-711 (Reissue 1958).

<sup>62</sup> *Kieselbach v. Commissioner*, 317 U.S. 399, 87 L.Ed 358 (1943), overruling *Seaside Improvement Co. v. Commissioner*, 105 F.2d 990, 23 AFTR 293 (1939).

## VI. CONCLUSION

Interstate highway condemnations within the next few years will present a definite opportunity for the alert lawyer to save his client tax dollars by proper planning. The amount of the award, the timing of the disposition, the allocation of the award between "consideration" and "severance damages" and the possibility, practicability and timing of reinvestment of proceeds, all may be important factors in advising a client.

Serious consideration should be given to amendment of Nebraska eminent domain statutes in order that Nebraska landowners may be assured maximum benefit of special rules pertaining to federal taxation of gain incurred by reason of condemnation. Before such amendments are adopted, however, special care must be taken to assure the preservation of the landowner's right to just compensation.