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Robert Edward Haden
West Virginia University College of Law

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so, sets up complex standards which are difficult to apply. A simpler approach to this problem might be the fragmentation of gain. At any rate, it would appear that Congressional revision or amendment will be necessary to alleviate the undue complication.

Frank Thomas Graff, Jr.

Income Tax—Nonrecognition of Gain Realized upon Involuntary Conversion of Investment Property

Taxpayer, a corporation, realized gain upon the condemnation of a building owned by the taxpayer and leased to a manufacturing company. Taxpayer replaced the condemned property with another building which was reasonably similar to the original building. The replacement property was leased to a wholesale grocery business. The Tax Court sustained the commissioner's determination of an income tax deficiency based on taxpayer's failure to include in gross income the gain realized on the condemnation. *Held*, reversed. Uses of original property, which taxpayer leased to a tenant for manufacturing purposes, and replacement property, which was leased for warehousing purposes, were "similar or related in service or use" within the meaning of INT. REV. CODE of 1954, § 1033 (a) (3) (A), and taxpayer's gain on original property was exempt from taxation. *LOCO REALTY CO. V. COMMISSIONER*, 306 F.2d 207 (8th Cir. 1962).

The Internal Revenue Code of 1954 provides that if property is involuntarily converted as a result of its destruction, theft, or requisition or condemnation, gain on the conversion need not be recognized if the money subsequently obtained is used to purchase replacement property which is "similar or related in service or use." INT. REV. CODE of 1954, § 1033 (a) (3) (A). In determining whether the replacement property fulfills the requirements of the statute, the various courts of appeals have distinguished the cases which involve a taxpayer-lessor and those which involve a taxpayer-user. The situation is further complicated by the fact that the courts are not in agreement as to what tests should be applied in ascertaining whether the taxpayer-lessor is entitled to the nonrecognition of gain benefits. As a result of the holding in the principal case there are now five different tests with respect to the taxpayer-lessor situations.

In construing section 1033 and its predecessor statutes the Tax Court has developed a "functional use" test. See, e.g. *Gaynor News Co.*, 22 T.C. 1172 (1954); *Winter Realty & Constr. Co.*, 2 T.C. 38 (1943), modified, 149 F.2d 567 (1945); *Flaxlinum Insulating Co.*, 5 B.T.A. 676 (1926). In applying the "functional use" test, the court considers the actual end use to which the converted and replacement properties are put. The Tax Court has encountered no serious opposition from the appellate courts in its application of the "functional use" test to a taxpayer-user. However, in extending this test to the taxpayer-lessor a considerable divergence of opinion has resulted in the various courts of appeals.

The "functional use" test was affirmed by the Third Circuit when it denied the benefit of nonrecognition of gain to a taxpayer-lessor who replaced a condemned public parking lot with a nine acre property containing a large two-story building which was leased for warehousing purposes. *McCaffrey v. Commissioner*, 275 F.2d 27 (3rd Cir. 1960). The court held that the fact that both the condemned property and the replacement property were used for the purpose of producing rental income was irrelevant. The opinion indicated that the statute is not concerned with why the taxpayer invests the proceeds, but only how he does so.

In sharp contrast to the *McCaffrey* case is *Steuart Bros. v. Commissioner*, 261 F.2d 580 (4th Cir. 1958). The taxpayer in this case had purchased land containing buildings used in the automobile business, a service station, and used car lots as a replacement property for commercially zoned land which he had committed to the erection of warehouses. The Fourth Circuit, in reversing the Tax Court and holding that the replacement property was "similar or related in service or use," emphasized the investment character of both properties. The court said the taxpayer held the replacement property ". . .for an investment exactly as it had previously held the condemned properties; and it is manifest that the purpose of the statute will be served if the taxpayer is not compelled at this time to recognize the gain. . . ." *Steuart Bros. v. Commissioner, supra* at 583. Although the court mentions that the replacement property should be of the "same general class," it seems content when it finds investment character in both properties.

The Second Circuit has promulgated a test which places primary emphasis on the service or use which the condemned property and replacement property have to the taxpayer-owner. In *Liant*

Record, Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962), the court held that apartment buildings, leased primarily as private residences, were properties "similar or related in service or use" to a condemned building which had been leased as commercial office space. The validity of comparing actual physical uses when the taxpayer is the end user of the property was recognized. However, the court held that when the taxpayer is an investor rather than a user, ". . . it is not the lessees' actual physical use but the nature of the lessor's relation to the land which must be examined." *Liant Record, Inc. v. Commissioner*, *supra* at 329. In applying this test to a lessor, the nature and extent of management activity, the services rendered to the tenants, and the business risks involved must be scrutinized. Thus, the Second Circuit has attempted to formulate a single test which would be equally applicable to both users and investors, i.e. a comparison of the services and uses of the original and replacement property to the taxpayer-owner. 11 U.S. TAX WEEK 958 (1962). This test has been recently accepted by the Seventh Circuit in *Pohn v. Commissioner*, 31 U.S.L. WEEK 2210 (7th Cir. Oct. 19, 1962).

The fourth test which has been advanced is that the replacement property and the condemned property must be of the "same general class." *Filippini v. United States*, 200 F.Supp. 286 (N.D. Calif. 1961). This court discusses the *Steuart* and *McCaffrey* cases, *supra*, and determines that the disagreement between the two is "more apparent than real." This district court feels that under the rule of the *Steuart* case, the mere fact that both properties are investments would not be sufficient, but that the properties must meet the further requirement of the "same general class" test. In applying this test, the Northern District Court of California would apparently require that both are ". . . generically comparable, e.g. commercial, industrial, agricultural, etc. . . ." *Filippini v. United States*, *supra* at 292. According to the court, such a comparison obviously involves a consideration of the characteristics and uses of the properties.

The Eighth Circuit in the principal case, after an exhaustive analysis of the various tests applied by the different courts, formulates its own test utilizing characteristics of the *Steuart*, *Liant*, and *Filippini* rulings, *supra*. The court regards the "functional use" test as too restrictive and the "investment" test at the other extreme as too liberal. Although finding merit in the "same general class" and "comparison of taxpayer-owner's use" tests, the court feels that they are not sufficiently flexible to accomplish the purpose of the statute. In holding that the end uses are not determinative, the court

finds that it is sufficient if, coupled with the investment character, there is also a reasonable similarity in the leased premises themselves.

Thus, at this time there are five different tests which have been formulated to determine whether a taxpayer-lessor shall qualify for the nonrecognition of gain provisions of section 1033. The only concrete lesson which can be drawn from the various cases is that all the courts which have decided the question, with the exception of the Third Circuit, will give some special emphasis to the taxpayer's investment status. The majority of the courts thereby seem to recognize that the purpose of the statute is to allow a taxpayer to maintain continuity of interest without being compelled to recognize a gain which is brought about by acts over which he has no control. *Filippini v. United States*, *supra*, is now on appeal to the Ninth Circuit, and *Clifton Investment Co.*, 36 T.C. 569 (1961), is on appeal to the Sixth Circuit. It is strictly a matter of conjecture as to whether these courts will clarify the situation by adopting one of the tests already formulated or will further complicate matters by promulgating additional tests.

The Internal Revenue Code also contains a provision that if property "held for productive use in trade or business or for investment" is exchanged for property of a "like kind," the gain on such exchange need not be recognized. INT. REV. CODE OF 1954, § 1031 (a). Under the "like kind" test it appears that the replacement of one investment property for another investment property, without regard to a comparison of uses or characteristics, would be allowable. 3 MERTENS, LAW OF INCOME TAXATION § 20.171 (Cum. Supp. 1962, at 90). The incongruous result is that there is a stricter standard for nonrecognition of gain on involuntary conversions than for nonrecognition of gain on voluntary conversions. To eliminate this illogical difference, the Internal Revenue Code was amended in 1958 to apply the "like kind" test to involuntary conversions of property "held for productive use in a trade or business or for investment." INT. REV. CODE OF 1954, § 1033 (g). This amendment was, however, made prospective in nature and applies only to involuntary conversions which occur after December 31, 1957. Thus, the problem under discussion appears to be solved as far as future condemnations are concerned. However, the fact that considerable volume of litigation is still likely to occur on condemnations which took place prior to 1958 makes the problems herein discussed of continuing interest and value.

Robert Edward Haden