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TAX TREATMENT OF CONDEMNATION PROCEEDS: AN ANALYSIS AND SOME PROPOSALS FOR REFORM

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I. INTRODUCTION

Vast urban renewal and highway construction projects have become a commonplace part of the American scene. A necessary concomitant of this development has been the more frequent use of eminent domain, the power of the sovereign to take land for public use after payment of just compensation. The use of this power often disrupts expectations and established patterns of life. As more people are being affected, more attention is being directed toward determining whether they are being treated fairly. Work in this area has, however, been directed primarily toward defining the appropriate standards and elements of a condemnation award. It appears that no explicit consideration has been given to the impact of the federal tax laws on the fairness of an otherwise fair award. This paper will analyze this impact and offer suggestions for making the federal tax law more equitable.

At the outset it is important to note that the impact of federal taxation may raise questions of constitutionality as well as questions of abstract fairness. Consideration of the tax treatment may therefore involve challenging the legality of governmental action in addition to raising debatable issues of policy. The standards of the fifth amendment's "just compensation" clause must be satisfied. Thus, before proposing methods of taxation, we identify the constitutional limitations imposed by these clauses.

The fifth amendment provides in part that private property shall not "be taken for public use without just compensation."¹ It is arguable that this clause requires the justness of an award to be evaluated after the imposition of any gains tax, on the theory that, since the payment of the condemnation award triggers the

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1. U.S. CONST. amend. V.

imposition of any tax, the condemnee has received "just compensation" only if the amount finally held by him constitutes a just payment.

The fifth amendment is silent on the question of whether the impact of taxation is to be considered in assessing the constitutionality of an award under the "just compensation" clause. Moreover, any attempt to ascertain legislative intent must contend with the fact that no federal income tax existed at the time the amendment was passed. There are apparently no decisions which specifically raise this question, but cases under the "just compensation" clause seem to have implicitly resolved it by never mentioning the impact of taxation in evaluating the fairness of an award. Since these cases are quite detailed in defining the losses for which compensation must be paid² and the methods of valuing those losses,³ one apparently must conclude that the impact of taxation is not now felt to be a factor in determining "just compensation."

This conclusion is further buttressed by the fact that the determination of the condemnation award and the taxation, if any, of that award are two entirely different transactions. Under a system which taxes income regardless of source, the rate of taxation depends not on the fact that the income comes from a condemnation proceeding but on the total amount of income earned by the taxpayer. Thus the impact of taxation should be judged under the constitutional standards for taxation rather than under the constitutional standards for eminent domain.

2. *E.g.*, *International Paper Co. v. United States*, 282 U.S. 399 (1931) (where the government requisitioned from a power company all of the electric power which could be produced by use of the water diverted through its intake canal, thereby eliminating the source of supply of a lessee whose right to draw a portion of that water had the status of a corporeal hereditament under state law, the lessee was awarded compensation for the rights taken); *Monongahela Nav. Co. v. United States*, 148 U.S. 312 (1893) (upon condemnation of a lock and dam belonging to a navigation company, compensation was required for the franchise to take tolls as well as for the tangible property); *United States v. Miller*, 317 U.S. 369 (1943) (government was not required to compensate a condemnee for any increment in value added to his property by the action of the public authority in previously condemning adjacent lands where the public project from the beginning included the taking of the condemnee's property as well as that of his neighbors or the possibility of such a taking); *Old Dominion Co. v. United States*, 269 U.S. 55 (1925) (government was not required to compensate for the value of improvement made by it when it had held the condemned property under a lease).

3. *E.g.*, *United States ex. rel. T.V.A. v. Powelson*, 319 U.S. 266 (1943) (market value is the normal measure of recovery); *United States v. Miller*, 317 U.S. 369 (1943) (the owner's loss, not the taker's gain, is the measure of just compensation); *McCandless v. United States*, 298 U.S. 342 (1936) (market value may reflect not only the use to which the property is presently devoted but also that to which it may readily be converted).

To be constitutional, a federal tax must satisfy the due process clause of the fifth amendment.⁴ The cases under this standard have made it clear that it is met whenever a tax is imposed to effectuate a reasonable policy.⁵ Numerous taxes have been upheld even though they appear to impose discriminatory burdens; examples are the graduated income tax,⁶ a tax on oleo-margarine greater than the tax on butter,⁷ and a tax on employers of eight or more employees.⁸ Because of this liberal constitutional standard, the present system of taxation appears to satisfy the due process clause.⁹

Although the constitutional limitations on the tax treatment of a condemnation award are not likely to be violated by a given statute, they should be kept in mind. First, situations may arise in which a constitutional claim will have merit.¹⁰ Second, and more significantly, the notions of fairness which this analysis attempts to refine proceed directly from the fifth amendment's broadly stated requirement of just compensation.

A second important introductory point relates the tax treatment of condemnation awards to the overall policy of present law regarding gains from the "sale or exchange" of property. (See Appendix A for an outline of tax treatment of a sale or exchange.) Basically, the whole problem of deciding how to tax a condemnation award stems from the policy of the current tax structure, which, by taxing appreciation only when property is sold or exchanged, normally permits the taxpayer to decide whether, and when, to incur a tax. It is often forgotten that this system is not the only reasonable way to tax appreciation.

A strong argument can be made that appreciation should be taxed in the year it occurs, regardless of whether the appreciated

4. *E.g.*, *Brushaber v. Union Pac. R.R.*, 240 U.S. 1 (1916) (progressive rate structure not a violation of fifth amendment due process).

5. *E.g.*, *Steward Mach. Co. v. Davis*, 301 U.S. 548 (1937); *Brushaber v. Union Pac. R.R.*, 240 U.S. 1 (1916); *McCray v. United States*, 195 U.S. 27 (1904).

6. *Brushaber v. Union Pac. R.R.*, 240 U.S. 1 (1916).

7. *McCray v. United States*, 195 U.S. 27 (1904).

8. *Steward Mach. Co. v. Davis*, 301 U.S. 548 (1937).

9. A claim on "equal protection" grounds cannot be made under the due process clause of the fifth amendment. "Unlike the fourteenth amendment, the fifth contains no equal protection clause and it provides no guaranty against discriminatory legislation by Congress." *Detroit Bank v. United States*, 317 U.S. 329, 337 (1943); *Helvering v. Lerner Stores Co.*, 314 U.S. 463 (1941).

10. A state law which might well be found to be unconstitutional is MASS. GEN. LAWS ANN. ch. 62, § 7A (Supp. 1966), which taxes at a rate of 50% gains accruing to one who purchased land within one year of its being taken by eminent domain or purchased by a body authorized to take by eminent domain.

property is sold or exchanged.¹¹ In support of the argument, it is contended that the taxpayer who retains appreciated property is in substantially the same position as if he had sold the property. The existence of any appreciation will be determined by current market value, which, by definition, means that the property can be sold at that value. Thus the taxpayer who retains appreciated property possesses the gain as if he had converted it to cash by a sale and therefore should be taxed on it.

An additional argument against the current tax policy of taxing gain only at the time of sale or exchange is that it distorts the free flow of capital by rewarding those property owners who do not change the form of their investments. This reward occurs in two ways. First, no tax is payable until the investment is sold or exchanged;¹² and, second, the taxpayer can escape the tax permanently by holding the property until his death.¹³ As a result of these incentives, capital tends to remain where it is rather than to move freely to more favorable investment opportunities. Thus the vaunted "proper" allocation of resources by a free market is hindered because a more favorable investment opportunity may not be sufficiently advantageous for the taxpayer to incur a gains tax. If the taxpayer had to incur the tax on appreciation even if he retained his investment, then he would move his capital into any slightly more favorable investment.

This alternative to our present system of taxing appreciation of property is relevant for this paper because its adoption would obviate the basic problem of the current Internal Revenue Code regarding the proceeds of a condemnation. The problem is that of harmonizing the treatment of such proceeds with the treatment of other gains. It arises because condemnation, by its nature, forces the taxpayer to change his investment, thereby depriving him of the opportunity to delay taxation by retaining his property. If taxation could never be postponed, it would not be necessary to define the circumstances under which postponement would be permitted.

This paper is not, however, an assessment of the present structure for taxing appreciation of property; this structure is accepted. The focus is on assuring that the condemnee is treated fairly within this structure. Thus the analysis is predicated on

11. Under *Eisner v. Macomber*, 252 U.S. 189 (1920), gain can constitutionally be taxed only when it is realized. Any change in the law which would tax appreciation prior to a realization by sale or exchange would thus have to contend with the holding of this case.

12. INT. REV. CODE OF 1954, § 1002 [hereinafter cited as IRC].

13. IRC § 1014.

an acceptance of two basic policies of the present law. The first is that the taxpayer is generally free to decide when to incur a gains tax by selling his property; therefore, the tax treatment of a condemnation award can be considered unfair when it accelerates the incidence of taxation so that it occurs before it would have occurred in the absence of condemnation. The second is that the gain is taxable when the taxpayer substantially changes the nature of his investment; therefore, the condemnee should not be able to utilize the fortuity of condemnation to avoid a tax he would have paid absent a condemnation.

II. THEORY

Given a system in which the taxpayer can postpone tax by retaining his property, the basic problem in the condemnation situation is that of deciding whether any property acquired with the condemnation proceeds is sufficiently similar to the condemned property to merit postponing taxation of gain on the condemned property. If the replacement property satisfies the standard of similarity which is adopted, the condemnee is deemed to have restored himself to his pre-condemnation position. He is then treated as if he had retained the condemned land, with the consequence that he is not taxable on any gain represented by the condemnation award.¹⁴

If the condemnee does not use his award to purchase property which meets the adopted standard of similarity, he is treated in accordance with the policy of the present law which taxes any gain at the time the taxpayer substantially changes the form of his investment. Since an ordinary taxpayer cannot sell property without being taxed on any gain, the condemnee cannot take advantage of the condemnation to make a tax-free change in the nature of his property. Therefore, he must pay a tax on any gain if he chooses to retain the proceeds of the condemnation award or invest them in property which, under the standard of similarity, is dissimilar to the condemned property.

The success with which any method of taxation harmonizes these two policies of not denying the condemnee's right to postpone tax and of not permitting him to receive a tax benefit as a result of the condemnation must depend on one's view of the equities involved in the condemnation situation. It is thus appropriate to analyze the event of condemnation to determine the

14. Under § 1033(a)(3) the taxpayer can, if he wishes, recognize the gain even though he has purchased qualifying replacement property.

relative merits of the equities concerned. Consideration can then be given to whether the standards of present law for determining how the condemnee should be taxed are in accord with the analysis.

The basic premise of this paper is that the government should act to make the condemnee whole. The award should be large enough to cover the economic cost of restoring the condemnee to his pre-condemnation position. He should be no worse off than he was, but he should not benefit from the condemnation.¹⁵ The tax treatment of the condemnation award should be in accord with this purpose.

In seeking to carry out this purpose of restoring the condemnee's *status quo ante* it should be remembered that he is deserving of sympathy because he suffers the loss of his land involuntarily and, presumably, for the public benefit. This sympathetic viewpoint is relevant in formulating the statute intended to promote the goal of enabling him to restore himself to his former position. It is relevant because the case by case application of any statute will yield decisions which will achieve with varying degrees of success the objective of the statute. As our purpose is to do justice by making it possible for the condemnee to restore himself to his pre-condemnation status, the cases arising under a statute aimed directly at this goal of a just result are likely to range along a continuum from undercompensation to overcompensation. Under such a statute, certain condemnees would almost inevitably receive tax treatment that is less than just.

Because the land is taken involuntarily and because it is taken by deliberate government action to produce a public benefit, a statute which produces a less than just result by undercompensating is intolerable. Therefore, the appropriate statute is one under which the least favorable result is nonetheless just, in which, that is, the other decisions reached under the statute would, to varying degrees, leave the condemnee with an improved economic situation. While this latter consequence is not desirable, it should be tolerated because, in the condemnation situation, it is more

15. This view that the award should enable the condemnee to restore himself to his pre-condemnation position goes beyond the constitutional requirements delineated in the cases. The cases require only that the condemnee "be put in as good a position pecuniarily as he would have occupied if his property had not been taken." *United States v. Miller*, 317 U.S. 369, 373 (1943); *Seaboard Air Line Ry. v. United States*, 261 U.S. 299 (1923). This means that he must be paid the full value of the property taken. Under our view, however, the condemnee should be compensated, not only for the land taken, but also for expenses incident to restoring him to his pre-condemnation status.

important to assure that everyone is justly compensated for economic losses than to prevent some from reaping an economic gain.

If the above rationale seems to provide an inadequate basis for permitting certain condemnees to improve their economic positions in order to assure that no condemnee's position is worsened, then an additional point should be made. Under present treatment, the condemnee is compensated only for economic losses. Non-economic losses are, however, often incurred as a result of the disruption caused by having to give up the condemned land. Grief at the loss of the family home is one of the more dramatic examples of a non-economic loss.

Since these non-economic losses are very likely to exist, it is possible to view any improvement in the condemnee's economic position as merely offsetting his non-economic losses. As the policy is to make the condemnee whole, the existence of an economic gain to offset non-economic losses can be seen as promoting this policy, rather than obstructing it.

In working to bring about tax treatment that is in accord with this sympathetic view of the condemnee's plight, one can proceed in two ways. The first is to set up standards solely in terms of this view, ignoring the treatment given by the Internal Revenue Code to transactions related to condemnation.¹⁶ The second is to construct standards with reference to the standards for these related transactions, making sure that the relative treatment of condemnation proceeds is appropriate. We work mostly from the first approach; however, we also give attention to related sections of the Code because they offer guides to the political feasibility of our proposals.

Having stated our views as to the appropriate manner of taxing condemnation awards so as to assure the condemnee fair treatment, we turn to the manner of taxation provided by present law.

III. PRESENT LAW

Section 1033 states the basic rules for permitting postponement of tax in the condemnation situation.¹⁷ When they are satisfied,

16. These transactions are covered in IRC §§ 1031-1038. *See also* IRC §§ 351, 721.

17. Section 1033 applies to property compulsorily or involuntarily converted "as a result of its destruction in whole or part, theft, seizure, or requisition or condemnation or threat or imminence thereof". IRC § 1033(a). We focus our attention on conversion by "condemnation or threat or imminence thereof."

the condemnee pays no tax and, in effect, transfers the unrecognized gain to the replacement property by reducing its "cost" basis by the amount of unrecognized gain. The basic rule is that no gain is recognized (1) where property used in a trade or business or held for investment is replaced with property of a "like kind"¹⁸ or (2) where a residence or property held for sale to customers is replaced with property "similar or related in service or use."¹⁹ These two standards are of great importance to the condemnee who must decide rather rapidly²⁰ what replacement property, if any, he will acquire.

Similar or related in service or use. Residences and property held for sale to customers by a real estate dealer must be replaced by property "similar or related in service or use" to the property condemned.

The Regulations, not too helpfully, provide three examples of when the "similar or related in service or use" test is *not* met: (1) when proceeds of condemned unimproved real estate are invested in improved real estate; (2) when proceeds of a condemnation are applied in reduction of indebtedness previously incurred in the purchase of a leasehold; and (3) when the owner of a requisitioned tug uses the proceeds to buy barges.²¹ As a result, the burden of laying down a test to administer this standard has fallen mainly to the courts which have developed at least four different approaches.

The Tax Court developed the so-called "functional" test which examines the actual physical use to which the two properties, original and replacement, are put.²² While the test emerged when the courts were dealing with situations where the taxpayer himself was the actual user of the properties, it was not confined to such situations but was applied where the taxpayer was leasing property to some other end-user.²³ The Tax Court rejected the proposition that it should be enough to replace one investment property with another.²⁴ The "functional" approach,

18. IRC § 1033(g).

19. IRC § 1033(a)(2)(A).

20. Under § 1033(a)(2)(B)(i) the taxpayer has until one year after the close of the first taxable year in which any part of the gain upon the conversion is realized to acquire qualifying replacement property. This period may be extended after application to the District Director. See Part V. A. 1(b) *infra*.

21. Treas. Regs. § 1.1033(a)-2(c)(9).

22. See, e.g., *Steuart Bros., Inc.* 29 T.C. 372 (1957), *rev'd*, 261 F.2d 580 (4th Cir. 1958).

23. *Id.*

24. *Thomas McCafferty*, 31 T.C. 505 (1958), *aff'd*, 275 F.2d 27 (3d Cir. 1960).

which has been picked up by courts other than the Tax Court,²⁵ gives taxpayers little leeway as to reinvestment which will qualify for non-recognition; not surprisingly, the Tax Court has sometimes been reversed on appeal, with the appellate courts laying down tests of their own.²⁶

A second approach was exhibited by the Fourth Circuit in *Steuart Brothers, Inc. v. Commissioner*.²⁷ The taxpayer owned vacant land on which it had contracted to erect a one-story building to be leased for use as a retail grocery store and a one-story warehouse which was also to be leased. Building permits were denied because the government intended to condemn the land. After the condemnation, the taxpayer bought two replacement properties: one improved with two one-story buildings used as automobile showrooms, repair shop, and service station; the other improved by a two-story building to be used as a service station. The court emphasized the investment character of the original and replacement properties with respect to the taxpayer and held that no gain need be recognized. The court intimated that it would distinguish the case where the taxpayer was the actual user of the condemned property. Allowing the taxpayer to replace investment property with investment property without regard to the use to which it would be put is the most liberal court-developed test from the standpoint of the taxpayer.

In *Filippini v. United States*,²⁸ the court took a third approach. The condemned property consisted of property leased for farming and for a drive-in theatre; the replacement property consisted of a commercial office building leased to various tenants. The court looked to see if the replacement property was of the "same general class," a test that attempts to reconcile the "functional" approach with the *Steuart* approach. The decision was against allowing non-recognition on the facts presented to the court.

In *Liant Record, Inc. v. Commissioner*,²⁹ the Second Circuit stressed that the service or use to the taxpayer and not the end use by the lessee was vital. It held that in applying the "related in service or use" test the court must compare, among other things, (1) the extent and type of the lessor's management ac-

25. *United Dev. Co. v. United States*, 212 F. Supp. 664 (E.D. Mo. 1962).

26. See, e.g., *Loco Realty Co. v. Commissioner*, 306 F.2d 207 (8th Cir. 1962), *rev'g* 35 T.C. 1059; *Liant Record, Inc. v. Commissioner*, 303 F.2d 326 (2d Cir. 1962), *rev'g* 36 T.C. 224; *Steuart Bros., Inc. v. Commissioner*, 261 F.2d 580 (4th Cir. 1958), *rev'g* 29 T.C. 372.

27. 261 F.2d 580 (4th Cir. 1958), *rev'g* 36 T.C. 372.

28. 200 F. Supp. 286 (N.D. Cal. 1961).

29. 303 F.2d 326 (2d Cir. 1962), *rev'g* 36 T.C. 224.

tivity, (2) the amount and kind of services rendered by him to the tenants, and (3) the nature of the business risks connected with the properties. The court went on to allow non-recognition of gain where proceeds from the condemnation of an office building were reinvested in apartment buildings. The Internal Revenue Service appears to have picked up this approach; a 1964 Revenue Ruling states that the primary factor in comparing the original and replacement properties is the similarity in use to the taxpayer and that, in applying this test, the nature of the business risks, management services, and relations to the tenants should be determined.³⁰

Subsequent decisions have not clarified the definition of "similar or related in service or use." Witness, for example, the Eighth Circuit's "reasonable similarity" test, which it arrived at after surveying the four approaches noted above.³¹ The resulting situation for the condemnee is not one conducive to sensible investment choices or to tax planning. Given no helpful guidance by the Regulations and faced with a maze of different court-established tests and decisions, he must rapidly make a reinvestment decision, knowing that to overstep the ill-defined line means paying a possibly substantial gains tax. Forced to sell by a government or public authority, he is pushed toward a rather hasty decision at risk of immediate loss of part of his capital. About all the condemnee can be sure of is that he can safely reinvest in property almost identical to that condemned and that in no event can he reinvest in non-real property such as municipal bonds,³² mortgages,³³ a savings account,³⁴ or reduction of an indebtedness.³⁵

Like kind property. Until 1958, a tax free replacement of any type of condemned property was limited to that "similar or related in service or use;"³⁶ in that year Congress acted to broaden the scope of possible reinvestments.³⁷ Now when property held for use in a trade or business or held for investment is disposed of under threat or imminence of condemnation, the con-

30. Rev. Rul. 64-237, 1964-2 CUM. BULL. 319.

31. *Loco Realty Co. v. Commissioner*, 306 F.2d 207 (8th Cir. 1962), *rev'g* 35 T.C. 1059. See also *Pohn v. Commissioner*, 309 F.2d 427 (7th Cir. 1962) ("continuity of interest" test).

32. I.T. 1617, II-1 CUM. BULL. 119.

33. *Winter Realty & Constr. Co. v. Commissioner*, 149 F.2d 567 (2d Cir. 1945) *cert. denied*, 326 U.S. 754.

34. G.C.M. 14693, XIV-1 CUM. BULL. 197.

35. *J. S. Murray*, 24 T.C.M. 762 (1965).

36. All replacements were governed by §§ 1033(a)(2) and (a)(3).

37. Section 1033(g), *added by* Pub. L. No. 85-866, § 46(a) (Sept. 2, 1958).

demnee qualifies for non-recognition of gain to the extent the proceeds are invested in property of a "like kind." The "like kind" standard is defined in the Regulations as follows:

[T]he words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not . . . be exchanged for property of a different kind or class. The fact that any real estate involved is improved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.³⁸

While the Regulations do provide that an exchange of a ranch or farm for city real estate, or a leasehold with thirty or more years to run for a fee, or unimproved real estate for improved real estate would be "like kind" transactions,³⁹ they do not give the condemnee a comprehensive statement as to what sort of property he can safely reinvest in.

The "like kind" standard has been read by the few courts which have passed on the question to mean that condemned real estate need only be replaced by other real estate in order to qualify for non-recognition of gain.⁴⁰ The court in *Commissioner v. Crichton*⁴¹ stated that:

[T]he distinction intended and made by the statute is one between classes and characters of property, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property, however dissimilar they may be in location, in attributes and in capacities for profitable use.⁴²

In holding that the exchange of a mineral interest in unimproved country land for improved city land was a "like kind" exchange, the court indicated it thought the scope of "like kind" was well settled and found it necessary to rebuff the Commissioner, saying:

[It] will not do for him to now marshall or parade the supposed dissimilarities in grade or quality, the unlikeness, in attributes

38. Treas. Regs. § 1.1031(a)-1(b). At present there are no "like kind" regulations under § 1033, but Treas. Regs. § 1.1033(g)-1(a) contains a reference to the "like kind" regulations of § 1031. Likewise, virtually all "like kind" case law arose under § 1031, since § 1033(g) is so new to the Internal Revenue Code.

39. Treas. Regs. § 1.1031(a)-1(c).

40. *Fleming v. Campbell*, 205 F.2d 549 (5th Cir. 1953); *Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941). See also *Alabama By-Products Corp. v. Patterson*, 258 F.2d 892 (5th Cir. 1958).

41. 122 F.2d 181 (5th Cir. 1941).

42. *Id.* at 182.

appearance and capacities, between undivided real estate interests in a respectively [*sic*] small town hotel and mineral properties.⁴³

Courts have found the "like kind" standard to be satisfied where brick and stone office buildings were exchanged for fifteen three story apartment buildings,⁴⁴ where city lots containing frame houses and an office building were exchanged for a ranch containing a house,⁴⁵ and where a lease was exchanged for some lots.⁴⁶ A court drew the line and held that there was no "like kind" exchange where the taxpayer exchanged land for the right to cut and remove standing timber.⁴⁷ The decision was partially based on the principle that trees which are to be immediately separated from the land constitute personalty and possibly on a finding that only a license to enter and cut was involved — thus there was either a difference in class or in quantum of interest.

Some early cases suggested that a substantial difference in the rights attaching to the original and exchanged property meant the "like kind" standard was not met.⁴⁸ However, a later case appears to have put this distinction to rest: the exchange of a fee interest for limited mineral rights or payments was held to be a "like kind" exchange.⁴⁹ And the Internal Revenue Service has indicated that the exchange of perpetual water rights for a fee interest qualified as a "like kind" exchange since the water rights were considered to be real property rights under state law.⁵⁰ There still remains an anomaly. A leasehold of thirty years or more is considered to be "like kind" to a fee;⁵¹ a leasehold of less than thirty years apparently is not.

Related Transaction. A second aspect of present law relevant for our analysis is the relation of the tax treatment in the condemnation situation to the tax treatment of similar transactions.⁵² The intent of Congress regarding all these transactions is that they should be tax-free if they do not substantially change the taxpayer's position. Different tests of substantial change are applied to the different transactions in this group. The difference in these tests is not, however, related to the difference in the

43. *Id.*

44. Arthur P. Pearce, 13 B.T.A. 150 (1928).

45. E. R. Bradley, 14 B.T.A. 1153 (1929).

46. Biscayne Trust Co., 18 B.T.A. 1015 (1930).

47. Oregon Lumber Co., 20 T.C. 192 (1953).

48. Bandini Petroleum Co., 10 T.C.M. 999 (1951); Kay Kimball, 41 B.T.A. 940 (1940); Midfield Oil Co., 39 B.T.A. 1154 (1939).

49. Fleming v. Commissioner, 241 F.2d 78 (5th Cir. 1957).

50. Rev. Rul. 55-749, 1955-2 CUM. BULL. 295.

51. Treas. Regs. § 1.1031(a)-1(c)(2).

52. IRC §§ 1031, 1033.

equities inherent in these transactions. Consequently, the relative treatment of these transactions is not in accord with their relative equities.

These transactions fall into three groups. The first consists of exchanges that are voluntary and are not intended to produce a public benefit. An example would be an exchange by a Boston resident of his Cambridge delicatessen for a similar delicatessen in Boston. Here the taxpayer is deemed not to have substantially changed his position if the two properties are of a "like kind."⁵³

The second group involves exchanges that are involuntary and that produce no public benefit. Examples from this group include loss of property by natural disaster or by theft and the use of any insurance proceeds to replace the lost property. The significant difference between these transactions and those of the first group is that here the taxpayer has entered the "exchange" against his will. He has been denied the right afforded to taxpayers of the first group to choose whether and when to make an exchange.

The test of substantial change applied here is, however, narrower than that applied to the voluntary exchange. Thus the Internal Revenue Code, by applying the "similar or related in service or use" test to these exchanges rather than the broader "like kind" test, gives the voluntary exchange more favorable treatment than the involuntary exchange.⁵⁴

The third group concerns condemnation proceedings which are both involuntary and intended to produce a public benefit.⁵⁵ Here the "exchange" is consummated by using the condemnation award to purchase replacement property. What distinguishes this form of involuntary exchange from those of the second group is that it is brought about, not by the forces of nature or by an anti-social act made illegal by the government, but by the government itself. The taxpayer is told that he must give up his property so that it can be used to benefit his fellow citizens. Despite these elements — involuntariness and deliberate government action to bring about a public benefit — that are absent from transactions of the first group, the Internal Revenue Code uses the "like kind" or the "similar or related in service or use standard" to determine taxability in the condemnation situation. Thus condemnation, which merits the most favorable treatment, is treated no better than the voluntary exchange when replacement of the condemned property is tested under the "like kind" standard. When the

53. IRC § 1031.

54. IRC § 1033.

55. *Id.*

"similar or related in service or use" test applies, the condemnee is treated worse than the taxpayer who makes a voluntary exchange.⁵⁶

A search through the legislative history of the provisions covering these transactions disclosed no indications that consideration has been given to taxing them in accordance with this analysis of their relative equities. One cause of the present inequities in the taxation of condemnation proceeds thus stems from this failure to recognize that condemnation involves considerations totally absent from the voluntary exchange situation.

IV. ANALYSIS AND PROPOSALS

Having outlined the treatment afforded under present law, we turn now to an analysis of it and to proposals for making it fairer to the condemnee. We recognize that under these proposals the condemnee may be able to improve his economic position. This possibility must, however, be tolerated to assure that the condemnee's economic position will not be made worse by reason of the condemnation. As already noted, the alternative of assuring that no condemnee reap an economic gain at the risk that some condemnees will suffer economic losses is unacceptable.

A. ANALYSIS AND PRIMARY PROPOSALS.⁵⁷

1. *Property held for use in a trade or business.* The present requirement of section 1033 that property used in a trade or business be replaced by "like kind" property in order to qualify for non-recognition of gain is subject to two primary objections. First, it makes inadequate provision for renting as a means of replacing the condemned property. Second, it is at times too broad.

56. Of course, the "similar or related in service or use" test now applies only to property held for sale to customers and residences of the taxpayer, neither of which is within § 1031's voluntary exchange provisions.

57. For purposes of simplicity, proposals made in the body of the paper are discussed on the assumption that the full amount of the price paid for the condemned land, which will be subject to taxation if not reinvested in qualifying property, has been reinvested. Any amount not so reinvested will be subject to tax to the extent of gain realized on the condemnation. If property having a basis of \$10 is condemned at a price of \$100 and \$80 is invested in qualifying property, the taxpayer is taxable on \$20 of the \$90 gain. If more than the amount of the condemnation payment which must be invested in qualifying property to avoid tax is invested in qualifying property, then the basis of the replacement property, in effect, is the carry-over basis of the condemned property plus the additional amount invested.

The rental problem arises because the sites most comparable to the condemned property in terms of business potential may be in buildings, such as in a shopping center, that are only available for rent. Under present law a lease apparently must be for thirty years or more in order to qualify as replacement property for a fee interest.⁵⁸ Thus where the most suitable replacement property is available only for a twenty, ten, or even a one year lease, the condemnee would be denied non-recognition treatment, a result opposed to our goal of putting the condemnee back in his pre-condemnation position.

We would alleviate this problem by defining replacement property to be "any interest in real property"⁵⁹ and by making it clear in the statute that this definition includes leaseholds of any duration. This provision is necessary because the laws of some states treat a lease as personal property⁶⁰ and a court might be tempted to look to state law to determine what is "an interest in real property."⁶¹

The objection might be raised that if it is necessary to have a more inclusive limit than that imposed by the "like kind" standard, it is arbitrary to set this limit at "any interest in real property." One could go on to suggest that replacement in any

58. Treas. Regs. § 1.1031(a)-1(c). Under present law, more limited interests, such as short-term interests in mineral rights, are, however, considered to qualify for tax-free treatment if exchanged for a fee. *See, e.g.*, *Fleming v. Commissioner*, 241 F.2d 78 (5th Cir. 1957). Thus present law can be criticized as being both inconsistent and as making inadequate allowance for renting as a means of acquiring qualified replacement property.

59. *Cf.* H.R. 3421, § 201, 89th Cong., 1st Sess. (1965) [hereinafter cited as H.R. 3421], which would permit tax-free replacement with "any interest in real property, and property used in the trade or business of the taxpayer (as defined in § 1231(b)(1), but without regard to any holding period) and any property to be held by the taxpayer for investment." We rejected the idea of permitting replacement with "any property used in the trade or business of the taxpayer" or with "any property to be held by the taxpayer for investment" on the ground that the options proposed in this paper more effectively harmonize the policy of assuring fair treatment for all condemnees with the policy against tax-free changes of investment. Permitting tax-free replacement with these kinds of property is necessary to assure fairness to the condemnee only when real property suited to his trade or business is unavailable. In this case, we permit it. In any other case, permitting it effectuates no policy of fairness to the condemnee while contravening the policy against tax-free changes in investment. H.R. 3241 died in committee in the 89th Congress and had not been resubmitted to the 90th Congress as of March 8, 1967. The office of Mr. Johnson of California, the bill's sponsor, indicated that the condemnation bill he plans to introduce in the 90th Congress would make no proposals for amending the Internal Revenue Code regarding condemnation.

60. *See* 1 AMERICAN LAW OF PROPERTY § 3.12 (A. J. Casner ed. 1952).

61. *See* Rev. Rul. 55-749, 1955-2 CUM. BULL. 295, for an example of looking to state law to determine whether a particular kind of property is "real property" (water rights).

property, real estate or non-real estate, should be acceptable. This contention is not without some merit, and consideration was given to proposing so broad a standard.⁶² However, on balance, there would seem to be more support for drawing the line at "any interest in real property." First it marks less of a departure from the general tax policy of not taxing when there is no substantial change in the character of the investment. Second, the law has often recognized distinctions between real property and other types of property.⁶³ Finally, since it involves only a small shift from the present "like kind" standard and reflects a long-recognized legal category, the "any interest in real property" standard would appear to be much more feasible politically than a standard embracing non-real estate.

Once the basic definition of replacement property is broadened to include all leases, provision must be made for determining the value of the replacement property considered to have been acquired by signing a given lease and for eventually recognizing the postponed gain. Two methods for determining the value of the acquired rental property suggest themselves.⁶⁴ The first would be to compute the present value of the lease obligations and consider that amount to be the amount of replacement property acquired. The primary difficulty with using such a method is that the condemnee might be unable, or unwilling, to acquire a long-term lease with a present value such that investment in it would enable him to avoid tax. For example, if the award was \$50,000 for property having a basis of \$10,000 and if the longest lease available was for three years with a present value of \$15,000, the condemnee would have to recognize \$35,000 of the \$40,000 gain. If the condemnee has gone into rental quarters of a value comparable to or greater than that of the condemned property, he should not have to recognize gain, because he has essentially put himself back in his pre-condemnation situation.

This suggests a second, and more acceptable, method of determining the amount of replacement property considered to have been acquired. It is to use the fair market value that the leased premises would have if they were to be sold rather than leased.

62. Cf. H.R. 3421, discussed note 59 *supra*.

63. See, e.g., IRC §§ 1245, 1250.

64. We rejected the possibility that the condemnee be required to prepay the lease in order to qualify for non-recognition of gain because, under present law as to purchase of property, there is no requirement that the entire purchase price of the replacement property be paid within the time limits set by § 1033 and there appears to be no strong reason for treating the acquisition of a lease any differently.

Thus, if the condemnee signed a three-year lease on property with a fair market value of \$30,000, he would be considered to have invested in \$30,000 of replacement property. While it might be argued that this method would be difficult to administer (for example, in trying to determine the fair market value of a suite of offices in a multi-story building) and might allow the condemnee to escape taxation, these contentions can be rejected on several grounds. First, fair market value determinations are rather common to the Internal Revenue Code.⁶⁵ Second, the fact that the fair market value is not as precise an amount as an actual purchase price paid for a piece of real estate does not form the basis for a persuasive objection that the condemnee might use this fair market value determination to escape taxation. The non-recognition sections by their very nature only postpone recognition of gain until a later time when it is deemed more appropriate for the tax to be imposed. The same concept applies in the condemnation situation under our proposal: that gain which the condemnee does not have to recognize at the present time because he is deemed to have invested in "x" dollars of replacement remains to be taxed at a later time.

The next problem is to determine when the postponed gain should be recognized where the taxpayer has rented as a means of acquiring replacement property. To preserve the pre-condemnation situation of the condemnee, whereby he would not have to recognize gain until he changed investments or not at all if he died, we would postpone recognition until the condemnee terminated his interest in the replacement rental property. We would allow him to exercise options to renew the lease on that property, to sign a new lease on it, or to purchase it. But at the time he ceased to rent it, or to own it if he had purchased it, the entire postponed gain would be taxable to him. A concomitant feature of this method would be that his death would erase the unrecognized gain, just as section 1014 erases gain on property owned by him at his death.

We considered, and rejected, two other possible methods of recognizing the gain. The first would be to treat it by analogy to the treatment given to a premium paid for a lease. When a premium is paid for the acquisition of a lease, the taxpayer is allowed to deduct an alliquot part of the premium over the term of the lease.⁶⁶ Here we have not a premium, but rather unrecognized gain, which is a kind of negative basis. By applying the

65. *E.g.*, IRC § 1014.

66. Treas. Regs. § 1.162-11(a). *See also* IRC § 178.

treatment of premium by analogy, gain could be recognized over the period of the lease by reducing the normal rental deduction by an aliquot part of the unrecognized gain. For example, if the condemnee with \$10,000 in unrecognized gain signed a ten-year lease at \$3,000 a year rental, he would be allowed to deduct only \$2,000 a year in rental expense (\$3,000 minus 1/10 of \$10,000). This approach is objectionable on the ground that it might turn capital gain into ordinary gain, a tax disaster from the condemnee's standpoint. Furthermore, it would be quite unsatisfactory where the condemnee is not entitled to any deduction for rental expense, as, for example, where he is using the leased property as his personal residence.⁶⁷

Under the second possibility, the condemnee might recognize the postponed gain over the term of the lease in a manner somewhat analogous to an installment sale under section 453. Thus, if the condemnee had \$50,000 of unrecognized long-term capital gain and a ten-year lease, he would recognize \$5,000 of long-term capital gain each year for ten years. This method would maintain the same character (capital or ordinary, short-term or long-term) of the original gain and would allow for some postponement of the tax. However, it is not entirely true to the condemnee's pre-condemnation situation of not having to recognize gain until he changed investments or not at all if he died, in which event his heirs would get a new basis.⁶⁸

We chose the termination of interest in the replacement property as the appropriate moment for recognizing the postponed gain not only because of the weaknesses of the other possibilities discussed above, but also on the theory that had the condemnee owned the property and terminated his interest in it, he would have incurred a gains tax at that time. However, in those situations under sections 1031 and 1033 in which a taxpayer is not taxed upon termination of interest in his property, we would permit continued non-recognition of gain. Thus there would be continued non-recognition of the gain where the condemnee exchanges his lease for another lease or other qualified property within section 1031 or acquires another lease or other qualified replacement property under section 1033 following the condemnation or destruction of his original replacement leased property.

The proposal to allow replacement with a lease would, there-

67. Section 262 specifically denies deduction of any personal, living, or family expenses unless expressly allowed by the Internal Revenue Code, and there is no provision allowing deduction for rental of personal living quarters.

68. IRC § 1014.

fore, be more effective than present law in achieving the goal of restoring the condemnee to his pre-condemnation position. It allows him to acquire the most suitable replacement property and, once it is acquired, treats him as if he owned it.

A second objection to the "like kind" standard is that it might impose unfair burdens on the condemnee by being too broad. Suppose, for example, that the condemnee owns a mill and that there is no property available in the same geographic area which is suitable for a mill. Under present law the condemnee must purchase "like kind" property to avoid tax; and, since the "like kind" standard is a broad one, it is possible that the new business he is forced into would bear little relation to the mill business. In other words, he may have to get involved in a new business in which neither his expertise nor his goodwill from the condemned business would be of benefit to him. Of course, in some ways this permission to go outside the mill business while qualifying for tax free treatment is a liberal measure. However, from our perspective of sympathy for the condemnee's plight, the broad standard is harsh in the sense that it requires the taxpayer to start a new business to avoid tax in those situations in which a site for his pre-condemnation business is not available. The use solely of the "any interest in real property" standard would be subject to this same broadness objection.

Our second proposal would deal with the broadness problem by permitting the condemnee to replace tax-free with any interest in any kind of property if he could show that no property was available which was suitable for carrying on the same business he was engaged in at the time of the condemnation. His basis in the condemned property would become his basis in the replacement property. Thus if the mill owner could not find an appropriate site for a new mill, he could, upon a showing of unavailability of a mill site, invest the condemnation award tax free in stocks.⁶⁹ We think that fairness to the condemnee requires per-

69. Alternatively, he could simply keep the money in a bank account and treat the bank account as his replacement property. Until the time for replacement had expired, the condemned would have the option of removing the money from the account and using it to purchase replacement property. If, when the replacement period expired, the money was still in the account, the account would become his replacement property. Once he had withdrawn an amount equal to his basis in the condemned property, he would be taxed on any subsequent withdrawal at the appropriate gains rate. To avoid problems of tracing, he would be required to keep the award in identifiable form, such as in a separate bank account. After the time for replacement expired, so that the bank account would become his replacement property, he would be subject to the requirement that the Commissioner be notified of the nature of the replacement property. If he died after expiration of the time for replacement, the bank account would take

mitting this tax free change of investment in these few situations in which unavailability can be shown.

The test of availability of property suited for a particular business does, however, raise certain problems. Before discussing them it is important to note that this provision will more likely be utilized only by condemnees, such as a mill owner, engaged in businesses that are somehow related to very specialized conditions; it is much more likely that specialized property, such as a mill site, will be unavailable than that there will be no sites suitable for a business such as a drug store. Consequently the problems of proving unavailability of a suitable site will not arise often and when it does proof will probably not be difficult because it will be necessary to show only the unavailability of sites at those places, such as riverbanks in our mill example, where the special conditions needed for carrying on the business exist.

The first problem of the unavailability of suitable property standard lies in defining the geographic area in which unavailability must be shown. We limit this area to a reasonable commuting distance from the condemnee's home where the condemned property is within such an area. This limitation will make meaningful the rule that investment in non-real property will be permitted when property suitable for the condemnee's particular business is unavailable. Requiring a showing of unavailability in a broader area would defeat the purpose of the rule which is to prevent undue burdens on the condemnee. One

as its basis its value at the date of death. IRC § 1014. If he died before the period for replacement had expired, his estate could replace tax-free with qualifying property which would get a basis equal to the value at date of death of the award; or his estate could instead treat the bank account as the replacement property, in which case its basis would be its date-of-death value. This alternative must be spelled out in the new Code section and accompanying regulations as it is unclear under present law that the estate can reinvest and qualify under § 1033. Compare *Estate of Goodman v. Commissioner*, 199 F.2d 895 (3rd Cir. 1952), with *Estate of Joseph Resler*, 17 T.C. 1085 (1952), and Rev. Rul. 64-161, 1964-1 (Part 1) CUM. BULL. 298.

It may be objected that that part of the proposal making a bank account replacement property is too liberal because it changes the basic rule that a failure to replace is a taxable event. The answer to this objection is that this provision treating the failure to replace as replacement applies only when the regular replacement rules do not apply because of the unavailability of appropriate replacement property. We have decided that in this situation the condemnee should not be taxed. Thus it is inconsistent with this provision to tax him for obtaining property in a savings account, thereby putting pressure on him to buy other property, when we would not tax him for obtaining any other kind of property. Moreover, treating a savings account as replacement property spares us from the hair-splitting task of deciding when the form in which the award is held is substantially equivalent to a bank account. We would not want to have to defend the position that a two-month saving certificate is substantially equivalent but that a three-month certificate is not.

of these burdens is forcing the condemnee to enter a new business to avoid tax. Another is requiring him to move his home to stay in his pre-condemnation business. Thus a standard embracing an area beyond a reasonable commuting distance from his home would force him to choose between these burdens when the only available property suited to his business was beyond the radius of a reasonable commute. If, however, this area is circumscribed by commuting distance, then he could invest in non-real property whenever he could show that he was faced with the choice of changing businesses or moving his family. This geographic limitation would impose neither of these burdens on him and is thus in keeping with our sympathetic view of his situation.

In the case where the condemned property is outside a reasonable commuting distance from the condemnee's residence, the condemnee has already shown that the operation of his business does not depend on his living within a reasonable commuting distance from it. However, a different consideration points to the need for limiting the area in which replacement property must be sought. A standard comprising an excessively large geographical area might require the condemnee to re-establish his business in an area which is so far from the condemned business that he would be unable to reacquire the services of his former employees. The standard which best accommodates this consideration appears to be one which would require the condemnee to show unavailability only within a reasonable commuting distance from the condemned property.

The second problem posed by the unavailability of suitable property standard is that of defining when property is "suitable" for carrying on the same business the condemnee was engaged in prior to condemnation. This definitional problem involves two aspects, the price of the property and its potential as a site for the specific business involved.

Suppose that a mill owner received a condemnation award of \$100,000. If there was only one other site available for a mill in the appropriate geographic area and buying this site and constructing a mill there would cost \$200,000, the condemnee should not be denied the right to invest in any property. Replacement property which is otherwise "suitable" should not be held "suitable" if the cost of reestablishing his business on it would appreciably exceed the amount of the award. Thus if it would cost \$10,000 to move to the new site, the available replacement property can be "suitable" only if buying it and preparing it for use as a mill would not cost more than approximately \$90,000.

As we have noted, there are few situations in which a condemnee will attempt to show unavailability of replacement property; consequently, any problems of proof raised by our proposed standard regarding price of the property will not arise often. It seems that they could be solved by deeming affidavits from real estate brokers in the area to be sufficient evidence of price. Any broker having knowledge of available sites would also know the approximate price of the land and any building involved. If replacement on a site would require the condemnee to build his own structures, he could testify himself concerning construction costs or submit estimates from appropriate builders.

Defining when a site is a "suitable" location for conducting a given business may be considerably more difficult than stating whether the site's price is "suitable." The difficulty is more likely to arise when the question of suitability relates to a site's economic potential for use in a particular business rather than to its geographic attributes. It is not clear that the test suggested above, evaluation by real estate brokers, is satisfactory. Moreover, certain tests, such as a consulting firm's evaluation of the profit potential of a site or of its geographic attributes, might prove too costly. It seems best to apply a test of reasonableness to properties indicated by the real estate broker to be available. Although this test appears vague when offered in the abstract, it seems likely that it would pose few problems when applied to a specific fact situation. This is so because only condemnees whose businesses require special geographic conditions, such as mill owners, are likely to seek the relief offered by our unavailability proposal. For them suitability of a site is not likely to be a disputed question. For the few remaining cases, it seems that an analysis of the area in which a site was located would determine without undue difficulty whether it was "suitable." For example, if a building was physically suited to housing a supermarket, it would not be considered "suitable" replacement property unless its location was such that a supermarket on it could successfully serve a residential area.

2. *Property held for investment.* The "like kind" standard for replacement of property held for investment poses problems similar to those posed by it with respect to property held for use in a trade or business: it makes inadequate provisions for renting, and it is too broad. Prior to the condemnation the investor could have leased his property to someone else or used it himself without incurring a gains tax; if after the condemnation the most comparable property is available only for lease, then the investor

should be able to acquire it, whether he intends to sublease it or use it himself. We would deal with the rental problem by employing the same proposals outlined with respect to renting property for use in a trade or business. Thus we would permit replacement to be tax-free when the replacement property was "any interest in real property."

The broadness problem would be met by permitting the taxpayer to invest the condemnation proceeds tax-free in any property when he could show that no property similar to his condemned property was available. The appropriate standard of similarity is a test comparing risks, management functions, and profit potential, namely whether the investment risks and management functions of the condemnee regarding available property would be substantially the same as or less than the risks and management functions with respect to the condemned property and whether the profit potential would be at least as great as that of the condemned property.⁷⁰ Thus when the condemnee could show that all of the real property available was such that investment in it would change his position adversely under one of these tests, he would not be forced to invest in real property to avoid tax but could invest in any property. It should be noted that utilization of this second proposal by the condemnee will probably be limited, since there will be few situations in which he will be able to show that investment property satisfying these tests is unavailable. The tests of unavailability regarding price and geographic area would be the same as those applied in showing unavailability of property suited for use in a particular trade or business.

3. *Property held for sale to customers.* Unlike the investor, who generally holds property for production of income or for long-term appreciation, and unlike the businessman, who generally holds property for use in his business with no present intent to sell, the dealer in property normally has in mind a sale within the foreseeable future. Since he intends to reduce the property to cash, then purchase property which he likewise will sell, there is less reason for allowing him to postpone recognition of gain in the condemnation situation than there is for permitting postponement by the investor or businessman who is likely to retain his property indefinitely. However, the condemnation may well have

70. Cf. *Liant Record, Inc. v. Commissioner*, 303 F.2d 326 (2d Cir. 1962), which used a test comparing management activity and business risks to determine whether replacement property was "similar or related in service or use" to the condemned property.

upset the expectations of the dealer in property. For example, some vacant land he was holding for development as a residential area may have been condemned. Assuming that the condemnation resulted in a profit of "x" dollars to him, he might have been able to reap a profit of "10x" dollars if he had been able to complete the development. Because of the disruption of his expectations caused by the condemnation, he should be allowed to postpone recognition of gain.

The present Internal Revenue Code permits him to do so if the replacement property is "similar or related in service or use" to the condemned property.⁷¹ This test poses two distinct problems for him. The first is that it is ambiguous. Unlike the "like kind" test, it has not been interpreted as permitting tax-free reinvestment in any kind of real property.⁷² The extent to which it is narrower than the "like kind" test is not, however, clear. Consequently, the condemnee must face the risk that the replacement property which he believed met the "similar or related in service or use" test will be found by the Commissioner and the courts not to have met it.⁷³ If he is mistaken in his judgment, he will probably not be able to cure his error by selling the non-qualifying property and investing in qualifying property.⁷⁴

The ambiguity of this test also creates problems of administration. The Commissioner must make careful inquiries about the condemned property and the replacement property to determine whether, in his view, the replacement property qualifies for tax-free treatment. Also, there is likely to be litigation concerning the application of this test to the facts of particular cases.

The second problem of the "similar or related in service or use" test is that it is too narrow. It seems that it limits the condemnee to replacing with land having the same status as the condemned land. A commentator has suggested, for example, that a dealer must replace raw acreage with other raw acreage.⁷⁵ Thus a dealer whose undeveloped land was condemned could not

71. IRC § 1033(a).

72. No case could be found which construed this test with respect to a real estate dealer. However, the court in *Liant Record, Inc. v. Commissioner*, 303 F.2d 326 (2d Cir. 1962), noted specifically that "like kind" has been interpreted as being broader than "similar or related in service or use."

73. It is not entirely clear that the taxpayer can get a ruling from the Internal Revenue Service as to whether the property the taxpayer proposes to purchase will qualify. See Rev. Rul. 55-14, 1955-2 CUM. BULL. 918.

74. He can cure his error only by selling the non-qualifying property and investing in qualifying property within the time limits set by IRC § 1033(a). Since he will probably be informed of his error by the Commissioner only after the time limit has passed, he will be unable to qualify for tax-free treatment.

75. Founts, N.Y.U. 19th INST. ON FED. TAX. 993, 996 (1961).

replace it with land on which a residence or a factory had been built. In view of the apparently limited scope of this standard, it is quite possible that the opportunities presented by the available property satisfying it would not fully restore him to his pre-condemnation position. This could occur, for example, where his property was on a site of great business potential and where all available qualifying property was in relatively less favorable locations. The dealer in real estate should therefore be able to replace tax-free with property beyond the scope of this standard.

To remedy these two problems of ambiguity and narrowness of the "similar or related in service or use" test, the Internal Revenue Code should be amended to permit the dealer whose property is condemned to invest the award tax-free in "any interest in real property." The standard of "any interest in real property" is generally unambiguous. It also greatly reduces the risk under the present standard that no qualifying replacement property of comparable profit potential will be available. If residential property is condemned and the condemnee wishes to purchase raw acreage or wants to acquire less than fee interests in real property, he can do so tax-free.

4. *Residence of the taxpayer.* When a residence is condemned, the replacement property must satisfy the "similar or related in service or use" test to qualify for tax-free treatment.⁷⁶ Since this test generally focuses on the use to which the property is put,⁷⁷ residential property probably must be replaced with residential property. As there is little likelihood that comparable residential property will not be available, the test is not open to the objection of narrowness that exists when it is applied to dealers in real estate. However, there is a possibility that the test could be interpreted to permit reinvestment in a category of real property broader than residences. Since no problems of unavailability make a broader category necessary, we would change the "similar or related in service or use" test to one of "any interest in resi-

76. IRC § 1033(a).

The taxpayer whose principal residence is condemned or sold under threat or imminence of condemnation can elect non-recognition of gain by complying with either § 1033 or § 1034. Should he select the § 1034 route, he must invest the proceeds in a new residence within one year before or after the condemnation or sale. If he chooses to build a new principal residence, the time is extended to eighteen months after the sale of the old residence. We propose no change in this option.

77. *E.g.*, *Liant Record, Inc. v. Commissioner*, 303 F.2d 326 (2d Cir. 1962). In this case the court said that the "similar or related in service or use" test requires "a comparison of the services or uses of the original and replacement properties to the taxpayer-owner." *Id.* at 329 (italics in original).

dential property" to eliminate any ambiguity on this point.

This test of "any interest in residential property" would also solve a second problem of the present law,⁷⁸ namely its inadequate provision for renting as a means of acquiring replacement property. Because of the vast increase in the number of apartments, even in areas that formerly had almost exclusively single-family dwellings, it is quite possible that the most suitable replacement property in the eyes of the condemnee is an apartment rather than another house. The "any interest in residential property" test would solve this problem by qualifying short-term leases for non-recognition treatment.⁷⁹

As indicated in the discussion of property used in a trade or business, the soundest test for valuing the replacement property considered to have been acquired is not the present value of the lease obligation but rather the fair market value that the leased premises would have if they were to be sold. Again, the postponed gain would be recognized, with certain exceptions, at the termination of interest in the leased residential replacement property. Section 1033 involuntary conversions would be accommodated by allowing the condemnee whose leased replacement property was involuntarily converted to replace it with qualified replacement property and thus escape non-recognition at that point.⁸⁰ And since section 1034 allows a taxpayer to postpone recognition of gain from the sale of his principal residence if within one year he purchases another principal residence, or if within eighteen months he builds another principal residence, we would allow the condemnee to move tax-free from the leased replacement residence to the residence he had purchased or built if he met all the other requirements of section 1034.

B. AN ALTERNATIVE PROPOSAL.

An objection that might be raised against our proposals is that they are not fully consistent with the policy of present law against a tax-free change to a dissimilar investment. They may therefore be of questionable political feasibility. In view of this problem

78. The status of a lease under the "similar or related in service or use" test is unknown, since Treas. Regs. § 1.1031(a)-1(c) only refers to "like kind" and no cases were found on the question.

79. Again, it would be necessary to provide in the statute that this definition includes leaseholds in order to avoid the possible problem that state law would consider a lease to be personal property. *See* 1 AMERICAN LAW OF PROPERTY § 3.12 (A. J. Casner ed. 1952).

80. Section 1031 exchanges need not be provided for, as § 1031 covers only property used in a trade or business or held for investment.

we have prepared an alternative plan which, though less certain to assure the condemnee of fair treatment, might prove politically more palatable. The plan retains the present treatment of condemnees under section 1033, thereby maintaining present limitations on tax-free changes of investment. Unlike present law, however, it offers an alternative to section 1033. Under the alternative, if the condemnee does not comply with section 1033, he is taxed on any appreciation over his basis in the condemned property at one half the capital gains rate the property would have been subjected to had it been sold in an ordinary sale and qualified for capital gains treatment.

The basis for this alternative is the belief that since replacing with property qualifying under section 1033 is a burden on the condemnee, he should have an alternative route which, like section 1033, will not subject him to the tax burden of an ordinary sale producing capital gain. The tax at one half the appropriate capital gains rate is imposed to accommodate two policies of present law. The first requires that changes of investment be taxed at the appropriate capital gains rate. The second permits the taxpayer to avoid a gains tax altogether by retaining the property until his death.

Since the condemnation has made it impossible to determine whether the condemnee would have sold the property or retained it until death, we must decide when and how to tax him. Section 1033 deals with this problem by treating the replacement property as if it were the condemned property and no condemnation had taken place; it assumes that any sale of the replacement property takes place when the condemned property would have been sold in the absence of condemnation. Our alternative to section 1033 treats the condemnee as if he had sold one half of the property at capital gains rates at the time of condemnation and had retained the other half until death. It thus stands at the midpoint of the two extremes of taxation to which he might have been subjected had he retained the condemned property for at least long enough for a sale of it to qualify for capital gains treatment.⁸¹

An advantage of this alternative to section 1033 is that it would be easy to administer. It would be necessary only to com-

81. Inquiries made through the office of Congressman Kupferman of New York indicated that no statistics are kept concerning the amount of taxes collected because of the failure of condemnees to replace under § 1033. Thus the cost of our proposal to the Treasury cannot be estimated. If this proposal were enacted, there is the possibility that some who would replace under present law rather than pay the full capital gains tax would elect to pay half the capital gains tax.

pute the capital gains tax on the gain produced by the award and then divide it in half. This plan is, however, subject to two limitations. First, in retaining the "like kind" and "similar or related in service or use" tests, it leaves unsolved the problems already indicated to be inherent in them. Second, the plan leaves unsolved the objection to section 1033 that a condemnee must invest in qualifying property or incur a gains tax, even though all available qualifying property lacks the economic potential of the condemned property. The fact that the tax imposed is less than the tax for a voluntary conversion will give the taxpayer some solace. Nonetheless, the forced imposition of any tax as a result of condemnation violates the general policy of present law that a tax is imposed when the taxpayer acts voluntarily to dispose of his property.

A variation of this proposal for taxing at half the capital gains rate is that the capital gains tax should be forgiven and that the amount of the tax forgiveness be included in the taxpayer's income to be taxed at ordinary rates. For taxpayers whose ordinary income rate is 50% or less, this proposal will produce the same result as taxing at one half the capital gains rate. However, for those in higher brackets the tax savings will be less. For example, the capital gains tax on a gain of \$100,000 for a taxpayer in the 70% bracket would be \$25,000, one half of which is \$12,500. If, however, the \$25,000 is taxed at the rate of 70%, the tax payable will be \$17,500. Taxing the capital gains tax "saving" at ordinary rates thus imposes greater progressivity than the capital gains rates. Whether this greater progressivity should be imposed depends on whether one feels that it is the tax "saving" that is being taxed, in which case ordinary rates should apply on the analogy of forgiveness of a debt,⁸² or that it is the gain on the property which is being taxed, in which case rates geared to the capital gains system of limited progressivity are appropriate. Since we feel that the standards of section 1033 do not permit the condemnee to reinvest tax-free in a broad enough range of property, we feel that, in any system which retains them, the condemnee should not be subjected to regular capital gains rates when he does not meet them. Thus, we feel, the concept of a tax "saving" for any difference between ordinary capital gains rates and the rates actually imposed is inappropriate. Instead, whatever tax is imposed should be viewed as a tax on gain realized on the disposition of property and should thus be con-

82. IRC § 61(a)(12).

sistent with the policies of limited progressivity applied to the taxation of capital gains.

V. TECHNICAL PROBLEMS

Once the proposed general scheme of taxation of condemnation proceeds has been decided on, a number of technical problems remain to be noted, analyzed, and provided for. Some arise out of present statutory and case law; others arise out of elements, such as compensation for moving expenses and loss of goodwill, which are found increasingly in condemnation awards. To facilitate discussion, these problems have been divided into three categories: (1) general problems of non-recognition of gain; (2) problems unique to partial takings; and (3) problems of compensation not attributable to the physical property.

A. GENERAL PROBLEMS OF NON-RECOGNITION OF GAIN.

1. *Time factors.* (a) Time at which "threat or imminence" of condemnation begins. Under the present law the term "threat or imminence" of condemnation has two meanings. It determines the time after which a sale must take place for it to qualify for treatment under the non-recognition of gain provisions. It also sets the time at which replacement property qualifying under these provisions can first be purchased.

To show "threat or imminence" of condemnation, the taxpayer must show: (1) that the threat came from an authority which possesses the power of eminent domain; (2) that the authority intends to acquire the property and would institute condemnation proceedings if it was unsuccessful in negotiating a purchase; and (3) that it is reasonable for the taxpayer to assume that the threats of the authority's representatives were authorized and would carry out.⁸³ For example, if the taxpayer learns of the intent to condemn his property through the news media, he must obtain confirmation of the correctness of the report from the public body in order to be in a position to claim the property was sold under "threat or imminence" of condemnation or that the replacement property was acquired after that time.⁸⁴

83. *Dominguez Estates Co.*, 22 T.C.M. 521 (1963); *Carson Estate Co.*, 22 T.C.M. 425 (1963); *Louis J. Hexter*, 11 T.C.M. 337 (1952). No "threat or imminence" exists when the public agency only "designates" sites to be used for urban renewal. *J.S. MURRAY*, 24 T.C.M. 762 (1965).

84. Rev. Rul. 63-221, 1963-2 CUM. BULL. 332, *modifying* Rev. Rul. 58-557, 1957-2 CUM. BULL. 402.

It is arguable that the date a "threat or imminence" is considered to exist should be pushed back in time. The argument is most persuasive with respect to testing the time at which a taxpayer can first sell and still qualify for the non-recognition of gain provisions. While a taxpayer who sells to a public body which possesses the power of eminent domain would presumably have little trouble showing the sale was under "threat or imminence," the taxpayer who sells to a third person⁸⁵ when the unconfirmed rumors of a forthcoming condemnation of his property begin to circulate presents a more difficult case. On the one hand, the taxpayer's desire to avoid a possible loss or to re-establish a business in an area where there is no such suggestion of a present taking is deserving of protection. On the other hand, pushing the point of "threat or imminence" back in time to a point where there may be no actual intent of the authority to take the property makes proof more difficult and opens the door somewhat to collusive "threats" created to allow a taxpayer to take advantage of the non-recognition of gain provisions designed to help out the actual condemnee.⁸⁶ On balance, it seems that the broad replacement standards proposed provide too great a temptation for collusion to move back to an earlier date the time at which "threat or imminence" of condemnation is deemed to exist. The present rules for determining this time should therefore be preserved.

(b) Time within which replacement must be made. The last day for reinvestment in qualified property so as to obtain non-recognition is one year after the last day of the taxable year in which any part of the gain was first recognized.⁸⁷ However, the District Director may extend the time after timely application by the taxpayer showing a reasonable time for delay.⁸⁸ The high market value or scarcity of replacement property has not been considered sufficient ground for granting an extension;⁸⁹ but an

85. The taxpayer can make such a sale to a third person under "threat or imminence" of condemnation and still qualify for § 1033. *Creative Solutions, Inc. v. United States*, 320 F.2d 809 (5th Cir. 1963); *S.H. Kress*, 40 T.C. 142 (1963).

86. Even under present law a court may well look to see if there is any evidence of collusion between the taxpayer and officials to create an artificial threat. *See Dominguez Estate Co.*, 22 T.C.M. 521 (1963).

87. IRC § 1033 (a) (3) (B) (i).

88. IRC § 1033 (a) (3) (B) (i); Treas. Regs. § 1.1033(a)-2(c) (3). Even a delinquent application for extension of time to replace condemned property may be granted if it shows reasonable cause for the late filing and is made within a reasonable time after the expiration of the required period of time. T.D. 6679, 1963-2 CUM. BULL. 335.

89. Rev. Rul. 60-69, 1960-1 CUM. BULL. 294; *W. J. Fullilove v. United States*,

extension was permissible where the taxpayer demonstrated the *impossibility* of replacing or restoring his remaining property within the statutory period.⁹⁰

We see little need for changing the one-year limit in favor of a longer period *if* the District Director does not take an overly strict view of what would constitute sufficient grounds for an extension. In addition, by broadening the permissible scope of qualified replacement property, we minimize the chance that such impossibility will exist.

2. *Replacement through corporate control.* Under the present law, the condemnee may qualify for non-recognition of gain by purchasing control of a corporation which owns property "similar or related in service or use" to the condemned property.⁹¹ To do so he must obtain eighty percent of the combined voting power of all classes of voting stock and at least eighty percent of all other classes of stock in the corporation.⁹² This can be done by buying the stock of an existing corporation⁹³ or by starting a new corporation.⁹⁴ Our proposed revision would continue the provision for replacement through purchase of corporate control but would extend the qualified property which must be held by the corporation to "any interest in real property."

One commentator has raised an important, but as yet unanswered question about present law, namely the bearing of the amount of the requisite property held by the acquired corporation on whether the condemned property has been adequately replaced.⁹⁵ For example, if the proceeds of the condemnation were \$100,000 (potential gain of \$90,000) and were used to purchase 100% control of a corporation owning \$60,000 of property

71 F.2d 852 (5th Cir.), *cert. denied*, 293 U.S. 586 (1934); D.L. Collins, 29 T.C. 670 (1958).

90. Rev. Rul. 60-69, 1960-1 CUM. BULL. 294.

91. IRC § 1033(a)(3)(A). IRC § 1033(g)(2) specifically provides that the "like kind" test does not apply to the purchase of stock in the acquisition of control of a corporation. *See also* Treas. Regs. § 1.1033(g)-1(b) providing for this same effect.

92. Treas. Regs. § 1.1033(a)-2(c).

93. *Gaynor News Co.*, 22 T.C. 1172 (1954); *Washington Mkt. Co.*, 25 B.T.A. 576 (1932).

94. *John Richard Corp.*, 46 T.C. ____ (1966). The taxpayer cannot, however, qualify for non-recognition of gain under § 1033 merely by making loans to a corporation owned by him. *Joseph Sacks*, 22 T.C.M. 475 (1963). Nor is it enough to purchase stock in a holding company which owns stock in a company having the property "similar or related in service or use." Rev. Rul. 66-33, 1966-6 INT. REV. BULL. 11.

95. Miller, *Land of Condemnation — Federal Income Tax Consequences*, 38 NEB. L. REV. 509, 519 (1959).

“similar or related in service or use,” has the condemnee fully satisfied the section 1033 requirement, or is \$40,000 of the potential gain to be taxed now? The latter would seem to be more in keeping with the purpose of the present section 1033; the law should be clarified to remove this possible loophole by providing that it is the amount of such qualifying real property held by the corporation that determines whether a sufficient amount of replacement property has been obtained.

3. *Basis and holding period of replacement property.* When the condemnee invests the condemnation proceeds in qualified replacement property, the basis of the replacement property is its cost, decreased by the amount of gain realized but not recognized on the condemned property.⁹⁶ The holding period is determined by reference to section 1223 which, in pertinent part, provides:

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if . . . the property has . . . the same basis in whole or in part in his hands as the property exchanged, and . . . property exchanged . . . was a capital asset . . . or property described in section 1231. For purposes of this paragraph —

(A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired . . .

(7) In determining the period for which the taxpayer has held a residence, the acquisition of which resulted under section 1034 in the nonrecognition of gain realized on the sale or exchange of another residence, there shall be included the period for which such other residence has been held as of the date of such sale or exchange.

Thus the intent of Congress would clearly seem to be that a condemnee be able to tack the holding period of the replacement property onto that of the condemned property. This result is clearly reached as to section 1034 replacement property. However, it takes some stretching of the statutory language to reach

96. IRC § 1033(c). A minor exception should be noted. If the condemnee's property is directly converted into replacement property, as where the condemning authority gives him a lot across the street in payment for the condemned property, the basis of the replacement property will be the same as the converted property and adjusted according to the provisions of § 1033(c).

this same result as to section 1033 property; the basis of most section 1033 replacement property will be "the cost of such property decreased in the amount of the gain not so recognized," and to come within the "same basis in whole or in part" language of section 1223 it is necessary to accept the proposition that the reduction of the replacement property's basis by the amount of unrecognized gain means the replacement property has the same basis "in part" as the condemned property. While a court would probably reach the conclusion that the holding periods could be tacked, the statutory language could easily be modified to remove any doubt.

B. PROBLEMS UNIQUE TO PARTIAL TAKINGS.

A partial taking may occur in different ways: (1) the condemning authority may take less than a fee interest, such as an easement or mineral or air rights,⁹⁷ or (2) the authority may take the fee interest in a portion of the condemnee's tract of land.⁹⁸ Where the authority takes easements or rights, the proceeds are treated as follow: If they are expended on section 1033 replacement property, no gain is recognized; to the extent they are not so expended, they reduce the basis of the affected land, and any excess over the basis is taxable gain.⁹⁹

Where a fee interest in a portion of the condemnee's land is taken, only that part of the proceeds which constitutes consideration for the land taken is used to determine the amount of gain or loss on the condemned land. Any portion of this amount not reinvested under section 1033 is taxable. The award may also include an amount as severance or consequential damages paid because of diminution in value of the abutting real estate owned by the condemnee. Severance damages qualify for non-recognition under section 1033 if they are expended for qualifying replacement property. To the extent they are not so expended, they reduce the basis of the abutting land to which they are attributed, and any excess over the basis is taxable gain.¹⁰⁰

97. See, e.g., Rev. Rul. 60-69, 1960-1 CUM. BULL. 294 (easements, privileges, and rights).

98. See, e.g., L. A. Beeghly, 36 T.C. 154 (1961).

99. Cf. Rev. Rul. 53-271, 1953-2 CUM. BULL. 36.

100. Rev. Rul. 53-271, 1953-2 CUM. BULL. 36; Pioneer Real Estate Co., 47 B.T.A. 886 (1942).

Expenses connected with the condemnation award should be allocated, or apportioned if no allocation is possible, between the amount for land taken and the amount for severance damages. Miller, *supra* note 95, at 511.

1. *Severance damages.* There may be some difficulty in determining what amount represents damages for the property taken and what, if any, is for severance damages. In the absence of evidence of collusion, a bill of sale from the condemning authority, as well as a court decree, which breaks down the award into amounts for land taken and for severance damages, is likely to be accepted by the Commissioner and the courts.¹⁰¹ The Internal Revenue Service considers severance damages to have been stipulated, even though the bill of sale does not refer to them, where the taxpayer is furnished an itemized statement or closing sheet at the time of settlement and payment by the authority which indicates an amount paid as severance damages.¹⁰² Where no such allocation is made, the authorities are divided as to whether the taxpayer may make the allocation after the fact.

In 1950, the Second Circuit¹⁰³ decreed that no such allocation could be made by the taxpayer despite evidence that the State of Connecticut, without informing the taxpayer, had taken into account a fixed sum attributable to such damages in deciding what price it was willing to pay for his land. Judge Augustus Hand based his decision not on the difficulty of making such an allocation but rather on the ground that "what the seller actually received is what he realized on the disposal of it by sale."¹⁰⁴ In his view:

[W]hat appellant would consider to be "severance damages" to the land retained may just as well be treated as an attribute of the land sold, *i.e.*, what might well be called its "protection value" to the remaining land.¹⁰⁵

The Hand view might mean that an apportionment is never allowable or is allowable only when set out in a court decree.¹⁰⁶

The Tax Court has been more inclined to accept allocation where it is supported by reasonable evidence.¹⁰⁷ In *L.A. Beeghly*,¹⁰⁸ the taxpayer had sold a diagonal right of way across his farm to the Ohio Turnpike Commission under threat

101. Rev. Rul. 59-173, 1959-1 CUM. BULL. 201.

102. Rev. Rul. 64-183, 1964-1 (Part 1) CUM. BULL. 297.

103. *Lapham v. United States*, 178 F.2d 994 (2d Cir. 1950). For a Tax Court opinion coming to the same conclusion, see *O. N. Bymaster*, 20 T.C. 649 (1953).

104. 178 F.2d at 996.

105. *Id.*

106. *Greene v. United States*, 173 F. Supp. 868 (N.D. Ill. 1959).

107. See, e.g., *Arch B. Johnson*, 42 T.C. 880 (1964); *L.A. Beeghly*, 36 T.C. 154 (1961).

108. 36 T.C. 154 (1961).

of condemnation. The Commission representatives had told the taxpayer that the \$20,350 purchase price included \$16,000 in severance damages, but the final agreement contained no such denomination. The Tax Court, in holding that \$16,000 was a reasonable figure for severance damages, noted that "it seems obvious that a large portion of the amount received was for damage to the larger amount of land not taken rather than the small amount taken."¹⁰⁹

Any adjustment of the present federal tax law of condemnation should reflect the *Beeghly* approach. The taxpayer should be allowed to introduce any normally admissible evidence to show that a portion of an award is for severance damages.¹¹⁰ This rule would eliminate the trap of having the condemnee's future tax treatment depend on his obtaining an apportionment at the time a bill of sale is written.

It is arguable that severance damages should not be taxed at all, even though they exceed the basis of the land to which they are attributable; instead the land would get a "negative basis." There are several difficulties with such a proposal. First, there has been a "realization" of gain from the property—the condemnee has cash in hand which exceeds his basis in the property. Second, there is the problem of collectibility of taxes—the government might find itself unable to collect the tax due at the time the property with a negative basis was sold. For example: severance damages of \$21,000 are received on land with a basis of \$1,000, giving the property a basis of -\$20,000; later the property is sold for \$1,000; the taxpayer faces a tax of \$5,000, yet has only \$1,000 in hand to meet it. For these reasons it seems unwise to codify the concept of negative basis. Moreover it is doubtful that such a proposal would be politically feasible.

2. *Special assessments.* The taxpayer who has only part of his land taken may find that an assessment has been levied against his remaining land on account of the improvement for which the land was taken. He can set off the assessment first against any severance damages awarded, and, to the extent it exceeds severance damages, it reduces consideration for the land taken.¹¹¹ For example, suppose that a narrow strip of the taxpayer's land is taken for a street widening project, that he received a net award for land taken of \$5,000 plus severance damages of \$1,000, and

109. *Id.* at 156.

110. H.R. 3241 would also have provided such a provision. See note 59 *supra*.

111. See Treas. Regs. § 1.1033(a)-2(c)(10); *Christian Ganahl Co. v. Commissioner*, 91 F.2d 343 (9th Cir.), *cert. denied*, 302 U.S. 748 (1937); *Langley Collyer*, 38 B.T.A. 106 (1938).

that at the same time a \$2,000 assessment was levied on his remaining property as his share of the cost of the improvement. The assessment would reduce the severance damages to zero, thereby removing them from consideration for tax purposes, and would reduce the award for land taken to \$4,000 for tax purposes. If the assessment was larger than the total of severance damages and the award for land taken, then the taxpayer would have to pay the excess out of his own pocket; he then would be entitled to add that amount to the basis of his remaining land.¹¹²

This applies only to assessments attributable to the improvement for which the partial taking occurred;¹¹³ assessments attributable to other improvements are to be added in their entirety to the basis of the remaining land when they are actually paid.¹¹⁴ This treatment seems eminently fair to the taxpayer and no change is suggested.

3. *Partial takings which destroy an economic unit.* When only part of the condemnee's land is taken, he may find himself in the position of being unable to continue operating a trade or business at his pre-condemnation location. If he desires to continue in that same business, the proceeds of the condemnation may not be sufficient to purchase another comparable business; yet if he sells his remaining property, he faces a capital gains tax which may take up to twenty-five percent of the proceeds of the sale. The Internal Revenue Service has taken different positions toward the argument that the taxpayer should be able to treat the proceeds of the sale of the remaining land as condemnation proceeds and therefore be able to benefit from the non-recognition provisions.

A 1957 Revenue Ruling stated that the sale of property which had lost its value as a golf course when it was bisected by a state highway and the use of the proceeds from the sale to purchase property on which to construct a course comparable to the one originally taken did not qualify for treatment under section 1033.¹¹⁵ The Service saw no destruction of the remaining land and noted the absence of severance damages as well as the fact that the remainder had been sold for residential development at a substantial gain. Thus the equities were not as strong for the taxpayer as they might have been, but the result as well as the validity of these "equities" can still be questioned.

A different result was reached by the Tax Court in *Harry G.*

112. IRC § 1016.

113. Langley Collyer, 38 B.T.A. 106 (1938).

114. *Id.*

115. Rev. Rul. 57-117, 1957-1 CUM. BULL. 261.

Masser.¹¹⁶ The taxpayer owned a freight terminal and eight vacant lots across the street where he stored or kept temporarily his semi-trailers. The city condemned the parking lots. When the taxpayer could not find adequate replacement lots in the immediate vicinity, the terminal was sold to a laundry and all the proceeds were expended for a suitable terminal and parking facility. The Tax Court allowed the non-recognition of gain provisions to be applied, noting that the lots were practically adjacent to the terminal and that the properties were intended to be used as an economic unit. In 1959, the Internal Revenue Service approved the economic unit concept of the *Masser* case and at the same time revoked the earlier golf course ruling.¹¹⁷ Thus at present the Service appears willing to provide relief to the taxpayer who lost only part of his property by allowing the non-recognition provisions to be applied to proceeds of sale of the remaining property.

It would seem advisable to codify the *Masser* rule so as to leave no doubt that a taxpayer who has the integrated nature of his property disrupted by a partial taking may sell the remainder of it and obtain non-recognition treatment for those proceeds if he reinvests them in the statutorily designated property.

C. COMPENSATION NOT ATTRIBUTABLE TO THE PHYSICAL PROPERTY.

1. *Goodwill*. A portion of the award may represent payment for loss of goodwill, in effect a payment for an anticipated loss of future earnings.¹¹⁸ Because goodwill is a non-capital asset, the excess of proceeds over any basis in that goodwill is taxable as ordinary income.¹¹⁹ Thus it is the Commissioner who is likely to be arguing for an apportionment of goodwill.¹²⁰ Restricting the evidence admissible to show payment for goodwill is as inappropriate when applied to the Commissioner as is a restriction on the evidence the condemnee can use to show a payment for severance damages. Therefore, to be consistent with the proposed rules for proof of payment for severance damages, the Commissioner should not be restricted to use of the court decree or bill of sale to show a payment for goodwill.

116. 30 T.C. 741 (1958).

117. Rev. Rul. 57-117, 1957-1 CUM. BULL. 261.

118. See, e.g., Draft, *Act to Provide Compensation for Loss of Goodwill Resulting from Eminent Domain Proceedings*, 3 HARV. J. LEGIS. 445 (1966).

119. *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944).

120. See the Commissioner's argument in *Claude B. Kendall*, 31 T.C. 549 (1958) (held to have been no such apportionment to anticipated loss of business).

2. *Moving expenses.* A portion of the condemnation award may represent compensation for anticipated expenses of relocating.¹²¹ Such compensation would be taxable as ordinary income.¹²² However, some condemnees are able to deduct the actual relocation expenses as "ordinary and necessary" expenses under section 162 or section 212;¹²³ thus, only the compensation for relocation not so expended would actually be taxed. On the other hand, the condemnee whose residence was taken would apparently be taxed on the entire relocation award, since no provision is made for him to deduct his actual relocation expenses. To avoid leaving him with too few after-tax dollars to actually move to his replacement residence, the relocation award should not constitute income to him to the extent it is so expended.¹²⁴ Section 217, allowing a taxpayer who changes jobs to deduct his moving expenses, suggests that Congress might well be willing to create a similar provision for condemnees.

3. *Interest.* The condemnee must report any interest on the condemnation award as ordinary income;¹²⁵ it is treated no differently from interest paid on a savings account. The rationale for this treatment is that the interest represents the income that would have been earned if the principal amount had been available to the taxpayer. Interest, however, has not always been treated apart from the award. A number of cases in the 1930s and 1940s considered interest to be part of the condemnation award and taxed it as part of the proceeds from the sale of the property.¹²⁶

An argument can be made that the interest is only compensating

121. See, e.g., H.R. 3421, discussed note 59 *supra*.

122. IRC § 61. See the Commissioner's contention in National Pub. Co., 24 T.C.M. 1470 (1965).

123. See, e.g., Electric Tachometer Corp., 37 T.C. 158 (1961), which held that moving expenses were deductible where there was no fixed right or agreement to be reimbursed for such expenses by the condemning authority. A distinction would be made between moving expenses and the cost of moving a building to a new site, the latter being a capital expenditure. Clarence E. Baldwin, 14 T.C.M. 794 (1955). However, the cost of moving a building might well qualify as replacement property under § 1033. See Rev. Rul. 58-396, 1958-2 CUM. BULL. 403.

124. See H.R. 3421, which also would have excluded relocation payments from taxable income.

125. IRC § 61; *Issac G. Johnson & Co. v. United States*, 149 F.2d 851 (2d Cir. 1945); *Commissioner v. Kieselbach*, 127 F.2d 359 (3rd Cir. 1942), *aff'd*, 317 U.S. 399 (1943).

126. *Seaside Improvement Co. v. Commissioner*, 105 F.2d 990 (2d Cir.), *cert. denied*, 308 U.S. 618 (1939); *Pioneer Real Estate Co.*, 47 B.T.A. 886 (1942). See also John J. Bliss, 27 B.T.A. 303 (1933), holding that interest on a condemnation award is not interest upon the obligation of a political subdivision within the meaning of the Internal Revenue Code.

the condemnee for a decline in the buying power of the dollars he received — that it only puts him in the same position as if he had been paid on the day the property was physically taken — and that it should be treated for tax purposes as part of the award. This loss of buying power argument can be objected to on three grounds: First, it is only descriptive of what may be happening in times of inflation and, of course, does not account for changing rates of inflation or for deflation; second, in no other place does the Internal Revenue Code take account of changes in the value of the dollar; and third, if the interest payment is to compensate for loss caused by inflation, the taxpayer has not been compensated for the loss of income between the time of the taking and the time of the award. For these three reasons we reject any change in the present treatment of interest.

APPENDIX A

The taxpayer generally must account for increases or decreases in the value of his property at the time of a “sale or exchange.”¹²⁷ Condemnation or a sale made under “threat or imminence” of condemnation is a “sale or exchange” within the meaning of the Internal Revenue Code.¹²⁸ Thus, unless the condemnee deal with the condemnation award or the proceeds of a sale made under “threat or imminence” of condemnation so as to obtain tax-free treatment, he must account for gain or loss in the same manner as if he had made a voluntary sale.¹²⁹

The initial step in determining the tax consequences of the condemnation is to compute the gain or loss, if any, to the taxpayer. Where the entire parcel of land owned is taken, the amount of gain or loss is measured by the difference between the net consideration received and the adjusted basis of the land condemned.¹³⁰ The net consideration is determined by deducting from the total award, which includes amounts retained by the condemning authority to satisfy liens and mortgages against the property,¹³¹ the reasonable and necessary expenses incurred in connection with the condemnation.¹³² Such expenses include fees

127. IRC § 1002.

128. *Commissioner v. Kieselbach*, 127 F.2d 359 (3d Cir. 1942), *aff'd*, 317 U.S. 399 (1943).

129. *Cf.* IRC §§ 1002, 1033.

130. IRC § 1001.

131. Treas. Regs. § 1.1033(a)-2(c)(11) (must be included regardless of whether the taxpayer was personally liable); *Washington Mkt. Co.*, 25 B.T.A. 576 (1932).

132. *See, e.g., Washington Mkt. Co.*, 25 B.T.A. 576 (1932).

to engineers¹³³ and lawyers¹³⁴ as well as costs of surveys¹³⁵ and of litigation.¹³⁶

The next step is to place the condemned property into one of the four major categories of real property recognized by the Internal Revenue Code. They are: (1) real estate held for productive use in trade or business; (2) real estate held for investment; (3) real estate held for sale by a real estate dealer; and (4) real estate used as a residence of the taxpayer. With regard to property held for use in trade or business, investment property, and residential property, the Internal Revenue Code makes a distinction between property held by the taxpayer for six months or less and that held for more than six months. In general, this line determines whether the gain or loss on the sale or exchange of these kinds of property will qualify for the rather favorable tax treatment accorded to "long-term" "capital" gains or will be taxed under ordinary income rules. The gain on the sale of property held for sale by a real estate dealer is always subject to ordinary income rates regardless of the length of time the property was held.¹³⁷

Losses. Losses on real estate held by a real estate dealer primarily for sale in the ordinary course of his business are deductible from ordinary income, as are losses on real estate used in trade or business and held six months or less.¹³⁸ Losses on real estate held as an investment for six months or less are deductible only as short-term capital losses, subject to section 1211 which limits the deductibility of such losses.¹³⁹

When real estate held for investment which has been held for more than six months is sold at a loss, the loss is ordinarily a long-term capital loss.¹⁴⁰ It is set off against capital gains with any excess of loss over gain being deductible, subject to the limitations of section 1211. However, when losses on investment property are realized because of condemnation, they are taxed

133. *Id.*

134. Mary W.T. Connally, 32 B.T.A. 920 (1935); *Washington Mkt. Co.*, 25 B.T.A. 576 (1932).

135. *Washington Mkt. Co.*, 25 B.T.A. 920 (1932).

136. Mary W.T. Connally, 32 B.T.A. 920 (1935); *Washington Mkt. Co.*, 25 B.T.A. 576 (1932).

137. IRC § 61(a)(3).

138. IRC § 165.

139. Under § 1211, a corporation is allowed to deduct capital losses only to the extent of capital gains; however, § 1212 provides for the carryover of capital losses not deductible because of the limits of § 1211. A taxpayer, other than a corporation, is allowed capital losses only to the extent of capital gains plus the taxable income of the taxpayer or \$1,000, whichever is smaller.

140. *See* IRC §§ 1221-23.

under section 1231. All property used in a trade or business which is sold at a loss receives section 1231 treatment.

Section 1231 deals with certain kinds of property deemed by Congress to warrant special tax treatment. Sales of section 1231 property at a gain produce capital gains which are taxed at capital gains rates; sales of section 1231 property at a loss become ordinary losses and are deductible from ordinary income, thereby reducing the amount of tax that will be imposed at the higher ordinary income tax rates. Thus the taxpayer who sells section 1231 property gets the best of all possible worlds. However, if the taxpayer engages in more than one section 1231 transaction during a given tax year, he must aggregate all the gains and losses subject to section 1231.¹⁴¹ It is the net gain or loss that is considered to be capital gain or ordinary loss. To make maximum use of this rather attractive provision, the condemnee must have his condemnation loss fall in a tax year when he has no offsetting section 1231 gains.

When the condemnation of a residence results in a loss to the condemnee, the loss is not deductible by him.¹⁴² Thus the homeowner who loses his home to the public bulldozer enjoys no tax advantage over his neighbor who voluntarily sells his home at a loss.

Gains. If the condemnee realizes a gain on the condemnation, it is taxable as if the property had been sold to a purchaser other than a condemning authority¹⁴³ except that (1) long-term gains from property held by others than real estate dealers for more than six months become section 1231 gains and (2) the condemnee has an election as to nonrecognition of all or part of the gain if he reinvests in property qualifying under section 1033. The section 1231 treatment of gains can be to the condemnee's detriment if he had section 1231 losses during the year which will be offset by the gains, thereby losing the opportunity to deduct the losses from ordinary income. This leads to a strong temptation to engage in tax planning so as to realize the gains in a year when there are no such section 1231 losses. Thus, in

141. Hence the term "hotchpot" is often applied to § 1232. See B. BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 553 (3d ed. 1964).

142. IRC § 165, specifically limiting losses of individuals, would not allow a loss on the sale under threat or imminence of condemnation of a personal residence to be deducted. Since it does, however, allow casualty losses to be deducted, it operates somewhat unfairly against the condemnee—who is more deserving of favorable treatment than the person who lost his property through an event not involving governmental action directed toward producing a public benefit.

143. Commissioner v. Kieselbach, 127 F.2d 359 (3rd Cir. 1942), *aff'd*, 317 U.S. 399 (1943).

the condemnation situation, a taxpayer might want to sell the threatened property to a private third party at a time before the condemning authority was to act in order to take the gain in a year when there would be no offsetting section 1231 losses.¹⁴⁴

144. Such a sale to a third party under "threat of condemnation" qualifies for non-recognition treatment under § 1033. *Creative Solutions, Inc. v. United States*, 320 F.2d 809 (5th Cir. 1963); *S. H. Kress Co.*, 40 T.C. 142 (1963).

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