

# Michigan Law Review

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Volume 57 | Issue 4

---

1959

## Taxation - Federal Income Tax - Involuntary Conversion Treatment Afforded Sale of Remaining Property After Partial Condemnation

Stevan Uzelac  
*University of Michigan Law School*

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### Recommended Citation

Stevan Uzelac, *Taxation - Federal Income Tax - Involuntary Conversion Treatment Afforded Sale of Remaining Property After Partial Condemnation*, 57 MICH. L. REV. 618 (1959).

Available at: <https://repository.law.umich.edu/mlr/vol57/iss4/15>

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TAXATION—FEDERAL INCOME TAX—INVOLUNTARY CONVERSION TREATMENT AFFORDED SALE OF REMAINING PROPERTY AFTER PARTIAL CONDEMNATION—Petitioner owned two parcels of real estate across the street from each other which were used as one “economic unit” for purposes of a trucking terminal. One parcel was improved with a terminal building from which trucks would pick up and deliver their shipments, while the other was used as a parking lot for trucks not in use. Petitioner was forced to sell the parking lot under threat of condemnation. Since it was economically unfeasible to operate his business without a nearby parking lot, petitioner subsequently sold the terminal facilities and reinvested the proceeds from the sales of both properties in new terminal facilities. In his 1951 tax return petitioner treated the gain from the sale of the terminal facilities, as well as from the sale of the parking lot, as non-recognized gain under section 112(f) of the 1939 Code, which provides for non-recognition of gain from involuntarily converted property. The Commissioner assessed a deficiency on the ground that the sale of the terminal facilities was a regular sale of business property which was not threatened with involuntary conversion. It was stipulated that the petitioner would not have sold the terminal facilities if the parking lot had not been involuntarily converted. In a Tax Court proceeding, *held*, for petitioner. When two practically adjacent pieces of property are used together as one economic unit and the sale of one piece under threat of condemnation renders the continuation of business on the remaining piece impractical, if the remaining piece is sold and the proceeds of both sales reinvested in similar property, the entire transaction is to be considered as an “involuntary conversion” of one economic unit within the meaning of section 112(f). *Harry G. Masser*, 30 T.C. 741 (1958).

Under section 112(f) of the 1939 Code, which was substantially re-en-

acted as section 1033 of the 1954 Code,<sup>1</sup> a taxpayer can elect not to be currently taxed on the gain realized from the "sale or exchange" of property which is "involuntarily converted." To get non-recognition he must reinvest the proceeds in property "similar or related in service or use" to the converted property within a limited period.<sup>2</sup> Section 1033 treatment has been limited to cases where the sale of property was literally a result of "condemnation or threat or imminence thereof."<sup>3</sup> Thus, where a taxpayer is forced to sell his property merely because of "business expediency," no matter how compelling, relief is denied under this provision.<sup>4</sup> The principal case agrees with the view that business necessity alone, without any threat or use of the power of eminent domain, will not amount to an "involuntary conversion."<sup>5</sup> As a case of first impression, however, it raises an interesting question of the extent of an "involuntary conversion" when only part of the land in question was actually threatened with condemnation.<sup>6</sup> The tax treatment of severance damages in condemnation cases presents an analogous situation. Where severance damages are given to compensate for the injury to remaining land no immediate tax is paid for the amount of these damages, and the basis of the retained property is reduced accordingly on the theory that severance damages are for an injury to capital.<sup>7</sup> Thus a taxpayer may acquire other property with the severance damages and thereby restore the full usefulness of his injured

<sup>1</sup> The provision originally appeared in Revenue Act of 1921, §234(a)(14). Section 1033 now provides in part: "(a) General Rule.—If property (as a result of destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted. . . ."

<sup>2</sup> The "Technical Amendments Act of 1958," 72 Stat. 1641 (1958) amended the 1954 code and broadened this definition by providing in new subsection 1033(g) that an investment in property of "like kind" is to be treated as an investment in property "similar or related in service or use" when applied to an involuntary conversion of real property held for productive use in a trade or business or for investment. See note 10 infra.

<sup>3</sup> *Davis Co.*, 6 B.T.A. 281 (1927). Originally relief was allowed for "involuntary conversions" in the form of a deduction from income. Revenue Act of 1921, §234(a)(14). It is perhaps the traditionally restrictive interpretation of deduction provisions which accounts for the literal application of the provision today, even though the section is now written in terms of non-recognition. On the other hand it has often been argued that since this is a relief provision it should be liberally construed to effect its purpose. *Massillon-Cleveland-Akron Sign Co.*, 15 T. C. 79 at 83 (1950). See generally S. R. Lipton, "Involuntary Conversions," 29 TAXES 529 (1951).

<sup>4</sup> *Davis Co.*, note 3 supra; *Piedmont-Mt. Airy Guano Co. v. Commissioner*, 8 B.T.A. 72 (1927). See also *Phillip F. Tirrell*, 14 B.T.A. 1399 (1929); *George S. Robbins*, 15 B.T.A. 1068 (1929).

<sup>5</sup> Because the sale for which relief is sought was not to a public authority exercising the power of eminent domain the principal case is easily confused with those cases where mere business expediency requires the sale. The principal case is distinguishable by the fact that the cause of the sale of the remaining land was a condemnation; without it the sale would never have occurred. It is this factor which removes the case from the "business expediency" category and brings it within §1033.

<sup>6</sup> But see *Rev. Rul. 57-117*, 1957-1 CUM. BUL. 261.

<sup>7</sup> *Pioneer Real Estate Co.*, 47 B.T.A. 886 (1942).

land without immediate tax consequences. Allowing non-recognition treatment on the sale of the retained property here carries this principle to its logical conclusion. In this setting the condemnation has caused an injury to the taxpayer's property which can be recouped only by reinvestment in new property. Accordingly, no tax consequences should result from this effort by the taxpayer to obtain other usable property.

While the underlying policy supporting the court's decision in the principal case is sound, the holding raises several interpretative problems which must be resolved. Clearly not every condemnation which adversely affects a taxpayer's remaining land will allow a sale of that land to be an "involuntary conversion" under section 1033. The court requires that a continuation of the same "business" on the remaining land would be "impractical" before there is an "involuntary conversion" of the remaining property.<sup>8</sup> How great an interference with business there must be to make its continuation "impractical" is uncertain. Would a mere reduction of profits, or potential profits, be enough, and if so, by how much? By making the decision turn on what is "impractical" the court has introduced into each case a subjective element which it must control by a test of reasonableness to prevent abuse by taxpayers. Moreover, this task becomes magnified when it is realized that this decision will probably not be limited to property used in a "trade or business" for its reasoning applies persuasively to property used in any gainful activity.

Another difficulty lies in the effect of the recent amendment to section 1033,<sup>9</sup> which substitutes the broader "like kind" test as an alternative for the narrowly construed "similar or related in service or use" test in determining the types of property in which proceeds from an "involuntary conversion" of business or investment property must be invested to qualify for non-recognition.<sup>10</sup> The main reason for allowing non-recognition in the principal case was that the taxpayer could not carry on the particular business in which he was engaged. Consequently, in choosing replacement property it would seem logical to limit the taxpayer to a business

<sup>8</sup> Principal case at 747. Under this test it is doubtful that the presence of severance damages would eliminate this problem. If no other land nearby could be acquired with the money received the reason for relief would still remain.

<sup>9</sup> I.R.C., §1033(g). See note 2 supra.

<sup>10</sup> S. Rep. 1983, 85th Cong., 2d sess., p. 72 (1958); 104 CONG. REC. 15736 (August 12, 1958). This preenactment material indicates that the substitution of the "like kind" test is to make §1033, in so far as it relates to property held for productive use in a "trade or business" or for investment, coextensive with §1031 which permits certain tax free exchanges of such property. Thus, the scope of "like kind" property can be measured by the interpretation given the phrase in the setting of §1031. For an extensive discussion of this provision including a definitive treatment of the "like kind" test, see Molloy, "Tax Free Exchanges of Property of Like Kind Under Section 112(b)(1) of the Internal Revenue Code," 37 VA. L. REV. 555 (1951). See also Treas. Reg. §1.1031(a)-1(c) (1958).

similar to that which entitled him to relief. Such limitation, however, cannot be imposed in view of the clear mandate of new subsection 1033(g), which allows reinvestment in "like kind" property. The effect is that a taxpayer would be allowed to sell his remaining land and reinvest in other real estate for use in a totally different business free of immediate tax consequences. In this situation the reason for allowing non-recognition has been subverted and the relief becomes merely a tool by which a taxpayer might change his investment. Thus the holding of the principal case, while resting on sound analysis under the "similar or related in service or use" test, will become more questionable in future application under the "like kind" test.

*Stevan Uzelac*