



MEMORANDUM

TO: Kathryn Emmett
FROM: D. Robert Morris
DATE: March 3, 2020
FILE NO: 70824.40
SUBJECT: Effect of Section 1033 on Condemnation of Taxpayer's Property

I. QUESTION PRESENTED:

You have asked us to outline the effects of Section 1033 of the Internal Revenue Code (the “Code”) on a Taxpayer’s tax liability as a result of the threatened eminent domain of the Taxpayer’s property by the City of Stamford (the “City”).

For purposes of this analysis, we have assumed the following:

1. The property to be acquired by the City consists of a three-family home of approximately equivalent units, one of which the Taxpayer lives in, and the underlying real estate.
2. The City is acquiring the Taxpayer’s entire property and not merely a portion of the property.¹
3. The Taxpayer has held the property for longer than one (1) year such that any gain on sale or exchange would be taxed as capital gain rather than at ordinary income rates.
4. The Taxpayer shall receive a cash award for the property from the City.
5. The Taxpayer shall purchase replacement property from an unrelated person.²
6. The Taxpayer shall be subject to a gain, not a loss, on the acquisition of the property by the City.³
7. The condemned property has not been affected by any federally declared disaster.⁴

¹ The acquisition of only part of the property would require further analysis of the treatment of related property voluntarily sold to the City or diminished in value by the City’s partial condemnation.

² Acquisitions of replacement property from related persons are subject to additional restrictions. *See* I.R.C. § 1033(i). This memorandum does not analyze the application of § 1231 to amounts not converted to replacement property or the potential for § 1245 recapture.

³ Generally, losses from involuntary conversions cannot be deducted. § 1033.

⁴ Federally declared disasters may subject the property to certain disaster relief and extended compliance periods. These programs are beyond the scope of this memorandum.

8. The Taxpayer will acquire all replacement property outright and not by acquiring control of a corporation owning such property.⁵
9. The Taxpayer is an individual.⁶

II. SHORT ANSWER

If the City condemns, or threatens to condemn, real property owned by the Taxpayer containing a three-family home, one of which they live in and the other two which are rented out as individual residences, then the Taxpayer will be treated for tax purposes as having transferred the property in two separate transactions—a sale of the portion of the property rented to others and a sale of the Taxpayer’s residence. The Taxpayer is entitled to defer any realized gain on either or both of the transfers if Taxpayer uses (a) the entire monetary award from the City with respect to the rental property to purchase other residential rental property and/or (b) the entire monetary award from the City with respect to the Taxpayer’s primary residence to purchase another residence for the Taxpayer.

The Taxpayer may elect to defer gain on one transfer and not the other. As such, the Taxpayer may purchase replacement property either in the form of another multi-family home or as separate properties. If the Taxpayer purchases property which has a lesser cost than the monetary award allocated to the rental property or the residential property, then the Taxpayer will recognize gain to the extent that the award for such portion of the condemned property exceeds the cost of the respective replacement property.

Additionally, the Taxpayer may be able to permanently defer some of the gain on the residential portion of the property pursuant to those rules which allow taxpayers to avoid up to \$250,000, if filing single, or \$500,000, if married filing jointly, of gain on the sale or exchange of the Taxpayer’s primary residence.

III. BACKGROUND:

(a) Voluntary Sale or Exchange of Property

Typically, the sale or exchange of property from the Taxpayer to the City is treated a sale or exchange subject to Section 1001 of the Code and requires the Taxpayer to recognize gain on the transaction equal to the amount paid by the City less the Taxpayer’s basis in the property sold or transferred in the year the amount was paid.

For example, if a Taxpayer owns commercial property with a basis of \$50,000 and the Taxpayer sells such property to the City for \$200,000, then the Taxpayer will have a gain of \$150,000, which is equal to the amount realized (\$200,000) less the Taxpayer’s basis (\$50,000) in the property.

⁵ Certain restrictions apply if the taxpayer replaces condemned property by acquiring control of a corporation owning property that is similar or related in service or use. See, e.g., Internal Revenue Service (“IRS”) Publication 544, Sales and Other Dispositions of Assets (p. 10) (“**Pub. 544**”) and § 1033(a)(2).

⁶ If the Taxpayer is a corporation or partnership, then the ability to permanently defer gain pursuant to § 121 on a primary residence may be eliminated or reduced and the mechanics of electing § 1033 treatment will be different.

(b) Property Subject to Involuntary Conversion under Section 1033

However, if property is “involuntarily converted” as provided in Section 1033 of the Code, then the Taxpayer may be entitled to defer recognition of capital gain. The intent of this provision is to put the Taxpayer in the same position they would have been in if the property had not been involuntarily converted by avoiding any immediate tax consequences of the conversion. Section 1033 provides that if property is involuntarily converted into money (i.e. by condemnation), then the taxpayer may be able to defer recognition of the gain if the taxpayer purchases similar property (called qualified replacement property) within the applicable time period (known as the replacement period).⁷ The gain is deferred by allowing the taxpayer to take a basis in the new property equal to the cost of the new property decreased by the amount of gain not recognized. The effect of this is to delay recognition of the gain until the replacement property is sold, at which time the Taxpayer will recognize both the gain on the converted property and the gain on the replacement property, if any. Any amount of sale proceeds which exceeds the cost of such new property shall be immediately recognized. The “price” of the deferred gain is a lowered basis in the replacement property, which may serve to reduce subsequent depreciation deductions.

For example, if the Taxpayer’s rental property has a basis of \$50,000 and the City takes such rental property by condemnation for \$200,000, then the Taxpayer may be able to defer the \$150,000 gain by purchasing similar rental property for \$200,000 or more. If the Taxpayer purchases the replacement property for \$200,000, then the Taxpayer will have a carryover basis of \$50,000 in the replacement property (equal to the cost basis of \$200,000 less the \$150,000 of deferred gain). If that replacement property further appreciates to \$250,000 and the Taxpayer sells it at that price, then the Taxpayer will recognize a gain of \$200,000 (equal to the \$250,000 amount received less the \$50,000 basis), which represents both the \$150,000 of unrealized gain on the condemned property plus the \$50,000 gain on the replacement property.

Alternatively, however, if the Taxpayer purchases replacement property for only \$100,000, then the Taxpayer will only be able to defer \$50,000 of the \$150,000 gain, but will need to recognize gain in the amount equal to the amount realized on the condemnation (\$200,000) less the cost of the replacement property (\$100,000), or \$100,000, which represents the cash from the City that the Taxpayer kept and did not reinvest in replacement property. In other words, the Taxpayer recognizes a gain on the amount of the condemnation award which is not reinvested (up to the amount of the gain on the property).

(i) Condemnation and Threat of Condemnation

Section 1033 treatment is only available for involuntary conversions such as condemnation by a municipality. There is no difference to the Taxpayer whether the City completes the formal condemnation process or purchases the property from the Taxpayer under the mere threat of condemnation.

⁷ I.R.C. § 1033(a)(2). See also § 1033(g)(1) providing special rule for real property held for productive use in trade or business or for investment which may be replaced by “like kind” property, discussed *infra*.

Generally, a threat of condemnation exists for purposes of Section 1033 if a representative of a government body or public official authorized to acquire property for public use informs the owner that the government body has decided to acquire the property and the Taxpayer has reasonable grounds to believe that the City will condemn the property if the Taxpayer doesn't sell it. Depending on the facts and circumstances, a "threat" may exist before the appropriate governmental authorities have actually taken any formal steps toward condemnation—mere communications to the taxpayer by the appropriate officials may suffice.

(ii) *Treatment of Multi-Use Properties*

If the Taxpayer uses part of the condemned property as the Taxpayer's home and part as business or rental property, then each part is treated as separate property for purposes of calculating and deferring any gain.⁸ Assuming that the condemned property consists of a three-family home with approximately equivalent units, one of which the Taxpayer uses as the Taxpayer's primary residence, then two-thirds (2/3) of the condemnation award would be attributed to the rental property and one-third (1/3) would be attributed to the residential property.

For example, if the Taxpayer's property has a total basis of \$120,000 and the Taxpayer sells it to the City for \$240,000 under threat of condemnation then the gain would be calculated separately for the residential property and the rental property as follows:

(a) for the residential portion, the amount of the condemnation award would be 1/3 of the \$240,000 or \$80,000, from which the Taxpayer would subtract the basis of 1/3 of the building (\$40,000) for a total gain of \$40,000; and

(b) for the rental portion, the amount of the condemnation award is 2/3 of \$240,000 or \$160,000, from which the Taxpayer would subtract the adjusted basis of the rental portion of the building (\$80,000 as adjusted by any depreciation taken by the Taxpayer in prior years, for purposes of this example, \$20,000) for a total gain of \$80,000.

The Taxpayer could then apply § 121, if available, to the residential portion of the gain, and the deferral of gain on both the residential and rental property would be determined with respect to separate replacement properties as discussed below.

(A) Application of Section 121 to Portion of Property that is Taxpayer's Principal Residence

Gain from the condemnation of the Taxpayer's principal residence may be permanently deferred pursuant to Section 121. Section 121, which applies both to involuntary conversions and

⁸ Pub. 544 (p.9). It is important to calculate the gain separately on the residential and rental portions to account for adjusted basis in the rental property and the potential for a loss on the residential portion of the property (which loss cannot be taken and does not offset the gain on the rental property). The gain on residential property may also be entitled to permanent deferral as set forth in § 121.

voluntary sales, allows the Taxpayer to exclude up to \$250,000⁹ of gain on the sale of a principal residence if the Taxpayer so elects, after the application of Section 1033.¹⁰ If the gain from a condemnation exceeds the amount that may be deferred under Section 1033, then the Taxpayer may exclude the rest of the gain pursuant to Section 121. The basis of the replacement property will be reduced by the gain postponed pursuant to Section 1033 and the taxpayer will be treated as having owned and used the replacement property as the taxpayer's principal residence for the period they owned and used the condemned property as their principal residence.

For example, if the Taxpayer owned and used property with a basis of \$40,000 as their principal residence for 5 years that was condemned by the City for \$400,000, then the Taxpayer would realize a gain of \$360,000 (the \$400,000 award less the property's \$40,000 basis). If the Taxpayer uses the condemnation award to purchase a new home for \$100,000, then the Taxpayer can exclude \$250,000 of the realized gain pursuant to § 121, so the amount realized for purposes of § 1033 is \$150,000 (\$400,000 less the \$250,000 exclusion) and the gain realized is the \$110,000 (the \$150,000 amount realized less the \$40,000 basis). The Taxpayer must recognize \$50,000 of the gain (the \$150,000 amount realized for purposes of § 1033 less the \$100,000 cost of the replacement property) and the remaining \$60,000 of gain may be postponed pursuant to § 1033.

(iii) *Replacement Property*

In order to defer any gain on the condemned property, the Taxpayer must purchase qualified replacement property that has a “similar use” to the converted property. Generally, in determining whether qualified replacement property is “similar use” for purposes of § 1033, the IRS and courts look to the ultimate use for the property intended at the time of acquisition. Whether property is of a “similar use” would be evaluated separately for the Taxpayer's residential property and rental property. For the residential property, the replacement property generally must become the Taxpayer's new residential property—even if not the Taxpayer's primary home. For the rental property, the replacement property generally must be similar rental property—here, residential rental property. If the Taxpayer wished to invest in a different type of rental or other investment property, then further analysis would be required.¹¹

(iv) *Replacement Period*

In order to postpone gain from a condemnation, the taxpayer must buy replacement property within the replacement period. The replacement period is either two (2) or three (3) years

⁹ § 121 allows the permanent deferral of \$250,000 of gain for single filers and up to \$500,000 for married taxpayers filing jointly, assuming the requisite holding periods are met.

¹⁰ § 121(f). The Taxpayer may elect to use only § 1033 and save the § 121 election for the replacement property acquired pursuant to § 1033 if the Taxpayer plans on selling the replacement property within two years, as the § 121 election may only be made once every two years, or in the event the involuntary conversion was a result of a federally declared disaster which is beyond the scope of this memorandum. If the Taxpayer does not apply § 121, the replacement property will be treated as if it were held and used as a principal residence for purposes of § 121 for the time the condemned property was held and used as a principal residence.

¹¹ What constitutes like-kind property where the converted property was rental property has been the subject of much litigation.

depending on the type of property replaced. The replacement period begins on the earlier of (a) the date on which the taxpayer disposed of the condemned property, or (b) the date on which the threat of condemnation began. For most property, the replacement period ends two (2) years after the end of the first tax year in which any part of the gain on the condemnation is realized. Real property held for use in a trade or business or for investment which is condemned is subject to a three (3) year replacement period instead of a two (2) year replacement period.

The Taxpayer may purchase replacement property before the condemnation as long as it is purchased after the *threat* of condemnation and it is still held at the time of the actual condemnation. Property which is acquired prior to the threat of condemnation does not qualify as property acquired within the replacement period.

The replacement period may be extended by the IRS area director for up to one (1) year. Taxpayers seeking an extension should apply prior to the end of the replacement period and demonstrate reasonable cause for the delay in purchasing a replacement property. The high market value or scarcity of replacement property is not a sufficient reason for granting an extension.

(v) *Mechanics of Section 1033 Election*

Individual taxpayers report their election to postpone recognition of the gain, and all necessary details, on a statement attached to their return for the tax year in which replacement occurs.¹² If replacement never occurs, then the Taxpayer must amend the return for the year in which the gain was realized but not reported. Generally, gain from condemnation of personal-use property will be reported on Form 8949 or Schedule D to Form 1040, and gain from condemnation of property held for business or profit will be reported on Form 4797, however, taxpayers should consult their tax preparers and the instructions on that year's forms for the necessary reporting requirements.

(vi) *Effect of No Valid Section 1033 Election*

A taxpayer who fails to make a qualified replacement under a Section 1033 election will need to recognize the gain on the condemnation under the general rule of Section 1001(c) and take a cost basis in the replacement property.¹³ The gain, therefore, becomes retroactively recognized in the year of the condemnation.

For example, if the City pays the Taxpayer a condemnation award in 2020 which the Taxpayer does not recognize in 2020, but the Taxpayer then fails to find replacement property after the expiration of the replacement period in 2023, the Taxpayer must amend their 2020 return and may be subject to penalties and interest on any amount owed as a result of the unreported gain.

¹² Pub. 544 (p.11).

¹³ § 1001(c); § 1012 (also, the holding period of the replacement property begins on the date of acquisition).