

**HIGH SPEED RAIL:
TAX ASPECTS OF CONDEMNATION**
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Example 1. *Sale of Farmland – §1033 Not Utilized-Amount Realized, Gain Realized and Gain Recognized.* A owns 100 acres of unimproved farmland that he purchased in 1999 for \$600,000. A owes Bank X \$500,000 which loan is secured by a deed of trust on the farm. Under threat of condemnation by the Rail Authority (“RA”), on July 1, 2013, A sells the 100 acres to Rail Authority Agent (“RA Agent”) for \$1,500,000. A does not desire to defer income under §1033 or purchase replacement property. RA Agent pays \$1,500,000 MM into escrow; Bank X receives \$500,000 and A receives \$1,000,000. **The amount realized by A is \$1,500,000 (cash received plus the payoff of the bank debt) and the gain realized is \$900,000 (\$1,500,000 minus \$600,000 basis). Since A did not take advantage of §1033, A’s gain recognized (taxable) is \$900,000.**

Example 2. *Sale of Almond Orchard-§1033 Not Utilized- Bank Loan Secured by Deed of Trust-Gain Realized and Recognized.* Same facts as Example 1 except that in 2000-2003, A developed the 100 acres into an almond orchard at a total cost of \$400,000, which A also borrowed from Bank X. In 2005, Bank X combined both loans into a single \$900,000 loan secured by a single deed of trust on A’s farm; no principal payments have been made. The trees came into commercial production in 2004; A has taken \$200,000 in depreciation on trees and other improvements. In 2013, under threat of condemnation, A sells the entire orchard to RA Agent for \$2.5 MM. A does not desire to utilize §1033 or purchase replacement property. In escrow, Bank X receives \$900,000 to pay off its loan and A receives \$1.6 MM. **A recognizes gain of \$1,700,000 calculated as follows:**

Sales price (amount realized):	\$2,500,000
Basis:	
A’s basis in land:	\$ 600,000
A’s cost of developing almonds:	\$ 400,000
Depreciation taken by A:	(\$ 200,000)
A’s adjusted basis (after depreciation):	(\$ 800,000)
Gain recognized:	<u>\$1,700,000</u>

(A will have §1245 depreciation recapture)

Example 3. *Sale of Lots by Land Developer-Inventory-§1033 Not Utilized-Ordinary Income Recognized.* A is a real estate developer who sells homes and lots. He has developed 30 acres into 120 lots for sale, some of which are completed homes. RA Agent notifies A that the RA requires five (5) of the lots for the rail right-of-way. A voluntarily sells all 5 lots to RA Agent for \$750,000. A’s tax basis in the five (5) lots is \$500,000, and therefore his gain realized is \$250,000. Although A could take advantage of §1033 by reinvesting in qualified replacement property, he does not desire to do so. **A is not entitled to capital gain treatment since his lots are held for sale to customers (inventory). A’s gain realized will be recognized as ordinary income.**

Example 4. Almond Ranch Sale. §1033 Not Utilized. §1245 Depreciation Recapture. Sale of Unharvested Crop. A owns a 200 acre almond orchard. RA Agent notifies A that a 10-acre corner of the orchard is needed for the rail right-of-way. The 10 acres have trees, wells and irrigation equipment, and no buildings. On July 13, 2013, RA Agent buys the 10 acres for \$180,000 (\$18,000 per acre). A's original cost of the 10 acres is \$90,000, and A has taken depreciation on the 10 acres of trees and improvements of \$30,000. His tax basis is therefore \$60,000 (\$90,000 minus \$30,000) and his gain realized on the sale to the RA Agent is \$120,000 (\$180,000 minus \$60,000). A decides not defer the gain under §1033. **A will recognize the \$30,000 in 2013 as §1245 depreciation recapture (ordinary income) and the balance of \$90,000 as capital gain. If the RA pays A an additional \$20,000 as the value of the unharvested 2013 almond crop on the 10 acres, that additional sum also qualifies as capital gain under IRC §1231(b)(4).**

Example 5. Leaseback of Condemned Property-Seller Harvests Crop. Same facts as Example 4 except that RA does not need to utilize the 10 acres it purchased until January 1, 2015, and does not pay an additional \$20,000 for the 2013 almond crop on the 10 acres. Instead it leases the 10 acres back to A until 12-31-2015, and permits A to farm and harvest crops for 2013 through 2015. **All of the crop income to A for the entire 200 acres, including the 10 acres leased back from the RA, will be ordinary income.**

Example 6. Land Sold Voluntarily To Third Party-No Official Notice of Condemnation-Threat or Imminence Missing. A owns an orchard which he desires to sell. A reads on a news website that one of the RA's routes for the train is through A's orchard. A speaks to his neighbor who tells him the train route is likely to go through both their properties. A sells his orchard to B, a third party. **A will have a difficulty obtaining involuntary conversion treatment because:**

1. **A was not informed by an official RA representative that the route of the train was through his property. Therefore there was no "threat" of condemnation. "Imminence" is also missing.**
2. **A's property is being considered for the train route, but the route over A's property is uncertain.**
3. **If the treat or imminence of condemnation is weak, A doesn't have objective criteria to prove that he had reasonable grounds to believe the condemnation of his property would occur.**

Example 7. Phone Call But No Written Notice From Condemning Authority- Land Sold Voluntarily To Third Party-Qualification Under §1033 Likely. Same facts as in previous Example, except that prior to the close of the sale to B, A calls the RA and is told that it is very likely that the train will go through his property, and if A's orchard isn't voluntarily sold to the RA, it will acquire his property in an imminent domain proceeding. **A has a stronger case than in the previous example to treat the sale as an involuntary conversion under §1033. It is not necessary that A receive written notice**

from the condemning authority threatening condemnation. A threat of condemnation can be either written or oral. However, a letter from the RA prior to the sale threatening condemnation would certainly be advisable.

Example 8. *Land Sold Voluntarily To Third Party-Written Notice From Condemning Authority-Uncertainty as to Condemnation Funding-Reasonable Grounds To Believe Condemnation Would Occur is Missing.* A receives a letter from the RA stating that the route of the train is definitely through A's orchard, but there is a question of whether the RA will ever have adequate funding to acquire A's property. A sells to his neighbor B. A's claim to §1033 treatment is questionable. A must prove that at the time he closed the sale to B that he had reasonable basis to believe that the condemnation would occur if the orchard was not sold to the RA; if condemnation is unlikely or remote, it is not threatened or imminent, and therefore reasonable grounds to believe the condemnation would in fact occur is missing.

Example 9. *Land Sold Voluntarily To Third Party-Written Notice From Condemning Authority That Purchase Will Be Delayed for Year.* A receives a letter from the RA stating that his property is directly in the route of the train, and that the orchard will be acquired either by voluntary sale, or if not by condemnation. But A reads in the paper that the RA will not have adequate funds for purchase of his property for five (5) years or more. A doesn't want to wait, and sells his property to his neighbor, B. This sale by A of his property has an excellent chance of being treated as an involuntary condemnation under §1033 even though the money for acquisition or condemnation by the RA will be delayed; there is definitely a "threat" of condemnation. §1033(a) requires either a threat or imminence of condemnation, but not both.

Example 10. *Lease-back of Condemned Property.* The RA requires A's ranch for future support facilities for the rail line, and threatens condemnation. A negotiates a voluntary sale of the ranch to the RA, with A leasing back the ranch to the RA for five (5) years. The IRS has ruled that such a leaseback of the taken property will not jeopardize 1033 treatment.

Example 11. *Option To Purchase.* The RA threatens condemnation of A's ranch, but doesn't have immediate funding to acquire it. Instead, the RA negotiates a lease of the ranch from A for five (5) years with an option to purchase; the RA informs A that it expects to have funds to actually buy the ranch within the five (5) year lease term. The IRS has ruled that the option, if exercised, does not disqualify the taken property from qualifying under §1033 deferral if the option was granted under threat or imminence of condemnation. However, rent paid under the lease arrangement is not part of the condemnation proceeds and must be treated by A as rental income not deferred by §1033.

Example 12. *Condemnation Splits Farm--Non-Condemned Portion of Farm Sold to Third Parties-Economic Unit Theory May Apply to Qualify Third Party Sale Of Retained Property As §1033 Condemnation.* A owns 220 acres of open ground, all adjacent, which he plants primarily to cotton and alfalfa. The RA condemns a 100-acre right-of-way through the middle to A's ranch. Because of this, A will have to drive and

transport his farm equipment 20 miles to get from one part of his ranch to another. A believes he no longer has an economically viable ranch and sells his remaining two fields, constituting 120-acres, to neighbors. **If A can provide strong evidence that the two remaining fields split by the rail right-of-way no longer constitute an economically viable farming unit, he may be able to treat the sale of those two fields as an involuntary conversion qualifying under §1033, even though neither field was itself condemned or sold under threat or imminence of condemnation.**

Example 13. *Taxpayer's Property Condemned-Gain Not Reported On Taxpayer's Return For Taxable Year Of Sale-Taxpayer's Return Contains No Details Of The Condemnation-§1033 Election Valid.* A owns a 300 acre ranch which has a tax basis of \$1 MM. In 2013, under threat of condemnation, Taxpayer sells the entire ranch for \$3 MM to the RA Agent. The Taxpayer is considering reinvesting the entire \$3 MM or more in replacement property. He does not report the sale to the RA on his 2013 return. **Under the regulations, the Taxpayer has properly "elected" §1033 treatment even though no details of the sale to the RA Agent were otherwise reported on his return.**

Example 14. *Condemnation Proceeds Used to Improve a Different Business Operated on Property Owned by Taxpayer-Not Related In Service or Use.* On the same parcel, A owned two buildings next to each other, one of which was rented to a restaurant and the other was an office used in A's farming business. In 2013, the restaurant and surrounding acre were acquired by the RA for \$500,000. In 2014, A spent \$600,000 on the same parcel to construct an additional 1,000 feet of space for his farm office. **The office addition is functionally different from the rented building, and therefore will not meet the similar or related in service or use test of §1033(a)(2)(A). It will also not meet the requirements of like-kind property under §1033(g) since improvements to retained property are not of a like kind to land taken.**

Example 15. *Machinery and Equipment of a Restaurant Condemned and Reinvested In A Printing Company-Not Related in Service or Use.* A rented commercial property in which he ran his restaurant. The RA condemned the property on which A leased a restaurant, and as a result, the business closed. A received a condemnation award of \$600,000, \$400,000 for his equipment and \$200,000 for loss of goodwill. Within the replacement period, A purchased a printing company for \$700,000; at least \$450,000 of the purchase price of the printing company was for printing machinery and equipment. **Under the functional use test, the end use of the replacement property is not similar to the equipment replaced and would not qualify under §1033(a)(2)(A).**

Example 16. *Proceeds From Condemnation Used To Make Improvements To Properties Taxpayer Owns-Can Qualify As Replacement Property Under §1033.* A owns a single parcel of land on which he constructed 3 separate commercial buildings on "building pads." All 3 buildings were leased to commercial tenants. In 2013, under threat of condemnation, A sold Building 1 to the RA for \$1 MM. In 2014, A spent \$1 MM to improve the remaining portion of his property for such things as storm-water management, access drives, curbing, guardrails, concrete sidewalks, a parking area and other common areas, lighting fixtures and poles, water lines, off-building fire protection

devices, sewer lines to the municipal sewer system, a natural gas line, and lines for the delivery of electrical service. Both before and after the condemnation, all the commercial pads were leased by A triple net. Since A's use of the converted property and replacement property are in the capacity of a lessor of commercial rental property, the improvements will be considered as similar or related in service or use to the condemned property. Both are rented, A's management activities (that of a landlord) are basically the same, as are A's business risks even though the tenants differ.

Example 17. *Personal Hunting Ranch Condemned and Reinvested in A Shopping Center. Improved Replacement Property Not Related In Service Or Use; §1033(g) Not Applicable.* A owns unimproved mountain property that he uses for hunting deer and wild boar. A's basis in the property is \$500,000. The RA threatens condemnation and A voluntarily sells the land in 2013 to the RA for \$2 MM. In 2014, A purchases a shopping center for \$2 MM. A cannot utilize 1033(g) because personal use property is not generally considered as held for investment or productive use in trade or business. A must therefore rely on the similar or related in service or use test of §1033(a)(2)(A). The Regulations are clear that the proceeds of unimproved real estate, taken in condemnation proceedings, invested in improved real estate, don't meet this test of similar in character or devoted to similar use. Therefore, A cannot utilize §1033 and must report the entire \$1.5 MM gain on his 2013 return. Since the condemned property was not used in the trade or business, A cannot utilize the like-kind standard for replacement property under §1033(g).

Example 18. *Leased Ranch Condemned-Replacement Property Is Motel-Qualifies For §1033 Treatment Under §1033(g) Like Kind Rule.* A owns a 200 acre ranch constituting open ground that A leased to B for a cash rent. Under threat of condemnation on July 1, 2013, A sold the ranch to the RA for \$1 MM. On November 30, 2016, A purchased a motel for \$2 MM which he then operated as an active business. Under the §1031 Regulations, real property held in the trade or business or for investment such as rented agricultural land is of a like kind to other real property that is actively managed. Therefore, the motel qualifies as like-kind replacement property under §1033(g). Since the replacement property qualifies as like kind under §1033(g), it also qualifies for the longer replacement period of §1033(g)(4). Since A purchased the motel before the end of 2016 (three (3) years after the year [2013] of sale of the ranch sold under threat of condemnation), the purchase of the replacement property qualifies under §1033.

Example 19. *Condemnation Proceeds Used To Pay For Improvements On Land Already Owed by Taxpayer-Improvements Are Not Of A Like-Kind As Land.* A owned two parcels of land, 1 and 2, both of which he farmed. Under threat of condemnation, A sold parcel 1 to the RA for \$500,000. A then used the \$500,000 to construct an office building parking lot, roads and water systems on parcel 2. The improvements to parcel 2 are not of a like-kind to the parcel 1 real estate sold. Although the term "real estate" is often used to describe both land and improvements on land, the IRS takes the position that the two are not of a like kind. Land is not of the same nature or character as a building or other improvements. Also replacement property is not considered similar or related in service or use to the converted property under §1033(a)(2)(A) unless the

physical characteristics and end uses of the converted and replacement properties are closely similar. Therefore, the improvements do not qualify under §1033 as replacement property. But if A had used the \$500,000 to purchase other property on which such improvements were already in place, then this would be considered as like-kind property qualifying under §1033(g). In such case the A would be buying replacement “land” rather than merely the improvements themselves. Under the like-kind rules, the grade or quality of land is not material.

Example 20. *Condemnation Proceeds Used To Pay For Improvements On Land Already Owed by Taxpayer-Improvements May Qualify As Similar Or Related In Service Or Use Under §1033(a)(2)(A).* A owed two parcels of land, both of which he farmed. On parcel 1 he had planted an almond orchard, and parcel 2 was open ground. Under threat of condemnation, on July 1, 2013 A sold parcel 1 to the RA for \$1 MM. A’s basis in parcel 1 was \$500,000. That same year, 2013, and in the following two (2) years, A spent \$1 MM in developing an almond orchard on Parcel 2. A has a strong argument that since the condemnation proceeds were used to restore an almond orchard (albeit on parcel 2), that he acquired property similar or related in service or use to the property converted for purposes of §1033(a)(2)(A). Since the replanting of an almond orchard on property already owed by the A is not of a like kind, the three (3) year replacement period under §1033(g)(4) is not available, and A must reinvest the proceeds by completing planting the orchard under the two (2) year rule of §1033(a)(2)(B). Since A invested all the \$1 MM in improvements to parcel B before the end of 2015, A can take full advantage of §1033 deferral and doesn’t have to report the gain in 2013. If A cannot utilize the entire \$1 MM to develop the orchard until 2016, he should request an extension of the replacement period.

Example 21. *Condemnation Proceeds Used To Buy A Farm Leasehold; Same Trees Grown On Condemned Property And Leased Property.* A owed two parcels of land; A farms almonds on parcel 1 and leased parcel 2 to farmer B for twenty (20) years on which B had planted almonds. Under threat of condemnation, A sold parcel 1 to the RA for \$1 MM. A wanted to farm the almonds on parcel 2 so he purchased the Leasehold from B for \$1.2 MM. A has an argument that by terminating the lease, he used the condemnation proceeds from the sale of parcel 1, which was an active almond orchard, to purchase property similar or related in service or use to parcel 1 qualifying under §1033(a)(2)(A), i.e. terminating the lease to acquire the almonds. The IRS may argue that a lease is not similar or related in service or use under §1033(a)(2)(A) to the fee interest in the condemned property. But if instead the lease purchased by A had more than thirty (30) years to run, then A could argue strongly that the lease is considered as real estate of a like kind under the §1031 exchange regulations 1.1031(a)-1(c) and the purchase would qualify under §1033(g).

Example 22. *Purchase of Replacement Property From Related Person.* A farms ranch X, consisting of 100 acres of open ground; On July 1, 2013, the RA condemns X and pays A \$1 MM. A’s basis in his orchard is \$800,000. Within the replacement period, A purchases ranch “Y” from his father. Since A’s father is a related party, and A’s realized gain on the condemnation exceeds \$100,000, A cannot use X ranch as qualified

replacement property under §1033 and therefore A has to recognize the \$200,000 gain. But if A's basis in his 100 acres was greater than \$900,000, his gain realized would be less than \$100,000 and the purchase of X ranch from his father would qualify. Further, under §1033(i)(1), if A's father had purchased the replacement property himself from an unrelated person within the replacement period of §1033(a)(2)(B), then the related person limitation doesn't apply and A's purchase of Y ranch would permit A to qualify under §1033(a).

Example 23. *Gain Recognized on Condemnation Where the Cost Of The Replacement Property Is Less Than The Amount Paid for The Condemned Property.* A's tax basis in 100 acres of almonds is \$1 MM. In 2013, the RA condemns the 100 acres and pays A \$1.5 MM. In 2014, A purchases qualified replacement property for \$1.2 MM. A must recognize \$300,000 of gain realized on the condemnation; i.e. the lesser of: i) the gain realized of \$500,000, or ii) \$300,000, the amount that the condemnation proceeds of \$1.5 MM exceed the cost of the replacement property of \$1.2 MM.

Example 24. *Gain Recognized Where The Difference Between Sales Price of the Condemned Property and the Cost of the Replacement Exceeds the Gain Realized on the Condemnation Sale.* Same facts as in preceding example except in 2014, A purchases qualified replacement property for \$800,000. A's gain realized from the condemnation in 2013 is \$500,000 (\$1.5 MM less \$1 MM), and the difference between the condemnation proceeds (\$1.5 MM) and the cost of the replacement property (\$800,000) is \$700,000. The gain recognized by A is the lesser of the two, or \$500,000.

Example 25. *Replacement Property Cost In Excess Of Amount Realized On Sale Of Condemned Property-Calculation of Gain Recognized and Basis of Replacement Property.* A owns ranch X consisting of 100 acres of almonds. A purchased the ranch X land in 2000 for \$500,000 and invested another \$500,000 in development of the orchard. After the orchard came into production, A depreciated the trees and improvements by \$200,000 (basis of trees and improvements is \$300,000). In 2013, under threat of condemnation, the RA Agent purchased all of X for \$1.5 MM. In 2014, A purchases ranch Y, a 130 acre almond orchard, for \$2 MM. A's gain realized is \$700,000 (sales price of \$1.5 MM less basis of \$800,000). Since the cost of qualified replacement property exceeds the sales price of ranch X (the amount realized of \$1.5 MM), no gain is recognized, and A's basis in Y is \$1.3 MM, calculated as follows:

Purchase price of ranch Y:		\$2,000,000
Less unrecognized gain:		
Condemnation proceeds		
(amount realized):	\$1,500,000	
Basis of ranch X:		
Land:	(\$500,000)	
Trees and improvements	<u>(\$300,000)</u>	
Gain realized:	\$ 700,000	
Unrecognized Gain:		<u>(\$700,000)</u>
Basis of ranch Y (replacement property)		<u>\$1,300,000</u>

Assume A purchased ranch Y in 2018, after the replacement period has ended. A would recognized the entire \$700,000 in 2013, and his basis in Y would be \$2 MM.

Example 26. *Replacement Property Cost Less Than The Amount Realized On Sale Of Condemned Property-Gain Recognized and Basis of Replacement Property* Same facts as in the prior example except that A is only able to reinvest \$1.2 MM instead of \$2 MM in ranch Y (replacement property) within the replacement period. A's gain realized upon receipt of the condemnation proceeds in 2013 for ranch X is \$700,000, per above, and the difference between the amount realized (\$1.5 MM) and the cost of the replacement ranch Y (\$1.2 MM) is \$300,000. The amount recognized is the lesser of the two; therefore, \$300,000 must be recognized by A in 2013. A's basis in ranch Y is \$800,000, calculated as follows:

Purchase price of ranch Y:		\$1,200,000
Less unrecognized gain:		
Condemnation proceeds:	\$1,500,000	
Basis of ranch X:		
Land:	(\$500,000)	
Trees and improvements:	(\$300,000)	
Gain realized:	(\$700,000)	
Gain recognized:	<u>\$300,000</u>	
Unrecognized Gain:		<u>(\$400,000)</u>
Basis of Replacement Property:		<u>\$ 800,000</u>

Example 27. *Taxpayer Unable to Purchase Replacement Property Within the Replacement Period-Gain Recognized.* Same facts as in the prior example except that A is unable to purchase replacement property within the replacement period. The entire gain realized of \$700,000 must be recognized in 2013. If the A had not reported any gain recognized on his 2013 return as filed (thereby electing §1033 treatment) in hopes of acquiring qualified replacement property, but was ultimately unable to do so within the three (3) year replacement period of §1033(g)(4), A must pay the tax due for 2013 on the gain recognized by filing an amended return for 2013.

Example 28. *Allocation of Basis of Replacement Property Between Land and Improvements.* A owns 100 acres of almonds. The basis of the land is \$200,000 and the basis of the almond trees is \$100,000. Under threat of condemnation, in 2013, A sold the entire property to RA Agent for \$1.5 MM. In 2014, A repurchased a 150 acre replacement almond orchard for \$2 MM. The entire gain realized of \$1.2 MM (\$1.5 MM less \$300,000 basis) is not recognized since the cost of the replacement property exceeds the amount realized. A's basis in the entire replacement property is \$800,000 (\$2 MM purchase price less \$1.2 MM unrecognized gain). A reasonable allocation of the total \$2 MM purchase price of the replacement property is land \$1 MM and \$1 MM to trees and irrigation systems. Therefore the basis of the replacement property of \$800,000 is allocated half to land and half to trees and irrigation systems. In applying the basis

allocation to the land and improvements of the replacement property, whether the taken property was improved or unimproved is not taken into account.

Example 29. *Allocation of Gain Resulting From Condemnation Proceeds To Two Separate Parcels Permitted Based On Relative Values. §1033 Treatment Permitted For One And Not The Other.* A owns two separate parcels of farm property, as follows:

	<u>Value</u>	<u>Tax Basis</u>
Parcel "X"	\$1,000,000	\$50,000
Parcel "Y"	\$ 500,000	\$550,000

The RA threatens to condemn both parcels, and on July 1, 2013, A sells both in a single transaction to the RA Agent for \$1.5 MM. On March 15, 2014, A purchases farm property for \$1.1 MM. A does not want to pay the taxes on \$950,000 (\$1 MM minus \$50,000 basis) gain realized on parcel X, but wants to recognize the loss of \$50,000 on parcel Y. On his 2013 return, A does not recognize the gain on the sale of X, but takes a \$50,000 capital loss from the sale of Y. A doesn't have to treat the parcels for tax purposes as one combined sale under threat of condemnation and doesn't have to recognize any gain on the total gain realized of \$900,000 (\$1.5 MM minus \$600,000 [combined basis]) because he didn't reinvest the entire \$1.5 MM received. Rather, A can allocate the sale proceeds to the two parcels based upon their relative fair market values and treat them as separate transactions for tax purposes. Therefore, A's tax return treatment of the transaction is correct; A's tax basis in the replacement property is \$150,000 (\$1.1 MM purchase price less \$950,000 unrecognized gain on the sale of parcel X). *Caveat:* A should make sure he has adequate evidence of the values of parcels X and Y, either by a valuation statement by the RA Agent in the sales agreement or otherwise, or by appraisal.

Example 30. *Replacement Property Purchased Before Sale of the Condemned Property.* A owns 20 acres of open ground which he leased for farming purposes. On March 30, 2013, the RA Agent informs A that his 20 acres will be condemned unless he voluntarily sells it to the RA. A is not satisfied with the price offered and does not voluntarily sell; the RA initiates condemnation proceedings in July, 2013. A does not receive any compensation for the 20 acres until December 1, 2016. The amount received by from the RA exceeds A's basis in the 20 acres. A entered into negotiations to purchase a nearby 50-acre farm which purchase was closed on September 1, 2013 at a price in excess of the condemnation award. The 50 acres can qualify as replacement property even though purchased before A received any part of the condemnation award in 2016. The replacement period begins on the date A was first notified by the RA agent of the imminent threat of condemnation. But A may have to prove that he intended to purchase the 50 acres as replacement property. Section 1033(a)(2)(a) states that the replacement property must be purchased "for the purpose of replacing the property so converted."

Example 31. *Determination Of Replacement Period For Acquisition Of Like Kind Replacement Property.* Same facts as in the previous example except that A closes the purchase of the 50-acre replacement property on October 15, 2019. Since the 20 acres is

real property held by A for productive use in the trade or business or for investment, it qualifies for the three (3) year replacement period of § 1033(g)(4). The taxable year in which A realized gain on the condemnation of the 20 acres was 2016; therefore, A has until December 31, 2019 in which to close the purchase of the 50 acres in order to qualify the replacement property.

Example 32. *Condemnation Award Paid Over Several Taxable Years; When Does the Replacement Period End?* A owned a 200 acre orchard with a basis of \$10,000 per acre. The RA notified A that it needed approximately 10 acres along the east side of the orchard and would pay A \$20,000 per acre or \$200,000. A would not agree to the price and the RA instituted condemnation proceedings. On October 15, 2013, the RA deposited \$200,000 with the court and A was entitled to withdraw that amount. Pursuant to the condemnation proceedings, A's final award was determined to be \$300,000, and the RA paid A an additional \$100,000 on May 30, 2017. A purchased qualifying replacement property on October 15, 2019. Although the 2019 purchase date of replacement property appears to be within the 3-year replacement period of §1033(g)(4) following the receipt of the final award of \$100,000 in 2017, the replacement period ended December 31, 2016 (3 years after the first taxable year [2013] that any part of the condemnation gain was realized). As a result, A cannot defer any of the gain on the condemnation under §1033. A must report \$100,000 of gain in 2013 (\$200,000 deposit less \$100,000 basis for the 10 acres), and \$100,000 of gain in 2017. If A had requested and been granted by IRS an extension of the replacement period (see below) until December 31, 2019, then the gain on the condemnation would have qualified for deferral under §1033.

Example 33. *Where Condemnation Proceeds Are Used To Pay For Improvement On Replacement Property, The 3-Year Replacement Period Of §1033(g)(4) May Not Be Available.* A owned farm X consisting of 50 acres of almonds. Under threat of condemnation, on July 1, 2013, A sells X to the RA for \$1 MM. A's tax basis in X is \$500,000. On November 1, 2015, A purchases property Y, consisting of 2 acres of undeveloped commercial property, for \$600,000. In 2016, A completes construction of improvements to Y consisting of an office building, a parking lot, underground utilities and the like for \$400,000. A's purchase of Y for \$600,000 in 2015 would qualify as replacement property under §1033(g) since it is like kind and was acquired within the three (3) year replacement period of §1033(g)(4). It is uncertain however whether the \$400,000 in improvements to Y paid by A in 2016 would qualify as replacement property under §1033 for two reasons. First, the IRS has ruled that improvements to real property are not generally considered of a like kind to real estate; that is, buildings or other improvements to real estate is not of the same nature or character as land. Second, if the like kind rule of §1033(g) is not available for improvements made to land owned by the taxpayer, neither is the 3-year replacement period of §1033(g)(4). If this is the case, then A must recognize \$400,000 (amount by which amount realized [\$1 MM] exceeds the cost of qualified replacement property [\$600,000]). Alternatively, if instead of purchasing the land and later constructing improvements, A acquired the land with improvements already completed for \$1 MM before the end of the three (3) year period, A would recognize no gain on the 2013 condemnation. Contrary to this analysis is the Private

Letter Ruling 9421002, in which the IRS ruled in that particular factual circumstance that improvements to purchased replacement property are treated more favorably than improvements to retained property, and qualify under §1033(g) and §1033(g)(4).

Example 34. *Condemnation Proceeds Used To Pay For Improvements On Retained Property Where Improvements Qualify Under The Two (2) Year Rule Of §1033(B)(2) As Similar Or Related In Service Test.* Assume the same facts as in the previous Example, but instead of purchasing Y, and improving it, A used the \$1 MM from the sale of X to develop an almond orchard on other property A owned. The development costs were \$250,000 per year for 4 years commencing in 2014. Improvements to the taxpayer's own property can qualify under §1033(a)(2)(A) as replacement property if similar or related in service or use to the converted property. A may meet this test since the physical characteristics and end uses of the converted and replacement property (almonds) are closely similar. However, §1033(a)(2)(B) states that the replacement property be acquired within 2 years of sale of the taken property. Therefore, only the almond development costs in 2014 and 2015 (within the two (2) year period) of \$500,000 would qualify, and the remaining \$500,000 paid for improvements for the years 2016-2017 would not. As a result, in 2013, A would have to recognize \$500,000. In such circumstances, it would be prudent for A to request and extension of time to complete the cost of the replacement property.

Example 35. *Replacement Property Cannot Be Purchased Within the Replacement Period. Request for Extension.* Under threat of condemnation, on July 1, 2013, A voluntarily sells his 100 acre vineyard for \$1.5 MM to the RA. A's basis in the vineyard is \$1.1 MM, and therefore he has gain realized of \$400,000. A desires to avoid the tax and on his 2013 return, and he does not report any gain realized. In 2015, A purchased a vineyard for \$1 MM. A made diligent efforts, but by the end of 2016, he is unable to find additional replacement property for \$500,000 or more so as to have reinvested an amount equal to the entire \$1.5 MM sales price. Under §1033(g)(4), A has 3 years after 2013 (year of sale), in which to find and purchase qualified replacement property i.e. until December 31, 2016. If A does not so reinvest the additional \$500,000, he will have to recognize the entire \$400,000 gain in 2013. Although it is not guaranteed that it will be granted, A should apply to the IRS, prior to December 31, 2016, to extend the replacement period for at least one year until December 31, 2017. Should A neglect to file his extension application before December 31, 2016, there is nonetheless authority under the Regulations for him to do so if he is prompt and can show reasonable cause for his delay.

Example 36. *Calculation of Depreciation Recapture In Condemnation of Orchard Where §1033 Is Not Elected And There Is No Acquisition Of Replacement Property. Allocation Of Purchase Price to §1245 Property And Non-§1245 Property.* A owns 100 acres of almonds. A bought the land ("L") in 2000 for \$600,000. From 2001 through 2004, A developed L into an almond orchard at a total development or capitalized cost of \$400,000 for trees, wells, pumps, irrigation systems and the like (trees and improvements or "T&I") The almonds came into production in 2005. In 2013, the RA threatens condemnation and on July 1, 2013, A sells the entire 100 acres to it for \$2 MM. At the

time of the sale, A had taken \$200,000 in depreciation with respect to the T&I. A does not elect to defer gain under §1033, or to purchase replacement property. A's gain recognized on the sale of the 100 acres is \$1.2 MM calculated as follows:

Sales price:		\$2,000,000
Basis:		
L basis:		\$600,000
T&I basis:		<u>\$200,000</u>
	Total Basis:	<u>(\$ 800,000)</u>
Gain Recognized:		<u>\$1,200,000</u>

Based on an appraisal, at the time of sale, the value of L is determined to be \$1.2 MM (\$12,000 per acre), and the value of the T&I is \$800,000 (\$8,000 per acre). The gain attributable to L is \$600,000 (\$1.2 MM less basis of \$600,000). The gain recognized attributable to the T&I is \$600,000 (\$800,000 less \$200,000 basis). A must report depreciation recapture by subtracting the adjusted basis of the T&I (\$200,000) from the lesser of: 1) the recomputed basis of the T&I of \$400,000, or 2) the amount realized of \$800,000. Thus, of the \$600,000 in gain recognized, \$200,000 is ordinary income and \$400,000 should be capital gain. If instead the orchard was old and toward the end of its useful life, and the appraised value of the T&I had been only \$300,000, the depreciation recapture would be limited to \$100,000 (\$300,000 value less \$200,000 basis). If the RA had only paid \$180,000 of the purchase price allocated to the T&I, there would be a loss and therefore no depreciation recapture.

Example 37. *Almond Orchard Condemned and Replacement Property Purchased. §1033 elected. Calculation of §1245 Recapture.* A owns a 50 acre almond orchard. A had purchased the land (“L”) in 2000 for \$200,000 and planted and developed the almond trees, irrigation systems and improvements (“T&I”) at a total cost of \$300,000. The trees came into production in 2005 and since that date A had deducted depreciation on T&I of \$150,000. Therefore A’s basis in the 50-acre ranch is \$350,000 (\$200,000 [L] plus \$150,000 [T&I]). The T&I is §1245 Property and its “recomputed basis” (cost before depreciation) is \$300,000. T&I’s potential depreciation recapture is therefore \$150,000. Under threat of condemnation, on July 1, 2013, A sells the entire 50 acres to the RA for \$1 MM. Based on an appraisal, the L value is \$400,000 and the T&I value is \$600,000. In 2014, A purchases a 60-acre almond orchard (“X”) for \$1.2 MM. Based on an appraisal, the replacement property X consists of land (“RL”) valued at \$500,000, and trees, irrigation systems and other improvements (“RT&I”) valued at \$700,000. Since the RT&I of X has a value (\$700,000), and this is more than the recomputed basis of T&I on the 50 acres sold (\$300,000), no depreciation recapture is recognized on the condemnation. But if the RT&I value was less than the \$300,000 recomputed basis of the T&I of the 50 acres, then A would be deemed to have received non-§1245 Property for the T&I on the taken property resulting in depreciation recapture.

Example 38. *Severance Damages On Retained Property Not Reinvested Per §1033. Determination of Gain Recognized and Basis of Retained Property.* A owns a 600 acre

ranch which he farms to cotton, alfalfa and other row crops. A purchased the ranch in 1990 for \$300,000 (\$500 per acre). The RA paid A a substantial amount for taking a 30-acre strip of land on the ranch for the rail right-of-way; this taking isolated 100 acres of A's ranch (not accessible by road). As a result, the RA paid A as additional compensation severance damages of \$200,000 for the reduction in value of the 100 acres. The RA did not pay A for the other remaining approximately 470 acres which wasn't adversely impacted. A did not reinvest any amount received from the RA, including the severance damages. **For tax purposes, the severance damage award is taxed as follows:**

1. The severance damages are applied first to reduce A's \$50,000 basis (\$500 times 100 acres) of the 100 acres.
2. The balance of the severance payment of \$150,000 paid in excess of A's basis is taxable gain to A.
3. A can only use the \$50,000 basis of the 100 acres to offset gain resulting from the \$200,000 in severance damages; the basis of the non-impacted 470 acres cannot be used to reduce gain.

If the severance damages paid for the 100 acres were less than \$50,000, A's basis would be reduced accordingly and no gain would be recognized.

Example 39. *Amount Paid For Condemned Property And Severance Damages For Retained Property Reinvested In Like-Kind Property. Basis Of Retained Property and Reinvestment Property.* A owes a 20-acre ranch which he purchased for \$220,000 and leased to farmer B. The RA condemned approximately 13 acres of the ranch for the rail right-of-way, which left the remaining approximate 7 acres not able to adequately sustain a profitable farming operation. A received a total of \$310,000 from the RA, consisting of \$175,000 for the 13 acres and \$135,000 as severance damages for the reduction in value of the retained 7 acres. A's basis in the farm was \$143,000 for the 13 acres and \$77,000 for the 7 acres. A did not restore the utility of the retained property nor locate another farm to purchase. Instead, within the prescribed period of time under §1033 for the acquisition of replacement property, A purchased a motel complex in Fresno for \$500,000. A then actively managed and directly operated the motel for his own account.

1. The total \$310,000 A received for both right-of-way and severance damages can qualify for deferral under §1033.
2. The replacement property does not have to meet the §1033(a)(2)(A) related in service or use test; rather it only needs to be of a "like kind" to the condemned property under §1033(g). The motel is of a like-kind to the condemned property.
3. A realized gain on condemnation of the right-of-way of \$32,000 (\$175,000 less \$143,000 basis), and gain on the receipt of the severance damages of \$58,000 (\$135,000 in severance damages less \$77,000 in basis). No gain is

recognized since the \$500,000 cost of the motel as replacement property exceeds the total paid A by the RA of \$310,000.

4. The basis to A of the retained property is zero since the severance damages of \$135,000 exceeded its basis (\$77,000).

5. A's basis in the motel is \$410,000, calculated as follows:

Purchase price of motel:	\$500,000
Reduced by condemnation gain not recognized:	
Condemnation and severance received:	\$310,000
Basis of ranch:	<u>(\$220,000)</u>
Unrecognized gain:	<u>(\$ 90,000)</u>
Basis of Motel:	<u>\$ 410,000</u>

Example 40. *Negative Easement-Reinvestment Of Proceeds In Improvements On Retained Land-Replacement Period.* A owed a 30 acre parcel in which he had a packing house on 5 acres and surrounding almond orchard on 25 acres. The route of the RA ran adjacent to the packing house and RA determined that the packing house activities were inconsistent with and interfered with the effective running of the rail line. Under threat of condemnation, on July 1, 2013, A granted to the RA a negative easement preventing operation of the packing house in exchange for a payment of \$500,000; A was permitted to continue farming the almonds on the remaining 25 acres of his property. A's basis in the packing house and surrounding 5 acres is \$300,000. The \$500,000 payment from the RA reduces A's basis in the packing house and 5 acres to zero. A has gain realized of \$200,000 (\$500,000 minus \$300,000). Since the remaining 25 acres was unaffected, A cannot use the basis attributable to that portion of his property to reduce the gain. In September, 2015, A began construction of a new packing house on other property he owed further from the railway. The new packing house is expected to cost \$700,000. The negative easement payment is similar to severance damages in that A retained title to 5 acres on which the old packing house was located. A is permitted to defer the gain realized from the severance payment under §1033. A cannot qualify the improvements as like-kind property under §1033(g)(1) and therefore he is not entitled to use the 3+-year period of §1033(g)(4). But, the new packing house on other property owned by A can qualify as replacement property under the similar or related in service or use test of §1033(a)(2)(A). Therefore the improvements completed within the 2+-year replacement period of §1033(a)(2)(B)(i) qualify as replacement property under §1033. If A cannot complete the improvements before December 31, 2015, he may request an extension of time from the IRS.