



it to commercial tenants.<sup>1</sup> On Date 2, City Agency filed a condemnation action to acquire Property A. On Date 3 (in Year 1), City Agency deposited \$X as “probable compensation” (the Deposit) for the property with the state treasurer.

On Date 4, Taxpayer filed an answer to the condemnation action, raising certain affirmative defenses challenging City Agency’s right to take the property. Taxpayer asserted that City Agency did not have the right to take the condemned property because it did not permit Taxpayer to participate in the redevelopment of Property A and its vicinity, as required by law.

Under State’s eminent domain law, Taxpayer could have applied for withdrawal of the Deposit at any time after the deposit was made. However, withdrawal of the funds would have effected an abandonment of their challenge to City Agency’s right to take Property A. The applicable statute provides that receipt of any portion of the money deposited constitutes a waiver by operation of law of all claims and defenses in favor of the persons receiving such payment except a claim for greater compensation.

Taxpayer did not apply for withdrawal of the Deposit in Year 1 because at that time it was unwilling to abandon their challenge of City Agency’s right to take. In Year 2, however, Taxpayer and City Agency entered into a settlement and stipulation for withdrawal of the Deposit. Taxpayer received its share of the deposited funds in Year 2. Its election to defer gain pursuant to § 1033 was reported on a statement attached to its Partnership Tax Return (Form 1065) for Year 2.

## LAW AND ANALYSIS

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized from the disposition over the adjusted basis of the property. Under § 1001(b), the amount realized from the disposition is the sum of money received plus the fair market value of the property (other than money) received.

Section 1033(a)(2)(A) generally provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or property, then at the election of the taxpayer the gain (if any) shall be recognized except to the extent the taxpayer, during the period specified in § 1033(a)(2)(B), for the purpose of replacing the converted property, purchases other property similar or related in service or use to the property so converted.

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<sup>1</sup> Taxpayer is a co-owner of Property A with another entity that is currently seeking identical rulings. Because the involvement of the other entity does not in any way change the outcome of the conversion for Taxpayer for purposes of § 1033, this letter refers only to the existence of Taxpayer.

Under § 1033(a)(2)(B), a taxpayer generally has two years from the close of the first taxable year in which any gain from the conversion is realized to acquire property similar or related in service or use to the converted property.

Under § 1033(g), a three year replacement period (to the close of the third taxable year in which any gain from the conversion was realized) is permitted for conversions that are condemnations of real property held for productive use of a trade or business or for investment. Valid replacement property (qualifying property) under §1033(g) is like-kind property to be held for productive use in a trade or business or for investment.

Section 451(a) provides that the amount of any item of income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-2 of Income Tax Regulations generally provides that income although not actually reduced to taxpayer's possession, is constructively received by the taxpayer in the taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Under § 1033(a) and (g), the replacement period for converted property is measured from the close of the first taxable year in which any gain is realized from the conversion. Under §§ 1001 and 451 and the regulations thereunder, Taxpayer realizes gain from the involuntary conversion of Property A when it actually or constructively receives money or property in excess of its basis. Money or property is constructively received when it is available for Taxpayer to draw on at any time without substantial restriction or other limitation. Under the law in State, Taxpayer's withdrawal of any portion of the Deposit would have constituted, by operation of law, a waiver of all claims and defenses with respect to the converted property except a claim for greater compensation. The waiver of all claims and defenses is a substantial limitation or restriction to Taxpayer's access to the Deposit held by the state treasurer. Consequently, Taxpayer did not have actual or constructive receipt of the Deposit in Year 1. Cases interpreting the application of the constructive receipt principles to involuntary conversions support this view.

In *Nitterhouse v. United States*, 207 F.2d 618 (3<sup>rd</sup> Cir. 1953), the government condemned taxpayer's land and, in 1944, deposited \$ 5,370 with the United States District Court to be awarded for the land. However, the taxpayer did not have access to the money until the court determined that the taxpayer held clear title to the land, free of tax or other judgment liens. The amount to be ultimately paid was litigated and in 1946, the taxpayer was awarded \$18,825. In the tax litigation that followed, the court

determined that the deposit was not taxable in 1944 because the money was not available to the taxpayer until a later year when the taxpayer's claim to clear title was validated.

Similarly, in *Rentz v. Commissioner*, 36 T.C.M. (CCH) 68 (1977), the state of Delaware commenced an action to condemn the taxpayer's property on August 9, 1965 and, on the next day, deposited a sum of money estimated to be fair compensation for the acreage taken. The Commissioner contended that the compensation was constructively received by the taxpayer on the day of deposit, but the court disagreed. First, there was more than one property owner entitled to compensation for the taking and the taxpayer's share of the deposit was not 'credited' to her account, 'set apart' for her, or 'otherwise made available' so that she could 'draw upon it at any time' within the meaning of § 1.451-2(a). Moreover, the Superior Court order permitted petitioner to occupy the house on the condemned property until March 1, 1966, and reserved to her until that date the right to use the condemned acreage for access to the land she retained. It was the policy of the state, while the owner was in physical possession of a dwelling or other structure on a condemned property, to object to withdrawal of funds deposited in court. Thus, to obtain any portion of the funds on deposit with the Superior Court in 1965, petitioner would have been required to establish to the satisfaction of the Superior Court the portion allocable to her rights in the condemned acreage and either abandon her home or convince the court to reject the state's objections to withdrawal of the deposit. In these circumstances, the necessity for obtaining a contested court order permitting withdrawal of the funds was a substantial limitation or restriction. Accordingly, the Tax Court determined that the taxpayer was not in constructive receipt of any portion of the deposit in 1965. *Compare Aldridge v. Commissioner*, 51 T.C. 475 (1968) (in which condemnation proceeds were held to be constructively received by the taxpayer upon deposit with a clerk of the county court because the deposit was subject to release to the taxpayer upon application for court order and there were no other restrictions or limitations on the taxpayer's right to the proceeds).

In the present case, Taxpayer's withdrawal of the Deposit would have constituted a waiver of Taxpayer's right to challenge the legality of City Agency's condemnation. The prerequisite of waiver of all claims and defenses was a substantial limitation or restriction to Taxpayer's right to the Deposit. Therefore, Taxpayer did not have constructive receipt of any portion of the Deposit until Year 2, when the parties entered into settlement of Taxpayer's claim.

## CONCLUSIONS

1. If Property A is real property that was held for productive use in a trade or business or for investment prior to its condemnation, Taxpayer may elect to apply the provisions of § 1033(g) to timely replace Property A with like-kind property to be held for productive use in a trade or business or for investment.

2. Taxpayer was not in actual or constructive receipt of the proceeds from Property A's condemnation until Year 2. Thus, Year 2 was the first year in which any part of the gain from the conversion was realized.
3. Under § 1033(g), Taxpayer has until three years from the close of Year 2 to replace the condemned property with qualifying replacement property.

**CAVEATS:**

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro  
Branch Chief, Branch 4  
(Income Tax & Accounting)

Enclosure (1)