

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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date: November 14, 2011

to: IRS Examination Division (LB&I)

from: Associate Area Counsel (Jacksonville, FL/Nashville, TN)
(Large Business & International)

subject: Taking Issue

This is in response to your request for advice.

Issue

Are the proceeds received by _____ in _____ and _____ for the temporary taking of two properties attributable to an involuntary conversion described in I.R.C. § 1033(a)?

Conclusion

No. The proceeds constitute compensation for the temporary taking of the properties and, consequently, result in rental income under I.R.C. § 61(a)(5). Thus, the proceeds are taxable as ordinary income to _____ in the year of receipt.

Facts

_____ is the owner of _____ acres of land in the _____ . The property includes 2 tracts: _____ acres referred to as the " _____ " and _____ acres referred to as the " _____ ."

_____ acquired the _____ in _____ . It then constructed an office building containing _____ square feet for the purpose of leasing it to the _____ . This lease began on _____ and ended on _____ .

_____ acquired the tracts that make up the _____ between _____ and _____ . On _____ , it entered into a _____ year lease with the _____ for the benefit of the _____ . After _____ entered into this lease with _____ , _____ instituted condemnation proceedings to take the _____ for its use. Due to these proceedings, _____ was unable to lease the _____ to the _____ .

The taking was annually renewed until a Stipulation for Settlement was reached, and the Stipulation was then approved in a Final Judgment dated . The final judgment provided for \$ of compensation payable for the taking of the leasehold from through .¹

initially treated the proceeds as ordinary income. They later filed amended returns for . On the amended return, deducted \$ of the basis of the in determining the gain on the \$ proceeds and reported the difference as long-term capital gain. reported the proceeds in a consistent manner on its tax returns. The Service did not examine 's tax returns.

was not prepared to vacate the or the in . Consequently, it instituted new proceedings to take the and the for a period of months.

prepared an appraisal of the dated , for in connection with the proceedings. The appraiser concluded that the present value of the taking for a three-year period was \$ based upon the fair rental value of the property. , also prepared an appraisal of the in connection with the proceeding, and concluded that the present value of the taking for a three-year period was \$ based upon the fair rental value of the property.

These proceedings resulted in a Stipulated Judgment being entered on , granting the use of both parcels for the -month period from , with an option to extend the taking through . The Stipulated Judgment provides for \$ of compensation, payable for the taking of the property rights identified in the complaint and declaration of taking "together with all improvements thereon and appurtenances thereunto belonging."² In addition, the Stipulated Judgment also provided that just compensation for any occupancy for the period through would be \$ per month.

received \$ of taking proceeds in . Of this amount, reported \$ as sales proceeds on their Schedule D. Furthermore, reported a \$ tax basis for the land and building resulting in a gain of \$. The remaining \$ proceeds were deferred on 's return until . In reported \$ of proceeds in addition to the deferred \$ from as sales proceeds on Schedule D. reported a basis in the properties of \$, resulting in a gain of \$.

Exam Position:

¹ Amounts were deposited through the term of the taking, and at the time of the Final Judgment \$ had been deposited. withdrew each deposit.

² While the Stipulated Judgment provided for \$ of proceeds, actually received \$.

Exam issued a Form 886-A to _____ for the \$ _____ received for the _____-month period. Exam allocated proceeds in the amount of \$ _____ based on the appraisals commissioned by _____ for a _____ month period. Using the percentages based on those appraisals, Exam allocated the balance of the \$ _____ between the _____ and the _____ for the remaining _____ months as follows:

			Totals
FMV			
Percentage	%	%	
Allocation of Remaining Proceeds			
Total allocated			

Exam proposed that the taking proceeds allocable to both the _____ and the _____ were in the nature of rent and therefore taxable as ordinary income. Furthermore, Exam concluded that _____ had not demonstrated that any of the proceeds were for the loss of restoration rights with respect to either parcel, and therefore _____ was not entitled to capital gain or loss treatment under I.R.C. § 1234A for any portion of the proceeds.

s Amended Return:

_____ filed an amended return and requested I.R.C. § 1033(a)(2) treatment for the proceeds from the taking. _____ has not yet acquired replacement property but requested an extension of time to acquire the replacement property on their amended return.

Law & Analysis

I.R.C. § 1033(a)(1) provides that if property is compulsorily or involuntarily converted into property “similar or related in service or use” through an exchange, no gain is recognized. However, if the property is compulsorily or involuntarily converted into money or property not similar or related in service or use, gain is recognized only to the extent provided in § 1033(a)(2)(A) if the taxpayer elects § 1033 treatment within the prescribed period, and acquires property “similar or related in service or use” to the converted property. I.R.C. § 1033(a)(2)(A). The period of replacement is “the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending 2 years after the close of the first taxable year in which any part of the gain upon of the conversion is realized” or at the close of such a later date by application from the taxpayer. I.R.C. § 1033(a)(2)(B). In the case of real property held for productive use in trade or business or for investment, the replacement period is three years after the close for the first taxable year in which any part of the gain is realized. I.R.C. § 1033(g)(1), (4).

This case involves a compelled lease of property for a period of _____ months. _____ filed an amended return to claim I.R.C. § 1033 nonrecognition treatment for the taking proceeds and requested an extension of the period to acquire replacement property. Since the property involved in the compelled lease was held for use by _____ as rental property, the three year period to acquire replacement property applies if the compelled lease is an involuntary

conversion to which § 1033 applies. In that case, if _____ first realized gain in _____, the three year replacement period expires on _____, unless extended. The question at issue is whether § 1033 applies to a temporary taking of property.

The IRS addressed the tax effect of a temporary taking in Rev. Rul. 38, 1953-1 C.B. 16. In Rev. Rul. 38, the United States Government requisitioned the use of a warehouse for a five-year period. The Service concluded that the condemnation proceeds were ordinary income because the payments for the temporary use of the building were in the nature of rent. The Service noted that the taxpayer had neither disposed of the property nor realized gain from its involuntary conversion. Similarly, in the present case, _____ took _____'s real property for a period of _____ months. _____ did not dispose of the property or realize gain from its involuntary conversion. It follows that the taking proceeds _____ received for the _____-month period constitute ordinary income.

There is additional support for the Service's position that the temporary taking of property is not an involuntary conversion. In *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960), the United States Government temporarily took over the taxpayer's trucking business for a period of 10 months during World War II when the taxpayer's drivers went on strike. The Supreme Court upheld the Service's position that compensation paid to the taxpayer for the temporary taking of its trucking business was ordinary income. The Court rejected the taxpayer's argument that taking proceeds constituted capital gain. The Court found that the Government took only the right to use the facilities and not a fee simple interest. The Court stated that compensation for the right to use property was "commonly regarded as rent." *Gillette*, 364 U.S. at 135.

In the present case, _____ took the right to the use of _____'s real property for a period of _____ months. _____ compensated _____ for the right to use the property, not for a fee interest in property. Therefore, it follows that these payments received by _____ were in the nature of rent.

_____ contends that Rev. Rul. 83-70, 1983-1 C.B. 189, is authority for its position that the proceeds it received were received in connection with an involuntary conversion. In Rev. Rul. 83-70, the Service ruled that a fee interest in real property acquired by a taxpayer with condemnation proceeds constituted "property similar or related in service or use" to a 15-year leasehold interest that had been involuntarily converted. The taxpayer had leased property that it used in its furniture storage business with a 15-year term remaining on the lease at the time of the taking. The taxpayer had no options to renew the lease. The taxpayer acquired a fee simple interest in property to use in its business and was allowed nonrecognition treatment.

Rev. Rul. 83-70 is distinguishable from the present case. In Rev. Rul. 83-70, the taxpayer's entire interest (its 15-year leasehold interest) was taken. Thus, the taking constituted a final disposition of the taxpayer's property. The taking was not a lease or sublease of the property.

In contrast, in the taking at issue in the present case, _____ took the _____ and the _____ for only _____ months and _____ retained a continuing fee interest in both properties. The taking did not affect _____'s right to develop the properties after the expiration of the _____-month taking period or to realize capital appreciation on the properties both during and after the _____-month period. Therefore, _____ temporary taking of the _____ and the _____ does not qualify as an involuntary conversion described in I.R.C. § 1033(a). The proceeds allocable to the properties are in the nature of rent

that is taxable as ordinary income and includable in income in the year of receipt.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum was reviewed by _____ (CC:ITA: B04).

Please feel free to contact the undersigned at _____ if you have any questions regarding these matters or if you require any further assistance.

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Associate Area Counsel
(Large Business & International)

By: _____
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cc: _____, Team Manager