Tax Implications of Highway Right-of-Way Acquisition

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● THE TOPIC of this paper is of increasing importance, for the construction of the 41,000-mi National System of Interstate and Defense Highways has now become a reality. By January 1, 1960, 7,570 mi of the system were open, 4,770 mi under construction, and 18,370 mi in progress through preliminary engineering or right-of-way acquisition. It has been estimated that approximately $5½ billion will be spent for rights-of-way for the system during its 13-yr construction period, and about $11 billion will be spent for all Federal-aid highway improvements rights-of-way during the next 12 to 15 years. Furthermore, this program will require the acquisition of about 1,000,000 acres and 730,000 individual parcels of land; 2,190,000 parcels of land will be required for the entire Federal-aid highway program.[1] The tax consequences of land acquisition of this magnitude are enormous.

TAX STRUCTURE

There are certain basic and familiar attributes of the taxation system. For example, the tax on the receipt of ordinary income differs from the tax imposed on the receipt of income realized from the sale or exchange of capital assets. The effective tax rate imposed on ordinary income received by an individual may amount to as much as 87 percent of that person's taxable income.[2] The maximum tax rate imposed on income realized from the sale or exchange of a capital asset is 25 percent. The importance of the distinction between ordinary income and income from the sale or exchange of capital assets is thus apparent. Everyone, quite naturally, is interested in having his income taxed at capital gain rates rather than ordinary income rates.

Furthermore, there is another advantage in selling or exchanging a capital asset. Not only is the gain from such a sale or exchange taxed at a lower rate but such a gain may be postponed by having such gains not recognized and, therefore, not taxed. On the other hand, losses on such sales or exchanges may be recognized as capital losses and these can be offset against capital gains and even against ordinary income to the extent of $1,000.

This latter advantage—the fact that certain gains from sales or exchanges of capital assets may not be recognized and possibly be avoided altogether[3]—applies in those situations where land is condemned by public authorities. This is so because a condemnation of land is deemed to be an "involuntary exchange" (conversion) within the meaning of the tax law. And it makes no difference whether real estate is voluntarily sold under threat or imminence of condemnation or taken by the government under a statutory condemnation procedure. Either transaction is considered an "involuntary conversion" under Section 1033 of the Internal Revenue Code of 1954. Such involuntary conversions where land is held over 6 months are taxed similarly to the sale or exchange of capital assets in many respects. They, therefore, are considered as sales or exchanges of quasi-capital assets.

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[1] Armstrong, "People, Rights-of-Way and Highways." 6th Annual Seminar, ARWA, 1960.

[2] The marginal rate of tax on income of $200,000 or over is 91 percent, but the tax is subject to the maximum effective rate limitation of 87 percent.

[3] If death intervenes, gains on appreciation in capital assets will escape tax, because the decedent's property acquired by others takes a date of death valuation under Sec. 1014(a).

To have an involuntary conversion, according to the Courts, there must be an element of sovereign power of "requisition" or "condemnation".[4] A condemnation generally means taking property for public use without consent of the owner but upon award and payment of compensation. Revenue Ruling 58-577, 1958-2 Cum. Bull. 744, defines it more particularly:

> It is considered that a condemnation occurs when, under local law, the right of the property owner to the condemnation award becomes vested and the correlative duty of the condemning authority to make payment is fixed. Generally, the rights of the parties do not become fixed prior to the confirmation of the award or the entry of the judgment for damages.

An involuntary conversion occurs, for example, where the acquiring authority in condemnation proceedings acquires certain easements, privileges, and rights-of-way for the purposes of constructing a facility, that, when completed, would render the taxpayer's manufacturing plant inoperable.[5] Also, as has been stated, an involuntary conversion occurs when the taxpayer must sell his property under the threat of condemnation. What constitutes sufficient notice of this threat under a particular revenue ruling and court decision will be examined later. However, the Revenue Service maintains that the sale of a building because a State Health Department declared it to be unfit for human use is not such a sale under the threat of condemnation that will qualify as an involuntary conversion.[6]

The tax law dealing the condemnations of property has been affected by the timing of particular condemnations of property because of the many amendments to the tax statutes dealing with condemnations over a period of years taking effect at different times. In order to simplify, it will be assumed that all the condemnation of property discussed was made after 1958.

GAIN NOT RECOGNIZED ON INVOLUNTARY CONVERSION

Gain will not be recognized or taxed to a taxpayer on involuntary conversion of his property in two situations: (a) where the taxpayer receives other property that is "similar or related in service or use" to the property converted, and (b) where money or other property not similar or related in service or use to the property converted is received by the taxpayer and within the replacement period the taxpayer spends an amount at least equal to the money proceeds received to purchase other property "similar or related in service or use." However, in the case of real estate held for use in a trade or business or for investment that is condemned by public authority or by the threat or imminence of condemnation, no gain will be recognized or taxed (a) if the entire proceeds resulting from the condemnation are used to purchase replacement property within the time limit provided by the law, and (b) if the new property purchased for replacement is of a "like kind" to the property condemned.[7] If the real estate is a taxpayer's residence or property held for sale by a real estate dealer, then the new property purchased for replacement must be "similar or related in service or use."

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[4]Dear Publication & Radio, Inc., 274 F. 2d 656 (3rd Circ. 1960).

[5]Rev. Rul. 60-69, I.R.B. 1960-8, 13. The expenditure by the taxpayer of the proceeds received as damages to enable the plant to continue in operation constitutes the acquisition of property "similar or related in use" to the property involuntarily converted.

[6]Federal Income Tax, 1961, p. 68.

[7]"Like kind" property shall be treated as property "similar or related in service or use." Treas. Regs. 1. 1033(g)-1.

PROPERTY OF "LIKE KIND" OR "SIMILAR" OR RELATED IN "SERVICE OR USE"

This is a situation where the first of many complications arise, for the courts over a period of time have interpreted the two concepts of "like kind" and "similar or related in service or use" quite differently. Although property of a "like kind" and property "similar or related in service or use" might appear to be closely connected in meaning, the courts in interpreting these phrases have said that property "similar or related in service or use" is property similar in economic usage to the property condemned. "Similar or related in service or use" has meant functional similarity between the two types of property. This means in practice that if farming property was condemned the proceeds have to be reinvested in other farming property, not in suburban real estate unless the taxpayer wishes to pay a capital gains tax on the proceeds.[8] This was changed by the Technical Amendments Act of 1958, Section 1033 (8), added by Section 46 (a), 72 Stat. 1641, at least for property used in a trade or business and/or for investment. Now proceeds from a condemned farm or ranch land may be invested in city rental real estate or in real estate to be used in a trade or business because it is "like kind" property. Similarly, where a taxpayer's unimproved real estate on which he plans to build a warehouse is condemned and the proceeds are invested in improved real property on which there is a garage, service station, or automobile sales rooms, "like kind" property is involved. Such was even held to be "similar or related in service or use" under prior law in the case of Stewart Brothers, Inc., 261 F. 2d 580 (4th Cir. 1958), primarily because "the original real estate was held ...for investment purposes and the proceeds of condemnation were reinvested in real estate of the same general class." This view, however, was rejected by the Court of Appeals for the Third Circuit in Thomas McCaffrey, Jr. et al. 275 F. 2d 27 (3rd Cir. 1960).

The Internal Revenue Service, prior to the change in 1958, had stated that the test to be applied under Section 1033 of the 1954 Code is the "character of the service or use of the property." In Revenue Ruling 58-245, 1958-1 Cum. Bull. 274, a taxpayer's parking lot was condemned. The taxpayer unable to procure a vacant lot in the vicinity expended the condemnation award on the purchase of property improved with a building and immediately demolished it, making the property suitable for use as a parking lot. The Service held that in view of the demolition of the building immediately upon purchase, the acquired property constitutes replacement property for the purposes of Section 1033.

However, "like kind" property does not apply for either a taxpayer's residence or for property held for sale by a real estate dealer or for property held by a corporation, 80 percent of the stock of which is acquired by a taxpayer whose property is condemned. Proceeds from a condemned residence must be invested in another residence, provided nonrecognition of gain is desired. Likewise replacement property owned by the corporation, stock of which is acquired by the taxpayer, must be "similar or related in service or use." For example, if a strip of farm land is condemned and the taxpayer receives therefor a $100,000 award, he can buy 80 percent of the stock of a corporation for $100,000, if the corporation owns farm land, but not if it owns an apartment building.

None of these broad rules solve the particular problems. For example, suppose one tract of land is condemned making another tract owned by the taxpayer useless for the purpose it was intended. Is the taxpayer justified in postponing his gain by selling the now useless tract and reinvesting the proceeds of both parcels in like property? The Internal Revenue Service has been of two minds about this question. In a Revenue Ruling published in 1957,[9] it stated it would not recognize the economic property unit of different parcels of land—one of which was condemned by the state and other that had to be sold by the taxpayer because it was rendered economically useless by the

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[8] U.S. Treas. Regs. 1.1033(a)-3(g).

[9] 1957-1 Cum. Bull. 261

condemnation. In that case, a taxpayer leased real property to an organization that operated a golf club. The state in which the property was located instituted proceedings to condemn acreage through the center of the golf course for a right-of-way for a state road and paid the taxpayer an agreed amount therefor. As the course was bisected by a heavily traveled highway and it was considered impossible to build a course on the remaining property, the property not taken by the state was sold at a considerable profit as a site for residential development and the proceeds of the sale, together with the amount received from the state, were used to purchase other property upon which a golf course comparable to the one originally owned could be constructed.

The Internal Revenue Service said:

> The property sold in the instant case was not under threat or imminence of condemnation and neither was theft or seizure involved. There is no evidence from the facts presented that the present or potential value of the property has been destroyed either in whole or in part.

This ruling was revoked in 1959[10] on the basis of a Tax Court case, Harry G. Masser, 30 T.C. 741 (1958), involving property used for a trucking terminal on one side of the street and storage lots for the trucks on the other. Under threat of condemnation, the taxpayer was forced to sell the parking lots, thus making the continued use of the terminal impractical. So he sold all of the property, reinvesting the proceeds of both sales in similar terminal and parking facilities suitable for the taxpayer's business operation. The Tax Court permitted involuntary conversion treatment of the proceeds of the sale of the terminal, as well as the proceeds from the sale of the condemned lots. The Internal Revenue Service stated:

> Where all the facts and circumstances show a substantial economic relationship between the condemned property and the other property sold by the taxpayer, so that together they constitute one economic property unit, such as existed in the Masser case, involuntary sale will be permitted.

Time Limits of Replacement and Returns

The proceeds from property received from condemnation or the threat or imminence thereof must be invested within certain time limits in order that a taxpayer may avoid the recognition of any gain. The first date that replacement property can be acquired is no sooner than the earliest date of the threat or imminence of condemnation of the taxpayer's property or the date of "disposition" (condemnation) of the converted property.[11] However, there is no clear guide as to when the date signifying the threat or imminence of condemnation occurs, although Revenue Ruling 58-577 1958-2 Cum. Bull. 402 sets out some standard. Revenue Ruling 58-577 states:

> A news article, appearing in a newspaper or magazine, to the effect that city officials are considering the condemnation of certain property does not, in itself, constitute a threat or imminence of condemnation, regard-

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[10] Revenue Ruling 59-361, 1959-2 Cum. Bull. 183.

[11] The date that the condemning authority is vested with title and possession is the effective date of condemnation and of "disposition." "Disposition" determines (a) holding period for purposes of short-term or long-term gain; (b) effective date of governing law (pre 1951, post 1950, 1954 Code, or 1958 Amendments); and (c) dates of disposition of residence under Section 1034.

> less of whether the new article is confirmed, personally or in the body of the article, by those or other city officials.
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> Accordingly, it is held that the publishing of newspaper articles to the effect that certain property is being considered for condemnation by the city authorities, even though confirmed by the mayor of the city, does not constitute a sufficient threat or imminence of condemnation under Section 1033 of the Code.

This Revenue Ruling indicates that the taxpayer should at least have some written "official notice" indicating that his property is about to be condemned before he attempts to purchase his replacement property. Yet the Tax Court in the case of Frank O. Maixner, et al. 33 T.C. No. 20 (1959) held that the oral threats of condemnation to the taxpayers by a highway engineer supervising purchases of the Minnesota Department of Highways during negotiations was a sufficient threat within the intent of the statute, although such threats are clearly something less than the requirement implied by the phrase "official action" in Revenue Ruling 58-577. The Court states, in fact, that in its view Revenue Ruling 58-577 "is too restrictive in the requirements therein set forth."

The last date that the replacement property may be acquired is one year after the last day of the taxable year in which any part of the gain from the condemnation is first realized. For example, assuming you are a calendar year taxpayer and were "officially" notified by the City Council on March 1, 1960, of its intention to acquire your property, on July 1 the City converted the property to its use and paid an award with the Court. On August 1st, the Court released to you a portion of the award which resulted in a realized gain. You would have from March 1, 1960, to December 31, 1961, within which to replace the property if tax is to be postponed. The District Director of Internal Revenue may extend this time, provided an application is filed by the taxpayer prior to the deadline for replacement showing reasonable cause for failure to acquire the replacement property before the deadline.

All details of the conversion of property at a gain should accompany the taxpayer's returns for the years in which any of the gain is realized. If gain from involuntary conversion is excluded from income except to the extent of the unexpended portion of the proceeds, such election should be indicated in the taxpayer's return. If the replacement property is acquired before the return is filed, a statement should be attached to the return disclosing the amount realized and the gain, if any, to be reported. If all of the proceeds of the award are spent in acquiring replacement property, gain is excluded. On the other hand, if the replacement property is acquired after a return is filed, a statement should be attached to the taxpayer's return showing all facts relating to involuntary conversion, including gain. When the replacement property is acquired, another statement containing information as to replacement property should be filed for the year in which replacement is made. Amended returns or claims for refund may have to be filed depending on whether gain has actually been realized and reported.[12]

Basis of Replacement Property

There is another concept in tax law that has a special meaning on which an understanding of the tax effects of the condemnation of property rests. This concept is known as "basis." Basis is important to determine gain on subsequent sale of property. Ordinarily a property's basis is its cost, and this is as true of replacement property as any other. Although the basis of replacement property is its cost, this cost, for example, must be decreased by any gain that is realized and not recognized as a consequent of receiving proceeds from the condemnation of the old property. If there

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[12] U.S. Treas. Regs. 1.1033 (a)-2 (c) (2)

were no reduction of basis from the property's actual cost when gain is realized yet not recognized for tax purposes, then this realized but untaxed and unrecognized gain would escape tax altogether, even on a subsequent sale of the replacement property. For example, if the taxpayer's old investment property had a basis of $20,000, and he received $35,000 in condemnation proceeds, his realized gain is $15,000. However, since he is putting the entire proceeds in replacement property, none of this gain is recognized or taxed. However, the basis for his replacement property is its cost of $35,000 reduced by the realized but untaxed gain of $15,000. Thus the basis of the new property is the same as the old: $20,000. Conversely, if gain is recognized and, therefore, taxed, the basis of the replacement property is increased so that any realized gain on a subsequent resale of the replacement property will be less.

Recognition of Gains or Losses on Involuntary Conversion

Most taxpayers when they realize gains from the condemnation of their property are going to want to have them postponed and not recognized for tax purposes. This is possible, as mentioned before, only if the entire proceeds from the condemnation are reinvested. However, if only a portion of the proceeds of a condemnation award is reinvested in replacement property, then gain is recognized and taxed to the extent that the proceeds are not no reinvested. For example, if a taxpayer received a condemnation award of $30,000 for 10 acres of unimproved land costing him $5,000 and if he replaced this property with unimproved land costing him only $22,000, the difference between $30,000 he received and the $22,000 he paid out for the replacement property (i.e., $8,000) is taxable. Since the condemnation of property is treated as the sale of a type of capital asset, even though a peculiar type, the gains on such sales are considered as gains from the sales of capital assets. However, the losses on such sales are treated as ordinary losses. Even this is not the whole story. For, if the taxpayer engages in the sale of more than one of these special types of capital assets (i.e. Section 1231 assets[13]) then all of the sales of these assets must be aggregated; if taken together they show a net gain, each constituent sale results in capital gain or loss, but if the net result is a loss each transaction gives rise to ordinary income or loss. A taxpayer must watch this carefully. For example, a taxpayer in 1960 has a $1,000 loss by reason of a sale of a truck used in his business. In 1960 he realizes a gain of $1,000 as a result of the condemnation of a vacant lot held for investment, the proceeds of which are not reinvested. Since the gains and losses are aggregate, they offset each other. If he could have voluntarily sold his lot, the gain would have been a pure capital gain, includible in taxable income only to the extent of $500 and the loss on the truck would have been entirely deductible for ordinary income, so he would have a net deductible loss of $500. By and large, however, treating the proceeds received from condemnation of property as a sale of a "quasi-capital" asset is favorable to the taxpayer and any adverse results can sometimes be avoided by postponing a specific condemnation transaction from one year to the next.

Some Factors in Computing Gain or Loss

Severance Damages and Special Assessments.—There are certain factors that enter into computation of gain or loss. Severance damages are not a factor when an entire parcel of land is taken. However, when only a portion of an owner's land is taken, severance damages become a factor in computing gain or loss. "Severance damages" is the amount paid to a landowner as a result of a change in the value of his remaining land resulting from the condemnation. Such damages are usually received in addition to a condemnation award. Severance damages merely reduce the basis of the remaining

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[13]Referring to Sec. 1231 of the Internal Revenue Code of 1954.

land of the taxpayer after certain expenses are first offset; for example, (a) expenses attributable to securing the award of severance damages, (b) amount of any special assessment levied for benefits to the remaining real estate,[14] and (c) expenses of restoring the retained property to its former use. Although the Internal Revenue Service recognizes that severance damages can be applied to reduce the basis of the remaining property, there must be specific proof that an award, whether it be by contract or by a court proceedings, states separately the amount granted for the land taken and the amount awarded for consequential damages to the remaining land and improvements. Otherwise, the entire amount received is considered to be paid as a condemnation award. Rev. Rul. 59-173, 1959-1 Cum. Bull. 201 states:

> An award received from a condemning authority may be considered as having been received as severance damages only where such designation has been stipulated by both contracting parties. When it is not clearly shown that the award includes a specific amount as severance damages, it will be presumed that the proceeds were given in consideration of the property taken by the condemning authority.

If the severance damage awarded exceeds the basis of the remaining land, then the gain will constitute gain realized from an involuntary conversion and, if the land has been held for over 6 months, will be taxed as a capital gain. If the land has been held less than 6 months, the gain will be taxed as ordinary income.

Negotiation.—Expenses of negotiation, appraisals, title conveying, and condemnation proceedings can be deducted in computing gain or loss realized upon the taking of the land.

Taxpayers, in negotiating with highway personnel, should be careful in discussing the price to be given for the property not to discuss an amount to be given for the loss of profit or for damage to or destruction of this business if such is involved. Such a factor should never enter into consideration in arriving at a price finally agreed on. A settlement should be negotiated as a lump sum matter or otherwise an amount representing consideration for loss of business will be included in gross income under Section 61 (a) of the 1954 Code. See Claude B. Kendall, 31 T.C. 549 (1958).

Interest on Award.—In many condemnation statutes, payment of interest is made to a taxpayer in cases where the condemnation award is appealed and the award is increased in the appeal proceedings. Any such interest paid is taxable as ordinary income to the taxpayer and has no effect on gain realized or recognized.

Condemnation of Residence

General.—Some condemnations will result in the taking of a taxpayer's residence. In such a case, if a taxpayer's residence is condemned or sold under threat of condemnation, the taxpayer may elect not to have any gain recognized or taxed, provided the proceeds are invested in a replacement residence and provided the taxpayer complies with the replacement requirements of either the specific section dealing with sale of a residence (Sec. 1034)[15] or the involuntary conversion sections of the Code (Sec. 1033). Once made, the election is irrevocable.

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[14] To the extent the assessments exceed severance damages, the consideration received for the condemned land is reduced. Central & Pacific Improvement Corp. v. Comm'r. 92 F. 2d 80 (9th Cir. 1937) rev'g. 34 B.T.A. 208 (1936).

[15] Such election is granted by Section 1034(i)(2); U.S. Treas. Regs. 1.1034-1(h)(2)(ii)

Regarding time limits for reinvestment of the proceeds received from condemnation awards where the property condemned was held in a trade or business or for investment purposes, it was mentioned earlier that the earliest date for the acquisition of replacement property could be no sooner than the threat or imminence of condemnation unless there is actual condemnation and that the last date replacement property could be acquired is one year after the last day of the taxable year in which any part of the gain from the condemnation is first realized. These time limits apply to a residence condemned under the involuntary conversion sections. Now the time limits for reinvestment where a taxpayer's residence is condemned are different if the taxpayer chooses to comply with the sale of residence section (Section 1034) rather than the involuntary conversion section (Section 1033) mentioned above.

If a taxpayer elects to proceed under the sale of residence sections of the Code, he must replace his old residence with a new residence within a period beginning one year before the date of disposition of his old residence and ending one year after such date. In the case of the construction of a new residence, the replacement period is extended until 18 months after the date of disposition of the old residence. The taxpayer makes this election as to which section he wishes to proceed under by filing a statement with his tax return during the year in which he disposes of his old residence. The statement shall indicate that the taxpayer elects under Section 1034 (i)(2) to treat the disposition of his old residence as a sale for purposes of Section 1034.

Recognition and Non-Recognition of Gain.—As stated previously, the gain realized on any condemnation of a taxpayer's residence is not recognized and therefore not taxed if the cost of the taxpayer's new residence exceeds or is equal to the amount of the condemnation award. To repeat, if the taxpayer receives a condemnation award of $35,000 for a house that originally cost him $20,000 and he buys a new house for $35,000, none of the realized gain of $15,000 is taxed. If the condemnation award does exceed the cost of his new residence, the owner is taxed on this excess amount, but, after all, this excess amount represents cash in hand to the taxpayer after paying for his new home. In other words, if he receives a $35,000 condemnation award and his new house costs him only $28,000, he is taxed at capital gain rates on the excess of $7,000.

Basis of New House.—Now what is the basis for this new house? As stated earlier, the starting point for all discussion of basis is cost. From the cost of the new house, the taxpayer subtracts any gain that is realized but not recognized or not taxed on the condemnation of his old residence. In the first example, the cost of the taxpayer's new house was $35,000. Although the taxpayer's old house cost him $20,000 with the realized gain on the condemnation being $15,000, all of which is untaxed, the basis of the new house remains at $20,000—namely $35,000 reduced by the realized but untaxed gain of $15,000. The effect of this is to postpone the taxation of gain on the sale of the old house until the new house is sold. However, if the new house is held until the death of the taxpayer, the gain of $15,000 may never be taxed, because the new home will take a basis at death equal to its fair market value, as a result of Section 1014(a).

In order for the taxpayer to take advantage of the postponement of any gain on the condemnation of his residence, he should expressly elect to take advantage of it in his tax return for the year in which any gain is realized. However, if he fails to report the entire amount of gain realized on the condemnation, he will be held to have elected these nonrecognition provisions.

CONCLUSION

The provisions in the tax law governing condemnation of property are technical and difficult, but they are of importance to taxpayers whose land will be condemned in the next few years as a result of the vast interstate highway programs. The amount of the award, the timing of the condemnation, the investment of the proceeds of the award, and the allocation of the award to provide for severance damages are important considerations for the taxpayer to be aware of. Awareness of these tax concepts illustrates the ancient adage that "the art of taxation consists of so plucking the goose as to procure the greatest quantity of feathers with the least possible amount of hissing."