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Property Condemnations Under Section 1033: What Is “Property”?  
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Section 1033 is an important relief provision allowing nonrecognition of gain upon the condemnation of a taxpayer’s property to the extent the taxpayer reinvests the proceeds in similar property. However, gain nonrecognition is limited to the proceeds from property. When a condemnation award or settlement payment is made with respect to non-property items, difficult apportionment issues may arise. The authors recommend analyzing these potential issues in advance and providing specific allocations whenever possible to improve and facilitate income tax reporting of a condemnation.

Eminent domain is a perennially controversial governmental power. Federal and state constitutions require the government to pay fair market value for any condemned property. However, both the propriety of the condemnation and the determination of fair market value are often hotly contested. Cases such as Kelo v. City of New London, in which land is transferred from one private owner to another, can even trigger a broader political backlash.

The income tax consequences of eminent domain actions can raise considerable controversies of their own. Because the Internal Revenue Code (the “Code”) generally treats a condemnation as an ordinary taxable sale of the property, a condemnation can sometimes lead to harsh income tax consequences. It can be crucial for the property owner to take steps to qualify under the strict requirements of the specific tax code sections that can permit nonrecognition of gain.

BASIC OPERATION OF §1033

Section 1033 is an important taxpayer relief provision. It represents the legislative recognition that condemnation is not an appropriate time for recognition of gain if there has been no substantial change in the form or productive use of the taxpayer’s property. If the government condemns property and the taxpayer reinvests, taxes arguably shouldn’t apply.

Section 1033 applies to property that is compulsorily or involuntarily converted as a result of its whole or partial destruction, theft, seizure, or requisition or condemnation (or threat or imminence thereof). If the taxpayer purchases other property similar or related in service or use to the property that was converted, then the taxpayer may elect to recognize gain only to the extent the amount realized upon the conversion exceeds the cost of the replacement property. The taxpayer may also qualify by purchasing a controlling stock interest in a corporation that owns the qualifying replacement property.

Timing is also important. In general, the taxpayer must purchase qualifying replacement property during the period beginning at the earlier of the date of disposition of the property or the threat of its condemnation, and ending two years after the close of the taxable year in which the taxpayer realizes gain from the conversion. In the case of the involuntary conversion of real property held for investment or for use in a trade or business, the replacement period is extended for an additional year.

Of course, §1033 provides only a deferral, rather than an exclusion, of gain. The gain inherent in the condemned property should eventually be subject to tax when the replacement property is sold. If a taxpayer elects nonrecognition under §1033 in a condemnation proceeding, the taxpayer’s basis in replacement property is calculated by subtracting the amount of gain that was deferred with respect to the condemned property.

LIMITED TO PROPERTY

Any tax practitioner advising a client whose property is under threat of condemnation must recognize that deferral under §1033 is available only for compensation with respect to property. Thus, if any portion of an award or settlement is attributable to a

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1 545 U.S. 469 (2005).

2 Graphic Press, Inc. v. Comr., 523 F.2d 585, 589 (9th Cir. 1975).

3 §1033(a)(2)(A).

4 Id.

5 §1033(a)(2)(B).

6 §1033(g)(4).

7 §1033(b)(2).
claim other than the condemned property, the tax consequences of that portion are determined under general tax principles. The amount of the taxpayer’s required reinvestment can also vary significantly depending on how a lump sum award is allocated.

In many cases, this simple property rule is what trips up taxpayers and their advisers. After all, at the time the taxpayer is fighting or negotiating the condemnation action by the government, the taxpayer is simply trying to maximize the amount the government will pay. Especially where the condemnation is difficult and the expenses, inconvenience, and ancillary consequences of the condemnation may be severe, why wouldn’t the taxpayer list as many items as possible, seeking to recover for them all?

The taxpayer may end up several years later trying to sort out what portion of a negotiated (or litigated) payment from the government is really for the “property” and what portion is for something else. The taxpayer’s documents, correspondence, pleadings and discovery may suggest that many large dollar items were beyond the value of the property and were really compensation for something else.

INTEREST

It is well established that a separate award of interest is not gain qualifying for nonrecognition under §1033. The same rule applies whether that extra compensation is named “detention damages,” “delay damages,” or “payment for delay in compensation.” Thus, any portion of a condemnation award or settlement attributable to interest is ordinary income that cannot be rolled over to a replacement property.

In some cases, interest is easy to identify. For example, in Tiefenbrunn, the taxpayer’s property was taken by condemnation. Upon judicial review of the compensation to which the taxpayer was entitled, the taxpayer received a judgment award consisting of the value of the condemned property, plus a specific amount of interest from the date of the condemnation. Rejecting the argument that the interest award was simply a part of the fair compensation to which the taxpayer was entitled, the Tax Court held that the interest was properly considered separately as ordinary income.

The court in Tiefenbrunn reasoned that the interest component did not represent gains derived from the property itself, but was instead compensation for delay in payment of the sale price. In other cases, however, a portion of a lump sum can be recharacterized as interest, even though no specific allocation was made to it. That was the result in Smith v. Comr., where the settlement agreement provided for a lump sum payment, but expressly stated that “said sum shall include therein any amount claimed for interest or detention damages.”

In Smith, the Tax Court agreed that the taxpayer’s lump sum award included interest. That result seemed clear in light of a Pennsylvania statute that presumed that a condemnee is entitled to interest as a matter of right. Furthermore, an opinion from the state attorney general had concluded that the taxpayer was, in fact, entitled to interest.

A more difficult case reaching the same conclusion was Walter Est. v. Comr. In Walter, the taxpayer and the government reached a settlement of condemnation proceedings. Under the settlement agreement, the taxpayer sold the property for a lump sum, without any specific allocation being made to interest.

Nevertheless, the Tax Court agreed with the IRS that the taxpayer could not defer the entire gain under §1033. The court noted that the taxpayer’s right to compensation accrued as of the date the taxpayer was deprived of possession of the property. As a result, the court believed that a portion of the settlement necessarily included an interest component.

LOST BUSINESS PROFITS

Similarly, a condemnation award cannot be deferred to the extent it compensates for what would otherwise be ordinary income. For example, in Rev. Rul. 57-261, the IRS ruled that compensation the taxpayer received for the use of property pursuant to a lease in conjunction with the involuntary conversion of the property is not part of the condemnation proceeds. Instead, that portion of the compensation represents rent taxable as ordinary income under §61(a)(5).

In other cases, the issues are not as clear. In comparison to cases involving interest, the IRS generally has been less successful reallocating lump sum condemnation awards to other income items. For example, in Asjes v. Comr., the Tax Court addressed whether the entire condemnation proceeds of the taxpayer’s nursery business were proceeds eligible for deferral under §1033. After years of negotiation and the filing of a condemnation action, the taxpayer was awarded a lump sum, without any allocation of the award among land, buildings, and vegetation. The taxpayer reinvested its entire net award in replacement property.

10 59 T.C. 107 (1972).
11 T.C. Memo 1971-244.
12 1957-1 C.B. 262.
The IRS argued that part of the proceeds was allocable to trees, shrubs, and other plants that the taxpayer raised for sale. To the IRS, that dictated that a portion should be taxable as ordinary income. The court disagreed, noting that where a lump sum condemnation award consists entirely of compensation for property, the award should not be reallocated after the fact among the various items of property involved.

Only the portion of an award representing compensation for non-property items is ineligible for deferral under §1033. The pivotal question, in the court’s view, was whether the taxpayer’s vegetation was an item of property. Because the trees and shrubbery were part of the land until severed, the court concluded that they were properly treated as property. The court did not think it critical that many of the trees and shrubs were ultimately to be sold to customers.

The IRS met a similar defeat in *Kendall v. Comr.* In that case, the taxpayer owned a restaurant that was threatened with condemnation. In the course of negotiations with the state, the taxpayer submitted an appraisal, which noted a recent reduction in revenues. Based on newspaper reports, some customers believed the restaurant had already closed. The taxpayer ultimately settled with the state for a lump sum, reinvesting the entire proceeds in replacement restaurant property.

The IRS seized on the appraisal report’s determination that the taxpayer had lost income in the amount of $24,000, arguing that the condemnation award should be taxable in this amount as compensation for lost business profits. The Tax Court disagreed, finding that the parties did not discuss any amount of lost profits in their negotiations. According to the court, a lump sum purchase price should not be reallocated after the event based on solely hypothetical factors.

**COMPENSATION FOR DESTRUCTION OF PROPERTY**

Even if a condemnation award relates solely to a taxpayer’s lost property, that does not necessarily mean that the entire realized gain will be eligible for deferral under §1033. For example, the IRS has taken the position that compensation for destruction may be treated differently than a taking of the property itself.

In *Rev. Rul. 74-206,* a taxpayer’s residence was destroyed by a flood. Because the residence was uninsured, the taxpayer claimed a casualty loss deduction. In the following year, the taxpayer’s land was condemned, and the taxpayer received an award equal to the pre-flood fair market value of his property. Thus, the award compensated the taxpayer not only for the value of the land, but for the value of the taxpayer’s destroyed residence.

The taxpayer reinvested the entire condemnation award in replacement property. The IRS ruled that, because the taxpayer had previously claimed a loss deduction, the portion of the award compensating the taxpayer for the flood damage was taxable income. Only the remaining gain could be deferred.

Notably, the IRS took the position that the entire condemnation award, including the compensation for flood destruction, needed to be reinvested in order to defer the taxpayer's realized gain. This seems harsh. Yet the IRS announced an even stricter view in *Rev. Rul. 89-2.* In that ruling, a portion of a condemnation award was allocable to compensation for the environmental contamination and destruction of the taxpayer’s property. The IRS held that only the gain attributable to the remaining proceeds, representing compensation for the taking of the property, could be deferred under §1033.

**MOVING COSTS**

Sometimes a settlement of a threatened condemnation may provide for additional cost reimbursement or releases from the condemnee. The question may arise whether, and to what extent, a lump sum payment is allocable to these separate costs or releases, rather than the condemned property itself. Many taxpayers, and perhaps some tax advisers, simply assume that the entire condemnation payment must be for the property and that it therefore all qualifies for reinvestment.

For example, in *Graphic Press, Inc. v. Comr.,* the State of California notified a printing business of its intent to acquire property in order to widen the San Bernardino Freeway. The taxpayer’s plant contained massive printing presses and other machinery classified as fixtures, all of which the state was required to include in its condemnation. However, the state recognized that it was likely to obtain only 10% of the machinery’s value if it were condemned and then sold at auction.

Rather than condemn the machinery and realize little value, the state paid the business an additional $407,192 to cover the costs of removing and transporting it to a new location. Although these costs were discussed and incorporated into the lump sum settlement, the state was actually prohibited by law from reimbursing a condemnee for moving costs exceeding $3,000. Thus, the settlement between the taxpayer and

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15 1974-1 C.B. 198.
16 1989-1 C.B. 259.
17 523 F.2d 585 (9th Cir. 1975).
the state was for a single lump sum, without any breakdown among components.

Facing a later tax dispute with the IRS, the taxpayer argued that the entire lump sum was its amount realized under §1033, and that no gain needed to be recognized because all proceeds were reinvested in replacement property. However, the Tax Court agreed with the IRS. Because state law did not permit an award of moving expenses, the payment exceeding the property's value was a severable award. The court labeled the separate award as compensation for the business's waiver of its statutory right to require condemnation of its entire property, including the equipment.

The Ninth Circuit reversed. As a preliminary matter, the court noted that an award for lost profits, rents, or interest cannot be deferred under §1033 as the proceeds of property. However, the Tax Court had previously found that none of the taxpayer's award was due to lost profits.

The appellate court agreed in principle with the Tax Court that the moving expense award was severable. Nevertheless, the court held that moving costs were also compensation for property, and were properly considered part of the condemnation award. As long as the condemnee reinvests the entire award into property similar in use within the statutory period, both the language and spirit of §1033 are met. The Second Circuit reached a similar conclusion in the earlier case of E.R. Hitchcock Co. v. U.S.18

SEPARATE COVENANTS

A challenge to condemnation of business property can involve multiple claims, not all of which relate to the property's value. A settlement agreement that resolves these claims for a lump sum, without any specific allocation among these claims, can invite a challenge by the IRS. However, just as in the cases of Graphic Press and E.R. Hitchcock, taxpayers appear to have been the victors in this instance as well.

In M.I.C. Limited v. Comr.,19 the Tax Court looked at such a lump sum settlement. In resolution of a condemnation proceeding involving an adult business establishment, the settlement agreement resolved all the taxpayer's claims for a single lump sum. The issues resolved included claims relating to the value of the real estate, going concern value, and covenants by the business owners not to operate an adult business in the area.

Although the agreement failed to set forth a value for any specific claim, the taxpayer was advised that the covenants had little value. The taxpayer purchased other property similar to or related in use to the condemned property and elected not to recognize the gain under §1033. The IRS contested the taxpayer's treatment, arguing that the condemnation award included damages for going concern value and the additional covenants. To the IRS, the payment of these amounts did not qualify for nonrecognition of gain.

The Tax Court disagreed with the IRS and declined to allocate any part of the award away from the taxpayer's real property. After analyzing competing expert testimony as to the property's actual value, the court concluded that the value of the condemnation award was “not significantly in excess of the fair market value of the property.” However, the court reached this conclusion only after it heard competing expert testimony on the property's appraised value.

In this case and many others — and surely in many tax disputes that never go to court and are rather resolved with IRS Appeals — the taxpayer's case could have been considerably strengthened if the settlement agreement had provided specific allocations of value to each claim. As with other language in settlement agreements, the IRS is free to go behind them and make its own assessment of the nature and value of the claims resolved. Yet, as a practical matter, the IRS often accepts the agreement of the parties.

Charitable Contributions

A government authority is generally not inclined to be generous in determining the fair market value of condemned property. As a result, some taxpayers have claimed the uncompensated “true” value of the property as a charitable contribution. However, this strategy is likely to be successful only if it is well documented in a settlement agreement.

This strategy may be especially difficult if the taxpayer's property is actually taken in a condemnation proceeding, as occurred in Hope v. U.S.20 In that case, after the taxpayer filed suit to obtain additional compensation for his property, the parties reached a settlement for a lump sum. The settlement agreement contained a recital that the settlement amount did not constitute an agreement that the amount represented the fair market value of the taxpayer's property. Instead, the amount was understood to be a negotiated settlement of the parties' litigation. The taxpayer probably thought these provisions left him room to argue that the purchase price was below actual market value. In fact, the settlement was for a much lower amount than the taxpayer's own appraisals.

The taxpayer chose to characterize the condemnation transaction as a bargain sale. Because the tax-

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18 514 F.2d 484 (2d Cir. 1975).
19 T.C. Memo 1997-96.
payer believed he had received less than fair market value in settlement of the condemnation proceeding, he claimed he was entitled to a charitable contribution deduction for the excess. The Claims Court disagreed, finding that a plaintiff in a condemnation proceeding who voluntarily accepts an agreed-upon amount as full compensation for the property cannot claim a greater value for the property for income tax purposes. Once the condemnation is complete and the taxpayer has negotiated the best terms available, the taxpayer retains no property rights in the land for which he can claim a contribution deduction.

However, better documentation sustained a charitable contribution deduction in Consolidated Investors Group v. Comr. Unlike the post hoc character of the taxpayer’s reporting position in the Hope case, in Consolidated Investors Group the donor’s charitable intent was well documented. The taxpayer had offered to structure the acquisition as a part contribution/part sale consistently throughout the negotiations.

Furthermore, the Tax Court found it significant that condemnation proceedings were initiated at the taxpayer’s suggestion, after it became clear that the state was not negotiating in good faith. Condemnation did not negate the taxpayer’s donative intent because the taxpayer simply desired a neutral determination of the property’s value. Finally, the parties’ settlement agreement expressly acknowledged that the taxpayer would file a Form 8283, Noncash Charitable Contributions, with its income tax return to indicate that the taxpayer had made a charitable contribution in connection with the settlement. The state also agreed that it would execute the donee acknowledgment section of that form.

Allocations Between Properties/Severance Damages

In cases where only a part of the taxpayer’s property is condemned, the owner may be entitled to compensation for damage the condemnation caused to the owner’s remaining property. This type of award is referred to as severance damages. A taxpayer who receives severance damages must reduce his basis in the retained property by a corresponding amount and realize gain only to the extent the award exceeds his basis. Realized gain is eligible for deferral under §1033.

In cases where a settlement does not specify the portion of an award that is allocable to severance damages, the courts have been called upon to determine the tax consequences. Of course, severance damages do not trigger gain unless they exceed basis. As a result, a taxpayer may have an incentive to allocate as much of his award as possible to severance damages in order to reduce the realized gain as to the condemned portion.

At first, both the IRS and the courts were generally unreceptive to allocating any portion of a lump sum settlement to severance damages unless there was strong supporting evidence. For instance, the Second Circuit in Lapham v. U.S., addressed whether a taxpayer who sold a portion of her property under threat of condemnation could allocate any portion of the lump sum to severance damages. The court denied the taxpayer’s attempt to do so, even after the taxpayer presented evidence that the State Highway Department, without informing the taxpayer at the time, took severance damages into account in determining the purchase price it was willing to pay.

The court believed the lump sum settlement simply reflected the purchase price for the particular property parcel conveyed. The Board of Tax Appeals earlier reached the same conclusion under similar circumstances. Indeed, in an early ruling, the IRS took the position that a condemnation award may be considered as having been received as severance damages only where such designation has been stipulated by both parties.

However, later rulings and cases have proven more generous. In Rev. Rul. 64-183, the IRS permitted the allocation of a lump sum condemnation award when the property owner was furnished with an itemized statement or closing sheet by the condemning authority indicating the specific amount of the total contract purchase price that was for severance damages.

The courts have since found extrinsic evidence to be persuasive. In Vaira v. Comr., the Third Circuit recognized that when a taxpayer receives a lump sum condemnation award, that award will be presumed not to constitute severance damages. However, the court found that the taxpayer overcame this presumption by introducing evidence that the state reviewing board had taken severance damages of $12,000 into account in determining the taxpayer’s award.

Similarly, in Johnston v. Comr., the taxpayer was able to show that throughout the condemnation proceedings and negotiations, both sides had acknowledged that the bulk of the award was attributable to severance damages, rather than the condemned prop-

21 T.C. Memo 2009-290.
property itself. Because the taxpayer had sufficient basis in its retained property, this meant that the taxpayer was required to recognize capital gain only with respect to the property it conveyed. The IRS’s acquiescence to Johnston may have signaled an end to the debate as to whether a lump sum award can be reallocated to severance damages based on extrinsic evidence.

ATTORNEYS’ FEES

A related issue in the context of a condemnation proceeding is the treatment of attorneys’ fees and other expenses. In order to fully defer realized gain, a taxpayer must reinvest at least as much as the amount realized upon the condemnation. A key issue in this determination is whether attorneys’ fees and related expenses are subtracted directly from the gross proceeds realized or whether they are included in the gross proceeds realized and only then subtracted as basis.

In other words, the question is whether a taxpayer must reinvest the gross proceeds including expenses, or only the proceeds net of expenses. Fortunately, this issue appears to be well settled in the taxpayer’s favor. In Rev. Rul. 71-476,30 the IRS held that in determining the amount realized from a condemnation award for purposes of §1033, the award is reduced by legal, engineering, and appraisal fees incurred in obtaining the award.

Thus, although these expenses must be capitalized,31 they are not adjustments to basis for purposes of §1033. Instead, they are treated as selling expenses.32 This favorable rule permits a taxpayer to invest only the net proceeds to fully defer gain.

CONCLUSION

It may not always be possible or practical to negotiate tax-driven (or even tax-savvy) allocations in the settlement of a threatened or actual condemnation proceeding. The courts appear to recognize this by adopting taxpayer-favorable presumptions. This approach seems fair in light of the taxpayer relief which §1033 was expressly designed to provide.

However, the IRS still appears eager to argue for tax-inefficient allocations of lump sum settlements or awards. In some cases, the IRS position may even appear to be overly aggressive. But whenever such positions are asserted they can require taxpayers to incur significant expenses to defend what ultimately boils down to a factual question of value.

In general, the best indication of value is what is agreed between two parties dealing at arm’s length. A well-advised taxpayer can strengthen his position by documenting in advance the key factors supporting his reporting position. Ideally, helpful allocation language should be inserted in the judgment award, settlement agreement, closing statement, or other contemporaneous acknowledgments by both parties.

It may not be possible to include such language in a judgment, as the court will ultimately decide on its final wording. But it is rarely impossible to include such language in a settlement agreement. Even though there may be impediments to negotiating it, a settlement rarely is derailed over such issues. Wherever possible, insist on settlement language with an eye on the tax return position the taxpayer may ultimately take. It is usually worth the effort and the small additional expenditure of time to do so.

32 See also TAM 8041002; PLR 200239012; PLR 200239009.