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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR BARBARA M. LEONARD
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FROM: George F. Wright
Assistant Branch Chief, CC:ITA:BR4

SUBJECT: Involuntary Conversions

This Chief Counsel Advice responds to your memorandum dated June 22, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

ISSUE 1:

If a taxpayer decides to make an election under § 1033(a)(2) of the Internal Revenue Code for a taxable year after he has already filed an income tax return for that year, must he file an amended return prior to expiration of the replacement period (as defined in § 1033(a)(2)(B)) or may he file it within the regular period of limitations for filing claims for refund as set forth in § 6511?

ISSUE 2:

If a taxpayer decides to make an election under § 1033(a) for a taxable year after he has filed an income tax return for that year, may he designate as replacement property qualifying property that he acquired prior to making the election?

ISSUE 3:

May a taxpayer amend his income tax return for a taxable year to designate as replacement property qualifying property that he acquired during that year, if he has made an election under § 1033(a) but did not designate such property, or any other qualifying property, on his original return?

CONCLUSIONS

ISSUE 1:

A § 1033(a) election is made either by filing a return for the first year in which gain from the conversion is realized consistent with § 1033 or by electing after a return is filed for that year but before the expiration of two years after the first year in which gain is realized (or three years in the case of § 1033(g)). Because the filing of a return in which § 1033 is not elected is itself an election not to apply § 1033, an election, in whatever form made, is effective for the year in which it is made and is not effective for a taxable year for which a return has already been filed. A claim for refund for any year in which gain from the involuntary conversion is realized may be filed within the regular period of limitations, as determined under § 6511.

ISSUE 2:

As in the Conclusion of Issue 1, a taxpayer may only make a § 1033(a) election for the year in which the election is made. If a taxpayer makes an election in the same year that the taxpayer acquires qualified replacement property and reports the details regarding the replacement in the return for that year, the requisite "intent to replace" appears to be present. However, if a return is filed for a year that does not report the details regarding replacement of the converted property, no property acquired in that year can be qualified replacement property. In Hypothetical 1, Property B is qualified replacement property because it was reported in the return for the year of election and the year of replacement, but in Hypothetical 2, Property B cannot be qualified replacement property because the requisite "intent to replace" was not present at the time of purchase, as reflected in the Year 2 return.

ISSUE 3:

No property can be designated as replacement property that was not described as such in the original return for the year of replacement.

LAW AND ANALYSIS

LAW:

Section 1033(a)(2) of the Internal Revenue Code provides that, except as otherwise provided in paragraph (2)(A), gain will be recognized if property is involuntarily converted into money or other property not similar or related in service or use to the converted property.

Section 1033(a)(2)(A) provides for nonrecognition of gain if the taxpayers purchases property (i) during the replacement period described in § 1033(a)(2)(B),

(ii) with the intention of replacing the converted property, (iii) which is similar or related in service or use to the converted property, and (iv) with respect to which the taxpayer has made an election at such time and in such manner as the Secretary may prescribe in regulations.

Section 1033(a)(2)(B) provides, in general, that the replacement period begins on the earlier of the date of disposition of the converted property or the earliest date of the threat or imminence of requisition or condemnation of the converted property, and ends two years after the close of the first taxable year in which any part of the gain on the conversion is realized.

Section 1.1033(a)-2(c)(1) of the Income Tax Regulations provides:

> 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 into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted . . . if the taxpayer purchased such other property . . . for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph.

Section 1.1033(a)-2(c)(2) provides:

> All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033(a)(2), the converted property is not replaced within the required period of time, or

> replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an amended return. If a decision is made to make an election under section 1033(a)(2) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

Section 1.1033(a)-2(c)(3) provides:

> The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning 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 the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer.

Section 1.033(a)-2(c)(4) provides:

> Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(b), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012.

Rev. Rul. 63-127, 1963-2 C.B. 333, addressed whether a refund claim must be filed by the close of the replacement period in order for a § 1033(a) election and the refund claim itself to be valid under § 1.1033(a)-2(c)(2). The ruling held that the decision to elect and the reinvestment in replacement property must both occur within the replacement period. However, the regulations in effect provide that a taxpayer who has made such an election may adjust his tax liability by filing a claim for refund within the period of limitations provided in § 6511, and the claim does not

have to be filed before the expiration of the replacement period. Therefore the ruling held that a claim for refund filed after the replacement period but within the § 6511 period of limitations was timely as to the refund claim and did not affect the validity of a § 1033 election.

In *Santucci v. Commissioner*, T.C. Memo 1973-178, the tax court held that a taxpayer failed to make an election under § 1033(a) because, among other reasons, no election had been made within the replacement period (before 1969, within one year after the taxable year in which conversion gain is realized). In describing the replacement period, the court stated that "the election must be made before the expiration of the period within which the converted property must be replaced and a claim for refund should be filed. Section 1.1033(a)-2(c)(2)."

In Rev. Rul. 83-39, 1983-1 C.B. 190, a taxpayer realized a gain on an involuntary conversion in 1978 and elected § 1033 deferral of gain on its 1978 return. In Situation (1), the taxpayer acquired replacement property and designated it as such on the taxpayer's 1979 return. In 1980, before the replacement period expired, the taxpayer required other property, designated the new property as replacement property on its 1980 return, and amended its 1979 return to delete the replacement property designation. Situation (2) is identical to Situation (1), except that the 1979 property was found not to be qualified replacement property. In Situation (1), the taxpayer could not substitute other replacement property for qualified replacement property that the taxpayer had already acquired. In situation (2), the taxpayer could substitute qualified replacement property before the expiration of the applicable replacement period for the replacement property already acquired by the taxpayer, which was determined not to be qualified replacement property. GCM 38694 (April 15, 1981) is an underlying GCM to Rev. Rul. 83-39.

In *McShain v. Commissioner*, 65 T.C. 686 (1976), the tax court held that a taxpayer who elected § 1033(a) could not revoke that election after replacing the involuntarily converted property with qualified replacement property.

In *Feinberg v. Commissioner*, 45 T. C. 635 (1966), aff'd 337 F.2d 21 (8th Cir. 1967), the tax court held, in part, that the taxpayer had failed to prove that certain property was purchased with an intent to replace involuntarily converted property where the designation of replacement property occurred several years after the replacement property was acquired.

ISSUE 1:

There are two basic requirements for § 1033(a) to apply: First, there must be an election that § 1033 applies, and second, qualified replacement property must be acquired. § 1033(a)(2)(A) and § 1.1033(a)-2(c)(1).

The time and manner for making an election are addressed in § 1.1033(a)-2(c)(2). The time for making an election runs from the first date of threatened conversion to the end of the second year (third year in the case of § 1033(g)) after the end of the first year in which any gain on the conversion is realized. This time frame also corresponds to the period in which qualified replacement property must be acquired (the replacement period). Rev. Rul. 63-127 and *Santucci* at 842. The replacement period, upon application, may be extended for purposes of acquiring qualified replacement property, but the election period may not be extended. § 1.1033(a)-2(c)(3), *Santucci* at 842.

The manner of election is spelled out less clearly. Section 1.1033(a)-2(c)(2) sentences 2 and 4 indicate that a taxpayer elects § 1033(a) for the year in which gain from the involuntary conversion first occurs by reporting the gain on its return for the year consistent with § 1033. A taxpayer who does not wish to elect reports gain in the "regular manner." § 1.1033(a)-2(c)(2) sentence 3. "This inclusion in income of the gain in the year of realization is itself an election not to apply section 1033(a)[(2)]." *Santucci* at 842. Therefore, a taxpayer's return for the first year in which gain from an involuntary conversion is realized either elects § 1033(a) or elects not to apply § 1033(a) depending on whether the gain is reported consistent with § 1033 or is reported in the "regular manner." "Taxpayers seeking to make delayed elections or revoke prior elections have received close scrutiny from the courts. Consonant with their efforts to protect our annual tax accounting system, the courts consistently have refused to permit taxpayers to alter prior positions to the detriment of the revenue once they have had the advantage of hindsight." *McShain* at 692-93. It therefore follows that, having elected not to apply § 1033(a) in a return for the first year in which gain from the involuntary conversion is realized, the taxpayer may not elect § 1033(a) for that year by amended return.

Section 1.1033(a)-2(c)(2) does provide that an election can be made after the first year in which gain is realized as long as the election occurs within the replacement period. § 1.1033(a) -2(c)(2) sentence 7. But this election will be for the year in which the decision to elect is made, not for an earlier year. In that case, an electing taxpayer may file a claim for credit or refund for the year in which the gain was reported. The claim for refund is independent of the decision to elect. That is, an election must be made within the replacement period, but "[t]he claim may be made filed within the regular period of limitations, as determined under section 6511 of the Code, and does not have to be filed prior to the expiration of the replacement period." Rev. Rul. 63-127. GCM 32563 (April 15, 1963), which accompanied Rev. Rul. 63-127, noted that the Service wanted to correct the impression given by several leading tax services that an election after the year of conversion is not available unless both the property replacement and the claim for refund occur within the replacement period. In addition, the GCM noted that care was taken so that the ruling could not be read to authorize elections to take place outside the

replacement period, but before the expiration of the period allowed for refund claims. As a result of the position in Rev. Rul. 63-127, § 1.1033(a)-2(c)(2) does not provide for the manner in which § 1033(a) is elected after the filing of the return for the first year in which conversion gain is realized.

ISSUE 2:

Issue 2 was framed with reference to two hypothetical fact patterns. In Hypothetical 1, the taxpayer realizes gain on an involuntary conversion on Property A in Year 1 but does not elect § 1033(a) in the Year 1 return. The taxpayer purchases Property B as qualified replacement property in Year 2. The taxpayer elects § 1033 in Year 2 by filing an amended Year 1 return (see Issue 1 discussion regarding effective date of an election) and at same time files a Year 2 return designating Property B as replacement property for Property A. Hypothetical 2 is similar to Hypothetical 1, except the taxpayer files the Year 2 return without mentioning the Property B acquisition. In Year 3, the taxpayer elects § 1033 by filing an amended Year 1 return and files an amended Year 2 return designating Property B as replacement property for Property A.

In addition to making a § 1033(a)(2) election, a taxpayer must acquire qualified replacement property. Qualified replacement property is property acquired (i) by purchase, (ii) within the replacement period, (iii) with the intent of replacing the converted property, and (iv) that is similar or related in service or use to the converted property. § 1033(a)(2)(A) and § 1.1033(a)-2(c)(1).

The intent to replace the involuntarily converted property must be present at the time of purchase of the replacement property. Rev. Rul. 83-39. Although a taxpayer electing § 1033 need not designate what property will be the replacement property at the time of election, once qualified replacement property is acquired, both the election and the choice of replacement property are final. *McShain* at 692 and Rev. Rul. 83-39. The last sentence of § 1.1033(a)-2(c)(2) provides that all details of the replacement of the converted property be included in the return for the year in which the replacement occurs. This provision requires the taxpayer's intent regarding replacement property to be reported currently. Thus, as stated in GCM 38694,

> [w]hen a taxpayer reports the detail of purchase of qualified replacement property in his income tax return for the year of purchase, he shows that he had the intent to purchase the property as replacement property; but when the taxpayer files his return for the year of purchase of property without reporting that the property is replacement property, he rather clearly indicates that the property was

not purchased for the purpose of replacing involuntarily converted property.

GCM 38694 also noted that "the Code and regulations do not allow the taxpayer to decide at the end of the replacement period that a property purchased in an earlier year is to be used as qualified replacement property." This is consistent with *Feinberg*, in which a taxpayer attempted to designate as qualified replacement property replacement property acquired during the replacement period, but not currently reported. "The obvious intendment of the statute is that petitioner must have the requisite intent during the specified period of time. He cannot (retroactively) simply pick out some property which he happened to purchase within the prescribed period and say 'I chose this one!' *Feinberg* at 642.

Similar to the analysis in Issue 1, the taxpayer is not permitted hindsight either in electing § 1033(a) or in designating replacement property. Therefore, a taxpayer, once having filed a return in which replacement property is not designated, may not later designate property acquired during that year as qualified replacement property by amended return.

ISSUE 3:

The analysis is similar to the analysis in Issue 2.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

There appear to be no significant litigation hazards absent facts of particular cases. Arguably, *Santucci* could be seen as standing for a stricter standard regarding either when a claim for refund should be filed or whether a claim for refund is necessary to make an election after the return is filed for the first year conversion gain is realized.

In *Santucci*, the tax court held that there was no evidence that a § 1033(a) election was made by the taxpayer by the end of the replacement period. In describing the requirements of an election under § 1.1033(a)-2(c)(2), the court stated that "the election must be made before the expiration of the period within which the converted property must be replaced and a claim for refund should be filed." However, there is no further mention of a claim for refund in the facts or opinion. The opinion notes only that the court's reading of the regulations indicates that, although an extension may be granted to purchase replacement property, the election itself must occur within the replacement period, and that, if an election is to be made, all details in connection with the conversion and the replacement must be reported on the return.

Because the issue regarding when a refund claim must be filed in regard to a § 1033(a) election was not being litigated in *Santucci* (nor was the issue mentioned on brief by the Service), the passing reference to refund claims should be considered as dicta. It is highly unlikely the *Santucci* court wished to establish a rule regarding refund claims without discussing the Service's less severe position in Rev. Rul. 63-127. The Service has never altered Rev. Rul. 63-127. Six years after *Santucci*, Rev. Rul. 63-127 was cited with approval in GCM 37874 (March 5, 1979) (an underlying GCM to Rev. Rul. 83-39). It is also unlikely that *Santucci* would be invoked by a taxpayer in preference to the more taxpayer-friendly Rev. Rul. 63-127.

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Please call if you have any further questions.

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