

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

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Legend

Taxpayer: =
State 1: =
State 2: =
County: =
Area: =
River 1: =
River 2: =
Easement 1: =

Easement 2: =

Decade: =
Date 1: =
Date 2: =
Date 3: =
a =
b =
c =
d =
e =
f =
g =
h =
i =
j =

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This letter is in response to your private letter ruling request dated August 22, 2000. The facts, as represented by Taxpayer, are as follows:

Taxpayer is a State 1 for-profit corporation that uses an accrual method of accounting and files its returns on a fiscal year ending July 31. Taxpayer's primary business activity involves the ownership, management, and leasing of its approximately a acres of land in County, State 2. The real estate assets include oil and gas reserves, agricultural lands, leased residential sites (recreational cabins and houses), leased hunting tracts, several commercial tracts, and substantial timber acreage. The real estate assets have a variety of uses, such as recreational (fishing, hunting, camping, boating, tourism), residential (vacation cabins, houses), and commercial (oil and gas development and production activities, timber harvesting).

Beginning in Decade, the U.S. Army Corps of Engineers ("Corps") became concerned with protecting the land it had designated as Area from overdevelopment. Approximately b acres of the lands owned by Taxpayer are located in Area. The land in Area mainly consisted of wetlands, which served as a habitat for both land and aquatic-based wildlife. However, the trend in Area, beginning in Decade, was to clear the land in Area for agricultural and commercial development. This reduced the wetlands, which decreased the wildlife and increased the sedimentation in the area. With increased sedimentation in Area, the flows of River 1 and River 2 were ultimately adversely affected.

In order to preserve the wildlife habitat and control the flows of River 1 and River 2, the Corps developed a comprehensive plan which consisted of curtailing the clearing and development of land in Area. To aid the Corps in carrying out its plan, the United States Congress passed legislation allowing the Corps to take control over the development of Area.

In furtherance of the objectives of the legislation, Congress authorized the Corps to acquire fee title to c acres from "willing sellers," and to acquire easements over a total of d acres within Area. There are two types of easements the Corps is allowed to take. Easement 1 specifically prohibits the following activities:

- (1) The conversion or development of Taxpayer's land from its existing uses to other uses;
- (2) The construction or placement of new permanently habitable structures on Taxpayer's land;
- (3) The construction or placement of all other new structures, including camps, without prior written approval of the Corps (this excludes structures used in the exploration, development, and/or production of oil,

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- gas, and all other minerals);¹ and
- (4) Any timber operation which involves:
- (a) Removal of any bald cypress greater than 42 inches in diameter at 10 feet above ground; or
 - (b) Removal of oak, ash, and sweet pecan less than 20 inches in diameter at 12 inches above ground, and water tupelo and bald cypress less than 24 inches in diameter at 2 feet above ground, unless 40 square feet of basal area, per acre, in any combination of these species, is maintained.

Easement 2 prohibits the same activities as Easement 1, and in addition, provides that the Corps has the right to overflow Taxpayer's land at any time, for any length of time, and to any elevation.

On Date 1, the Corps announced its desire to purchase e acres of Taxpayer's land in fee simple ("Fee Acres").² While the Corps did not have the power to compel taxpayer to sell a fee interest in Taxpayer's lands, the Corps did have the power to condemn easements on the lands. In a letter to Taxpayer dated Date 3, the Corps indicated that it would initiate eminent domain proceedings for the easements by filing a condemnation suit in the United States District Court for the Western District of State 2. Easement 1 would have covered g% of Taxpayer's land, or h acres, and Easement 2 would have covered i% of Taxpayer's land, or j acres. Taxpayer believed that the condemnation of the easements would diminish the value of its land for investment purposes very significantly and, thus, decided to sell its entire fee interest (excluding mineral rights) in the Fee Acres. The sale of the Fee Acres by Taxpayer to the Corps was closed on Date 2.

RULINGS REQUESTED

- (1) Whether proceeds from the sale by Taxpayer of the Fee Acres (excluding minerals) to the Corps constitute proceeds from an involuntary conversion for purposes of § 1033(a) of the Internal Revenue Code.
- (2) Whether Taxpayer's land constitutes real property that meets the requirements of § 1033(g)(1), and is therefore eligible for the three-year

¹ The standards for obtaining the approval of the Corps are very restrictive. Any new camps would have to be adjacent to existing bodies of water, spaced at least _____ feet apart, have clearings of less than _____ acre, have less than _____ square feet, be movable or elevated structures, have proper utility systems, and meet other requirements.

² In addition, the Corps also wishes to purchase easements over f acres. The Corps is seeking permission from Congress to acquire these f acres, but such permission has been delayed due to current constraints on the federal budget.

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replacement period under § 1033(g).

- (3) Whether the purchase of replacement land by Taxpayer within the three-year period that is either similar or related in service or use under § 1033(a) or like-kind under § 1033(g) will be qualified replacement property for the purposes of § 1033.

LAW AND ANALYSIS – RULING REQUEST 1

Section 1033(a)(2)(A) provides, in part, 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 and if the taxpayer during the time specified purchases property similar or related in service or use to the property so converted, at the election of the taxpayer, the gain shall be recognized only to the extent the amount realized on such conversion exceeds the cost of such other property. See also § 1.1033(a)-1(a) of the Income Tax Regulations.

Section 1033(a)(2)(B) provides, in part, that the period referred to in subparagraph (A) shall be 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 two years after the close of the first taxable year in which any part of the gain upon the conversion is realized. See also § 1.1033(a)-2(c)(3).

Section 1.1033(a)-2(a) provides, in part, that the term “disposition of the converted property” means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

Section 1.1033(a)-2(c)(1) provides, in part, that if property (as a result of its destruction in whole or in part) 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.

In Rev. Rul. 54-575, 1954-2 C.B. 145, a taxpayer who owned 300 acres of farm land adjacent to an air base granted a perpetual easement of air rights to the government over 80 percent of the area. He had no alternative in selling air rights in view of the government's right of condemnation. Because of the glide angle plane used at the base (which struck 4 to 6 feet above the ground at certain points), the value of the taxpayer's beneficial interest in the property increased as the easement extended away from the runway. Other portions of the acreage closer to the runway were unsafe for farm usage and habitation. On these facts, the Service concluded that the granting

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of the easement deprived the taxpayer of practically all the beneficial interest (except for retaining legal title) of a portion of the land covered by the easement. Thus, the transaction was considered to be a sale of that portion of the land. Because the proceeds were received as a result of granting an easement under threat of condemnation, any gain realized from the sale was entitled to § 1033 treatment.

In Rev. Rul. 72-433, 1972-2 C.B. 470, the taxpayer, a farmer, received condemnation proceeds from the United States Government for a perpetual flowage easement. The easement gave the government the perpetual right to flood taxpayer's farm. It was expected that the property would be flooded once every six years, and the taxpayer was able to farm the land in the years in which no flooding occurred. The taxpayer took the condemnation proceeds and invested them in farmland to restore his farming operation to its former capacity. The Service concluded that the taxpayer had been affected by the condemnation of the easement and was eligible for § 1033 treatment. The Service also modified Rev. Rul. 54-575, and found that a taxpayer does not have to be deprived of practically all his beneficial rights in his property to receive § 1033 treatment.

In Rev. Rul. 82-147, 1982-2 C.B. 190, the taxpayer owned a fishing resort, which was adjacent to a lake. After 3 years of operation, an act of Congress prohibited the use of motorboats with motors of greater than 25 horsepower on the lake. The act gave an affected resort owner the option to require the government to purchase the resort at its fair market value without regard to the restriction. Although the taxpayer could have retained the land, the resort with the restrictions on motorboats was no longer useful or available to the taxpayer for its originally intended purpose. The restriction, together with the provision authorizing purchase by the government, effectively constituted a taking of the property upon payment of fair compensation. Therefore § 1033 treatment was granted to the taxpayer for the sale of the resort.

In the present case, Taxpayer is seeking § 1033 treatment on land sold in fee when the Corps had the power to only condemn an easement on the land. However, the purpose of the easements is to essentially preserve the land in its current state, preventing development of the land from wetlands to agricultural or commercial uses. While the easements would allow many of Taxpayer's current uses of the land to exist, the restrictions on the current uses would essentially prohibit any further significant timber operations. In addition, hunting, camping, and tourist operations would be limited due to the restrictions on habitable structures, and the fact that some of the lands may be flooded. Therefore, while the Corps had only the power to condemn easements on the land, the easements would have been so restrictive on Taxpayer's right to use and control its property that the easements would have substantially deprived Taxpayer of its beneficial interest in the land. The sale of the land to the Corps thus constitutes an involuntary conversion under § 1033.

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Section 1033(g)(1) provides in part that if real property (not including stock in trade or other property held primarily for sale) held for productive use in a trade or business, or for investment, is (as the result of its seizure, requisition, or condemnation, or threat or imminence of thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in a trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Section 1033(g)(4) provides that in the case of a compulsory or involuntary conversion described in § 1033(g)(1), subsection 1033(a)(2)(B)(i) shall be applied substituting “3 years” for “2 years.”

In the present case, Taxpayer owned, managed and leased land that was used for hunting, camping, and miscellaneous activities. Taxpayer’s property is not stock in trade or other property held primarily for sale. Therefore, Taxpayer’s property constitutes real property under § 1033(g)(1) and would qualify for the three-year replacement period under § 1033(g).

LAW AND ANALYSIS – RULING REQUEST 3

Section 1033(a)(2)(A) provides, in part, 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 and if the taxpayer during the time specified purchases property similar or related in service or use to the property so converted, at the election of the taxpayer, the gain shall be recognized only to the extent the amount realized on such conversion exceeds the cost of such other property. See also § 1.1033(a)-1(a).

Section 1033(g)(1) provides, in part, that if real property (not including stock in trade or other property held primarily for sale) held for productive use in a trade or business, or for investment, is (as the result of its seizure, requisition, or condemnation, or threat or imminence of thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in a trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Section 1.1031(a)-1(b) provides, in part, that as used in § 1031(a), the words “like kind” have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment

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and not primarily for sale.

Rev. Rul. 64-237, 1964-2 C.B. 319, held that in determining whether replacement property acquired by an investor is “similar or related in service or use” to involuntarily converted property within the meaning of § 1033, the nature of the service or use that the original and replacement properties have to the taxpayer must be similar. In applying this test, a determination must be made as to: (1) whether the properties are of a similar service to the taxpayer, (2) the nature of the business risks connected with the properties, and (3) what the properties demand of the taxpayer in the way of management services and relations to its tenants.

Rev. Rul. 83-49, 1983-1 C.B. 191, held that severance damages received as part of a condemnation award for a portion of the taxpayer’s property may be accorded nonrecognition treatment under § 1033(g)(1) even though the taxpayer reinvests the severance damages in property that is not similar or related in use to the condemned property. The taxpayer owned land that it leased to a farmer for agricultural purposes. A portion of the land was condemned by the state for use as an interstate highway, and the remainder of the land was not adequate to sustain a profitable farming operation. Therefore, the taxpayer used its severance damages to purchase a motel complex, which the taxpayer managed and directly operated for its own account. The Service found that the taxpayer’s investment of the proceeds realized from the condemnation of agricultural property held as a passive investment in an urban motel complex, actively managed and operated by the taxpayer, constituted a continuing interest in real property. Therefore, the replacement property qualified as like-kind property within § 1033(g).

In the present case, Taxpayer has not identified its replacement property as of the date of this ruling. However, because Taxpayer’s land is involuntarily converted through a threat of condemnation, Taxpayer may use either the “similar or related in service or use” standard of § 1033(a)(2)(A) or the like-kind standard of § 1033(g). Therefore, as long as Taxpayer’s replacement property is either similar in related service or use to its converted property, or like kind to its converted property, the replacement property will constitute as qualified replacement property under § 1033.

CONCLUSIONS

- (1) Proceeds from the sale by Taxpayer of the Fee Acres (excluding minerals) to the Corps constitute proceeds from an involuntary conversion for purposes of § 1033(a).
- (2) Taxpayer’s land constitutes real property that meets the requirements of § 1033(g)(1), and is therefore eligible for the three-year replacement period under § 1033(g).

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- (3) The purchase of replacement land by Taxpayer within the three-year period that is either similar or related in service or use under § 1033(a) or like-kind under § 1033(g) will be qualified replacement property for the purposes of § 1033.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) 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 the taxpayer.

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,
Kimberly L. Koch
Assistant to the Chief, Branch 1
Office of the Associate Chief Counsel
(Income Tax & Accounting)