Replacement After Involuntary Conversion (Scenario 1)

- **Scenario #1**: Taxpayer operates a manufacturing plant. The plant is destroyed by fire, with loss of plant, equipment, materials, and finished goods.
Various Scenarios—Involuntary Conversions (Scenario 2)

• **Scenario #2**: Taxpayer operates a manufacturing plant. The property upon which the plant is situated is condemned by the State.

Various Scenarios—Involuntary Conversions (Scenario 3)

• **Scenario #3**: Taxpayer operates a manufacturing plant. The plant is destroyed in a Federally declared disaster.
  
  • Alternatively, Taxpayer leased the plant to another manufacturer for use in the latter's business.
Various Scenarios—Involuntary Conversions (Scenario 4)

- Scenario #4: Taxpayer operates part of a plant in its own manufacturing business and leases part of the facility to a third party. The plant is destroyed by fire.

What is an “Involuntary Conversion”? 
Tax Consequences of Involuntary Conversions

- Section 1231(a)(3)
- Section 1033(a)(2)(A) election
- Qualification for nonrecognition treatment:
  - Replacement period
  - Replacement purpose
  - “Similar or related in service or use”

“Similar or Related in Service or Use”

- Regulation sec. 1.1033(a)-2(c)(9)
  - unimproved real estate/improved real estate
  - real property/ reduction of indebtedness incurred in purchase of leasehold
  - tug/barge
“Similar or Related in Service or Use”

- **Liant Record** (2nd Cir. 1962)
  - Commercial office bldg/apt. bldg.
- **Revenue Ruling 64-237**: IRS’s turn-about
  - Distinguish: Owner-users/owner-lesseors

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“Functional Use” Test for Owner-Users

- Compare physical characteristics
- Compare end uses
- Examples:
  - bowling alley/billiards center
  - mobile home park/motel
  - land-based seafood processing plant/ocean floating seafood processing plant
“Relationship” Test for Owner-Lessors

- Similarity in taxpayer’s relationship to the properties
- Properties may have different end uses
- Compare services to the taxpayer
- Compare nature of business risks
- Compare extent of taxpayer’s required involvement
- Examples
  - Changes in taxpayer’s responsibility for maintenance
  - Net leased hotel/hotel operated by taxpayer
  - Part rental/part business property

Condemnation of Real Property

- Section 1033(g)
- Limited to real property
- Like kind standard of replacement
- Same standard for 1031 and 1033:
  - Congress: Continuity of investment
  - Congress concern: Saw no justification for stricter standard of replacement in 1033
Compare: 1033(a) vs. 1033(g)

• Section 1033(a) applicable to all property
• Section 1033(a) has no holding purpose
• Section 1033(a) not constrained by Rev. Rul. 67-255
• Section 1033(g) allows replacement of trade or business property with rental property and vice versa

Federally Declared Disasters

• Section 1033(h)(2)
• Limited to trade or business and investment property
• Replacement with any tangible property used in trade or business
  – Congress: Allow taxpayers flexibility to reinvest in new business venture
Current Law—Scenario 1

- **Scenario #1**: Taxpayer operates a manufacturing plant. The plant is destroyed by fire, with loss of plant, equipment, materials, and finished goods.
- **1033(a)**: Must satisfy "functional use" test
  - See Rev. Rul. 64-237

Current Law—Scenario 2

- **Scenario #2**: Taxpayer operates a manufacturing plant. The property upon which the plant is situated is condemned by the State.
- **Alternatives**:
  - **1033(a)**: Must satisfy “functional use” test
    (see Rev. Rul. 64-237)
  - **1033(g)**
Current Law—Scenario 3

- **Scenario #3**: Taxpayer operates a manufacturing plant. The plant is destroyed in a Federally declared disaster.
- Alternatively, Taxpayer leased the plant to another manufacturer for use in the latter’s business.
- Alternatives:
  - 1033(a): Must satisfy “functional use” test (see Rev. Rul. 64-237)
  - 1033(h)(2)

Current Law—Scenario 4

- **Scenario #4**: Taxpayer operates part of a plant in its own manufacturing business and leases part of the facility to a third party. The plant is destroyed by fire.
- -1033(a): Must satisfy tests for owner-users and owner-lesseors (Rev. Rul. 64-237 & Rev. Rul. 79-261)
Option for Tax Reform

• Simplification: Amend 1033(a)
• New general standard of replacement based on continuity of investment
• Applicable to all trade or business or rental property
• Correct for perceived unfairness

Option for Tax Reform: Alternative 1

• Use 1033(h)(2) as model
• Modify 1033(h)(2):
  – Applicable to all involuntary conversions
  – Allow replacement with rental property as under 1033(a) and (g)
  – No holding purpose for replacement property as under 1033(a)
  – Replacement with intangible property
Option for Tax Reform: 
Alternative 2

• Use 1033(g) as model
• Modify 1033(g):
  – Applicable to all involuntary conversions
  – Applicable to all business or rental property
  – No holding purpose for replacement property as under 1033(a)
  – Address Revenue Ruling 67-255

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