31 T.C. 505 (1958)

For nonrecognition of gain in an involuntary conversion under Section 112(f) of the Internal Revenue Code of 1939, the replacement property must be "similar or related in service or use" to the converted property, based on a "functional" test.

Summary

Thomas McCaffrey, Jr. received proceeds from the condemnation of his Pittsburgh property, used as a parking lot. He reinvested these funds by purchasing stock in a corporation that owned a property in New Castle, PA, leased to the Federal Civil Defense Administration for warehouse use. The Tax Court held that McCaffrey was not entitled to nonrecognition of gain under Section 112(f) of the Internal Revenue Code of 1939 because the warehouse use of the New Castle property was not sufficiently similar or related to the parking lot use of the Pittsburgh property. The court emphasized a "functional" test, focusing on the actual use and purpose of the properties rather than merely their general industrial classification.

Facts

- Thomas McCaffrey, Jr. acquired an interest in a Pittsburgh property in 1947 used as a parking lot.
- In 1952, the property was condemned by the Commonwealth of Pennsylvania.
- McCaffrey received $57,477.27 from the condemnation.
- He investigated replacement properties and found a property in New Castle, PA, owned by the Arsenal Corporation, consisting of a building leased to the Federal Civil Defense Administration for warehouse purposes.
- McCaffrey purchased all of the issued and outstanding shares of Arsenal Corporation for $64,029.45 to obtain control of the New Castle property.
- The IRS determined a deficiency in McCaffrey's income tax, claiming the gain from the condemnation should be recognized.

Procedural History

The IRS determined a deficiency in McCaffrey's income tax. McCaffrey petitioned the U.S. Tax Court, which decided the case based on stipulated facts and legal arguments, ruling in favor of the Commissioner.

Issue(s)

1. Whether the Arsenal Corporation's property, leased for warehouse use, was "similar or related in service or use" to the condemned Pittsburgh property, which was used as a parking lot, under Section 112(f) of the Internal Revenue Code of 1939.

Holding

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1. No, because the New Castle property was used for warehouse purposes, which was not sufficiently similar to the parking lot use of the condemned property to qualify for nonrecognition of gain.

Court's Reasoning

The court applied the "functional" test to determine if the properties were "similar or related in service or use." The court cited *Lynchburg National Bank & Trust Co. v. Commissioner*, which affirmed that the test is functional. The court reasoned that the mere fact that both properties were industrial was insufficient. It focused on the actual use of the Pittsburgh property as a parking lot and the New Castle property as a warehouse. The court noted that while the New Castle property had some parking incidental to the Civil Defense use, this was not the primary function and did not make the properties similar in use. The court highlighted that the taxpayer, an industrial realtor, sought to make the New Castle property warehouse, which is what it was used for, rather than as a parking lot.

Practical Implications

This case emphasizes the importance of the "functional use" test in determining whether a taxpayer qualifies for nonrecognition of gain from an involuntary conversion under Section 112(f) or its successor in the Internal Revenue Code. Attorneys should advise clients that merely replacing one type of real estate with another, even of similar general classification (e.g., industrial property), is insufficient for nonrecognition. The critical factor is whether the properties serve a similar function for the taxpayer. This case also highlights the care that must be taken when structuring transactions to ensure the new property is put to a substantially similar use to the old property. Failure to meet the functional test results in taxable gains that the taxpayer may not have anticipated, or prepared for.

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