Estate of Herrick L. Johnston, Deceased, Margaret V. Johnston, Executrix, and Margaret V. Johnston, Individually, Petitioners v. Commissioner of Internal Revenue, Respondent, 51 T. C. 290 (1968); 1968 U. S. Tax Ct. LEXIS 22

A 'purchase' for the purpose of involuntary conversion tax relief under IRC Section 1033 occurs when ownership, including the burdens and benefits of property, is acquired.

Summary

In Estate of Johnston v. Commissioner, the U. S. Tax Court clarified that for a 'purchase' to qualify under IRC Section 1033 for nonrecognition of gain from involuntary conversion, the taxpayer must have acquired ownership of the replacement property within the statutory period. Herrick L. Johnston entered into an executory contract to buy the Nordhoff Street property in 1958 but did not receive legal title or the burdens and benefits of ownership until January 1959. The court held that the purchase was not timely under Section 1033, as the critical elements of ownership did not transfer until after the statutory deadline. This case underscores the necessity of actual property acquisition for tax relief purposes.

Facts

Herrick L. Johnston sold property in Columbus, Ohio, under threat of condemnation in May 1957, realizing a gain of $182,876. 38. To replace this property, Johnston entered into an agreement on October 24, 1958, to purchase the Nordhoff Street property in California for $200,000, with a down payment of $10,000. The purchase was set to close through an escrow arrangement, with the title transfer scheduled for January 23, 1959. Until that date, the seller, Harold C. Boyer, retained possession, paid taxes, and maintained insurance on the property. Johnston's purchase-money note interest did not accrue until the escrow closed.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Johnston's income taxes for several years, including 1957. Johnston and the Commissioner agreed on all adjustments except the treatment of the gain from the involuntary conversion of the West Poplar Street property. The case proceeded to the U. S. Tax Court, where the sole issue was whether the Nordhoff Street property was 'purchased' before the end of 1958, thereby qualifying as replacement property under Section 1033.

Issue(s)

1. Whether the Nordhoff Street property was 'purchased' by Herrick L. Johnston on or before December 31, 1958, so as to constitute qualified replacement property under IRC Section 1033(a)(3)(A) and (B).

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Holding

1. No, because the burdens and benefits of property ownership, including legal title, did not pass to Johnston until January 23, 1959, after the statutory deadline for a qualifying purchase under Section 1033.

Court’s Reasoning

The court analyzed the term ‘purchase’ in the context of Section 1033, concluding that it requires the acquisition of property ownership. The court referenced California law, which recognized the escrow instructions as an enforceable contract, but emphasized that the key factor for tax purposes was the transfer of ownership. The court noted that Johnston did not receive legal title, possession, or other incidents of ownership until after the statutory period. The court distinguished this case from others like Ted F. Merrill, where some burdens and benefits had transferred, and underscored that the purpose of Section 1033 is to provide tax relief when a taxpayer reestablishes a prior capital commitment within the statutory timeframe.

Practical Implications

This decision highlights the importance of timely acquisition of replacement property to qualify for tax relief under Section 1033. Attorneys advising clients on involuntary conversions must ensure that all elements of property ownership, including title and the burdens and benefits of ownership, are transferred within the statutory period. This case may influence how practitioners structure escrow agreements to ensure compliance with tax deadlines. Businesses and individuals should be cautious about relying on executory contracts alone for tax purposes and should consider applying for extensions if necessary. Subsequent cases applying this ruling may further refine the definition of ‘purchase’ in tax law, impacting real estate and tax planning strategies.

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