James River Apartments, Inc. v. Commissioner, 54 T. C. 618 (1970)

Failure to report gain from an involuntary conversion in a tax return constitutes a constructive election under IRC Section 1033, and the statute of limitations for assessing deficiencies does not begin until proper notification of replacement or intent not to replace is given.

Summary

James River Apartments, Inc. constructed apartments on leased land at Fort Eustis, which were condemned by the U. S. government in 1957. The taxpayer did not report the resulting gain in its 1958 tax return, effectively making a constructive election under IRC Section 1033 to defer recognition of the gain. The issue was whether the IRS could assess a deficiency for 1958, given the statute of limitations. The Tax Court held that the IRS was not barred from assessing a deficiency because the taxpayer failed to notify the IRS of the replacement of the converted property or its intention not to replace it within the statutory period, as required by Section 1033(a)(3)(C)(i).

Facts

James River Apartments, Inc. leased land from the U. S. government and constructed apartment buildings at Fort Eustis, Virginia, completed in 1954. In October 1957, the U. S. government initiated condemnation proceedings, assumed the mortgage on the property, and deposited an estimated just compensation of $182,000, which the taxpayer withdrew. The taxpayer intended to replace the condemned property but did not report the gain from the condemnation in its fiscal year 1958 tax return. The condemnation was settled in 1964, and the taxpayer reported the gain in its 1964 return, electing to treat the condemnation as an involuntary conversion under IRC Section 1033.

Procedural History

The IRS issued a statutory notice of deficiency in 1967, asserting deficiencies for both 1958 and 1964. The taxpayer petitioned the U. S. Tax Court, arguing that the statute of limitations barred the assessment of any deficiency for 1958. The parties agreed that gains were realized in 1958 and 1964, but the key issue was whether the IRS could assess a deficiency for 1958 under the statute of limitations provided by Section 1033(a)(3)(C)(i).

Issue(s)

1. Whether the taxpayer’s failure to report the condemnation gain in its 1958 tax return constituted a constructive election under IRC Section 1033.
2. Whether the IRS was barred from assessing a deficiency for 1958 due to the statute of limitations under IRC Section 1033(a)(3)(C)(i).

Holding

1. Yes, because the taxpayer's failure to include the gain in its 1958 return constituted a constructive election to defer recognition of the gain under Section 1033.
2. No, because the taxpayer did not notify the IRS of the replacement of the converted property or its intention not to replace it, as required by Section 1033(a)(3)(C)(i), thus the statute of limitations did not begin to run.

Court's Reasoning

The court applied the rules of IRC Section 1033, which allow for nonrecognition of gain from an involuntary conversion if the taxpayer elects to replace the converted property within a specified period. The court found that the taxpayer's failure to report the gain in its 1958 return was a constructive election under the regulations, which state that such a failure constitutes an election to defer recognition of the gain. The court emphasized that the statute of limitations for assessing deficiencies under Section 1033(a)(3)(C)(i) does not begin until the taxpayer notifies the IRS of the replacement of the converted property or an intention not to replace it. The taxpayer's 1959 return did not provide such notification, as it did not explicitly state an intention to replace or not replace the property. The court rejected the taxpayer's argument that a "failure to replace" could trigger the statute of limitations, as the statute requires notification of "an intention not to replace. "

Practical Implications

This decision clarifies that taxpayers must explicitly notify the IRS of their intention regarding the replacement of involuntarily converted property to trigger the statute of limitations for deficiency assessments under IRC Section 1033. Practitioners should ensure clients report gains from involuntary conversions accurately and, if electing to defer recognition, promptly notify the IRS of their replacement intentions or decisions not to replace. The case also underscores the importance of timely reporting and the potential consequences of failing to do so, as the IRS retains the ability to assess deficiencies for extended periods if proper notification is not given. Subsequent cases, such as *Feinberg v. Commissioner*, have reinforced these principles, emphasizing the necessity of clear communication with the IRS in such situations.

