R.A. Stewart & Co. v. Commissioner, 57 T.C. 122 (1971)

An advance payment from a condemning authority, received without restriction on use, constitutes realized gain under the claim of right doctrine, starting the period for replacement property to qualify for nonrecognition of gain under Section 1033.

Summary

R.A. Stewart & Co. received an advance payment from New York City for condemned property in 1965, exceeding its basis in the property. Stewart sought nonrecognition of gain under Section 1033, arguing gain wasn't realized until the final condemnation award in 1968. The Tax Court held that the 1965 advance payment, received under a claim of right, triggered gain realization and the statutory replacement period. Because Stewart replaced the property outside the one-year replacement period and did not seek an extension, nonrecognition was denied. This case clarifies that receipt of unrestricted advance condemnation payments starts the clock for Section 1033 replacement.

Facts

Petitioner, R.A. Stewart & Co., owned property in New York City used for its business.

On April 22, 1965, New York City condemned Stewart's property, with title vesting in the city on that date.

On December 15, 1965, Stewart received an "involuntary advance payment" of $70,000 from the city, without restrictions on its use.

Stewart's adjusted basis in the property at the time was $55,005.53.

On November 6, 1968, Stewart received a further payment of $104,570.95 as a "Second Separate and Partial Final Decree".

Stewart purchased replacement property on April 21, 1969.

Stewart did not apply for an extension of time to replace the property.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Stewart's 1965 and 1966 federal income taxes.

R.A. Stewart & Co. petitioned the Tax Court contesting the deficiency for 1965, arguing for nonrecognition of gain under Section 1033.

The Tax Court ruled in favor of the Commissioner.

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Issue(s)

1. Whether the advance payment received by the petitioner in 1965 from the City of New York for condemned property constituted a realization of gain for purposes of Section 1033 of the Internal Revenue Code.

2. If gain was realized in 1965, whether the petitioner met the statutory requirements for nonrecognition of gain under Section 1033 by replacing the property within the prescribed time period.

Holding

1. Yes, because the advance payment received by the petitioner in 1965, without restrictions on its use, constituted realized gain under the claim of right doctrine.

2. No, because the petitioner did not replace the property within one year after the close of the taxable year in which gain was realized (1965), nor did it obtain an extension of time for replacement.

Court's Reasoning

The court applied the claim of right doctrine, stating, "Amounts received by a taxpayer under a claim of right, not subject to any limitation on use, are taxable to the taxpayer in the year received…" even if there's a potential obligation to repay.

The court found the $70,000 advance payment in 1965 met this definition as it was paid without restrictions on use, even though the final condemnation award was still pending.

Section 1033(a)(3)(B)(i) requires replacement property to be acquired within one year after the close of the first taxable year in which any part of the gain is realized. The court determined the replacement period began in 1965 when gain was realized from the advance payment.

Since the replacement property was acquired in 1969, and no extension was sought, Stewart failed to meet the statutory deadline for nonrecognition under Section 1033.

The court distinguished cases cited by the petitioner where gain recognition was deferred until final award determination, noting that in those cases, no advance payments were made.

Practical Implications

This case establishes that taxpayers receiving advance payments in condemnation proceedings must be aware that such payments can trigger immediate gain recognition for tax purposes, even before final awards are determined.

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Legal practitioners should advise clients receiving advance condemnation payments to immediately consider the implications for Section 1033 like-kind replacement and the associated timeframes.

Taxpayers seeking nonrecognition under Section 1033 in condemnation cases must diligently track the replacement period starting from the year of receiving advance payments, not just the final award year.

This ruling emphasizes the importance of understanding the claim of right doctrine in the context of involuntary conversions and the strict deadlines associated with Section 1033 nonrecognition.

Later cases applying this ruling would likely focus on whether advance payments are truly unrestricted and whether taxpayers took appropriate steps to comply with Section 1033’s replacement rules from the point of advance payment receipt.

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