58 T.C. 459 (1972)

Judgment proceeds are taxed according to the nature of the underlying claim; proceeds compensating for lost capital are treated as capital gains (to the extent they exceed basis), while proceeds compensating for lost income (like interest) are taxed as ordinary income; furthermore, voluntary demolition of property does not qualify as an involuntary conversion for non-recognition of gain under Section 1033.

Summary

Wheeler demolished a building (Lighthouse Club) on his land based on an agreement with White for financing improvements. When White failed to provide financing, Wheeler sued and won a judgment that included compensation for the building's value and interest for the delay. Wheeler had already recovered his basis in the property through depreciation and a prior land sale. The Tax Court held that the judgment proceeds were taxable. The portion compensating for the building was capital gain because Wheeler had zero basis, and the interest portion was ordinary income. The court also ruled that reinvesting the judgment proceeds in a motel did not qualify for non-recognition under sections 1031 or 1033 because the demolition was voluntary and not an involuntary conversion, and a sale and repurchase does not constitute an exchange.

Facts

Petitioner Wheeler owned land with a building (Lighthouse Club) with a basis of $47,015.13.

In 1956, Wheeler agreed with White that White would finance improvements on Wheeler's land.

Relying on this agreement, Wheeler demolished the Lighthouse Club in 1956 or 1957.

White failed to secure financing.

Wheeler sued White for breach of contract in Texas state court.

In 1958, Wheeler sold the land for $28,160.45 and reported a capital gain, having reduced his basis by $26,452.87 in depreciation on the Lighthouse Club, resulting in an adjusted basis of $20,562.26.

In 1967, Wheeler received $49,365.55 from White in satisfaction of a judgment, including $30,000 for the building's value and $18,000 interest.

Wheeler reinvested approximately $19,000 of the judgment proceeds in a motel.

Wheeler did not report any of the judgment proceeds as income in 1967.

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Procedural History

The Commissioner of Internal Revenue determined a deficiency in Wheeler's 1967 income tax.

Wheeler petitioned the Tax Court to contest the deficiency.

The Texas District Court initially dismissed Wheeler's suit against White, which was affirmed by the Court of Civil Appeals of Texas.

The Supreme Court of Texas reversed, holding Wheeler had a cause of action under promissory estoppel.

Following the Texas Supreme Court's reversal, the Texas District Court awarded Wheeler a judgment, which is the subject of this Tax Court case.

Issue(s)

1. Whether the judgment proceeds received by Wheeler in 1967 are taxable as income, either as capital gain or ordinary income.

2. If the judgment proceeds are taxable income, whether any portion qualifies for non-recognition under Section 1031 or Section 1033 of the Internal Revenue Code.

Holding

1. Yes, the judgment proceeds are taxable income. The portion attributable to the value of the demolished building is taxable as capital gain, and the portion attributable to interest is taxable as ordinary income because the judgment substitutes for what it was intended to replace: the building (a capital asset) and compensation for delayed payment (interest income).

2. No, no portion of the judgment proceeds qualifies for non-recognition under Section 1031 or Section 1033 because Section 1031 requires an exchange of like-kind property, not a sale and repurchase, and Section 1033 applies to involuntary conversions, not voluntary demolitions.

Court's Reasoning

The court reasoned that the taxability of judgment proceeds is determined by the nature of the underlying claim. Citing *Hort v. Commissioner*, the court stated, "Amounts received in satisfaction of a judgment are taxed in the same manner as the proceeds would have been taxed if voluntarily paid."

Regarding capital gain, the court noted that because Wheeler had already recovered his entire basis in the building through depreciation and the land sale, his adjusted basis in the building was zero. Therefore, the portion of the judgment compensating

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for the building’s value was entirely capital gain, less legal expenses.

Regarding ordinary income, the court held that the interest portion of the judgment compensated Wheeler for the delayed receipt of damages and is therefore taxed as ordinary income, citing *Kieselbach v. Commissioner* and *Spangler v. Commissioner*.

Addressing Section 1031, the court stated that it does not apply because Wheeler sold the land for cash and then reinvested, which is not an “exchange” of like-kind property as required by the statute, citing *Carlton v. United States*.

Regarding Section 1033, the court found it inapplicable because the demolition of the Lighthouse Club was voluntary, not an involuntary conversion due to casualty or condemnation. The court emphasized that Section 1033 is intended for “public takings and casualty-like conversions,” quoting *Dear Publication & Radio, Inc. v. Commissioner* to define involuntary conversions as events “wholly beyond control of the one whose property has been taken.”

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