Graphic Press, Inc. v. Commissioner, 60 T. C. 674 (1973)

A condemnation award can be allocated between payment for property taken and payment for a waiver of rights, with the latter being taxable as ordinary income.

Summary

Graphic Press, Inc. received a $725,000 condemnation award from the State of California, which it treated as proceeds from an involuntary conversion under IRC Section 1033. The Tax Court held that $407,192 of the award was payment for Graphic Press's waiver of its right to have its machinery condemned, thus taxable as ordinary income. The court reasoned that the lump-sum award could be allocated based on the underlying transaction's substance, not just the contract's language. This decision emphasizes the importance of examining the true nature of payments in condemnation cases for tax purposes, impacting how similar cases are analyzed and how attorneys structure such transactions.

Facts

In December 1966, the State of California notified Graphic Press, Inc. of its intent to condemn the company's property, including land, building, and machinery, for a freeway expansion. The machinery, considered part of the real property under state law, had a fair market value significantly higher than what the State could realize upon resale. Negotiations led to an agreement where Graphic Press would retain and remove most of its machinery, thus waiving its right to have it condemned. The State paid $725,000 for the property, which Graphic Press reinvested and treated as proceeds from an involuntary conversion under IRC Section 1033.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Graphic Press's federal income tax, asserting that $407,192 of the $725,000 was ordinary income rather than proceeds from an involuntary conversion. Graphic Press petitioned the U. S. Tax Court, which upheld the Commissioner's determination, finding that part of the payment was for the waiver of the right to have the machinery condemned.

Issue(s)

1. Whether the entire $725,000 condemnation award received by Graphic Press, Inc. can be treated as proceeds from an involuntary conversion under IRC Section 1033, or whether a portion of it must be allocated to ordinary income.

Holding

1. No, because the court found that $407,192 of the $725,000 represented payment for Graphic Press's waiver of its right to have the machinery condemned, which constituted ordinary income ineligible for nonrecognition under IRC Section 1033.

© 2025 SCOTUSreports.com. All rights reserved.

Court’s Reasoning

The Tax Court applied the principle that taxation is a practical matter and that the Commissioner can look behind the apparent simplicity of a lump-sum award to determine its true nature. The court found that the agreement between Graphic Press and the State explicitly included a waiver of the right to have the machinery condemned, which was valuable to the State. This waiver was not merely incidental but a bargained-for element of the transaction, justifying the allocation of part of the payment to ordinary income. The court rejected Graphic Press’s argument that the contract’s language allocating the entire payment to the property was binding, citing cases like *Vaira v. Commissioner* and *Russell C. Smith*, which support looking at the substance of transactions. The majority opinion also noted that payments for waivers of rights to sell property are typically treated as ordinary income, not capital gains. A concurring opinion by Judge Scott agreed with the result but suggested that any portion of the payment used for moving expenses could be deductible as a business expense. Dissenting opinions argued that the entire award should be treated as proceeds from an involuntary conversion, emphasizing the purpose of IRC Section 1033 to prevent inequitable taxation.

Practical Implications

This decision underscores the importance of carefully structuring and documenting condemnation agreements to avoid unintended tax consequences. Attorneys should be aware that the IRS may challenge the tax treatment of lump-sum condemnation awards, particularly when they include payments for waivers or other non-property elements. The case suggests that parties to such agreements should clearly delineate the purpose of each payment to prevent allocation to ordinary income. For businesses facing condemnation, this ruling implies that they may need to negotiate separate payments for property and any waivers to maintain favorable tax treatment under IRC Section 1033. Subsequent cases have cited *Graphic Press* when analyzing the tax treatment of condemnation awards, highlighting its influence on legal practice in this area.

© 2025 SCOTUSreports.com. All rights reserved.