McShain v. Commissioner, 65 T. C. 686 (1976)

A decision not to replace property under IRC §1033(a)(3) must be made before any actual replacement occurs and within the statutory replacement period.

Summary

The McShains elected to defer gain recognition under IRC §1033(a)(3) after receiving condemnation proceeds in 1967, which they reinvested into a hotel by 1969. They later attempted to revoke this election to gain more favorable tax treatment under IRC §453 for the hotel's 1970 sale. The Tax Court held that the McShains could not revoke their election because their decision not to replace came after the statutory period and after actual replacement had occurred, emphasizing that such a decision must precede any replacement in fact to be valid.

Facts

John McShain received a condemnation award of $2,890,000 from the District of Columbia in 1967 for property he owned. He elected to defer gain recognition under IRC §1033(a)(3) by reinvesting the proceeds into a hotel built on leased land in Philadelphia by 1969. In 1970, McShain sold the hotel, claiming installment sale treatment under IRC §453. He then sought to revoke his §1033(a)(3) election to avoid the basis adjustment requirements that would affect the 1970 tax treatment of the sale.

Procedural History

The IRS disallowed the installment sale treatment and issued a notice of deficiency for 1969 and 1970. McShain filed a motion for partial summary judgment in the Tax Court, seeking to revoke his prior §1033(a)(3) election. The Tax Court denied the motion, ruling that the revocation was untimely.

Issue(s)

1. Whether a taxpayer may revoke an election made under IRC §1033(a)(3) after the statutory replacement period has expired and after replacement property has been acquired.

Holding

1. No, because the decision not to replace must be made within the statutory replacement period and before any actual replacement occurs.

Court's Reasoning

The Tax Court interpreted the regulation governing §1033(a)(3) elections, specifically Treas. Reg. §1. 1033(a)-2(c)(2), to mean that a decision not to replace must be made prior to any actual reinvestment of the conversion proceeds. The court emphasized that the term “replacement” in the regulation refers to actual reinvestment, not just a legal decision. Since McShain had already replaced the condemned property with the hotel before attempting to revoke his election, his decision was untimely. The court also noted that allowing post-replacement revocations would undermine the annual tax accounting system by permitting taxpayers to use hindsight to their advantage. The court cited precedent that generally prohibits revocation of elections to the detriment of the revenue.

Practical Implications

This decision underscores the importance of timely decision-making in tax elections. Taxpayers must carefully consider their options under §1033(a)(3) before the statutory period expires and before any actual replacement occurs. The ruling reinforces the IRS’s position against allowing revocations that could harm the revenue, particularly when based on hindsight after replacement property has been acquired. Practitioners should advise clients to thoroughly evaluate their tax strategies at the time of conversion and not rely on the possibility of later revoking an election. This case also highlights the need to correctly apply the basis rules when electing nonrecognition under §1033 to avoid adverse tax consequences in subsequent years.

