McShain v. Commissioner, 68 T. C. 154 (1977)

A leasehold interest of 30 years or more is considered like-kind property to a fee simple interest in real estate for purposes of nonrecognition of gain under section 1033 of the Internal Revenue Code.

Summary

John McShain received a condemnation award for his Washington, D. C. property in 1967 and elected to defer recognition of the gain under section 1033 of the Internal Revenue Code by reinvesting in a Holiday Inn in Philadelphia. The Tax Court ruled that the Philadelphia property, held under a 35-year lease, was like-kind property to the condemned Washington property, thus upholding McShain's section 1033 election. The court's decision was based on the IRS regulations defining like-kind property and the fact that McShain's interest in the condemned building was a present possessory interest at the time of the condemnation.

Facts

In 1950, John McShain purchased an 85% interest in two parcels of unimproved real estate in Washington, D. C. , which were leased to Capitol Court Corp. until February 1, 1967. On January 20, 1967, the U. S. filed a condemnation complaint, and the lease expired on February 1, 1967, with the building reverting to McShain and his co-owner. On May 22, 1967, McShain received $2,890,000 from the condemnation award and elected to defer recognition of the $2,616,000 gain under section 1033 by reinvesting in a Holiday Inn in Philadelphia, held under a 35-year lease from November 24, 1969.

Procedural History

McShain filed a motion for summary judgment in the U. S. Tax Court on December 6, 1976, arguing that his section 1033 election was invalid. The Tax Court had previously ruled in a related case that McShain's attempt to revoke his section 1033 election was untimely. On May 2, 1977, the Tax Court denied McShain's motion for summary judgment, holding that the Philadelphia property was a valid like-kind replacement for the condemned Washington property.

Issue(s)

1. Whether John McShain's interest in the Washington property was a partnership interest, thus requiring the partnership to reinvest the condemnation proceeds to elect nonrecognition under section 1033.
2. Whether the Philadelphia property, held under a 35-year lease, qualified as like-kind property to the condemned Washington property for purposes of section 1033.

Holding

© 2025 SCOTUSreports.com. All rights reserved.

1. No, because McShain and his co-owner were co-owners, not partners, as they had only passive obligations under the lease agreement.
2. Yes, because under section 1. 1031(a)-1(c) of the Income Tax Regulations, a leasehold of 30 years or more is considered like-kind to a fee simple interest in real estate.

Court’s Reasoning

The Tax Court applied the definition of a partnership under section 7701(a)(2) and found that McShain and his co-owner were co-owners, not partners, as they did not actively carry on a trade or business. The court then applied section 1. 1031(a)-1(c) of the Income Tax Regulations, which states that a leasehold of 30 years or more is like-kind to a fee simple interest in real estate. The court rejected McShain’s argument that his interest in the Washington building was only a future interest, as the lease expired before the condemnation award was finalized, making McShain the sole owner of the building at the time of the condemnation. The court also found that McShain’s selection of the Philadelphia property as a like-kind replacement was deliberate and in accordance with section 1033.

Practical Implications

This decision clarifies that a long-term leasehold interest can be considered like-kind property to a fee simple interest for purposes of nonrecognition of gain under section 1033. Taxpayers should carefully consider the nature of their property interests when electing nonrecognition under section 1033, as the court will look to the substance of the ownership interest at the time of the condemnation. This case also highlights the importance of timely revocation of section 1033 elections, as the court will not allow a taxpayer to revoke an election after the statutory period has expired. The decision has been applied in subsequent cases to determine the validity of section 1033 elections and the like-kind nature of replacement property.

© 2025 SCOTUSreports.com. All rights reserved.