Tiefenbrunn v. Commissioner, 74 T.C. 1566 (1980)

Interest earned on condemnation awards is considered ordinary income and is not eligible for non-recognition as part of the gain from involuntary conversion under Section 1033 of the Internal Revenue Code; depreciation deductions for trust property are allocable to beneficiaries, not the trust itself, when the trust instrument and state law do not require or permit a depreciation reserve.

Summary

The Tax Court addressed two issues: (1) whether interest received as part of a condemnation award is taxable income or part of the non-recognized gain from an involuntary conversion under IRC § 1033, and (2) whether a trust or its beneficiaries are entitled to depreciation deductions on trust property. The court held that the interest portion of the condemnation award is taxable as ordinary income because it compensates for delayed payment, not the property itself. Regarding depreciation, the court determined that under Connecticut law and the trust's will, no depreciation reserve was permitted, thus allocating depreciation deductions to the income beneficiaries, not the trust.

Facts

The Carl Roessler Trust, a simple testamentary trust, owned commercial property in New Haven, Connecticut.

In 1968, the property was condemned by the New Haven Redevelopment Agency.

The agency initially deposited $1,060,000 as compensation.

In 1971, the Connecticut Superior Court awarded the trust $1,700,000 for the property plus $103,912.76 in interest.

Between 1969 and 1972, the trust reinvested the condemnation proceeds into similar real properties exceeding the award amount.

The trust claimed depreciation deductions on its tax returns, while the Commissioner argued that the interest was taxable income and the depreciation should be allocated to the beneficiaries.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes related to the trust income for 1971 and 1973.

The taxpayers, income beneficiaries of the trust, petitioned the Tax Court contesting these deficiencies.

© 2025 SCOTUSreports.com. All rights reserved.

The case was submitted to the Tax Court on stipulated facts.

Issue(s)

1. Whether the "interest" portion of a condemnation award qualifies for non-recognition of gain under Section 1033 of the Internal Revenue Code as part of an involuntary conversion.

2. Whether the Carl Roessler Trust is entitled to depreciation deductions on its real property under Section 167(h) of the Internal Revenue Code, or whether these deductions should be allocated to the income beneficiaries.

Holding

1. No. The "interest" received as part of the condemnation award is not part of the gain from the involuntary conversion of property and is therefore includable in the trust's income and taxable to the beneficiaries because it is compensation for delayed payment, not payment for the property itself.

2. No. The trust is not entitled to depreciation deductions because neither the trust instrument nor Connecticut law permits the establishment of a depreciation reserve; therefore, the depreciation deductions are allocable to the income beneficiaries.

Court's Reasoning

Interest Income: The court relied on *Kieselbach v. Commissioner*, which established that interest in condemnation awards is ordinary income, not capital gain. The court quoted *Kieselbach* stating, "Whether one calls it interest on the value or payments to meet the constitutional requirement of just compensation is immaterial. It is income * * * paid to the taxpayers in lieu of what they might have earned on the sum found to be the value of the property on the day the property was taken. It is not a capital gain upon an asset sold * * *" The court reasoned that Section 1033 only applies to gain from the conversion of property, and interest is not gain from the property itself but compensation for delayed payment. The court distinguished *E.R. Hitchcock Co. v. United States*, noting that while condemnation awards should not always be separated into components, interest is fundamentally different from moving expenses, which are intrinsically linked to the property's value.

Depreciation Deduction: The court interpreted Section 167(h) and its regulations, which allocate depreciation between trusts and beneficiaries. The regulations state that depreciation is allocated based on trust income distribution unless the trust instrument or local law requires or permits a depreciation reserve. Analyzing the testator's will, the court found no provision for a depreciation reserve beyond a specific $25,000 reserve for other expenses. Furthermore, the court determined that Connecticut law, while defining trust income broadly, does not explicitly allow for depreciation reserves, especially when income beneficiaries and remaindermen are

© 2025 SCOTUSreports.com. All rights reserved.

the same. The court cited regulation 1.167(h)-1(b), example (1), which indicates that if trust income is distributable to beneficiaries without reducing it by depreciation, the beneficiaries are entitled to the depreciation deduction. The court concluded that allocating depreciation to beneficiaries aligns with both the will's intent and Connecticut law.

Practical Implications

Tiefenbrunn clarifies the tax treatment of condemnation awards, specifically distinguishing between compensation for the property and interest for delayed payment. Legal practitioners should advise clients that while the principal amount of a condemnation award can qualify for non-recognition under Section 1033 if reinvested, the interest portion is unequivocally taxable as ordinary income. For trusts holding depreciable property, this case emphasizes the importance of the trust instrument and state law in determining who can take depreciation deductions. Unless the trust document or governing state law explicitly mandates or permits a depreciation reserve, income beneficiaries will likely be entitled to the depreciation deductions, potentially offsetting their distributable income. This ruling informs tax planning for trusts holding real property and for recipients of condemnation awards, ensuring proper income characterization and deduction allocation.

© 2025 SCOTUSreports.com. All rights reserved.