Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Legend:

Taxpayer =

State A =

Location A =

City X =

Year 1 =

Year 2 =

A =

B =

Year 3 =

C =

Group A =

D =

Group B =

Year 4 =

E =

Document A =

Date 1 =

$aa =

$bb =

$cc =

F =

Date 2 =

G =

$dd =

Date 3 =

Date 4 =

$ee =

$ff =

Date 5 =

Date 6 =

$gg =

Date 7 =

Buyer =

Dear :

This is in reply to your letter of January 24, 2000, and additional correspondence dated May 26, 2000, July 5, 2000, July 7, 2000, and September 20, 2000, requesting rulings on the reinvestment of proceeds under § 1033 of the Internal Revenue Code. Specifically, Taxpayer seeks rulings that (1) the Taxpayer's relinquishment of real property was under the "threat or imminence of condemnation" and therefore qualifies as an involuntary conversion under § 1033, and that (2) the real property was "held for productive use in a trade or business or for investment" by the Taxpayer under § 1033(g)(1).

Taxpayer is a State A corporation, involved in the rental of real property. Taxpayer owns improved real property (the "Property"), which Taxpayer represents is at Location A in City X. Taxpayer has directly owned and used the property as rental property since Year 1.

In Year 2, City X adopted the A Redevelopment Plan (the "Plan"). The objective of the Plan is to remove blight through the redevelopment of property located within the boundaries of approved redevelopment areas, including property within the A Redevelopment Project (the "Redevelopment Project"). The City X Redevelopment Agency (the "Agency"), a State A governmental agency, and the A Development Corporation (the "Corporation"), a non-profit organization established to plan and implement City X's downtown redevelopment program on behalf of the Agency, have authority to act on behalf of City X in order to carry out the Plan. The Agency, and thus, the Corporation, have the legal authority to acquire property necessary to implement the Plan by eminent domain, pursuant to Section B of the Plan. Taxpayer's Property is located within the Redevelopment Project.

In Year 3, after City X became concerned with the potential loss of the C, the Mayor of City X created Group A. In Year 3, Group A issued a report concluding that a new D was necessary. Following that report, Group B was established to recommend a site and financing alternatives for a new D. In Year 4, Group B issued a report recommending a new D in the E area of City X and that the new D be part of a larger redevelopment effort.

Negotiations between City X and C concerning a new D were formalized in Document A, which provides the essential terms of an agreement for the construction and operation of a new D. A public presentation of the terms of Document A was held on Date 1. The terms included investment from C and the private sector of $aa, City X of $bb, and the Agency of $cc.

After Document A was approved by the F's, it was executed by City X , the Agency, the Corporation, and C on Date 2. Document A provides that the purpose and intent of the agreement is to provide for the establishment of a D District (the "District"), the construction of a D within the District, and construction of new development in the District, all within an underdeveloped area in downtown City X. Document A authorizes a D District within the area of the Redevelopment Project, which includes Taxpayer's Property. Taxpayer's property is located directly outside one of the planned entrances to the D.

There are several provisions in Document A that are designed to insure that C will profit from the development associated with the D. Under the terms of Document A, C is authorized to select a master developer to implement the development in the vicinity of the D, including Taxpayer's Property. The master developer chosen by C is G (the "Developer"). Although Document A contemplates that proposals for the development of properties within the Redevelopment Project can be submitted by either the Developer, the owners of the properties, or other developers, the Developer has the

right of first refusal over all other development proposals under Document A, and C is credited with any investments made by other developers. Moreover, the Agency is precluded, for a period of three years after the opening date of the D, from providing greater development incentives to any other developer proposing development of properties identified in Document A. As master developer, the Developer has the right to ask City X to acquire, by eminent domain, property necessary to execute the intent of the agreement that cannot be acquired by negotiated purchase. Such property will be sold to the Developer at the Agency's cost.

In an attempt to retain the Property, Taxpayer hired an architect to prepare a $dd development proposal which included a multi-story apartment building and renovation of a warehouse building for retail/lofts. On Date 3, Taxpayer submitted an "Owner Participation Development Proposal" to the Corporation. Ultimately, this proposal was rejected by the Corporation because "the proposal was not providing the amount of residential development envisioned for the Property by the Plan." Taxpayer represents that it was informally advised that there was not much likelihood that the project would be approved, because City X was looking for a "much bigger project," of at least $ee.

As an alternative to Taxpayer's $dd development proposal, Taxpayer approached the Developer on Date 4 to discuss a "joint venture" development proposal. At that meeting, Taxpayer was shown detailed architectural plans which included Taxpayer's property, for a $ff development proposal, which was substantially larger than Taxpayer's $dd development proposal. In a letter dated Date 5, the Developer acknowledged that although the Taxpayer did not have any plans to sell the Property, it would make sense to enter into a joint venture with the Developer, due to (1) the Developer's beneficial relationship with City X which entitled the Developer to certain rights and benefits, (2) economies of scale and established relationships the Developer had with architects, engineers, banks, construction companies, and City X, and (3) special expertise the Developer had in real estate development and management. The Developer also indicated it was purchasing the property adjacent to Taxpayer's property (as well as other surrounding blocks), and that it would make "the most sense to try to develop the entire block."

Taxpayer ultimately rejected the "joint venture" proposal of the Developer, but contracted to sell the Property to another developer, the Buyer, on Date 6. Buyer was willing to propose a $$gg development proposal, which was more than the Developer's proposal. The sale to the Buyer was contingent upon approval by the Corporation.

In a letter dated Date 7, the Corporation approved the Buyer's development proposal for Taxpayer's Property, and the Developer did not object. The Corporation also made it clear to Taxpayers in that letter that if the Buyer were not able to acquire the Property through private negotiation (i.e., if the contract between Taxpayer and the Buyer fell through), other development proposals from qualified developers (including the Buyer and the Developer) would be solicited by the Corporation through a "Request for Qualifications/Proposal" ("RFQ/P") process. Development proposals from Taxpayer would also be considered. If a development proposal other than a Taxpayer proposal

were selected by the Corporation, and negotiations with the selected developer were successful, the Agency would acquire Taxpayer's property pursuant to the exercise of the Agency's power of eminent domain, if necessary, to have the Property developed in the manner required by City X. The letter conveys the Corporation's belief that the RFQ/P process would result in an acceptable development plan given the qualifications and financial strength of the Buyer, the Developer, and others that would be expected to respond to the RFQ/P. Alternatively, the Corporation was prepared to enter into an exclusive negotiation agreement directly with the Buyer, which would ultimately result in the Agency taking Taxpayer's Property.

Section 1033(a) of the Code provides, in part, that if property, as a result of requisition or condemnation or the threat or imminence thereof, is involuntarily converted into money and if the taxpayer during the time specified purchases property similar or related in service or use to the property so converted, at the election of the taxpayer, the gain shall be recognized only to the extent the amount realized on such conversion exceeds the cost of such other property.

Rev. Rul. 63-221, 1963-2 C.B. 332, holds that, for purposes of § 1033 of the Code, the threat or imminence of condemnation is generally considered to exist when a property owner is informed, either orally or in writing, by a representative of a governmental body or public official authorized to acquire property for public use, that such body or official has decided to acquire his property and the property owner has reasonable grounds to believe, from the information conveyed to him by such representative, that the necessary steps to condemn the property will be instituted if a voluntary sale is not arranged.

Rev. Rul. 81-180, 1981-2 C.B. 161, holds that the sale of property to one other than the threatening authority, by a taxpayer having reasonable grounds to believe that necessary steps to condemn the property eventually would be taken, qualifies as an involuntary conversion under §1033 of the Code.

Under the standards provided in Rev. Rul. 63-221, we believe numerous factors are present in this case that clearly indicate Taxpayer contracted to sell its Property to Buyer under the threat of condemnation. That ruling provides that the threat or imminence of condemnation is considered to exist when a property owner is informed, by a representative of a governmental body or public official authorized to acquire property for public use, that such body or official has decided to acquire his property and the property owner has reasonable grounds to believe, from the information conveyed, that the necessary steps to condemn the property will be instituted if a voluntary sale is not arranged.

First, the information transmitted to Taxpayer in the letter of Date 7 from the Corporation expressly communicated the threat of condemnation. That letter basically stated that the taking of Taxpayer's property was essential to its plans for the Redevelopment Project, and that if the contract with the Buyer fell through, Taxpayer's property would be acquired pursuant to the exercise of the power of eminent domain, if

necessary. The Corporation, through the Agency, clearly has the power to execute such a threat, and that threat was clearly communicated to Taxpayer. The fact that Taxpayer was given the opportunity to retain and develop the Property as an owner participant does not extinguish the threat that existed, as Taxpayer was compelled to sell the Property because of circumstances beyond its control. See S&B Realty Co. v. Commissioner, 54 T.C. 863 (1970), acq. 1970-2 C.B. xxi (1970) (opportunity of owner to retain property by making additional investments does not negate conclusion that the only realistic alternatives were sale or condemnation). Moreover, given that the Corporation rejected Taxpayer's $dd proposal and the expressed confidence that a developer of the caliber of the Buyer or the Developer would be successful in bidding for the development of Taxpayer's Property (and the fact that the proposal ultimately approved by the Corporation was far in excess of Taxpayer's proposal), Taxpayer could only reach one conclusion–that there was a real threat the Corporation would take Taxpayer's Property.

Second, it is clear Taxpayer's Property would only be developed in a manner sufficient to increase property taxes to help pay for the $bb in bonds to be issued by City X and the $cc in bonds to be issued by the Agency, as evidenced by the Corporation's rejection of Taxpayer's $$dd proposal and approval of Buyer's $gg proposal. If Taxpayer did not find a suitable developer, the Corporation made it clear that it would take Taxpayer's Property. Thus, Taxpayer was compelled, given the circumstances, to sell the Property to Buyer.

Third, the negotiations with the Developer regarding a potential joint venture revealed that the Developer held the upper hand in terms of real estate development expertise, connections with other essential businesses and City X, and benefits under the terms of Document A. In the letter dated Date 5, the Developer stated its belief that development of entire blocks made the "most sense," and had already formulated a development proposal which included architectural plans showcasing Taxpayer's Property. The Developer's acquisition of property adjacent to Taxpayer's Property gave Taxpayer reason to believe the Developer might request that the Corporation take Taxpayer's property using its power of eminent domain for the benefit of the Developer in order to carry out its plan of developing the entire block at once.

And finally, the proximity of Taxpayer's Property to one of the entrances of D made it likely that the Corporation would use its power of eminent domain, if necessary, to ensure that the Property would be developed in an acceptable manner. The proximity of Taxpayer's Property to the D also made the Property visible from inside the D. Taken together, these factors amount to more than a reasonable basis for Taxpayer to believe that the Property would be condemned if the Buyer, the Developer, or the Corporation could not obtain it by negotiation. In interpreting the word "threat," the Tax Court has observed that § 1033 does not require the possibility of condemnation be reduced to a certainty, but that the crucial factor is that a taxpayer is compelled by impending, undesirable consequences (that may never occur) to take evasive action. S&B Realty Co. at 870. Furthermore, under Rev. Rul. 81-180, the fact that Taxpayer sold the property to a third party does not affect the status of the transaction as an

involuntary conversion so long as the sale occurs at a time when the threat of condemnation is present.

Section 1033(g)(1) of the Code provides that if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as a result of condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of like kind to be held for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. Section 1033(g)(4) provides that the replacement period for involuntary conversions described in this subsection is three years instead of two. Section 1.1033(g)-1(a) of the Income Tax Regulations includes a cross reference to section 1.1031(a)-1 for principles for determining whether replacement property is property of like kind.

To be eligible for nonrecognition treatment under § 1033(g) of the Code, the property to be replaced (not including stock in trade or property held primarily for sale) need only be real estate held for productive use in a trade or business or for investment and subject to a real threat of condemnation. Taxpayer represents that the Property was real property held for productive use in a trade or business. Thus, under the given facts, Taxpayer's sale of the Property to a third party while such Property was under threat of condemnation constituted an involuntary conversion eligible for nonrecognition under § 1033(g) of the Code to the extent that the converted property is replaced within the statutory three-year period with property of a like kind.

Therefore, we hold (1) that the sale by Taxpayer of the Property to Buyer qualifies as an involuntary conversion under § 1033 of the Code resulting from the threat or imminence of condemnation and (2) that §1033(g) is applicable to this sale.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,
Associate Chief Counsel
(Income Tax and Accounting)
By: Douglas A. Fahey
Acting Chief, Branch 5

cc: