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Meaning of “Similar or Related in Service or Use” in Involuntary Conversions

-by Neil E. Harl*

The basics of involuntary conversion are well known – if eligible property is involuntarily converted (e.g., by fire or other casualty, theft or condemnation), to the extent the converted property is replaced with property “similar or related in service or use”¹ within the designated period² no gain is recognized.³ For real property taken by condemnation or threat or imminence of condemnation, the property only needs to be of a “like-kind” to the converted property if held for productive use in a trade or business or for investment.⁴ If those conditions are met, like-kind property is treated as property similar or related in service or use.⁵

With the great bulk of replacements involving the “similar or related in service or use” test, the key issue is what that test allows in terms of replacement property.⁶

Meaning of “similar or related in service or use”

For several years, the Internal Revenue Service interpreted strictly the clause “similar or related in service or use.”⁷ For example, unimproved real estate was not similar to improved real estate and applying the proceeds from condemnation or real property to reduce a mortgage previously incurred in the purchase of a leasehold did not meet the test.⁸ A bowling alley was not similar or related in service or use to a billiard center.⁹

In 1964, IRS reconsidered its position and, while continuing to adhere to its position with respect to owner-users of property, articulated a more liberal rule where both the converted property and the replacement property were rented.¹⁰ For rented properties, the new IRS position was to look to the “. . . similarities in the extent and type of the taxpayer’s management activities, the amount and kind of services rendered by him to his tenants, and the nature of his business risks connected with the properties.”¹¹

In a 1988 private letter ruling,¹² a plant producing forest products was destroyed by fire with the collection of casualty insurance proceeds. The taxpayer proposed to invest the proceeds in a new manufacturing plant for producing a slightly different product.¹³ IRS agreed that the new plant would be similar or related in service or use to the converted facility and, therefore, would be a qualified replacement.¹⁴ The ruling emphasized the “functional” test for owner-users as to what is similar or related in service or use as discussed in *Rev. Rul. 64-237*.¹⁵ Under the functional test, the physical characteristics and the end uses of the converted property and the replacement property must be closely similar.¹⁶ The 1964 ruling goes on to say that replacement of a light manufacturing plant with a grocery warehouse does not meet the functional test.¹⁷ The end uses are different.

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A 1993 private letter ruling¹⁸ involved the loss by fire of a warehouse building which had been rented. The taxpayer proposed to replace the destroyed warehouse with an apartment building which was to be rented. The taxpayer also proposed to invest some of the funds in a sprinkling system and to upgrade the heating system. The ruling states that both properties involved rental property and the replacement would qualify for tax-free reinvestment treatment.¹⁹ Similarly, where a landlord replaced converted property with a building partially occupied by the landlord, only the rented portion of the new building qualified.²⁰

In a 1994 private letter ruling, a farm with three barns and a warehouse was replaced with land on which a greenhouse, farm storage buildings and other improvements would be erected was held to meet the “similar or related in service or use” test.²¹

IRS seems to be continuing to adhere to the functional test in the case of owner-users of property as distinguished from landlords where the focus is more on rentals.

Presidentially-declared disasters

Property held for productive use in a trade or business or for investment that is involuntarily converted as the result of a Presidentially declared disaster is treated as property similar or related in service or use. *Any tangible property* held for productive use in a trade or business is treated as similar or related in service or use.²² Note that the statute does not extend to eligible property being replaced by property held for investment.²³

The term “Presidentially declared disaster” means any disaster which resulted in the area in which the property is located being declared to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.²⁴

Term for reinvestment

The general rule for reinvestments as a result of involuntary conversions is that the period for reinvestment begins with the date of disposition of the converted property (or the earliest date of condemnation or threat or imminence of condemnation or requisition) and ending two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.²⁵ The statute authorizes extensions of time for reasonable cause.²⁶

For real property (not including stock in trade or other property held primarily for sale) held for productive use in a trade or business or for investment taken by condemnation or threat or imminence of condemnation, the reinvestment period is three years rather than two years.²⁶ Thus, a barn destroyed by fire is subject to the two year reinvestment rule; a barn taken to widen a highway can be replaced within the three year period.²⁷

Footnotes

¹ I.R.C. § 1033(a)(1).

² See I.R.C. § 1033(a)(2)(B).

³ I.R.C. § 1033(a)(2)(A). See generally 4 Harl, *Agricultural*

Law § 27.06 (2006); Harl, *Farm Income Tax Manual* §§ 333, 334 (2006). Compare Harl, *Agricultural Law Manual* § 4.02[5][b].

⁴ I.R.C. § 1033(g).

⁵ I.R.C. § 1033(g)(1). This rule does not apply to the purchase of stock in the acquisition of control of a corporation which is otherwise permissible for replacement property. I.R.C. § 1033(a)(2)(A), 1033(g)(2).

⁶ See Harl, *Farm Income Tax Manual* § 333(e) (2006).

⁷ GCM 14693, XIV-1 C.B. 197; Rev. Rul. 56-347, 1956-2 C.B. 517; Rev. Rul. 58-245, 1958-1 C.B. 224. See Liant Records, Inc. v. Comm’r, 36 T.C. 224 (1961), *rev’d*, 303 F.2d 326 (2d Cir. 1962); McCaffrey, Jr. v. Comm’r, 275 F.2d 27 (3d Cir. 1960), *cert. denied*, 363 U.S. 828; Treas. Reg. § 1.1033(a)-2(c)(9).

⁸ *Id.*

⁹ Rev. Rul. 76-319, 1976-2 C.B. 242.

¹⁰ Rev. Rul. 64-237, 1964-2 C.B. 319. See, e.g., Liant Record, Inc. v. Comm’r, 303 F.2d 326 (2d Cir. 1962) (reversed the Tax Court in a case involving the condemnation of an office building and purchase of three apartment buildings; real property was not eligible for the “like-kind” test for condemnations until enactment of Section 46 of the Technical Amendments Act of 1958).

¹¹ *Id.*

¹² Ltr. Rul. 8844049, Aug. 9, 1988.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ 1964-2 C.B. 319.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ Ltr. Rul. 9326042, April 2, 1993.

¹⁹ *Id.*

²⁰ Rev. Rul. 79-261, 1979-2 C.B. 295.

²¹ Ltr. Rul. 9421002, Feb. 2, 1994.

²² I.R.C. § 1033(h)(2).

²³ *Id.*

²⁴ I.R.C. § 1033(h)(3).

²⁵ I.R.C. § 1033(a)(2)(B), (B)(i).

²⁶ I.R.C. § 1033(a)(2)(B)(ii).

²⁷ I.R.C. § 1033(g)(4).

²⁸ *Id.*