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INVOLUNTARY CONVERSION OF PROPERTY

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Mr. GEORGE, from the Committee on Finance, submitted the following

REPORT

[To accompany H. R. 3590]

The Committee on Finance, to whom was referred the bill (H. R. 3590) relating to the income-tax treatment of gain realized on an involuntary conversion of property, having considered the same, report favorably thereon with amendments and recommend that the bill do pass.

GENERAL STATEMENT

Section 112 (f) of the Internal Revenue Code now provides for the nonrecognition of gain if property is compulsorily or involuntarily converted into property similar or related in service or use to the property converted, or into money which is reinvested in property similar or related in service or use to the property converted. In effect, this section of the code postpones payment of tax upon gain from the converted property except to the extent that the proceeds from the converted property are not reinvested in property which is similar or related in service or use. Section 113 (a) (9) provides for the making of appropriate adjustments in the basis of the replacement property so as to reflect the nonrecognition of gain on the converted property.

While section 112 (f) of the code now operates in the majority of cases to relieve taxpayers from the payment of a tax upon gain where property has been involuntarily converted, the requirements of this provision have operated to deny relief in some cases where your committee believes that relief should be granted. No relief is accorded under existing law where, before receipt of the proceeds for the converted property, the taxpayer purchases replacement property. Relief is denied in these anticipatory replacement cases since the benefits of section 112 (f) are limited to those cases in which the proceeds from the converted property can be directly traced into the subsequently acquired property. A problem also arises under the present law where the taxpayer uses a part of the proceeds from the converted

property to pay off indebtedness on the converted property. In such a case the taxpayer is denied the benefits of section 112 (f), that is, the taxpayer must pay a tax on any gain from the converted property up to the amount of the proceeds which are used in liquidation of indebtedness on the converted property, even though he also fully replaces the converted property, since the amount used to pay off the indebtedness cannot be directly traced into the replacement property.

The bill eliminates the requirement of existing law that the taxpayer, in order to have the benefits of section 112 (f), must trace the proceeds from the converted property into the replacement property.

The bill retains the requirement of present law that the replacement property be similar or related in service or use to the property converted. Under existing law, and under the bill, the replacement property need not be an exact duplication of the converted property. For example, if the Government by condemnation acquires farm land used by the taxpayer for growing crops and the taxpayer for the purpose of replacing the converted property purchases other farm land to be used for raising livestock or for growing fruit, such replacement property meets the requirement of being similar or related in service or use to the property converted.

Under existing law and under the bill, loss upon an involuntary conversion is recognized.

The prompt enactment of the bill is desirable in view of the large number of acquisitions of property by the Federal Government in connection with the defense program. Delay is sometimes now encountered in the acquisition of land for defense purposes since taxpayers are reluctant, in view of the existing provisions of section 112 (f), to acquire and move to replacement property prior to receipt of the proceeds from the converted property. The enactment of the bill will not only provide appropriate relief for taxpayers who promptly acquire replacement property before receipt of the proceeds from the converted property, but will also facilitate acquisition of the land needed in connection with defense projects.

TECHNICAL EXPLANATION OF THE BILL

Section 112 (f) of existing law provides, in general, that no gain will be recognized if property, as a result of its destruction, theft, seizure, requisition, condemnation or threat or imminence thereof, is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith expended in the acquisition of such property, or in the acquisition of control of a corporation owning such property, or in the establishment of a replacement fund. If any part of the money is not so expended, the gain is recognized to the extent of the money not so expended.

The bill amends section 112 (f) by subdividing subsection (f) into three numbered paragraphs. Paragraph (1) deals with cases where the taxpayer receives for the converted property, in lieu of money, property which is similar or related in service or use to the converted property. The existing law on the nonrecognition of gain in the case of such exchanges is unchanged by the bill.

Paragraph (2) of section 112 (f) states the rules of existing law in cases where the taxpayer receives money for the converted property, but the bill limits the application of paragraph (2) to those cases where the disposition of the converted property occurred prior to January 1, 1951. "Disposition of the converted property" is defined to mean the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under the threat or imminence of requisition or condemnation. Paragraph (2) will apply where the disposition of the converted property occurred prior to January 1, 1951, even though the taxpayer receives the money, and hence the gain, after 1950. Thus, if property is destroyed by fire in 1950, and the taxpayer receives the insurance proceeds in 1951, the nonrecognition of any gain with respect to such proceeds will be governed by the provisions of paragraph (2) which retain the tracing rules of existing law.

Paragraph (3) of section 112 (f) as amended by the bill provides new rules for the nonrecognition of gain where the disposition of the converted property occurs after December 31, 1950, and the taxpayer receives money or receives property not similar or related in service or use to the converted property. Under this paragraph there is no requirement that the proceeds from the converted property be traced into the replacement property. It is sufficient if the taxpayer, for the purpose of replacing the property so converted, purchases property similar or related in service or use to the property so converted or purchases stock in the acquisition of control of a corporation owning such property.

Such a purchase, however, must be made within the period of time commencing with the date of the disposition of the converted property or the date of the beginning of the threat or imminence of condemnation or requisition of the converted property, whichever is the earlier, and ending 1 year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as the Secretary may designate upon the application of the taxpayer. Such application shall be made at such time and in such manner as the Secretary may prescribe by regulations. Any extension of time shall be subject to such terms and conditions as the Secretary may prescribe. Under this provision the Secretary may require that the taxpayer post a bond conditioned upon payment of the proper tax in case the replacement is never made or is made at a cost lower than the amount realized upon the conversion.

While the new paragraph (3) permits anticipatory replacement, it is provided that no property or stock which was acquired prior to the disposition of the converted property shall be considered to have been acquired for the purpose of replacing the converted property unless such replacement property or stock is held by the taxpayer on the date of such disposition. Property or stock shall be considered to have been purchased only if, but for the provisions of section 113 (a) (9) of the Internal Revenue Code, the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 113 (a). If the taxpayer's unadjusted basis of the replacement property would be determined, in the absence of section 113 (a) (9), under any of the other numbered paragraphs of section 113 (a), the unadjusted basis of the property would not be its cost within the meaning of section 113 (a). For example, if property similar or related

in service or use to the converted property is acquired by gift, such property will not qualify as a replacement for the converted property.

The bill also provides specifically that the benefits of section 112 (f) (3) are elective. Such election is to be made at such time and in such manner as the Secretary may prescribe by regulations. Such regulations could provide, for example, that a failure to report the gain on the return for the taxable year in which the gain is realized shall constitute an election to take the benefits of section 112 (f) (3).

If the taxpayer elects to take the benefits of section 112 (f) (3), the gain upon the conversion shall be recognized only to the extent that the amount realized upon such conversion, regardless of whether such amount is realized in one or more taxable years, exceeds the cost of the replacement property or stock.

Section 112 (f) (3) (C) provides that, when a taxpayer elects to take the benefits of section 112 (f) (3), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time prior to the expiration of 3 years from the date the Secretary is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, notwithstanding the provisions of section 272 (f) of the Internal Revenue Code or the provisions of any other law or rule of law which would otherwise prevent such assessment. Such notification is to be made in such manner as the Secretary may prescribe by regulations.

Section 112 (f) (3) (D) provides that, when a taxpayer elects to take the benefits of section 112 (f) (3) and the replacement property or stock was purchased prior to the beginning of the last taxable year in which any part of the gain upon such conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time prior to the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 272 (f) or 275 of the Internal Revenue Code or the provisions of any law or rule of law which would otherwise prevent such assessment.

A technical amendment is made by the bill to section 276 of the Internal Revenue Code by adding a new subsection (e) thereto which provides that any deficiency described in section 112 (f) (3) (C) or (D) may be assessed prior to the expiration of the period of time specified in such section 112 (f) (3) (C) or (D), respectively.

Section 113 (a) (9) of the Internal Revenue Code is amended by section 2 of the bill so as to provide that in the case of property purchased by the taxpayer which resulted, under the provisions of section 112 (f) (3), in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis of such property shall be the cost of such property decreased in the amount of the gain not so recognized. For example, assume a taxpayer receives $8,000 from the involuntary conversion of his barn; the adjusted basis of the barn to him was $5,000, and he spent $7,000 for a new barn which resulted in the nonrecognition of $2,000 of the $3,000 gain on the conversion. The unadjusted basis of the new barn to the taxpayer would be $5,000—the cost of the new barn, $7,000, less the amount of the gain not recognized on the conversion, $2,000. The unadjusted basis of the new barn would not be a "substituted

basis" in the hands of the taxpayer under section 113 (b) (2) (B) of the Internal Revenue Code.

Section 3 of the bill provides for the effective date of the amendments made by the bill. Such amendments are applicable only with respect to taxable years ending after December 31, 1950, except that the provisions of section 112 (f) (3), and the amendment of section 113 (a) (9), shall also be applicable to any taxable year ending prior to January 1, 1951, in which any gain was realized upon the conversion of property and the disposition of such converted property occurred after December 31, 1950, or in which the basis of property is affected by an election made under the provisions of section 112 (f) (3).

The amendments made by the committee are purely technical, and were made necessary to conform to the revenue bill of 1951.

CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) * * *

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[(f) INVOLUNTARY CONVERSIONS.—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain shall be recognized, but loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain).]

(f) INVOLUNTARY CONVERSION.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) CONVERSION INTO SIMILAR PROPERTY.—Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED PRIOR TO 1951.—Into money, and the disposition of the converted property occurred before January 1, 1951, no gain shall be recognized if such money is forthwith in good faith, under regulations prescribed by the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund. If any part of the money is not so expended, the gain shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain). For the purposes of this paragraph and paragraph (3), the term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(3) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED AFTER 1950.—Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of Gain.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary may by regulations prescribe. For the purposes of this paragraph—

(i) no property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) the taxpayer shall be considered to have purchased property or stock only if, but for the provisions of section 113 (a) (9), the unadjusted basis of such property or stock would be its cost within the meaning of section 113 (a).

(B) Period Within Which Property Must Be Replaced.—The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—

(i) one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) subject to such terms and conditions as may be specified by the Secretary, at the close of such later date as the Secretary may designate upon application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary may by regulations prescribe.

(C) Time for Assessment of Deficiency Attributable to Gain Upon Conversion.—If a taxpayer has made the election provided in subparagraph (A), then (i) the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain upon such conversion is realized, attributable to such gain shall not expire prior to the expiration of three years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) of the replacement of the converted property or of an intention not to replace, and (ii) such deficiency may be assessed prior to the expiration of such three-year period notwithstanding the provisions of section 272 (f) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

(D) Time for Assessment of Other Deficiencies Attributable to Election.—If the election provided in subparagraph (A) is made by the taxpayer and such other property or such stock was purchased prior to the beginning of the last taxable year in which any part of the gain upon such conversion is realized, any deficiency, to the extent resulting from such election, for any taxable year ending before such last taxable year may be assessed (notwithstanding the provisions of section 272 (f) or 275 or the provisions of any other law or rule of law which would otherwise prevent such assessment) at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed.

This subsection shall not apply, in the case of property used by the taxpayer as his principal residence, if the destruction, theft, seizure, requisition, or condemnation of residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950.

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SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

(1) * * *

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(9) INVOLUNTARY CONVERSION.—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion, described in [section 112 (f)] *section 112 (f) (1) or (2)*, the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made. *In the case of property purchased by the taxpayer which resulted, under the provisions of section 112 (f) (3), in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.*

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SEC. 276. SAME—EXCEPTIONS.

(a) FALSE RETURN OR NO RETURN.—In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

(b) WAIVER.—Where before the expiration of the time prescribed in section 275 for the assessment of the tax, both the Commissioner and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(c) COLLECTION AFTER ASSESSMENT.—Where the assessment of any income tax imposed by this chapter has been made within the period of limitation properly applicable thereto, such tax may be collected by distraint or by a proceeding in court, but only if begun (1) within six years after the assessment of the tax, or (2) prior to the expiration of any period for collection agreed upon in writing by the Commissioner and the taxpayer before the expiration of such six-year period. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(d) NET OPERATING LOSS CARRY-BACKS AND UNUSED EXCESS PROFITS CREDIT CARRY-BACKS.—In the case of a deficiency attributable to the application to the taxpayer of a net operating loss carry-back or an unused excess profits credit carry-back, including deficiencies which may be assessed pursuant to the provisions of section 3780 (b) or (c), such deficiency may be assessed—

(1) in case a return was required under subchapter E of chapter 2 for the taxable year of the net operating loss or unused excess profits credit resulting in the carry-back, at any time before the expiration of the period within which (under section 275 or subsection (a) or (b) of this section) a deficiency (with respect to tax imposed either by chapter 1 or by subchapter B or E of chapter 2) for such taxable year (whichever is the longer period) may be assessed; or

(2) in case a return was not required under subchapter E of chapter 2 for the taxable year of the net operating loss or unused excess profits credit resulting in the carry-back, at any time before the expiration of the period within which (under section 275 or subsection (a) or (b) of this section) a deficiency (with respect to tax imposed either by chapter 1 or by subchapter A or B of chapter 2) for such taxable year (whichever is the longer period) may be assessed.

(f) INVOLUNTARY CONVERSION.—In the case of a deficiency described in section 112 (f) (3) (C) or (D), such deficiency may be assessed at any time prior to the expiration of the time therein provided.

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