DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: ASSOCIATE CHIEF COUNSEL (INCOME TAX & ACCOUNTING) CC:ITA

SUBJECT: I.R.C. § 1033 -- THEFT; DAMAGES SETTLEMENT

This Field Service Advice responds to your request dated November 9, 2000. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

Taxpayer =

Corp. A =
Corp. B =

Corp. C	=	
Corp. D	=	
Property	=	
State	=	
Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
Date 6	=	
$X	=	$
$$X	=	$
$$$X	=	$
$$$$X	=	$
$$$$$X	=	$
Tax Year 1	=	
Tax Year 2	=	
Y	=	

ISSUE:

Whether a portion of certain damages recovered by Taxpayer in connection with the settlement of state court action brought for breach of contract and tortious interference with a supply contract are eligible for nonrecognition treatment under I.R.C. § 1033.

CONCLUSION:

There was no involuntary conversion of property within the meaning of section 1033; thus, the settlement amounts in issue are ineligible for section 1033 nonrecognition treatment.

FACTS:

On Date 1, Taxpayer, a corporation filing its returns on a calendar year, entered into an agreement with Corp. A (later renamed Corp. B) whereby Corp. A agreed to buy large quantities of Property over a Y-year period. Shortly thereafter, Corp. C entered into a similar agreement with Corp. A. On or about Date 2, Corp. A breached its earlier agreement with Taxpayer.

On Date 4, Taxpayer filed suit in State court against Corp. B (formerly Corp. A) for breach of contract and against Corp. C for tortious interference with contract relations. The breach of contract claim against Corp. B was ordered to arbitration. Proceedings in the lawsuit were stayed pending the outcome of that arbitration. The final award of the arbitrator issued on Date 5. It awarded the taxpayer $X in damages for Property already sold and delivered to Corp. A and $$X for "lost profit damages" on the Property contract.

The State lawsuit then proceeded to trial on Taxpayer's claim of tortious interference by Corp. C. A jury rendered a verdict in favor of Corp. C; but, prior to entry of judgment, the parties entered into a comprehensive agreement covering both defendants. Taxpayer received $$$X in settlement of all its claims.

With its Form 1120S for Tax Year 1, Taxpayer submitted a purported election pursuant to section 1033(a)(2). That statement included the following:

> To the extent of the tortious interference claim, the taxpayer's contract was involuntarily converted into cash and deferral is available under § 1033(a)(2). The portion of the settlement allocated to tortious interference was [$$$$X].

The district director subsequently granted extensions of time until the end of Tax Year 2 "to replace property that was involuntarily converted."

On its Form 1120S for Tax Year 2, Taxpayer submitted a Notification of Replacement Property, namely an agreement dated Date 6, Tax Year 2, whereby Corp. D agreed to purchase Property from the taxpayer over a Y-year period. Taxpayer asserts that it "made qualifying reinvestment expenditures totaling [$$$$$X] . . . in connection with the [Corp. D] Agreement." Taxpayer has not elucidated why these payments were necessary or specifically what was procured by virtue of those payments.

LAW AND ANALYSIS:

Under sections 61(a)(3) and 1001(c), gain realized on the disposition of property generally must be recognized. Since 1921, however, Congress has provided relief of some sort to taxpayers whose property has been taken from them against their will and, as a result, they have realized gain. See Internal Revenue Act of 1921, Ch. 136, § 214(a), 42 Stat. 227. Taxpayer has the burden of proving itself within some provision allowing nonrecognition treatment. See Insurance & Title Co. v. Commissioner, 36 F.2d 842, 844 (2d Cir. 1929).

Prior to the 1921 Act, the Treasury Department had already promulgated regulations achieving the same substantive relief. Treas. Regs. § 45, Arts. 49, 50 (1919 ed.). The apparent impetus for both the regulations and the subsequent revenue legislation was the destruction or requisitioning of property necessitated by World War I. See American Natural Gas Co. v. United States, 279 F.2d 220 (Ct. Cl.), cert. denied, 364 U.S. 900 (1960). It was viewed as unfair to make an owner, for example, who had had his boat "submarined" by the enemy or requisitioned by the Government, pay the tax on any gain and possibly, therefore, be unable financially to replace that boat in his business. The deduction for qualified replacement costs initially provided for by the statute was eventually supplanted by nonrecognition treatment. Revenue Act of 1924, § 203(b)(5), 43 Stat. 253. The nonrecognition treatment is currently provided for in section 1033.[1]

Section 1033(a) generally requires that the taxpayer's property be "compulsorily or involuntarily converted" into other property or money; yet, the provision does not cover all situations where taxpayers are deprived of any property rights without their approval. It is limited, rather, to the property's involuntary destruction, theft, seizure, requisition or condemnation, or disposition under the threat of requisition or condemnation. The section is inapplicable to many "compulsory" sales or dispositions dictated by other adverse considerations–including normal business dealings where contracts may be breached or those breaches are fairly or unfairly induced by third parties. See, e.g., Rev. Rul. 74-532, 1974-2 C.B. 270 (sale of rental property as result of extensive and recurring vandalism is not an involuntary conversion).

Congress did not contemplate nonrecognition relief for dispositions resulting from tortious actions–short of theft or destruction–or business expediency (actionable or not) such as what occurred here; rather, it intended relief for taxpayers faced with the actual or threatened loss of their property to the government and/or a loss by casualty or theft.[2]

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[1] Section 1033(a)(2)(A) provides that if, during a specified period, the taxpayer purchases other 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 that the amount realized exceeds the cost of such other property. See also Treas. Reg. § 1.1033(a)-2(c). The quid pro quo for this nonrecognition, of course, is a lower basis in the qualified replacement property. Section 1033(b). In actuality, therefore, it is just deferral of recognition.

[2] Even an outright condemnation of property by the government is not always an involuntary conversion under section 1033, despite the express language of the statute. For example, where real property may be unfit for human habitation, the condemnation thereof is not covered by section 1033. Rev. Rul. 57-314, 1957-2 C.B. 523. Compare Rev. Rul. 82-147, 1982-2 C.B. 190 (sale of a resort hotel where Congress had declared the surrounding region a wilderness area constituted an involuntary conversion). Forced sales or exchanges made pursuant to state statute (Hitke v. Commissioner, 296 F.2d 639 (7th Cir. 1961); Dear Publication and Radio, Inc. v. Commissioner, 274 F.2d 656 (3d Cir. 1960); Rev. Rul 69-550, 1969-2 C.B. 161; Rev. Rul. 55-717, 1955-2 C.B. 298); a Securities and Exchange Commission order (American Natural Gas, supra; Rev. Rul. 57-517, 1957-2 C.B. 524), an antitrust order (Behr-Manning Corp. v. United States, 196 F. Supp. 129 (D. Mass. 1961); Rev. Rul. 58-11, 1958-1 C.B. 273), a court order of partition (Roth v. Commisioner, T.C. Memo.

Unfortunately, the dearth of litigated cases illuminating what is a qualifying "theft" for section 1033 purposes proves less helpful to our instant inquiry than those noted below regarding condemnation. Apparently few, if any, taxpayers have ventured to gainsay seriously the rather unequivocal nature and limited applicability of the "theft" standard. While the Service has, for example, allowed the unauthorized pledging of corporate shares to be treated as a theft for purposes of section 1033 where money was eventually recovered from the pledgee, Rev. Rul. 66-355, 1966-2 C.B. 302, the term is not without clear limits. The Tax Court has expressly and consistently acknowledged the limitations of section 1033. In Hope v. Commissioner, 55 T.C. 1020, at 1033-34 (1971), the court restated the "theft" criterion as follows:

> The term theft as used in the Internal Revenue Code is a word of general and broad connotation intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile. [citing Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); Gerstell v. Commissioner, 46 T.C. 161 (1966); Nichols v. Commissioner, 43 T.C. 842 (1965)]

Despite the "general and broad" phrase adopted from Edwards, it is more instructive to note that the Tax Court promptly found that the putative "involuntary" sale involved in Hope was indeed not a result of fraud; furthermore, the lack of a prior adjudication or admission of fraud was critical to the failure of that assertion. Id. at 1034. The defining emphasis throughout the analysis was clearly on whether there was criminal activity. Indeed, the Tax Court looked only to the applicable local criminal law. Prior to Hope, while stating that the precise crime involved was unimportant (e.g., whether embezzlement or larceny), the Fifth Circuit in Edwards, supra at 111, nevertheless looked only to crimes to determine whether a "theft" had occurred for purposes of federal tax implications. There was no hint in either

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1977-17), a loan foreclosure (Cooperative Publishing Co. v. Commissioner, 115 F.2d 1017 (9th Cir. 1940); Recio v. Commissioner, T.C. Memo. 1991-215), a tax delinquency sale (Rev. Rul. 77-370, 1977-2 C.B. 306), and bankruptcy (Rev. Rul. 79-269, 1979-2 C.B. 297) or receivership proceedings (Shields v. United States, 74-2 U.S.T.C. ¶ 9537 (W.D. Tex. 1974)) are just some of the numerous examples of property dispositions that are not involuntary conversions within the purview of section 1033–notwithstanding the taxpayer's manifest unwillingness to part with the property involved. So, while section 1033 is clearly a relief provision, the requisite qualifying standards are not quite as flexible as Taxpayer apparently wants to assume.

opinion that either court would be likely to entertain the notion that a mere tort, which did not also constitute a crime, would pass muster as "theft."[3]

There is no authority for expanding the definition of theft to encompass the circumstances presented here; even if Taxpayer's allegations of tortious interference against Corp. C could be reasonably established (which, given the jury verdict, seems highly unlikely). That failure, standing alone, would appear to be close to dispositive of Taxpayer's nonrecognition theory; yet, there are additional reasons Taxpayer's argument should not prevail.

Taxpayer's receipt of the settlement funds is most closely akin to the situation first addressed in Rev. Rul. 73-477, 1973-2 C.B. 302, where amounts were received under a use and occupancy insurance policy that provided for per diem payments whenever specific causes resulted in suspended business operations. The Service ruled that those funds were in lieu of expected ordinary income, were taxable as such ordinary income, and were thus ineligible for section 1033 nonrecognition treatment.[4] This position, now encapsulated in Treas. Reg. § 1.1033(a)-2(c)(8), has ample case support. See, e.g., Graphic Press, Inc. v. Commissioner, 523 F.2d 585, 589 (9th Cir. 1975); Marshall Foods, Inc. v. United States, 393 F. Supp. 1097 (D. Minn. 1974), aff'd, 75-2 U.S.T.C. ¶ 9536 (8th Cir. 1975); Miller v. Hocking Glass Co., 80 F.2d 436 (6th Cir. 1935); Massillon-Cleveland Akron Sign Co. v. Commissioner, 15 T.C. 79 (1950). There is no inherent conceptual difference between the aforementioned insurance proceeds and the settlement reached by Taxpayer here. Both represent recovery of lost profits.[5]

Consequently, the compelled conclusion in this case is that since the damages settlement received by Taxpayer was intended to reimburse it for profits it lost when the contract was breached–irrespective of how that breach is characterized–the money was ordinary income to Taxpayer. For this reason, we do not view the executory contract rights in the first instance as constituting property within the intended meaning of section 1033 nonrecognition. See generally Beck v.

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[3] See also PLR 8947032 (Aug. 28, 1989), which specifically examined just the criminal law of the state where certain alleged acts occurred to ascertain whether those acts constituted larceny by false pretenses in determining whether a "theft" had occurred under section 1033.

[4] See also Rev. Rul. 86-12, 1986-1 C.B. 290 (amplifying Rev. Rul. 73-477), holding that the Service will look to underwriting and actuarial criteria, as well as any other information, in determining if amounts involved were to reimburse lost profits.

[5] This is true irrespective of whether any amount of the settlement is properly allocable to the tortious interference claim. Even If punitive damages were part of that tort portion, by definition, those damages would be outside section 1033 because these would be to punish or make an example of the taker of the property.

Commissioner, T.C. Memo. 1987-359 (ownership of cattle not recognized for federal income tax purposes despite executory contract for sale); Estate of Johnston v. Commisioner, 51 T.C. 290 (1968), aff'd, 430 F.2d 1019 (6th Cir. 1970) (executory contract to purchase section 1033 replacement property untimely for statutory purposes under section 1033 since the benefits and burdens of ownership had not passed by close of provided replacement period). Moreover, even if Taxpayer were to argue that the executory contract represented merely a transitional step en route to certain property acquisition and towards that end we were to "look through" the contract, there is simply no underlying cognizable property asset that Taxpayer would eventually acquire upon execution. Similarly, nothing in the legislative history indicates that Congress meant to go beyond actual physical assets already in hand.[6] It is the "prior commitment to capital" that is most critical. Johnson v. Commissioner, 43 T.C. 736, 741 (1965) (quoting authorities), acq. 1965-2 C.B. 5.

On another aspect of these facts, the apportionment of the settlement funds to the alleged tortious interference claim appears devoid of any rationale basis. Taxpayer has provided no explanation as to this very generous allocation–about 35 percent of the total. Taxpayer's asserted allocation is especially suspect here in light of the jury's verdict in favor of Corp. C (albeit not reduced to judgment) on the tortious interference claim as well as the fact that the settlement amount allocated to lost profits was much less than the amount of lost profits found to be due Taxpayer by the arbitrator.[7] At a minimum, even if the alleged tortious interference did constitute "theft" under section 1033 (and we do not believe it does, as we discussed), the failure of Taxpayer to prove even that the tort occurred at all would in and of itself be quite telling as to whether section 1033 should be invoked.

Taxpayer has failed to establish that a conversion by theft or other qualifying circumstance has occurred within the meaning of section 1033; it has failed to demonstrate that the monetary recovery in question was not merely a taxable reimbursement in lieu of anticipated ordinary income; it has failed to offer a rationale basis for its significant allocation of the funds it received to the putative "theft" involved–even assuming arguendo that the alleged tort were a qualifying theft; and it has failed to demonstrate why the payments to secure a new contract with another buyer were ordinary, necessary, or reasonable or why that new contract should be considered "similar property" within the meaning of section

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[6] See H.R. Rep. No. 486, 67th Cong., 1st Sess. (1921), reprinted in 1939-1 (Part 2) C.B. 206; S. Rep. No. 275, 67th Cong., 1st Sess. (1921), reprinted in 1939-1 (Part 2) C.B. 181. Intangible assets, however, for example, a patent or easement, would still be covered. See, e.g., Rev. Rul. 76-69, 1976-1 C.B. 219 (scenic easement).

[7] It represents less than one-half of the amount the arbitrator had found to be due on just the breach of contract by Corp. B.

1033. We must conclude, therefore, that Taxpayer is not entitled to nonrecognition treatment under section 1033 on the circumstances described in this case.[8]

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

There are very limited, if any, litigation hazards for the Service in this case. We have discovered no relevant authority supporting Taxpayer's notions with regard to the applicability of section 1033 to the instant fact pattern. Even accepting the view that the executory contract involved was "property" within the meaning of section 1033 and despite Taxpayer's characterizations of the purported nefarious actions of Corp. C, the provisions of section 1033 were simply never intended to reach these types of dealings. This holds true irrespective of whether some tortious conduct happens to be involved--short of theft or actual destruction of property. This has long been the Service's position and practice; thus, we recommend that the issue be pursued in this case.

HEATHER C. MALOY
By: ___________________________
GERALD M. HORAN
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[8] There is also the nettlesome question for Taxpayer of whether the new supply contract (the ostensible replacement property) is "similar property" within the meaning of the statute. Given the other substantial infirmities in Taxpayer's position, however, we limit our discussion to those already examined above.