



The California Office of Tax Appeals Holds that Taxpayers Were Entitled to Nonrecognition of Gain Due to an Involuntary Conversion

by Robert S. Horwitz

Internal Revenue Code (“IRC”) sec. 1033 allows a taxpayer to elect to defer gain from an involuntary conversion of property if the taxpayer “purchases other property similar to 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.” In a recently issued precedential decision, *Appeal of Mitchell*, 2026-OTA-196P, the California Office of Tax Appeals (“OTA”) held that a taxpayer was entitled to nonrecognition of gain under sec. 1033 from the sale of property adjacent to the converted property. Let’s first look at the facts and then the OTA’s analysis that led to its holding in favor of the taxpayers.

The Mitchells’ Acquisition and Use of the Property

The taxpayers were husband and wife. Mr. Mitchell purchased land in Fresno (“the Clinton property”) in April 2005. He constructed three buildings totaling 33,000 square feet, with adjacent land and parking. The buildings were covered by a roofed two-story breezeway with second floor walkways. The center building (“Building B”) contained all electrical, communication, data, utilities, and public restrooms for the three-building complex. It also contained the only water and electrical meters. Neither of the other two buildings (“Buildings B and C”) had public restrooms or any of the utilities. The property was subject to a \$2 million mortgage with monthly payments of \$10,000.

In January 2017, Mr. Mitchell leased all three buildings to a charity for a five-year term with an option to purchase. In April 2017, there was a major storm that damaged all three buildings. The roof of Building B collapsed, making it structurally unsound. The charity vacated Buildings B and C. It continued to occupy Building A even though it had suffered damage in the storm. Following the storm, all the copper wiring in Building B and the air conditioning units in all three buildings were stolen.



It took Mr. Mitchell over a year to get payments from his insurer. When the insurer did pay, it only paid the depreciated value of the property, \$1.75 million, and not the cost to reconstruct the buildings, which was estimated to be over \$2.75 million. Because Mr. Mitchell did not have the funds to reconstruct the property and could not get a bank loan, in June 2018, he sold the property to the charity for a \$2 million note. The following month, he purchased property in Monterey using the \$2 million note as a downpayment.

The Franchise Tax Board (“FTB”) Audit and the Mitchells’ Appeal

On their 2018 California income tax return, the Mitchells reported the sale as a like-kind exchange under IRC sec. 1031, with deferred gain of \$1.677 million. The FTB audited the return. During the audit, the Mitchells stated that they intended to elect deferral under sec. 1033 and not sec. 1031. That didn’t make any difference to the FTB, which disallowed the deferral of gain and proposed additional tax of \$120,000. The proposed assessment was sustained by the FTB protest unit and the Mitchells appealed to the OTA.

The OTA framed the issue before it as whether the Mitchells are “entitled to nonrecognition of gain from the sale of real property under Internal Revenue Code section 1033.” It noted that sec. 1033 is to be “liberally construed” “to relieve the taxpayer of unanticipated tax liability arising from involuntary conversion of his property.”

The OTA Examines Federal Legal Authority

The OTA examined two Tax Court cases, *Masser v. Commissioner*, 30 TC 741, and *C.G. Wells, Inc. v. Commissioner*, 41 TC 468, and Rev. Rul. 78-377, to determine the circumstances under which an involuntary conversion of one piece of property can result in the involuntary conversion of other property owned by the taxpayer.

In *Masser*, the taxpayer owned a trucking business with a terminal and a parking lot across the street from the terminal. The city condemned the parking lot but not the terminal. Because the parking lot was essential for the economic



operation of the terminal, the taxpayer sold both parcels and purchased another property where he could locate a terminal and parking lot. Ruling for the taxpayer, the Tax Court held that where two properties were used as one economic unit in the taxpayer's business and one property was involuntarily converted so that continuation of the taxpayer's business on the second property is impractical and the taxpayer, in the exercise of "sound economic judgment," sells the remaining property, the transactions as a whole constitutes an involuntary conversion within the meaning of sec. 1033.

In *C.G. Wells, Inc.*, the taxpayer owned a ship. The ship's hull was breached and the boiler room flooded. Rather than repair the ship, the taxpayer sold it and purchased a barge. The Tax Court held that sec. 1033 did not apply since the ship could be economically repaired and restored to usefulness for its intended business purpose.

In Rev. Rul. 78-377, the IRS ruled that the sale of an undamaged portion of a property would qualify for nonrecognition treatment under sec. 1033 where (1) the converted property could not reasonably or adequately be repaired and (2) there is a substantial economic relationship between the converted property and the second property such that they constituted one economic unit.

OTA's Analysis

The OTA looked at three factors to determine whether the involuntary conversion of one property could result in the involuntary conversion of a second property: (1) where the properties one economic unit; (2) was one of the properties involuntarily converted; and (3) was continuation of the business impractical.

The OTA held that the Mitchells' buildings were one economic unit. All three buildings were located on a single piece of property, were interconnected and all the buildings were reliant on Building B. All three buildings were leased to one person, the charity. While the charity continued to use one of the buildings



following the storm, if Building B were demolished for repair, the charity would be forced to abandon the tenancy.

The OTA rejected the FTB's argument that there was no involuntary conversion because the Mitchells could have repaired the property. According to the OTA, the FTB's argument "would have the result that no involuntary conversion caused by a casualty event may qualify for IRC section 1033 if the property is repairable, regardless of the severity of the damage or the cost of repair." The storm resulted in the involuntary conversion of the Mitchells' property: the storm rendered the property no longer useful or available because the cost of repair was not economically feasible for them. They did not have and could not borrow the funds to make the needed repairs and the carrying costs of the property while repairs were being made were, for the Mitchells, prohibitive. Thus, the property was involuntarily converted.

Finally, the OTA held that the Mitchells established that continuation of the business on the Clinton property was impractical. Buildings A and C were dependent upon Building B for utilities and public restrooms. Repairing Building B would render the other two buildings unusable while repairs were ongoing. These repairs were economically unfeasible. The OTA found that "economic considerations may render continued business operations impractical" and that this comports with the liberal interpretation of sec. 1033. As a result, the OTA found that the Mitchells had established an involuntary conversion and were entitled to nonrecognition of gain under sec. 1033.

Takeaways

The OTA has shown a willingness to rule for the taxpayers on issues involving nonrecognition of gain provisions, such as section 1031. See, *Appeal of Mitchell*, 2018-OTA-210 (holding that the taxpayer who engaged in a "drop and swap" did not recognize gain under sec. 1031). Where there is clear Tax Court or federal or California appellate court precedent that supports a taxpayer's position, the OTA will tend to follow that precedent. An advocate should therefore look for such precedent in preparing for a case before the OTA.



Additionally, the OTA found both Mr. Mitchell and the project manager, who evaluated the property and solicited bids for its repair, credible and that their testimony was supported by contemporaneous documentation establishing the damage to the property and the cost of repairs, all of which led to the OTA finding that the three elements needed to establish entitlement to gain deferral under sec. 1033, including that repairing the damage was not economically feasible, were present. Having credible witnesses whose testimony is supported by contemporaneous documents is also important in persuading the OTA, like any adjudicatory body, that it should rule in favor of your client.

When litigating tax issues with the OTA, or other tax authorities, consulting with an experienced tax controversy attorney will assist with ensuring the best record to achieve a successful result.

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