TREATMENT OF CAPITAL GAINS TAX WHEN THE PLEASANT HILL REDEVELOPMENT AGENCY ACQUIRES YOUR PROPERTY

Prepared by the
Pleasant Hill Redevelopment Agency

This Guide is intended to provide general information and background of the requirements to defer taxable gain upon sale of property in condemnation situations. It is not intended as legal, tax or any other advice. There are many special tax rules that have not been explained in this Guide. Ultimately, all readers should consult with their own tax consultants or advisors, tax attorneys, accountants or your local IRS office to discuss particular circumstances regarding availability of tax deferral.

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Dear Property Owner:

Selling your property to the Pleasant Hill Redevelopment Agency may have certain tax advantages because the purchase of your property is considered to be made under threat of eminent domain (condemnation). In general, when a government agency with the authority to condemn acquires your real property for public purposes, the property owner may postpone the payment of federal capital gains tax on any profit made from the sale if the profit is reinvested in property of similar services and use within a certain replacement period.

The Pleasant Hill Redevelopment Agency is pleased to provide the attached general information of some of the applicable federal tax rules that apply to a gain or loss resulting from acquisition of real property by condemnation or by the threat of condemnation.

You are encouraged to discuss these issues with your tax advisor or your local Internal Revenue Service (IRS) office. Publications addressing the sale and other disposition of assets are available from the IRS.

Property owners are eligible to defer payment of federal taxes on capital gains in property when the Pleasant Hill Redevelopment Agency purchases the real property by condemnation or under threat of condemnation (eminent domain). Property used for personal use as well as property used for business and investment may qualify for tax deferral treatment. 1

IS THERE A GAIN ON THE PROPERTY?

Is the Redevelopment Agency paying more for the condemned property than the property owner's adjusted tax basis in such property? 2

If the answer is yes, the property owner has a capital gain.

If the answer is no, the property owner has a loss. This memorandum does not apply to losses. Other tax provisions may apply to limit the deductibility of these losses, and losses must be reported in the tax year it happened. Please consult your tax advisor or the local IRS office.

HOW IS THE GAIN FROM MY PRINCIPAL PLACE OF RESIDENCE TREATED?

If you have a gain because your principal place of residence is condemned, you generally can exclude the gain from your income as if you had sold or exchanged your home. You may be able to exclude up to $250,000 of the gain (up to $500,000 as married filing jointly). If your gain is more than you can exclude but you buy replacement property, you may be able to postpone reporting the rest of the gain. See below.

HOW CAN THE PROPERTY OWNER DEFER PAYMENT OF CAPITAL GAINS TAXES?

The property owner can choose to defer some or all of the otherwise taxable capital gains if the profit from the sale of the property is reinvested in a qualifying replacement property that is similar or related in service or use to the condemned property within a specific

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1 The tax deferral provisions are found in Section 1033 of the Internal Revenue Code of 1986, as amended, and Section 18031 of the California Revenue and Taxation Code. For further information, see Internal Revenue Service Publication 544 "Sales and Other Disposition of Assets."

2 The term "condemned property" is used in this guide to mean property that the Redevelopment Agency purchases. Such purchases are made "under threat of condemnation."

replacement period. To postpone all the gain, the cost of the replacement property must equal or exceed the amount realized for the condemned property.

A property owner must ordinarily report a gain if the replacement property is unlike property.

HOW ARE SEVERANCE DAMAGES TREATED?

Severance damages are paid to you if part of your property is condemned and the value of the part you keep is decreased because of the condemnation. Your *net* severance damages are treated as the amount realized from an involuntary conversion of the remaining part of your property. They may be used to reduce the basis of the remaining property. To calculate your net severance damages, you must first reduce your severance damages by your expenses in obtaining them. This means you may subtract such items as legal, engineering and appraisal fees. If your net severance damages are more than the basis of your retained property, you have a gain. You may, however, be able to postpone reporting the gain if you purchase replacement property that costs at least as much as your net severance damages plus the amount realized for the condemned property. If you restore the remaining property to its former usefulness, you can treat the cost of restoring it as the cost of replacement property.

HOW IS THE COMPENSATION PAID FOR A TEMPORARY CONSTRUCTION EASEMENT TREATED?

Sometimes the Agency will take possession of a property on only a temporary basis, such as for purposes of a temporary construction easement. If the taking is for a period of five years or less, the money received by the property owner is treated as rental income and is taxable as ordinary income.

WHAT IS A QUALIFYING REPLACEMENT PROPERTY?

The replacement property must satisfy either of the tests described below:

1. The replacement property must be similar or related in service or use to the condemned property, such as a personal home is replaced with property to be used for your personal home; or

2. When the condemned property is real property held for productive use in a trade or business or held for investment (excluding real property held primarily for sale), the replacement

property must be of a like-kind, and the property owner must hold the replacement property in the same manner as the condemned property.

A gift of the replacement property to the property owner would not satisfy the purchase requirement. The qualifying replacement property must be purchased.

The property owner must purchase the replacement property with the intent to replace the condemned property. Although this requirement is easily met in most situations, it might be problematic for property owners who acquire the replacement property in the ordinary course of business. It is often advisable for property owners to document, in connection with the acquisition of the replacement property, their intention of acquiring the property to replace the condemned property.

WHAT IS THE REPLACEMENT PERIOD?

The purchase of the replacement property must occur within the applicable time period described below:

1. The replacement period begins on the earlier of:

    (1) The date the Agency purchases the condemned property; or

    (2) The date of the threat or imminence of the requisition or condemnation.

2. The replacement period ends as follows:

    (1) If the condemned property is real property held for productive use in a trade or business or held for investment, the replacement period ends <u>three years</u> after the close of the first tax year in which any gain from the sale is realized.

    (2) Otherwise, the replacement period ends <u>two years</u> after the close of the first tax year in which any gain from the sale is realized.

    (3) Alternatively, the replacement period could end at a later date if allowed by the Internal Revenue Service upon application by the taxpayer.

HOW DOES A PROPERTY OWNER NOTIFY THE IRS OF THE CHOICE TO POSTPONE THE GAIN?

A property owner must make a tax election to defer the gain from the sale of the condemned property on the tax return for the taxable year in which the gain is realized. If the property owner fails to make the election, and also fails to report the realized gain on the appropriate tax return, the taxpayer will be deemed to have made the election to postpone.

The election can be revoked by the property owner at anytime, unless qualifying replacement property is purchased within the qualifying replacement period and prior to the revocation.

WHAT IS THE PROPERTY OWNER'S BASIS IN THE REPLACEMENT PROPERTY?

The property owner's new basis is the cost of the replacement property reduced by the amount of the gain that he/she realized from the sale of the condemned property. In effect, this allows a deferral of the gain.

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