EMINENT DOMAIN IN OIL AND GAS: TAX TREATMENT WHEN A PIPELINE DEVALUES SURROUNDING PROPERTY

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I. INTRODUCTION

The United States currently has more than 1.8 million miles[1] of underground natural gas pipeline and 160,000 miles[2] of underground oil pipeline in place to move oil and gas minerals from production sites to processing locations and ultimate consumers. While other means of transporting oil and liquid petroleum products exist, such as by truck, rail or water, the most efficient means is underground pipelines and the use of pipelines is virtually the only method for transporting natural gas. The U. S. Department of Energy estimates that in North America an additional 28,900-61,600 miles of underground pipelines will be required by 2030. Much of the new pipeline additions are already planned or under construction and will stretch from Alaska through Canada and across the United States.[3] Before new construction of pipelines can begin, the pipeline company must obtain right of way easements from the owners of property along the proposed route. Since 1938, eminent domain for interstate pipelines has rested at the federal level. Currently, an interstate pipeline company may invoke eminent domain where the pipeline company has not been able to successfully negotiate a purchase price with the property owner if the Federal Energy Regulatory Commission has issued a certificate of public convenience.[4] The right of way easements are typically from twenty-five to one hundred and

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[1] Brian von Schulz, *Hardwood Mats Help Protect the Environment During Pipeline Construction*, NORTH AM. OIL & GAS PIPELINES, (May 14, 2011), http://www.napipelines.com/featured/2011/2011-05-feature-3.html.

[2] Daniel Yergin, *Ensuring Energy Security*. 85 FOREIGN AFF. 69, 80 (2006), http://www.un.org/ga/61/second/daniel yergin energysecurity.pdf.

[3] Rita Tubb, *2011 Worldwide Pipeline Construction Report,* 238 PIPELINE AND GAS J. 1 (Jan. 2011), http://www.pipelineandgasjournal.com/2011-worldwide-pipeline-construction-report.

[4] Dianne Rahm, *Regulating Hydraulic Fracturing in Shale Gas Plays: The Case of Texas,* 39 ENERGY POL'Y 2974, http://www.sciencedirect.com/science/article/pii/S0301421511001893.

fifty feet wide, depending upon the diameter of the pipe to be laid.[5] The best situation is for the pipeline company to negotiate a contract with each of the landowners on the pipeline route. If negotiations fail, the pipeline company may resort to eminent domain to force the landowner to grant the easement. Use of eminent domain changes the nature of the transaction for the landowner when calculating gains or losses.

II. SCOPE

The construction of new pipelines is driven by two major factors: the need to provide adequate oil and gas for consumption and the recent development of technology to support the production of oil, condensate and natural gas from shale formations. The costs and benefits among the stakeholders often conflict.[6] Underground pipelines serve three distinct purposes: gathering lines are used to carry oil and gas production from well sites to processing facilities or to transmission lines; transmission lines (also called trunk lines) are used to transport oil and gas minerals to processing facilities and from processing facilities to distribution hubs; distribution lines are very narrow gauge pipelines used to deliver processed natural gas from distribution hubs to the ultimate consumers (homes and businesses).[7] Gathering lines are typically narrow gauge, one foot in diameter or less,[8] and cover short distances. Transmission lines are larger gauge pipelines and range from twelve to forty-two inches in diameter.[9] Of the 1.8 million miles of natural gas pipelines, more than 300,000 miles are large gauge transmission lines.[10] The remainder consists of gathering or distribution lines. A large portion of the expected new pipeline construction will be transmission lines, requiring wider easements for construction and maintenance. One example of proposed new construction is the Keystone XL Gulf Coast Expansion Project that consists of 1,661 miles of thirty-six inch crude oil pipeline.[11] In addition, expansion of distribution pipelines is expected to be required as a result of growth and shift in the population of the United States.

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[5] *See Chesapeake Energy Corporation Natural Gas Pipeline Fact Sheet* (Sept. 2011), http://www.chk.com/media/educational-library/fact-sheets/corporate/pipeline_transportation_fact_sheet.pdf.
[6] *See generally* Jeffrey E. Lewin, David Strutton, & Audhesh K. Paswan, *Conflicting Stakeholder Interests and Natural Gas: A Macromarketing Perspective,* 31 J. OF MACROMARKETING 340 (Dec. 2011).
[7] *Chesapeake Energy Corporation Natural Gas Pipeline Fact Sheet*, *supra* note 5.
[8] von Schulz, *supra* note 1.
[9] *Id.*; *see also Chesapeake Energy Corporation Natural Gas Pipeline Fact Sheet*, *supra* note 5.
[10] *Chesapeake Energy Corporation Natural Gas Pipeline Fact Sheet*, *supra* note 5.
[11] Tubb, *supra* note 3.

The more pressing issue requiring expansion of current pipeline infrastructure for oil, condensate and natural gas is the rapid growth in new production from shale formations in the United States. Increased domestic production of oil and natural gas has the potential to significantly reduce the U.S. dependence on imported oil and gas. While the location and size of mineral deposits in the shale formations (a combination of oil, natural gas and condensate) has been known since the 1800's, the technology to produce the minerals developed slowly and it was not until 2005 that production became economically feasible. Horizontal drilling techniques and hydraulic fracturing (known in the industry as fracking) processes have resulted in increased production of oil and natural gas from shale deposits in 2010-2011 with further increases expected. Many of the shale formations are located in the mid-West, mid-Atlantic and northeast regions of the U.S. However, the minerals need to be transported to the processing facilities and distribution hubs located mostly along the Gulf Coast and miles of new transmission lines must be constructed to accommodate the production.[12]

The Marcellus Shale is the largest shale play in the U.S. and is located in Pennsylvania, Ohio, West Virginia and New York.[13] Efficient production of the shale minerals will require increased pipeline infrastructure to deliver the natural gas to the surrounding populace, as well as, newly constructed transmission lines to carry the natural gas and oil to distant processing and distribution points. Processing facilities are also being expanded to handle the increased production and existing oil transmission pipelines are being converted to carry natural gas and condensate. Recent reports indicate production is exceeding estimates. The Eagle-Ford Shale, located in Texas, produced 21.8 million barrels of oil and 18.7 million barrels of condensate, when initial estimates had indicated production of only 8.6 million barrels of oil and 5.6 million barrels of condensate.[14]

A. *Landowner Issues*

Landowners face a number of issues when negotiating right of way easements with pipeline companies. Most pipelines are designed from 'the shortest distance between two points is a straight line' perspective. Consequently, the easement may not be conveniently located along property

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[12] *See Shale Gas: Applying Technology to Solve America's Energy Challenges*, U.S. DEP'T OF ENERGY (Mar. 2011), http://www.netl.doe.gov/technologies/oil-gas/publications/brochures/Shale_Gas_March_2011.pdf.

[13] *Review of Emerging Resources: U.S. Shale Gas and Shale Oil Plays*, U.S. ENERGY INFO. ADMIN. (U.S. DEP'T OF ENERGY) (July 2011), at 4.

[14] Mike D. Smith, *Eagle Ford Shale Communities Work Toward Sustainable Futures Amid Booming Oil, Gas Production*, CORPUS CHRISTI CALLER TIMES, Mar. 3, 2012, at A1.

lines or natural boundaries and may disrupt the livelihood of the landowner by preventing the free movement of livestock and wild animals. It may also disrupt the landowner's access to water or roadways.

Landowner access to the right of way easement is restricted during construction of the pipeline but typically allowed after the pipeline is completed. The surface area of the easement is restored after completion. However, the construction process is destructive of vegetation and wild life and usually results in permanent damage or a long recovery period before normal vegetation returns.

Longer pipelines may require lifting and pressurizing stations at various points along the pipeline route. The buildings and equipment for lifting and pressurizing are permanent installations and are typically fenced to prevent access. Roadways must be constructed to provide the pipeline operator access to the facilities and the pipeline for inspection and maintenance. The easements are also typically kept free of vegetation to allow for aerial surveillance of the pipeline route.

B. *Political and Regulatory Issues*

Construction of pipelines is expensive and requires a long approval process involving both state and federal agencies. Pipelines represent a number of potential hazards. Pipelines may develop leaks over time and pollute the soil surrounding the pipeline. Pipelines operate at high pressure and may explode. In urban areas, safety (due in part to dense populations) and noise are considerable issues.[15] In less urban areas, the construction process may destroy the surface area in the right of way easement and damage or reduce the quantity of plant and animal life in the surrounding area. The decision to approve the construction of additional underground pipelines is a balance between the risk involved and the need to provide the infrastructure necessary to support production and consumption needs. State and local issues may also be pertinent.[16]

The Keystone XL Gulf Coast Expansion Project is currently planned to expand existing pipelines from Alberta, Canada to delivery terminals near Port Arthur, Texas. The planned expansion is in two sections, one running from Alberta across Montana to connect to existing pipeline in Nebraska. The other section runs from Cushing, Oklahoma to Nederland, Texas. The

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[15] Billie Ann Maxwell, *Texas Tug of War: A Survey of Urban Drilling and the Issues an Operator Will Face*, 4 TEXAS J. OF OIL, GAS & ENERGY L. 338, 345 (2008).

[16] *See e.g.* Laura Springer, *Waterproofing the New Fracking Regulation: The Necessity of Defining Riparian Rights in Louisiana's Water Law*, 72 LA. L. REV. 225 (2011); Charles Davis, *The Politics of Fracking: Regulating Natural Gas Drilling Practices in Colorado and Texas*, 29 R. OF POL'Y RES. 177 (2012).

total project encompasses 1,661 miles of pipeline and is expected to cost $7 billion.[17] The section of the expansion that crosses the Montana/Canadian border requires White House approval and the entire project was stopped due to failure by the current administration to approve the project. The company constructing the pipeline (TransCanada) has recently said it plans to go ahead with the section of the project that runs from Oklahoma to Texas, as it does not need federal approval for the construction.[18] Environmental groups are expected to oppose the construction, due to the nature of the petroleum and the potential impact on the environment. Interestingly, TransCanada says it "has approval from more than 99% of the landowners"[19] along the Oklahoma/Texas route but appears to be using eminent domain to obtain a large number of easements in Texas.[20]

III. EMINENT DOMAIN

Eminent domain (sometimes referred to as condemnation), is the power of the government to take private property for the public use without the consent of the owner.[21] This power was left to the sovereign to shape the use of the property as it sees fit.[22] In Colonial America, the power to use eminent domain did not require compensation to the owner of that property, and was often used to divest the owners of the property for some public benefit.[23] After the Revolution, the constitutions of two states, Vermont in 1777 and Massachusetts in 1780, required that just compensation be given when the state chooses to use its power of eminent domain.[24] James Madison recognized the importance of the just compensation requirements and when drafting the Fifth Amendment to the Constitution, making it a requirement for all states within the United States.[25] The Fifth Amendment contains the now familiar language that became the basis of modern eminent domain law,

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[17] Tubb, *supra* note 3.
[18] Chris Isidore, *Part of Keystone Pipeline to Move Forward*, CNNMONEY.COM (Feb. 27, 2012), http://money.cnn.com/2012/02/27/news/companies/keystone_pipeline/index.htm?hpt=hp_t3.
[19] *Id*.
[20] John McFarland, *Texas Debate over Pipeline Condemnation Rights Now Affecting Keystone Pipeline*, OIL & GAS L. BLOG (Feb. 17, 2012), http://www.oilandgaslawyerblog.com/2012/02/texas-debate-over-pipeline-con.html.
[21] Peter J. Kulick, *Rolling the Dice: Determining Public Use in Order to effectuate A "Public-Private Taking"-A Proposal to Redefine "Public Use,"* 2000 L. Rev. M.S.U.-D.C.L. 639, 643 (2000).
[22] *Id*.
[23] Daniel P. Dalton, *A History of Eminent Domain*, 3 STATE BAR OF MICH. PUB. CORP. L. Q. 1, 3 (2006).
[24] *Id*.
[25] *Id*. at 4.

that "private property [shall not] be taken for public use, without just compensation."[26]

A. *Recent Issues*

Recently, there has been much interpretation of the public use requirement of the Fifth Amendment. In *Kelo v. City of New London*, the United States Supreme Court held that the public use clause of the Fifth Amendment allowed for the government to transfer private property to another private party to promote economic development.[27] The *Kelo* case brought swift and broad-based political denunciation.[28] In "probably the broadest legislative reaction ever generated by any Supreme Court ruling,"[29] "[f]orty-three states and the federal government enacted legislation intended to curb economic development takings."[30] The state legislative reactions to the *Kelo* decision may be broadly put into two categories. The first category being restrictions on eminent domain based on purpose, the second being legislation involving valuation and compensation requirements.[31] Texas, however, like many other energy producing states, when reacting to the *Kelo* decision, specifically allowed for taking of private property by eminent domain to be used create oil pipelines. Texas Government Code § 2206.001[32], which was enacted in 2006, one year after *Kelo,* restricts the uses for which an eminent domain action may be brought. Section 2206.001(b) states the broad provisions that limit the uses by disallowing a benefit on a "particular private party." In relevant part section (b) of the statute states:

> (b) A governmental or private entity may not take private property through the use of eminent domain if the taking:
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> (1) confers a private benefit on a particular private party through the use of the property;
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> (2) is for a public use that is merely a pretext to confer a private benefit on a particular private party;

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[26] U.S. CONST. AMEND. V.
[27] 545 U.S. 469, 489-490 (2005).
[28] Ilya Somin, *Eminent Domain in the United States: Public Use, Just Compensation, & "The Social Compact": Introduction: The Judicial Reaction to Kelo*, 4 ALB. GOV'T L. REV. 1, 2 (2011).
[29] *Id*.
[30] *Id*.
[31] *See* Alex Hornaday, *Imminently Eminent: A Game Theoretic Analysis of Taking since Kelo v. City of New London*, 64 WASH. & LEE L. REV. 1619, 1633-38 (2007).
[32] TEX. GOV'T. CODE ANN. § 2206.001 (2011).

> (3) is for economic development purposes, unless the economic development is a secondary purpose resulting from municipal community development or municipal urban renewal activities to eliminate an existing affirmative harm on society from slum or blighted areas under:
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> > (A) Chapter 373 or 374, Local Government Code, other than an activity described by Section 373.002(b)(5), Local Government Code; or
> >
> > (B) Section 311.005(a)(1)(I), Tax Code; or
>
> (4) is not for a public use.[33]

However, section (c) of the statute makes exceptions to the blanket prohibitions that are in section (b). Section 2206.001(c) of the Texas Government Code excepts, among other things, oil pipelines from the prohibited uses. Section (c) reads in relative part:

> (c) This section does not affect the authority of an entity authorized by law to take private property through the use of eminent domain for:…
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> (7) the operations of:
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> > *(A) a common carrier pipeline; or*
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> > *(B) an energy transporter, as that term is defined by Section 186.051, Utilities Code…*[34]

The Texas legislature left no doubt in Texas Government Code § 2206.001(c)(7) of its intent to allow for the use of eminent domain for the creation of new oil pipelines, even if the transfer of property would be from one private owner to another. Section 2206.001(c)(7)(A) specifically allows for the power to be used to create a public carrier pipeline and § 2206.001(c)(7)(B) allows it to be used for an "energy transporter," which "is a person who gathers or transports oil, gas, or oil and gas products by pipeline."[35]

In jurisdictions that do not specifically allow for eminent domain for private pipelines, other, sometimes creative approaches have been taken. Pennsylvania, for example, allows for the use of eminent domain to be used by private pipeline companies in two ways. Section 204 of the Pennsylvania

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[33] TEX. GOV'T. CODE ANN. § 2206.001(b) (2011) (emphasis added).
[34] TEX. GOV'T. CODE ANN. § 2206.001(b) (2011) (emphasis added).
[35] TEX. UTIL. CODE ANN. § 186.051(3) (2012).

Eminent Domain Code, expressly prohibits private enterprises from using eminent domain, stating that:

> (a) Prohibition.--…[T]he exercise by any condemnor of the power of eminent domain to take private property in order to use it for private enterprise is prohibited.[36]

However, eminent domain is allowed in Pennsylvania if "the property is taken by, [or] to the extent the party has the power of eminent domain, transferred or leased to [among other entities]…*a public utility*…."[37] Essentially, this would allow for a party to lease or transfer property to a public utility and then the public utility would then have the power to use eminent domain in the taking of the land.

Traditionally interstate transmission lines have been federally regulated, and have been considered public utilities with the power of eminent domain in Pennsylvania. Conversely, gathering lines are considered to be run by private entities and not serving the public need, and therefore do not receive the power to condemn.[38] Recently however, Laser Northeast Gathering Company (Laser), a private natural gas pipeline company, applied to be considered a public utility in Pennsylvania.[39] The Pennsylvania Public Utilities Commission (PUC) developed a four-part test to determine if Laser was a public utility and therefore would get the power of eminent domain. In its determination that Laser could be considered to be a public utility the PUC stated:

1. Laser will be transporting or conveying natural or artificial gas by pipeline or conduit for compensation.
2. Laser will serve any and all potential customers needing to move gas through the pipeline system.
3. Laser intends to utilize negotiated contracts to secure customers; contracts are not meant to be exclusionary, but rather to establish technical requirements, delivery points, and other terms and conditions of service.

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[36] 26 PA. CONS. STAT. ANN. § 204(a) (2012).
[37] 26 PA. CONS. STAT. ANN. § 204(b) (2012) (emphasis added).
[38] Dale A. Tice, *Eminent Domain for Pennsylvania Pipelines*, MARCELLUS SHALE L. MONITOR (Sept. 2, 2011), http://www.marcellusshalelawmonitor.com/marcellus-development/eminent-domain-for-pennsylvania-pipelines/.
[39] *Application of Laser Northeast Gathering Company, LLC for Approval to Begin to Offer, Render, Furnish, or Supply Natural Gas Gathering and Transporting or Conveying Service by Pipeline to the Public in Certain Townships of Susquehanna County, PA*, PA. PUBLIC UTIL. COMM'N, A-2010-2153371 (Aug. 25, 2011).

4. Laser has made a commitment to expand its capacity, as needed, to meet increased customer demand.[40]

This approach again would allow a state such as Pennsylvania, which limited takings by private parties after *Kelo*, to have takings by an essentially private company by redefining it to be a public utility, since they will allow for any company to use their lines to transport gas.

B. *Issues of Valuation*

Since the United States Constitution requires that there be just compensation in the use of eminent domain, and Texas, as is typical of other oil producing states, specifically allows for the use of eminent domain for oil pipelines, a question of how one would value that compensation arises. Of particular issue is the case, *LaSalle Pipeline, L.P. v. Donnell Lands, L.P.*,[41]where the court was asked to determine how to value land that was taken by eminent domain for an oil pipeline owned by LaSalle Pipeline, L.P (LaSalle). LaSalle filed an eminent domain proceeding to acquire temporary workspace easements and permanent right of way easements on tracts of land owned by Donnell Lands, L.P. (Donnell).[42] The pipeline crossed two tracts of land owned by Donnell. On the first tract, LaSalle acquired 15.95 acres of land for the permanent easement from a tract of land that was comprised of 8,034 acres. The second tract contained about 46 acres, of which .97 acres was acquired.[43] At the trial, the court found that the value of the land was $19,206 for the temporary easements and $34,533 for the permanent easements. The contentious issue was that in addition, the jury awarded Donnell $604,950 for the diminution in the value of the remaining tracts held by Donnell.[44] On appeal, the court recognized the "before and after" measure of damages for Donnell.[45] The court held in explanation that:

> When, as here, a condemnor takes only a portion of a landowner's property, the landowner is entitled to compensation in the amount of the market value of the part taken, plus the damage to the remainder caused by the condemnation. The measure of damages to

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[40] *Id*. at 19 (original citations removed).
[41] 336 S.W. 3d 306 (Tex. App. 2010, *pet filed*).
[42] *Id*. at 309.
[43] *Id*. at 310.
[44] *Id*. at 309.
[45] *Id*. at 314.

> the remainder is the difference in market value of the land immediately before and immediately after the taking.[46]

How to measure the damages to the remainder is an issue of fact. The court allowed for the damages to be measured in a typical way, which is a comparable sales approach stating:

> [C]ourts have long favored the comparable sales approach when determining the market value of real property. Under the comparable sales approach, the appraiser finds data for sales of similar property, then makes upward or downward adjustments to these sales based on differences in the subject property. Comparable sales must be voluntary, and should take place at or near in time to the condemnation, occur in the vicinity of the condemned property, and involve land with similar characteristics.[47]

LaSalle has filed a petition for review with the Supreme Court of Texas challenging the diminished valuation of the remainder of Donnell's land. The central argument made by LaSalle is that the jury awarded the diminution of value based on conjecture and speculation.[48] LaSalle argues that the testimony of the experts and the testimony of members for the Donnell family as to the before and after values are not based in fact and the diminution of the remainder is way overvalued.[49] LaSalle argues that the letting evidence of the Donnell family allows for personal valuations rather than market value, and that the experts hired by Donnell used improper valuation techniques. They claim that there was no diminution in value at all to Donnell.[50] Donnell's experts argue that properties burdened by pipeline easements are diminished by 10%-25% and therefore Donnell should have received $843,490.[51] The jury award was based on a 20% diminution in value. La Salle argues that only their appraiser was credible, therefore that should be the only appraisal which is given weight, and that allowing speculation will make it impossible to determine the value of a pipeline project prior to starting the construction.

More importantly, however, is the further implication of the decision. Amicus Briefs that are filed show the policy disagreements that could happen

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[46] *Id*. (original citations removed).
[47] *Id*. at 314-15 (original citations removed).
[48] LaSalle Pipeline, L.P. v. Donnell Lands L.P., Petitioners Brief, Petition for Review, Supreme Court of Texas, at 1.
[49] *Id*.
[50] *Id*. at 12-13.
[51] LaSalle Pipeline, 336 S.W. 3d at 318.

in future eminent domain cases, especially in light of major new pipelines that will be built in South Texas to support the Eagle Ford Shale. They essentially argue that it would be impossible to determine the cost of a pipeline project if the diminutions could be argued by conjecture and speculation. Energy Transfer Partners LP filed an amicus letter brief stating that:

> ETC has an interest in this case, because in conjunction with two common carrier pipelines that will transport natural gas liquids produced from the Eagle Ford Shale in South Texas it has been faced with landowners arguing in over twenty condemnation hearings that there is at least a 20% diminution in the value of property as a result of a taking for a pipeline easement. The landowners are making these arguments without any supporting evidence, but relying solely on the appellate opinion in *LaSalle.*[52]

The view of LaSalle and Energy Transfer Company is disputed in an Amicus Brief of the Texas Land and Mineral Owners Association (TMLA). TMLA argues instead that:

> More than a few pipeline companies proceed on the assumption embraced by LaSalle's appraiser in this case—that pipelines have no effect at all on property values. But the reality is that pipeline easements frequently have a detrimental effect on property values. An underground pipeline often reduces the development potential of a tract by limiting the structures that can be built over or near the pipeline. The fact that this diminution in value can be difficult to measure with precision does not justify imposing the extensive evidentiary burdens proposed by LaSalle.[53]

Regardless of the Texas Supreme Court's decision to hear the case or not, and what the outcome of the case is, it is clear that diminution of surrounding property is a possibility in eminent domain cases, and there are Federal Tax implications as to the value of the diminution in the remainder of the land since it is an involuntary conversion of property.

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[52] No. 11-0226; LaSalle Pipeline LP v. Donnell Lands, LP, Supreme Court, Letter Amicus Brief of Energy Transfers Partners LP in support of Petitioner, at 2-3.

[53] No. 11-0226; LaSalle Pipeline LP v. Donnell Lands, LP, Supreme Court, Amicus Curiae Brief of Texas Land and Mineral Owners Association in support of Respondent at 1-2.

IV. FEDERAL TAX LAW FOR SALE OF PROPERTY AND INVOLUNTARY CONVERSION

A sale under eminent domain is an involuntary conversion. Proceeds may include both amounts for the land taken (sale) and compensation for reduction in value of surrounding lands that were not sold, commonly called a "basket purchase." That is, the proceeds include both the value of the land purchase and also compensation for the diminution value of the surrounding land. While the treatment of the sale portion is fairly straightforward, what should the tax treatment be for the diminution value of surrounding lands?

A. *Basket Purchase*

Where a partial taking occurs that affects the portion of the property not taken, a determination must be made whether the property portions are severable or part of a single economic unit. If the conversion is part of single economic unit, Internal Revenue Code (I.R.C.) § 1033 gain deferral treatment applies to both the condemned portion and the part not condemned if it is voluntarily sold. For example, in *Masser v. Commissioner,*[54] a truck freight terminal became useless when the adjoining parking lot for the trucks was condemned. In this case, a single economic unit existed and I.R.C. § 1033 applied to both the parking area and the sale of the terminal. However, in Revenue Ruling 78-377,[55] a shopping center that was sold after a fire destroyed only part of the structure was pro-rated: the fire insurance proceeds, but not the sale of the undamaged surrounding stores, qualified for deferral from income tax under I.R.C. § 1033.

Where portions of property are severable and a taxpayer receives both compensation for the property taken and mutually designated severance damages, only the amount received as compensation for the property is considered proceeds for the property.[56] Diminution, usually called "severance awards" in tax cases, generally results when a portion of property is condemned and the value of the taxpayer's remaining property has declined as a result of the condemnation. Severance awards are generally a tax-free recovery of capital that reduces the basis of property. If the amount of severance damages received exceeds the adjusted basis in the remaining affected property, the taxpayer recognizes a gain, unless either 1) the severance damages are used to restore the usability of the remaining property, or 2) the usefulness of the remaining property is destroyed by the

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[54] 30 T.C. 741 (1958), *acq*. 1959-2 C.B. 5. *See also* Rev. Rul. 59-361, 1959-2 C.B. 183.
[55] 1978-2 C.B. 208.
[56] Pioneer Real Estate Co. v. Comm'r, 47 B.T.A. 886 (1942), *acq.* 1943 C.B. 18.

condemnation, and the property is sold and the condemnation award, severance damages and sales proceeds are reinvested in property of equal or greater value. Where at least one of these conditions is met, non-recognition of gain exists under I.R.C. § 1033.

I.R.C. § 1033 allows a taxpayer who suffers an involuntary conversion of property to postpone recognition of a gain realized from the conversion to the extent the taxpayer reinvests the amount realized from the conversion in replacement property. (I.R.C. § 1033 does not change the treatment of losses, which are recognized when they are realized, unless the condemnation is related to a personal use asset like a personal residence. Then, losses are neither recognized nor postponed. A taxpayer may choose to exclude at least part of a gain on a personal residence under I.R.C. § 121 rather than to defer it. This discussion is outside the scope of this paper.)

An involuntary conversion is the complete or partial destruction, theft, seizure, requisition or condemnation or sale or exchange under threat of imminent requisition or condemnation of a taxpayer's property.[57] Where a (threat or imminence of) condemnation exists, the property must be taken without the taxpayer's consent for compensation.[58] Threat or imminence only exists if officials of a government with the authority to condemn have communicated the intent to condemn, and the taxpayer has good reason to believe they would. Media reports of condemnation are not sufficient.[59] The taking of the property is not enough, the property must be taken by a government that has the authority to condemn the property, and not as a result of the (in)actions of the taxpayer.[60]

The taxpayer must also be able to show that there has been a decision to acquire property for public use, and have reasonable grounds to believe the property will be taken.[61] Where these criteria are satisfied, the taxpayer can sell the property to another party. The sale of property to a condemning authority by a taxpayer who acquired the property knowing the property was under threat of condemnation still qualifies for involuntary conversion treatment under I.R.C. § 1033.[62]

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[57] I.R.C. § 1033(a) (2012).

[58] *See* Hitke v. Comm'r., 62-1 U.S.T.C. P 9114, 8 A.F.T.R.2d (RIA) 5886, 296 F.2d 639 (7th Cir. 1961).

[59] Rev. Rul. 58-557, 1958-2 C.B. 402.

[60] *See* Coop. Pub. Co. v. Comm'r, 40-2 USTC P9823 (CCH), 25 A.F.T.R. (P-H) 1123, 115 F.2d 1017 (9th Cir. 1940); Recio v. Comm'r, T.C. Memo 1991-215, 1991 Tax Ct. Memo LEXIS 238, 61 T.C.M. (CCH) 2626 (1991); Davis Co. v. Comm'r, 6 B.T.A. 281 (1927), *acq.* VI-2 C.B.2. *See also* Rev. Rul. 57-314, 1957-2 C.B. 523.

[61] Rev. Rul. 63-221, 1963-2 C.B. 332 and Balistrieri v. Comm'r 38 T.C.M. (CCH) 526, T.C. Memo 1979-115.

[62] Rev. Rul. 81-181, 1981-2 C.B. 162.

B. *Replacement Property for § 1033 Gain Deferral*

For most property, the amount of the gain deferred is the lesser of the gain itself or the amount reinvested in property that is "similar or related in service or use" to the property converted.[63] For example, replacing a bowling alley with a billiard parlor is not a similar or related use.[64] In the case of rental properties that have been involuntarily converted, the replacement property must be used by the lessor/taxpayer the same way (as rental property) regardless of the lessee's use.[65] Conversely, replacing a rental residence with a personal residence does not qualify as similar.[66]

Similarly, replacement property may be indirectly owned, as is the case where property that is involuntarily converted is replaced with a controlling ownership of stock in a corporation owning property that is "similar or related in use or service."[67] Control means owning at least 80% of all voting stock and 80% of all other classes of stock.[68] If livestock are sold because of environmental contamination and it is not feasible for the owner to reinvest in other livestock, then other farm property (including real property) will qualify as replacement property.[69]

Where real estate used in a trade or business or for investment is condemned, replacement property must be "similar or related in use."[70] Applied, any property that would meet the like-kind test under I.R.C. § 1031 would qualify as similar or related in use for this real estate. These rules generally provide for gain deferral where any U.S. real estate is replaced with any other U.S. real estate.

Interpretation of similar or related use is more flexible in federally declared disaster areas.[71] Property already owned by the taxpayer does not qualify as replacement property.[72] Regular corporations, partnerships with regular corporations as partners, and others deferring gains in excess of $100,000 may not defer a gain if the replacement property is purchased from a related party, including close family members and entities where the

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[63] I.R.C. § 1033(a) and Treas. Reg. § 1.1033(a).
[64] Rev. Rul. 76-319, 1976-2 C.B. 242.
[65] Rev. Rul. 71-41, 1971-1C.B. 223. S*ee also* Loco Realty Co. v. Comm'r, 62-2 U.S.T.C. (CCH) P9657, 10 A.F.T.R. 2d (RIA) 5359, 306 F.2d 207 (8th Cir. 1962)).
[66] Rev. Rul. 70-466, 1970-2 C.B. 165.
[67] I.R.C. § 1033(a)(2)(A).
[68] I.R.C. § 1033 (a)(2)(E)(i).
[69] I.R.C. §1033(f).
[70] I.R.C. § 1033(g)(1).
[71] I.R.C. § 1033(h).
[72] I.R.C. § 1033(a)(1)(A)(i).

taxpayer has more than 50% control.[73] Where property is converted directly into property with a similar or related use, deferral of the gain is mandatory.[74]

C. *Replacement Time*

The taxpayer must reinvest the condemnation proceeds within two years *after* the close of the taxable year in which the gain occurred[75] or apply for an extension of time before this period expires.[76] Generally the gain occurs when the proceeds are received, not when the property is condemned. In some cases, the period for applying for an extension can be extended where reasonable cause is shown. Where the property condemned is real property used in a trade or business or held for investment, the taxpayer has an additional year to replace the property.[77] Where there is a threat of condemnation, property may be replaced immediately, before the actual condemnation of the first property takes place. If a taxpayer makes an election but fails to reinvest timely, an amended return must be filed for the year in which the gain was realized, and the deficiency must be paid.

D. *Calculation of Gain on Involuntary Conversion of Property Sold*

The realized gain on the sale portion of an involuntary conversion is measured as the amount realized (net proceeds) minus the adjusted basis of the property. The lesser of the realized gain or the realized gain minus the cost of qualified replacement property is the gain recognized.

E. *Basis and Holding Period on Replacement Property*

The basis of replacement property is the property's cost minus the deferred gain, if any.[78] Property must have a cost basis; it cannot have been acquired by gift, inheritance or any other non-cost method of measuring basis.[79] Where an election to defer the gain has been made, the holding period includes the holding period of the converted property.

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[73] I.R.C. § 1033(i).
[74] I.R.C. § 1033(a).
[75] I.R.C. § 1033(a)(2)(B).
[76] Treas. Reg. § 1.1033(a)-2(c)(3).
[77] I.R.C. § 1033(g)(4).
[78] I.R.C. § 1033(b).
[79] Treas. Reg. § 1.1033(a)-2(c)(4).

F. *Capital Gain or Loss Recognition Where Replacement Property Is Not Timely Secured*

Property sold at a gain will trigger gain recognition to the extent the taxpayer has not reinvested all the proceeds in replacement property.[80] Normally, the character of the gain is a capital gain, either because the asset seized is a capital asset[81] or because the property sold is depreciable property used in a business that qualifies for I.R.C. § 1231 capital gain treatment. The taking of real property subdivided for sale would result in ordinary income where the owner is considered to be a real estate dealer unless the owner only engages in limited development activities under I.R.C. § 1237. Under this provision, the owner is allowed capital gain treatment if:

1. The taxpayer is not a corporation.
2. The taxpayer is not a real estate dealer.
3. No substantial improvements are made to the lots sold.
4. The taxpayer must have held the lots for at least five years prior to sale.[82]

Capital gain treatment is available until the year in which the sixth lot is sold (I.R.C. § 1237 does not apply to losses). A "lot" is a contiguous piece of land conveyed in one transaction, so if parcel numbers 1-4 were transferred to one buyer in one transaction, this transaction would count as the sale of one "lot" for purposes of I.R.C. § 1237, even though four houses may be built on that 4-parcel tract of land.[83]

I.R.C. § 1231 assets are depreciable assets held for more than one year and used in a trade or business. When these assets, which by definition are non-capital, are sold at a loss, they receive ordinary loss treatment. Where losses are relatively extensive, a net operating loss may occur.[84] However, when these assets are sold at a gain, they are afforded capital gain treatment subject to depreciation recapture and the I.R.C. § 1231 "lookback" provision. Depreciation recapture is normally not relevant to real property. The

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[80] I.R.C. § 1033(a)(2).
[81] I.R.C. § 1221(a) (2012) (defines what a capital asset is *not*, including depreciable property or real estate used in a business).
[82] If the property was inherited, this rule does not apply.
[83] Beginning with the year the sixth lot is sold, five percent of the revenue from the lot sales less any selling expenses from those sales produce the gain may that be classified as ordinary income. However, brokerage fees often exceed five percent of the sales price, so as a practical matter, none of the gain is normally, ultimately allocated to ordinary income.
[84] The discussion of net operating losses is generally outside the scope of this paper.

lookback provision[85] is an effort to prevent individual taxpayers from timing a loss for property in one-year, producing a tax break at ordinary rates in close succession with gains from property in another year, which produce a tax break at lower, long-term capital gain rates. Under the lookback rule, a taxpayer must net an I.R.C. § 1231 gain this year against any unrecovered I.R.C. § 1231 losses for the past five taxable years. The favorable long-term capital gains tax rates would only apply to the excess gain net of lookback losses.

Treatment of net capital gains and losses depends on whether the taxpayer is a corporate or non-corporate taxpayer. Corporate taxpayers may offset capital gains with capital losses, and if a net capital gain results, will pay tax at their ordinary income tax rates. Capital losses are only deductible to the extent that the corporation has capital gains; however, unused capital losses can be carried back three years and forward five years before expiring.[86]

Non-corporate taxpayers may also offset capital gains with capital losses, and if a net long-term[87] capital gain results, pay taxes at a favorable income tax rate of either 28%[88] (for collectibles and taxable portion of qualified small business stock), 25% (for unrecaptured I.R.C. § 1250 gain property, generally real estate used in a trade or business), 15% (for all other property, except where the taxpayer has an ordinary tax rate of 15% or lower) and 0% (for where, but for capital gains, the taxpayer would be in an ordinary tax bracket of 15% or lower). In any given year, up to $3,000 of capital losses may be deducted in excess of capital gains, with unused capital losses carried forward indefinitely to future tax years.[89]

In addition, where the taxpayer elects to defer the gain on involuntary conversions, but does not replace the property timely, the statute of limitations for that conversion is extended. The IRS may audit the conversion and assess a deficiency within three years after the taxpayer: 1) notifies the IRS that the converted property has been replaced, or 2) has failed to replace the property, thus triggering the recognition of gain.[90]

Where the property taken was adjacent to a personal residence, the motivation to allocate more to the diminution of property is stronger still. Under I.R.C. § 121, the first $250,000 of gain (proceeds less adjusted basis) on the sale of a personal residence ($500,000 if the taxpayers file married, jointly) is generally exempt from taxation. So, reducing the basis on the

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[85] I.R.C. § 1231(c) (2012).
[86] I.R.C. § 1212(a)(1) (2012).
[87] Long-term capital gains are gains on assets held more than one year.
[88] Tax rates are shown in I.R.C. § 1(2012).
[89] I.R.C. § 1211(b) (2012).
[90] I.R.C. § 1033(a)(2)(C).

personal residence in turn increases the gain at sale, but that gain is largely exempted from any tax. Where both I.R.C. §§ 121 and 1033 apply, taxpayers generally maximize the I.R.C. § 121 exclusion then uses the I.R.C. § 1033 provisions to defer the remainder of the gain.

G. *Adjusted Basis on Property for which Severance Damages Were Received*

Normally, adjusted basis is the unrecovered cost for tax purposes.[91] The cost of the asset originally capitalized includes all costs to get the asset ready for its intended use, including: sales tax, delivery, installation and settlement costs. However, a purchase from a related taxpayer may include the purchase cost plus (up to) the loss disallowed to the related seller under I.R.C. § 267, as necessary to eliminate the buyer's gain on the property subsequently sold. Property may be acquired by inheritance, gift or previous like-kind exchange rather than purchased. Property acquired through inheritance is generally the property's fair market value (FMV)[92] at the date of death, unless the administrator of the estate elects an alternate valuation date some time up to six months after the date of death.[93] Appreciated property acquired by gift is generally the basis of the property in the hands of the donor increased by the amount of any gift tax paid attributable to appreciation portion of the property, if any.[94] Where a property has not appreciated and is sold for a loss, the basis of the property is the lesser of the donor's basis or the asset's FMV at the date of gift.[95] Assets' bases acquired in a like-kind exchange[96] are valued at the basis in the old property given up (or "substitute basis"), provided the taxpayer received no boot.[97] Where the taxpayer does receive boot in a like-kind exchange, the basis in the new property is the basis in the

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[91] Liabilities assumed by a buyer net of any liabilities assumed by the seller increase the basis of the property. Treas. Reg. § 1.1001-2(a)(1).

[92] FMV is the price that a willing seller will pay a willing buyer, both knowing all the relevant facts. Generally, this determined by appraisal.

[93] I.R.C. § 1014(a) (2012). Rules may differ significantly however for decedents who passed in 2010. Basis of assets inherited from someone dying in 2010 is outside the scope of this paper.

[94] I.R.C. § 1015 (2012). However, the bases of "deathbed gifts" of appreciated property are valued as if they were inherited. I.R.C. § 1014(e). Further, spousal transfers are non-taxable under IRC §1041, and may result in a step-up of both halves of the property where that property was considered community property.

[95] This disjointed calculation of basis will sometimes lead to no gain *or* loss recognized on the sale of property when sold.

[96] A like-kind exchange refers to the nature or character of a property. *See* Treas. Reg. § 1.1031(a)-1(b).

[97] "Boot" refers to non-like kind consideration received. Usually, boot is cash or the assumption of a liability (e.g. mortgage), but it can also be the FMV of a non-like kind asset.

old property less any gain on the exchange recognized to date.[98] Property converted from personal use to business use is valued at the lower of the property's adjusted basis or FMV on the date of conversion.[99]

Where multiple assets are acquired for a single purchase price, the cost basis is allocated based on the relative FMV of each of the bundled assets.[100] An agreement between buyer and seller may establish relative FMVs unless those assigned values are shown to be arbitrary or unreasonable.[101] The basis for self-constructed assets includes the cost of land, demolition costs of existing buildings,[102] labor (including employees), materials, depreciation on construction equipment, operating and maintenance costs for that equipment during construction, business supplies and materials, architect's fees, permit fees, payments to contractors, rental equipment, rehabilitation expenses net of rehabilitation credits, inspection fees, and, in some cases, uniform capitalization of overhead.[103]

Subsequent increases to basis include capital improvements (that increase the length or quality of an assets life), assessments for local improvements, zoning costs and legal fees for defending and perfecting title.[104] Subsequent decreases to basis include tax credits taken for costs of property, I.R.C. § 179 elections to expense property, depreciation (including bonus depreciation),[105] tax credits for rehabilitation expenditures and certified historic structures,[106] and previous net casualty or theft loss deductions.[107] The value of the taxpayer's own labor does not affect the basis in property. Since some adjustments to basis are different for alternative minimum tax than for regular income tax, a property may have two different bases under the Internal Revenue Code.

H. *Gain on Severance Damages*

Severance damages will generally be the decrease in the FMV of the property, less reimbursements from other sources, if any. Normally,

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[98] I.R.C. § 1031(d) (2012).
[99] Treas. Reg. § 1.165-9(b)(2).
[100] Treas. Reg. §1.61-6(a). *See also* Fairfield Plaza, inc., 39 T.C. 706 (1963) and Rev. Rul. 72-255, 1972-1 C.B. 221. If goodwill is involved, the purchase price is assigned to all other assets to the extent of their FMV, the remainder is assigned to goodwill, and this valuation is binding on both buyer and seller, I.R.C. § 1060.
[101] John B. Resler, 38 TCM 153, T.C. Memo 1979-40.
[102] I.R.C. § 280B (2012).
[103] I.R.C. § 263A (2006).
[104] I.R.C. § 1016(a)(1) (2012).
[105] I.R.C. § 1016(a)(2) (2012).
[106] *See* I.R.C. §§ 46(a), 48(q), and 1016(a)(22).
[107] *See* Treas. Reg. §1016-6 and Rev. Rul. 74-206, 1974-1, C.B. 198.

reductions in FMV are not deductible until property is sold.[108] However, in some instances, courts have allowed for the possibility of reduction due to permanent decline in a property's FMV. For example, in *Cox v. United States*,[109] the taxpayers purchased a land on which oil was subsequently discovered. Then, an underground intrusion of salt water caused oil production to cease. The taxpayers however were still able to use the surface land for their original purpose. The taxpayers deducted the loss of the oil on their investment property from their federal income tax, but the government denied that deduction. A lower court sustained the decision of the government, disallowing the deduction, and held that the taxpayers only suffered the loss of a portion of an unexpected and unrealized appreciation in the land, not any injury to the surface of the land. Therefore, the taxpayers did not have any out-of-pocket expenses related to the cessation of oil production, and that the net effect to the taxpayer was that the land appreciated overall in value even after the salt water intrusion. Distinguishing their position from that of *Pulvers*, the court wrote:

> [Pulvers, et al.] only hold that the threat of a *future* injury which causes a present decline in value is not deductible under § 165(c)(3). In the instant case there was an actual injury to the underlying mineral rights which caused a decline in the value of the real property.

In *Finkbohner v. United States*,[110] the taxpayers claimed a casualty loss equal to the decline in FMV of the property before and after a flood. Part of this decline resulted from "permanent buyer resistance." Other factors in the decline include that a neighboring creek would be brought nearer to his property and flood exposure would increase over time. In this suit, a lower court instructed the jury they could award compensation for the loss of value due to "buyer resistance" to the extent it was *permanent,* but not to the extent of general market decline affecting damaged and undamaged property alike, consistent with Treasury Regulation § 1.165-7. The court acknowledged

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[108] Pulvers v. Comm'r**,** 48 T.C. 245, *aff'd*. in 69-1 USTC ¶9272, 23 AFTR2d 69-678,407 F.2d 838 (9th Cir. 1969); Squirt Co. v. C.I.R., 423 F.2d 710 (9th Cir. 1970). *See also* Treas. Reg. § 1.165-8(b)(1).

[109] 371 F. Supp. 1257, 1973 U.S. Dist. LEXIS 10576, 33 A.F.T.R.2d (RIA) 475, 74-1 U.S. Tax Cas. (CCH) P9210 (N.D. Cal. 1973)(emphasis added), *vacated on other grounds* 537 F.2d 1066; 1976 U.S. App. LEXIS 8528; 76-2 U.S. Tax Cas. (CCH) P9529; 38 A.F.T.R.2d (RIA) 5351. *See* Dankos v. Comm'r, T.C. Memo 1986-498; 1986 Tax Ct. Memo LEXIS 111; 52 T.C.M. (CCH) 722; T.C.M. (RIA) 86498 for interpretation after the vacated judgment.

[110] Finkbohner v. United States, 788 F.2d 723; 1986 U.S. App. LEXIS 25062; 86-1 U.S. Tax Cas. (CCH) P9393; 57 A.F.T.R.2d (RIA) 1400 (11th Cir. 1986).

Kamanski v. Commissioner,[111] where a casualty loss was errantly claimed beyond the minor damage actually sustained for "buyer predictions that future casualties would cause further damage," but concurred that the "claim of loss must await the event." However, in *Finkbohner*, the very neighborhood changed, including the removal of seven of twelve neighboring houses. Therefore, an allowance for the permanent decline in value was allowed.[112]

In *Strutz v. Commissioner*,[113] the court allowed taxpayers to claim a casualty loss for a post-storm reduction in the value of their property due to the destruction of a natural, physical barrier to storms that was best cured by the construction of a manmade seawall in an area where the appraiser testified that purchasers were looking for natural aesthetics and large sand beaches and the seawall would permanently depress the value of that property. In *Philmon v. United States*, the court concedes that "[i]f a taxpayer's property is not actually physically damaged during a disaster, but is no less damaged due to a permanent impairment of value caused by the event, the taxpayer may claim a section 165 deduction."[114] However, no casualty loss was allowed for O.J. Simpson's neighbors who dealt with extensive traffic and media attention after the notorious murder of his ex-wife.[115]

While a basis may be reduced by permanent diminution, it is bounded to zero, and may not be negative. Any proceeds received beyond the amount of the pre-condemnation basis are taxable, generally as capital gains. For individuals, long-term capital gains are taxed at a maximum rate of 15%.

V. DISCUSSION

Allocations of value must be reasonable and not arbitrary. Otherwise when there is a gain, the seller/taxpayer would allocate the entire purchase price, up to the amount of basis, to diminution in the land the seller still holds, and the remainder of the proceeds to the property conveyed to the condemnor. In this way, taxes are deferred on as much of the proceeds as possible. This situation is especially beneficial where condemned property has been held for one year or less by the seller, resulting in an ordinary

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[111] 477 F.2d 452 (9th Cir.1973). *See also Capozzoli v. United States,* 753 F.2d 1073 (1985).
[112] Finkbohner*,* 788 F.2d 723, 726.
[113] T.C. Memo 1980-274; 1980 Tax Ct. Memo LEXIS 311; 40 T.C.M. (CCH) 757; T.C.M. (RIA) 80274.
[114] William F. & Ruth Philmon v. United States, 1999 U.S. Dist. LEXIS 14258; 99-2 U.S. Tax Cas. (CCH) P50,832; 84 A.F.T.R.2d (RIA) 6037 (M.D. Fla. 1999).
[115] Gerald & Kathleen Chamales, v. Comm'r, T.C. Memo 2000-33; 2000 Tax Ct. Memo LEXIS 33; 79 T.C.M. (CCH) 1428.

income tax rate on the gain for the property sold, with a chance for a lower, 15% individual long-term capital gain rate for the property retained.

On the other hand, if there is no allocation, the Internal Revenue Service may construe the entire proceeds to be in satisfaction of the property conveyed, allowing none for diminution. In this case, all income taxes are accelerated into the current period and the taxpayer is harmed by an amount equal to the net present value of paying the capital gains tax now over that of paying the tax, if any, on the amount of the diminution in the future. Ideally, both the buyer and seller, after agreeing on the total proceeds for the land conveyed and the diminution on the surrounding land, would also agree to and clearly list the allocation between components. Such agreements, unless unreasonable, are seldom successfully challenged by the IRS.

However, that assumes that tax rates remain unchanged over time. During these politically charged times, tax overhaul rhetoric has increased, and tax rates may feasibly go materially up or down in the future. Long-term capital gains rates are historically low. If taxpayers expect them to rise substantially before the sale of the retained property, it may be more advantageous to pay 15% now than much more in the future.

For example, the diminution value awarded to Donnell Lands, L.P.[116] was approximately $674,792. Assuming the lands ceded to condemnation were taxed at a long-term capital gains rate of 15% and the diminution award did not fully exhaust basis, $101,219 of tax was successfully deferred by this allocation.

Further assuming the land will be sold in ten years, with a 5% return, the net present value of those tax savings is $62,140. However, if long-term capital gains tax rates are increased to a historically feasible 28%, Donnell will suffer by postponing the tax. At 28%, the same $674,798 gain would increase taxes by $188,942. Using the same ten-year holding period and 5% return, the net present value of those taxes is $115,994. That is, Donnell would be better off by an estimated ($115,994-101,219 =) $14,775 by paying the taxes now if the principal's expect long-term capital gain tax rates to increase significantly.

Since future tax rates are uncertain, this model can be extended by using Bayes' Theorem. Building on the last example, if the Donnell's believed there was a 2/3 chance that tax rates would be raised to 28% and a 1/3 chance that tax rates would remain the same, the expected value of tax savings for deferring tax by allocating the maximum to diminution would be: [2/3*(-$14,775) + 1/3*(101,219)] = $23,890. Continuing that planning horizon and return on investment, the break-even point for paying tax now versus deferring tax would be an 87.26% (or, just under 7/8) belief that long-term

[116] *Id*. at 17.

capital gains tax would rise to 28%, and a 12.74% (just over 1/8) belief that current tax rates would remain the same.

Similarly, if a loss results, taxpayers would want as much loss as possible attributable to the property sold, especially if that property is I.R.C. § 1231 property, thus generating a current, ordinary loss, and possibly a net operating loss that could be immediately carried back to prior years, with any unused portion carried forward to offset future years' income without the $3,000 capital loss limitation for non-corporate taxpayers (or capital loss' only offsetting capital gains limitation for corporations). Since the basis of the property conveyed is fixed, the taxpayer would still want the allocation of proceeds to be smallest for the property conveyed, and the largest allocation for the diminution value, up to that property's original basis.

VI. CONCLUSION

Proper tax planning, and in particular, the allocation of value between property sold and diminution of surrounding property in an eminent domain condemnation for pipelines is important, and potentially costly to the seller if improperly or hastily administered. Because amounts allocated for the sale of property are taxed, and amounts allocated for diminution are deferred (through a reduction in basis) until the property is sold, considerable attention should be paid to the diminution valuation, especially when the taxpayer expects long-term capital gains rate to remain low. Generally, taxpayers would prefer ordinary losses, if any, to be recognized in full, immediately, without any allocation to diminution. For gain properties, taxpayers prefer an ample allocation for diminution, up to the basis in the property suffering that decline in value, with the remainder allocated to the proceeds of a sale treated at long-term capital gain rates, *unless* the taxpayer believes long-term capital gains rates will be substantially higher when the value of the diminished property is sold. In that case, carefully crafted present value calculations must be made where the split between the diminished property and the property sold is not crisp and precise.