

SECTION 1031 or SECTION 1033?

Section 1031, Tax Deferred Exchanges, can be used in concert with or as substitution for Section 1033, Involuntary Conversions- when a property is completely or partially destroyed by fire, natural disaster, theft or seizure or other taking or condemnation, including the disposition of the property upon threat or imminence of condemnation or eminent domain. Section 1033 transactions carry longer time periods for performance; however, the replacement property is restricted to the same character and quality of the previous property. This differs from Section 1031 transactions which must be completed in 180 days, yet have very broad replacement property choices.

Section 1033 of the Internal Revenue Code provides specific guidance on how gains or losses incurred are accounted for. These actions are also followed when an eminent domain proceeding or other taking is executed. Similar to Section 1031, Section 1033 provides for non-recognition of tax if the injured property (fire, disaster or taking) is replaced with property of similar character or quality. The time period for replacing the property is up to three years, if condemnation or two years for reasons other than condemnation. While these time periods can be attractive, the requirement to replace the injured property with similar character or quality is far more restrictive. If your land bordering a busy highway is scheduled for an eminent domain proceeding, you will have little choice of qualified replacement property if you comply with the provision of Section 1033.

A 1033 conversion does not require the engagement of a third party to facilitate the transaction, you can receive the proceeds of the sale directly as long as you reinvest them according to the rules within the prescribed time frame.

If you receive the cash in a Section 1033 involuntary conversion and you do not replace the injured property fully in similar property, you will be subject to capital gains tax, both federal and state. After months or even years of wrangling over the taking of your property, you will be faced with the untimely taxation of the proceeds. This can be financially disrupting if the property has been held for a long period of time and/or the basis is very low.

There is another way to administer the transaction; simply elect to engage a Qualified Intermediary and have the sale structured as a Section 1031 Exchange. This strategy can be accomplished by having the owner enter into an Exchange Agreement with a Qualified Intermediary and have the net proceeds directed to the QI for the acquisition of new property.

The Section 1031 “like-kind” test is very broad and provides that all real property is “like-kind” to all other real property, the requirement for similar character or quality does not apply. This kind of flexibility would allow for the proceeds of an eminent domain taking to be used to acquire a rental property in South Carolina or a strip mall in New York and still be valid replacement property.

Replacement Property choices can be any kind of real property and can consist of multiple properties located anywhere in the United States. Section 1031 Exchanges are, however, much more rigid in the time frame for identification/purchase of a replacement property. In a 1031 Exchange you have 45 days to identify the replacement property choices and 180 days to complete the acquisition of the new property(ies).

Before cash is accepted from a 1033 involuntary conversion, stop and get professional advice from your Qualified Intermediary, accountant or attorney!