IPX 1031® Exchange Topics

Section 1033

Section 1033 involves the "involuntary" conversion of property. This situation is frequently triggered by the government's exercise of its powers of eminent domain. Eminent domain is defined as "the power of a government to take private property for public use, usually with compensation paid to the owner". Property owners have limited rights when facing the threat of their property being taken via eminent domain ("condemnation").

The treatment of capital gains tax associated with a property that is appropriated by the government via eminent domain is a subject investment property owners need to be aware of. Section 1033 of the Internal Revenue Code addresses how a property owner can defer payment of capital gains taxes when participating in an involuntary conversion of their property. This process is sometimes called a 1033 Exchange. Although the most common "trigger" for a 1033 Exchange is seizure due to eminent domain, there are other circumstances that create eligibility. These are:

- Destruction of the property that is beyond the control of the taxpayer (fires, severe storms, floods, etc.);
- Theft – the criminal appropriation of property by another (swindling, false pretenses, etc.); and
- Taking of the property through seizure (contraband and the fruits and instrumentalities of crime).

Section 1033 provides that taxpayers must replace their property within the period beginning with the involuntary conversion and ending three (3) years (two (2) years if not condemnation of real property) after the close of the first taxable year in which any part of the gain is realized. Notification of replacement must be included in the owner's tax return for the taxable year or years in which replacement occurs in order to avoid keeping the period for assessment open. The notification must set forth all the details in connection with the investment.

The Replacement Property

Rules for choosing a Replacement Property set forth in Section 1033 are very specific. The kind of Replacement Property is narrower than under a 1031 Exchange. The general requirement is that the Replacement Property must be similar or related in service or use (similar-use requirement). This has been defined to mean property which is functionally similar and has the same use as the converted property.

Condemned real estate held for business or investment can be replaced by property held either for productive use in a trade or business or for investment (1031 like-kind standard), which is less restrictive than the similar-use requirement for other involuntary conversions. Other condemned real estate (such as primary residences or second homes) would be subject to the more rigid similar-use requirement. The taxpayer must intend and document that the acquired real estate serve as the replacement for the condemned real estate. The replacement requirement can also be satisfied through construction of a Replacement Property on land already owned by the taxpayer. Funds from any source (including the condemnation) can be used to construct the Replacement Property.

Comparing Sections 1033 and 1031

If the property is not the subject of an eminent domain proceeding (or threat of one) and is used in business or investment, Section 1031 Exchanges provide more flexibility than Section 1033 Exchanges when it comes to choosing a Replacement Property. 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 and 180 days to complete the sale while a Section 1033 allows 2-3 years to close on a replacement.

A 1033 Exchange does not require the use of a qualified intermediary (you can take the proceeds of the sale as long as you reinvest them within the applicable time period) while 1031 Exchanges require the funds be placed with a neutral third party.