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Property Exchanges For Involuntarily Relinquished Land

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Income taxes that would otherwise be incurred as a result of the involuntary conveyance or destruction of real property can be deferred to a later date by using the tax-free exchange of property provisions of the federal Internal Revenue Code.

The Problem.

A real property owner can incur unexpected and unwanted income tax liability if the owner's property is involuntarily sold or destroyed. For example, a government agency, or another holder of the power of eminent domain such as a railroad or utility company, may condemn and take ownership of the property, or the improvements located on the property may be destroyed by a casualty such as a fire or a hurricane, or a theft. If the amount paid by the condemning authority or the amount of insurance proceeds received exceeds the tax basis the owner has in the property, the owner will realize a tax gain and owe taxes on that gain. However, property owners may defer gain from the involuntary sale or destruction of real property by replacing that property with other property in an "exchange" pursuant to Section 1033 of the Internal Revenue Code ("Section 1033").

Although similar in concept to replacement of voluntarily sold property under the more commonly recognized Section 1031 of the Internal Revenue Code ("Section 1031"), the rules and procedures applicable to a Section 1033 exchange are more lenient. The most common situation in which this tax deferral strategy is utilized is after the condemnation or "taking" of real property by a governmental or other entity having the power to do so; but it may also be applied to loss of real property due to destruction as a result of a casualty or theft. By deferring the recognition of taxable gain, the property owner may roll the entire proceeds received by the owner into a replacement property without immediately incurring taxes, so long as requirements of the applicable statutes and regulations are met.

When Section 1033 Applies.

Section 1033 addresses involuntary conversions. These may arise out of "destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof." This article will address only the exchange provisions relating to real property. Somewhat different rules may apply to other types of property taken in an involuntary conversion.

Unlike a Section 1031 exchange, which may only be utilized in connection with the sale of property held for investment purposes, a Section 1033 exchange may be utilized to defer gain from principal residence or from investment real property. In practice, owners are more likely to rely on this strategy when investment property is involved because the gain associated with the sale of a principal residence is often otherwise exempted. Nonetheless, a Section 1033 exchange may be utilized following the involuntary sale or destruction of a principal residence where other exemptions do not apply, for example if the gain is greater than the exemption limits or where the owner has held the property for less than two years out of the five-year period prior to the sale or destruction. Section 1033 allows deferral of the taxes on such gain if the proceeds are reinvested in another residence within two (2) years after the close of the first tax year in which any part of the gain from the involuntary conversion is realized.

For real property held either for productive use in a trade or business or for investment purposes, it is possible to reinvest in property of a "like kind" without having to recognize gain on the transaction. This "like kind" reinvestment standard is more liberal than the "similar or related in service or use" standard which applies to other types of property involuntarily converted.

The Benefits of a Section 1033 "Exchange."

One of the significant benefits of a like-kind exchange of real property taken in an involuntary conversion and held for use in a trade or business or for investment purposes is the ability of the owner to take up to three (3) years after the close of the first tax year in which any part of the gain resulting from the involuntary conversion is realized in which to acquire the replacement property. This extended period for completing the exchange provides substantially more flexibility than the one hundred eighty (180) day period for exchanges under Section 1031, and may even be further extended upon application to the Internal Revenue Service under limited circumstances.

Another significant benefit of a Section 1033 exchange is that the owner may receive the proceeds of the sale or destruction and then later reinvest them, without a requirement for the use of a third party "qualified intermediary." This is distinct from a Section 1031 exchange following a voluntary sale where the seller must utilize a third party qualified intermediary in order to avoid actual or constructive receipt of the proceeds of the sale by the seller, either of which will cause the taxable gain to be immediately recognized.

As with other exchanges, the utilization of a Section 1033 exchange only defers the recognition of gain. It does not eliminate it. Deferral results in a carryover basis for the replacement property.

Summary.

The ability of a property owner to defer recognition of taxable gain upon condemnation or a transfer in lieu of condemnation, or following the destruction or theft of real property or the improvements located on real property can provide a significant benefit to property owners by allowing them to postpone the impact of taxes due to such transfer. This allows the owner to be made whole by replacing the property with property of a similar value. However, the rules and regulations governing the utilization of a Section 1033 exchange are complicated, and an affected owner should seek professional advice as soon as possible after the loss of the property and certainly before the owner actually receives payment or insurance proceeds for the lost property.

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 For further information regarding the issues described above, please contact Samuel B. Franck or Stanley M. Sams.

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