

Involuntary Conversions ("Condemnation") - § 1033 Exchange

The § 1033 Roll-Over Exchange

If a taxpayer loses his/her property through an "involuntary conversion", Section (§) 1033 of the Internal Revenue Code can provide relief. An involuntary conversion occurs when property is destroyed, stolen, condemned, or disposed with the threat of condemnation, and other property or compensation as money is received in payment.

In particular, states, counties, cities, and other government entities often find it necessary to acquire real estate, sometimes against the wishes of the property owner. If a one's property is involuntarily converted by a governmental or quasi-governmental agency through a condemnation or a negotiated sale under the threat of condemnation and the property owner has a gain resulting from the involuntary conversion, he or she may elect to postpone recognition of that gain by buying a qualified replacement property within a specified replacement period. The basis of the taxpayer's replacement property is reduced by the non-recognized gain.

The tax deferral provisions of § 1033 are, in many ways, more generous to the taxpayer than the § 1031 rules. For instance, the § 1033 roll-over exchange does not require application of the technical rules of a § 1031 exchange. As a result, there are **no concerns about the taxpayer's constructive receipt of funds** and no requirement that a qualified intermediary be involved in the transaction.

With respect to the condemnation of "*real property held for investment or in a trade or business*" (including rental income property), § 1033 provides that a taxpayer has a **period of three years to roll over the proceeds** into a new investment that is "like-kind".

- Under this special rule, conversion of real property into "property of like-kind" to be held for either business use or investment is considered a conversion into property "similar or related in service or use" and qualifies for Section 1033 treatment. The term "real property" as used here means land, and generally anything erected on, growing on, or attached to the land. The nature and character of each property should be considered.
- Under the special real property rule, all qualified real estate is like-kind with all other qualified real estate. This like-kind test is the same as that found in Section 1031 exchanges and it does not matter if your condemned property or your replacement property is improved or unimproved. As a result, a Tenant-In-Common (TIC) Fractional Ownership Interest may qualify as a like-kind replacement property.
- Keep in mind that the IRS also treats the following, when condemned, as like-kind property if held for use in business or for the production of income:
 - Easements.
 - Rights-of-way.
 - Leaseholds for a term of 30 years or more. The term includes the initial term of the lease and all optional renewal periods.
 - Perpetual water rights, if they are considered real property rights under state law.
 - Any similar continuing interests in real property.

- **Corporate Stock as Replacement Property**

It is not necessary to make a direct purchase of the qualified property. The taxpayer can qualify by buying stock in a corporation owning qualified replacement property. However, the taxpayer must buy a controlling interest. The term control means ownership of 80% or more of the total combined voting power of all classes of stock entitled to vote and 80% or more of the total number of shares of all other classes of stock of the corporation.

Forming a new corporation to acquire the replacement property is also permitted. However, the qualified replacement property must be owned by the corporation at the time the taxpayer gets control of the corporation.

- **Improving Property Already Owned**

The IRS has sent out mixed signals regarding the replacement of unimproved land with improved property meeting the like-kind test. But they have accepted the reinvestment of net awards into property already owned as long as the like-kind test is met. They have agreed a qualifying replacement was made where the taxpayer reinvested proceeds from condemnation of a manufacturing plant's land and facilities were used to rearrange the plant facilities on the remaining land and to build a garage on land already owned.

One important tax case permitted the taxpayer to reinvest the proceeds from condemned property in improvements to property already owned. [Davis v. United States, 411 F. Supp. 964 (aff'd, 589 F.2d) 446.

- Davis's agricultural land was condemned. He reinvested the net award proceeds with physical improvements including a water system on industrial land already owned. The Court said the replacement of unimproved property with improved property satisfied the like-kind test. And it agreed the reinvestment in improvements on property already owned satisfied the replacement property qualification.

For all other property (including real property converted as a result of casualty or destruction, personal use property such as your residence and dealer property), the taxpayer has **two years** to roll over the proceeds into a new investment and the **replacement property must be "*similar or related in service or use*"**.

The "similar or related" test is narrower where real estate is concerned. Such a test focuses on whether the property is functionally similar to and has the same uses as the property being converted, which usually means that the properties are physically similar and the taxpayer's relationship to each of them is substantially the same.

The Replacement Time Period

Generally, the replacement period for a Section 1033 involuntary conversion begins upon the earlier of: i) the date of disposition of the condemned property; or ii) the date the property is first subject to threat of condemnation or seizure. Obtaining a threat letter from the condemning authority can assist the taxpayer in establishing the exact commencement date.

In Rev.Rul.63-221, the IRS ruled that a threat or imminence of condemnation is generally considered to exist if you obtain information through a news medium as to a decision to acquire your property for public use. The following two conditions must be met:

1. You must obtain confirmation from a representative of the governmental body involved as to the correctness of the published report.
2. You must have reasonable grounds to believe the property will be condemned if a voluntary sale is not arranged.

To qualify as a threat:

1. The other party must have the legal power to condemn or requisition, and
2. must make a threat of condemnation, or there must be a known imminence of condemnation.

A threat of condemnation need not be a certainty. It exists if it might reasonably be believed from representations of government agents and surrounding circumstances that a condemnation is likely to take place.

Replacement of the condemned property must be completed by the end of the replacement period. Merely exerting best efforts, or having construction in progress will not satisfy the requirement.

Making the Election

Unlike Section 1031, unless the relinquished property is directly converted into qualifying replacement property, the taxpayer must make a valid election to qualify for the Section 1033 roll-over. The election is made by the taxpayer purchasing the replacement property within the replacement period and filing a claim for a tax refund for each year in which gain from the conversion of the condemned property was reported.

The Replacement Amount Requirement - Calculating Gain

To avoid recognition of all the gain, the cost of the replacement property must equal or be more than the net proceeds received for the condemned property. The net proceeds are the total proceeds reduced by the expenses incurred in securing the award and any special assessments levied against remaining property resulting from the installation of an improvement. If the cost is less, the difference is recognized as gain and the excess is treated just like boot received in a Section 1031 like-kind exchange. It's taxable.

Other considerations include:

- If only part of your property is condemned, you must allocate the basis between the condemned part and the remaining part. If the property is unimproved land, you allocate based on original cost. If the condemned part is improved real estate, you may use a relative value allocation based on market or assessed values.

- If you used part of your condemned property as your home and part as a business or rental property, you must treat each part as a separate property and figure your gain or loss separately for each part.
- If interest is paid on your award to compensate you for delay in payment, it is taxed as ordinary interest income. It is not treated as part of the award.
- Sometimes the governmental authority condemning your property will levy an assessment against the remaining property. This assessment is usually withheld and reduces the award you get. The assessment is made under the theory that the portion of property you retain is benefited by the improvement for which the condemnation was made. A withheld assessment reduces the gross award for purposes of figuring gain or loss on the condemnation.

Severance Damages

Severance damages are distinct from the condemnation award, They are paid for injury to the property whereas award payments are for the property taken from you. If you receive severance damages, figuring the gain on conversion gets very complicated. Severance damages are compensation paid to you in addition to the condemnation award. They are paid because part of your property is condemned and the value of the part retained by you is decreased because of the condemnation. Examples are impairment of access, flooding or erosion of the property retained, replacement of fences, trees, etc., to restore the retained property to its former use.

If severance damages are included in the award, the amount of the special assessment withheld must first reduce these severance damages. The balance is used to reduce the amount of the award for the condemned property.

Condemnation expenses must be allocated between the severance damage payments and the condemnation proceeds. Net severance damage payments are applied to reduce the basis of the retained property. If the payment is more than the basis, the difference is realized gain. This gain qualifies for non-recognition under § 1033.

No Tax or Legal Advice

The rules of Section 1033 are a legal matter and complex. Therefore, it is very important that you not rely on the information presented here but rather discuss tax and legal matters with your accountant, attorney, and other qualified person/s. Due to the complexity of the rules regarding the replacement period, taxpayers should consult their attorneys or tax advisors in order to avoid pitfalls regarding the replacement period.