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1033 Exchanges: Similar but different than 1031

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While offering 1031 Tax Deferred Exchange services on the sale of investment property, every so often we receive calls from taxpayers looking to complete a 1033 Exchange. Under the Code, the IRS provides assistance to those who lost their property through "involuntary conversion:" destruction or loss of property through casualty, theft or threat of condemnation by government powers (eminent domain). Even though the action is involuntary, the taxpayer is still liable for any depreciation recapture and capital gain tax on the sale/compensation received, and therefore able to take advantage of deferral with a 1033 Exchange.

Timelines for replacement under 1033 are more lengthy than 1031.

In cases of casualty or theft of property, including personal use or dealer property, the property must be replaced within two years after the end of the first taxable year in which any part of the gain is realized. Replacement property must be "similar or related in service or use," meaning the property must have the same functional use as the old property, unlike the §1031 "like-kind" standard.

Condemned real property "held for productive use in a trade or business, or for investment" must be replaced within three years after the end of the first taxable year in which any part of the gain is realized, and follows the more flexible 1031 "like-kind" replacement property requirements.

Constructive receipt of funds regulations in the 1031 Code do not apply to 1033 Exchanges; the taxpayer can receive proceeds directly and purchase replacement property in the allotted reinvestment time period. Therefore, a 1033 Exchange does not require the use of a Qualified Intermediary.

Note that a taxpayer wishing to take advantage of the broader "like-kind" standard can structure the transaction as a 1031 Exchange using a Qualified Intermediary, and if unable to acquire like-kind replacement property within the 180 day exchange period, can still fall back on rights to obtain tax deferral through a 1033 Exchange.

Taxpayers should consult their tax advisor, as qualifications and reporting details relevant to the involuntary conversion may vary.

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