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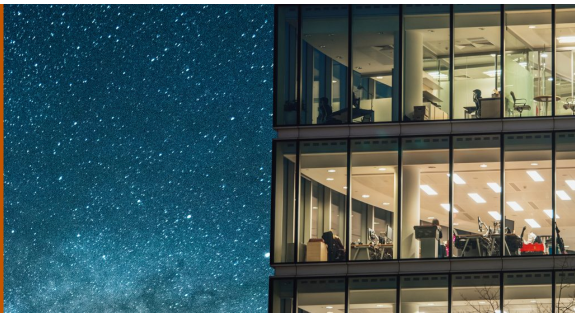
# JO Knows how to deal with the tax treatment of fires, floods, and other items causing involuntary conversions



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An involuntary conversion occurs when property is no longer useful or available to an owner because of something outside of the owner's control.  This includes flood, fire, condemnation or seizure by eminent domain.  An involuntary conversion can be either full or partial.  If you receive money such as insurance proceeds or eminent domain payments, this can create taxable gain.

Real estate owners may be familiar with Code Section 1031 exchanges, which allow you defer tax on the gain from the sale of real estate by reinvesting it into a similar property.  This requires the use of a qualified intermediary to hold the sale proceeds and there are multiple deadlines that must be met.

An IRS Code Section 1033 exchange allows a similar process to defer taxation on gain on an involuntary conversion.  The requirements for a successful 1033 exchange are different and generally less stringent than those for a 1031 exchange. What qualifies for replacement property is far more flexible than the 1031 exchange where the proceeds could be used to not only buy a new piece of property but also make improvements to other property the taxpayer owns under certain circumstances.

In a 1033 exchange there is no need to use a qualified intermediary.  The owner can receive the proceeds directly.  However, this means that the owner must be aware of and meet all the exchange deadlines.

The cost of the replacement property must be equal to or greater than the net proceeds received.  As with a 1031 exchange, the value of the debt on the replacement property must be equal to or greater than the debt on the converted property.  Unlike a 1031 exchange, equity can be replaced with debt.  Therefore, you could take out a larger loan on the replacement property and retain some of the cash proceeds while preserving your deferral of the gain.

Replacement property for a 1033 exchange must be similar or related in service or use.  This is more stringent than the 1031 exchange like-kind standard and depends on the owner's relationship to the property.  Property held for investment cannot be replaced with property used in an active trade or business.  For example, you cannot replace a rental property you leased to a tenant under a triple-net lease with a property which is occupied by your own trade or business.  Unlike a 1031 exchange, replacement property generally cannot be purchased from a related party.

The replacement property in a 1033 exchange must be acquired within two years from the end of the first year in which the gain is realized.  Special rules can extend this to three or four years.  This is considerably longer than the 1031 exchange deadline of 180 days after the disposition of the original property.

A 1033 exchange can be an important tool to defer tax when you have suffered a significant loss.  We can help you determine whether you should consider a 1033 exchange and assist you through the process.

To learn more about Johnson O'Connor's Real Estate services, click **here**.

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