SPECIAL REPORT
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Comparing Like-Kind Exchanges With Involuntary Conversions

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In this article, Wood and Greiner compare and contrast section 1031 exchanges with section 1033 involuntary conversions.

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Section 1031, allowing like-kind exchanges, is a kind of everyman's tax provision, one that almost every practitioner seems to know by number. It is even routinely used as a verb. Involuntary conversions under section 1033 are less well known. However, California's wildfires and other natural disasters, as well as government and quasi-government threats of condemnation, may draw more attention to it.

Occasionally, taxpayers review both provisions. For example, someone who has experienced an involuntary conversion might still decide that section 1031 is the safer route. Or a taxpayer who relies on section 1033 after a fire loss or a government takeover of property for some civic purpose may want to consider section 1031 as well.

Under section 1031, if a taxpayer exchanges property for other property that is similar in kind, gain on the exchange is deferred until the replacement property is sold. Section 1033 provides that if a property is involuntarily converted, gain is deferred to the extent that the taxpayer purchases replacement property that is similar or related in service or use to the converted property. Those treatments sound quite different, and they are. Let's compare them.

Voluntary vs. Involuntary

A fundamental difference between the two provisions is that section 1033 requires the conversion to be involuntary and section 1031 does not. Section 1033 states that involuntary conversions can occur "as a result of . . . destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof." The IRS interprets the involuntariness requirement strictly, but taxpayers can enter into negotiations to sell the property under threat of condemnation.

However, if the taxpayer is "too willing" to sell the property, that may jeopardize its treatment under section 1033. Generally, to withstand scrutiny under the threat of condemnation doctrine, the taxpayer must be informed, either orally or in writing, that the acquiring entity has decided to obtain the property. The taxpayer must also have reasonable grounds to believe, based on all the available information, that the entity will condemn the property unless the owner sells voluntarily. Documentation of the entity's intent is particularly important.

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Types of Property

Another difference between the two provisions is the type of property eligible for favorable treatment. Beginning in 2018, section 1031 treatment is available only for real estate. In contrast, section 1033 treatment is generally available for any type of property, whether real, tangible, or intangible.

The standards for comparability are also different. Section 1031 requires the exchanged properties to be of "like kind." However, improved real estate can be exchanged for unimproved real estate. City real estate can be exchanged for a ranch or farm.

Section 1033 requires replacement property to be "similar or related in service or use to the property so converted." Section 1033 provides that if both the converted property and the replacement property are real estate that is used in a trade or business or held for investment, the "similar or related use" test will automatically be satisfied if the properties are like-kind.

However, if the converted property is not real estate, the replacement property must satisfy the "similar or related use" test, which is generally a more difficult standard to meet than the like-kind requirement. The "similar or related use" test is a functional test that requires the use of the replacement property to be substantially similar to the use of the converted property. For example, inventory cannot be replaced with depreciable manufacturing assets.

Legal Entities

In addition to purchasing replacement property directly, section 1033 allows the taxpayer to purchase replacement property by buying a controlling interest (that is, at least 80 percent of the stock) in a corporation that owns the property. In contrast, section 1031 does not allow the taxpayer to acquire replacement property by acquiring control of a corporation that owns the property. Under section 1031, the taxpayer must generally acquire the property directly.

Under both provisions, transfers of single-member limited liability companies that own property are treated as direct transfers of the property owned by the LLC, as long as the LLC has not elected to be taxed as a corporation. Both regimes are also somewhat flexible regarding properties owned through tenancy-in-common arrangements or Delaware statutory trusts, although there are risks involved. For example, the IRS might treat a tenancy-in-common arrangement as a partnership, depending on the facts.

Timing and Deadlines

There are differences in the timing requirements for the exchange, with section 1031 deadlines being much shorter. Section 1031 has an identification requirement and a receipt requirement. Under the identification requirement, replacement property must be identified within 45 days after the taxpayer transfers the relinquished property. Under the receipt requirement, the property must be received by the earlier of: (1) 180 days after the date of the transfer of the relinquished property; or (2) the due date (including extensions) of the transferor's tax return for the tax year in which the transfer of the relinquished property occurs. The IRS generally has no authority to grant extensions.

Section 1033 provides that the replacement property must be purchased within a set period, which begins on the earlier of the date of the disposition of the converted property, or the earliest date of the threat of condemnation. The period ends three years (two years if not real estate, or four years for property in federally declared disaster areas) after the close of the first tax year in which any gain on conversion is first realized. Therefore, if the taxpayer is on a cash basis, no gain is realized until the proceeds received exceed basis. Under section 1033, the IRS has the authority to grant extensions.

Notice and Statute of Limitations

The statute of limitations for the IRS to audit and assess additional income tax is generally three years. However, if a taxpayer defers gain for a particular tax year under section 1033, the statute of limitations for that year does not expire until three years after the taxpayer notifies the IRS that the taxpayer has either replaced the converted property or has decided not to replace it.

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This notification generally should be made on the taxpayer's income tax return for the year of the replacement. If the taxpayer fails to file the notification, the statute of limitations appears to remain open indefinitely. In contrast, section 1031 contains no unique exceptions to the general three-year statute of limitations.

Intermediaries

Under section 1033, an intermediary is not needed. The taxpayer can receive cash for the converted property and use that cash to purchase replacement property. There is no tracing of the funds involved.

Section 1031 requires that relinquished property be "exchanged for" replacement property. The IRS allows the taxpayer to transfer the relinquished property to a qualified intermediary, who sells the property for cash, uses the cash to purchase the replacement property, and transfers the replacement property to the taxpayer.

Debt, Equity, and Boot Rules Under Section 1031

There are nuanced rules under section 1031 regarding debt, equity, and boot. Section 1033 is quite different and simpler, as summarized in the next section. Section 1031 provides that boot is any form of property other than like-kind property that is transferred in a section 1031 exchange, such as cash, personal property, and the assumption of liabilities.

A taxpayer is generally required to recognize taxable income to the extent of any boot received in a section 1031 exchange. However, a taxpayer can generally offset specified types of boot received with some types of boot paid. The general rule is that if the boot received is the assumption of a liability, it can be offset by any type of boot paid, whether cash, other property, or the assumption of a liability.

Even so, if the boot received is cash or other property, it cannot be offset by the assumption of a liability. Under section 1031, a mortgage payoff at closing is generally treated as the assumption of a liability — that is, a receipt of boot — even though the buyer may not be taking the property subject to the mortgage. Although the taxpayer can offset this receipt of boot, the general rule is that the offset must be in the form of a mortgage on the replacement property in an amount equal to or greater than the debt on the relinquished property. Any cash the taxpayer receives as a result of the exchange will also be treated as the receipt of boot.

Example: A taxpayer owns property with a fair market value of $10 million that is subject to a mortgage of $6 million. The taxpayer engages in a section 1031 exchange and acquires replacement property worth $10 million by using $3 million of the sale proceeds and incurring a new mortgage of $7 million. The taxpayer walks away from the transaction with $1 million in cash.

In this example, the taxpayer satisfies the mortgage payoff requirement of incurring at least $6 million of new mortgage debt on the replacement property. The taxpayer's boot received is $7 million total: $1 million cash plus $6 million of mortgage payoff. The taxpayer's boot paid would also equal $7 million, because of the new mortgage incurred. However, the new mortgage cannot also offset the cash received. Therefore, the taxpayer would have a net positive boot receipt amount of $1 million, which would be taxed immediately as long-term capital gain.

When a taxpayer walks away from an exchange with cash because of an increase in mortgage debt, the taxpayer may have taxable boot. However, this rule generally applies only if the mortgage is incurred as an interdependent part of acquiring the property in the section 1031 exchange. Some taxpayers place a mortgage on the replacement property after (and independent of) a section 1031 exchange. Some commentators have suggested that as long as a later mortgage is truly independent of the exchange (in form and substance), the cash taken out should not be treated as boot.

Debt, Equity, and Boot Rules Under Section 1033

Section 1033 does not have boot income recognition requirements. It simply provides that "gain shall be recognized only to the extent that the amount realized upon such conversion . . . exceeds the cost of [the replacement] property." The cost of property generally includes any debt incurred to purchase the property.

A taxpayer is usually free to incur any level of debt to purchase the replacement property, regardless of the amount of any debt on the

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converted property. However, if the condemning authority pays off any mortgage on the converted property, that payoff is treated as part of the amount realized on the conversion.

Transactions With Multiple Properties

There are no express limitations on the number of relinquished or replacement properties that can be used in a section 1031 exchange. You can exchange one large property for multiple smaller properties, or the reverse. Of course, gain and basis must be allocated among the multiple properties.

There are also no express limits on the number of properties that can be used to satisfy the replacement property requirements of section 1033.

State Tax Issues Under Sections 1031 and 1033

Complications can arise under section 1031 or 1033 when multiple states are involved. For example, issues may arise if California real estate is substituted for non-California real estate, or if taxpayers change their states of residency after the exchange. For state tax issues, it is important to keep in mind the general residency rules.

For example, if the taxpayer is a California resident, all of his income is generally taxable in California, regardless of its source. If a resident taxpayer has income that is sourced to another state and pays tax in that state, the taxpayer generally should be able to claim a credit on the California return for taxes paid to the other state. If the taxpayer is not a California resident, the taxpayer is generally only subject to tax on California-source income.

Various tax rules determine the source of income and business activity. For example, some states require multistate businesses to determine their in-state income by using a three-factor apportionment formula consisting of property, payroll, and sales. For individual taxpayers, income from real estate — such as rents and gains on sale of property — is usually sourced to the location of the real estate. California follows this rule.

California conforms to sections 1031 and 1033. California does not impose a requirement that the replacement property also be located in California. Thus, it allows for deferral of gains that are realized on like-kind exchanges and involuntary conversions.

However, if the replacement property is located in another state, California aggressively tracks when the replacement is ultimately sold. When the replacement property is sold, California treats the gain as California-source income to the extent of the original deferred gain. Several other states follow this rule, but California may be the most aggressive in enforcing it.

To assist with enforcement of the rule, California has a special reporting requirement for taxpayers who engage in section 1031 exchanges and acquire out-of-state replacement property. These taxpayers must file an annual information return (Form 3840, "California Like-Kind Exchanges") with the state every year until the deferred gain from the section 1031 exchange is ultimately recognized. Interestingly, this reporting requirement does not by its terms apply to section 1033 exchanges.

When the taxpayer ultimately sells the out-of-state property, California will treat any gain as California-source income to the extent of the gain deferred on the original exchange. Obviously, the second state will also want to tax at least some of the gain. Some states have indicated that they will tax this gain only if it represents appreciation that occurred in their state. However, there may be some risk of the second state being overaggressive and trying to tax the entire gain.

If the taxpayer is a California resident, the sourcing rules will generally be irrelevant because the entire gain will be subject to tax in California and the taxpayer will be allowed a credit for taxes paid to the other state. If the taxpayer is a California nonresident at the time of the sale, the taxpayer may be subject to tax in both states on a nonresident basis.

Notably, the nonresident taxpayer would not be allowed a credit on a California return. However, the taxpayer would be allowed a credit for taxes paid to California (and to the other state, if the taxpayer is a nonresident of that state) on the resident state return. Most states allow for such a credit.

Example: Taxpayer is a California resident and makes a section 1031 exchange in 2019 of property with an FMV of $10 million and a basis of $1 million. Taxpayer acquires replacement

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property in Georgia with an FMV of $10 million. In 2024 the taxpayer sells the replacement property for $16 million. The taxpayer's total gain is $15 million. Of this amount, $6 million is sourced to and subject to tax by Georgia.

As a California resident, the taxpayer is subject to tax on the entire $15 million. However, the taxpayer generally can claim a credit for the taxes paid to Georgia. If instead the taxpayer was a California nonresident and a Georgia nonresident at the time of the second sale, he would still owe nonresident tax to Georgia.

As a nonresident of California, rather than being subject to California tax on the entire $15 million, the taxpayer is subject to California tax only on the California-source income amount. In this example, that is the original deferred gain of $9 million. The taxpayer would probably be subject to tax on the entire $15 million on the resident state return.

However, the taxpayer can claim a credit for the taxes paid to both California and Georgia on a resident state return so he is not paying taxes on the same dollars in two states.

Conclusion

Section 1031 exchanges may seem ubiquitous, but they can be the cause of numerous practitioner missteps. Section 1031 exchangers should be particularly attentive to the unforgiving 45-day and 180-day deadlines, and confusion can arise when debt is involved in the transaction.

Of course, section 1033 has strict rules as well, starting with the involuntary conversion. However, because that fundamental requirement can be satisfied by a threat or the imminence of condemnation, section 1033 can be worth a closer look. ■

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