

Losing Land to Eminent Domain? Plan for Tax Consequences Using an Internal Revenue Code Section 1033 Exchange

Article

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Under general tax rules, if the government takes your property through eminent domain and pays you condemnation proceeds, you may have to pay capital gains (or any depreciation recapture) tax if the condemnation proceeds exceeds your basis in the property.

The Internal Revenue Code of 1986, as amended ("Code"), however, provides an important exception. If you are subject to an involuntary conversion of property, you may be able to elect to defer the realized gain under Code section 1033. An involuntary conversion of property includes a property's destruction (in whole or in part), theft, seizure, requisition or condemnation, or sale made under threat or imminence of requisition or condemnation.

If your property is converted into money or property not similar or related in service or use to the converted property (i.e., insurance proceeds, condemnation award, or upon qualifying sales), you may be able to defer the tax gain you would otherwise have to recognize by following the rules of section 1033, including timely purchasing qualified replacement property.

Qualified replacement property generally has to be property "similar or related in service or use" to the property converted. There is an exception for certain condemned real property. If real property has been (1) held for productive use in trade or business or for investment and (2) involuntarily converted through seizure, requisition or condemnation, or threat or imminence thereof, then replacement property that is "like kind" to the property converted is also treated as "similar or related in service or use." This like kind replacement standard is usually an easier standard to meet than the general "similar or related in service or use" standard. Eligible real property can qualify for section 1033 treatment by satisfying either standard.

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It is also important to note that in order to achieve complete deferral of gain, the entire amount of monetary proceeds received from the involuntary conversion needs to be reinvested. If not, gain is recognized to the extent of any amount not invested.

A tax advisor can help you navigate the rules for section 1033 and consider various options and related elections.

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