



The 1033 Exchange

A Replacement Strategy After Natural Disaster or Condemnation Loss

Section 1033 of the Internal Revenue Code covers involuntary conversions, be it a loss via condemnation under power of eminent domain or natural disasters. Property owners may not realize that funds received as a result of these actions – condemnation award proceeds or insurance proceeds – would normally trigger recognition of gain. Section 1033 of the code, similar to Section 1031, allows taxpayers to defer that recognition of gain on involuntary conversions of their real estate.

Generally speaking, Section 1033 provides that the gain that would result on the receipt of insurance or other compensation due to involuntary conversion of real estate is deferred if the amount realized (net of legal, appraisal and other expenses) is reinvested in real property similar or related in service or use to the converted real property.

The specific operation of Section 1033, including the rules on the types of real property that qualify as similar or related in service or use, and the time period during which such property must be acquired, depends in part on whether the real property was subject to a condemnation under power of eminent domain or a natural disaster.

What Is an Involuntary Conversion?

Under Internal Revenue Code Section 1033, involuntary conversion is defined as destruction or loss of property through casualty, condemnation pursuant to government powers of eminent domain, or a sale under threat of condemnation.

Two Types of Involuntary Conversions

Conversion Type	What It Means	Period to Acquire Replacement Property
Condemnation Under Power of Eminent Domain	• Condemnation under power of eminent domain when the property owner has lost the property because the government wishes to take or has taken the property • Imminence of condemnation when the property owner sells the property because he or she is aware of a threat and reasonably believes that a condemnation is likely to occur	3 years from the end of the year in which the condemnation occurred
Casualty or Natural Disaster	• Property is destroyed or damaged by events such as fire, hurricane or another qualifying casualty • QI is not required	2 years from the end of the year in which the casualty occurred

For condemnation or under power of eminent domain situations, if the converted property was real property held for investment or used in a trade or business excluding property held primarily for sale, Section 1033 generally uses Section 1031 like-kind guidelines to determine whether the new real property is qualified replacement property.

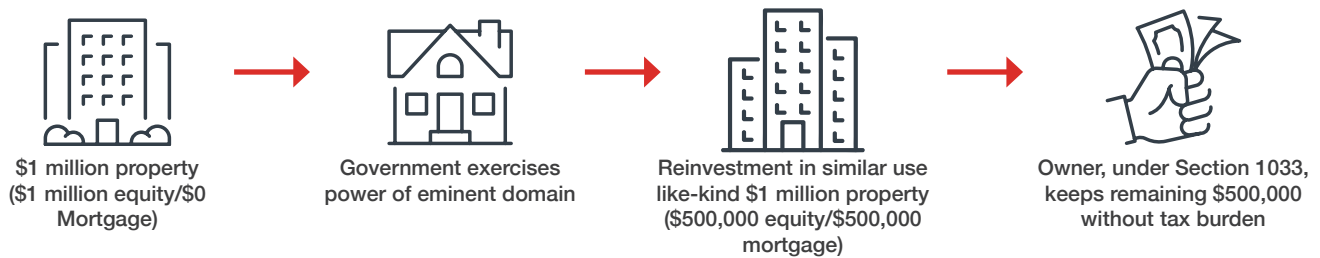
For involuntary conversions where real property is not covered by the condemnation rule, either because it was destroyed by fire, hurricane or other casualty, it was a personal residence, or because it was held primarily for sale to customers, Section 1033 gain deferral applies if the replacement property is similar or related in service or use to the converted property.

There is no clear test for determining whether replacement property is similar or related in service or use to converted property, and each property owner's case will depend on his or her own facts and circumstances. It is recommended each property owner consults with his/her tax provider.

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Hypothetical Example

The following example is provided solely for illustrative and educational purposes. Whether gain may be deferred under Section 1033 depends on a property owner's individual facts and circumstances, including satisfaction of all applicable replacement property requirements.



Property owners should consult with their own tax advisors regarding the application of Section 1033 to their particular circumstances.

General Guidelines for Non-Condemnation Conversions

If the property owner operated the converted property as part of a business, the replacement property must generally be used in the same or similar business as the converted property.

If the property owner held the converted property for rental income, the replacement property must also be held for rental income and the property owner's business risks and responsibilities in the way of management, services and relations with respect to the replacement property must be substantially similar to the risks and responsibilities that arose with respect to the converted property. However, the specific business use of the properties by tenants is not important.

Example: If the property owner's converted property was a warehouse that he rented out to third parties, the replacement property can be rented out to third parties for office, residential or other purposes so long as the property owner's level of management, services and business risks is similar.

To further explore the concept, a conversion from one triple net leased property to another should generally satisfy Section 1033, even if the properties are used by their tenants for different purposes. However, if an investor's conversion from an actively rented property requiring significant management participation to a triple net leased property may be problematic for Section 1033 purposes.

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An investment in a privately offered security in connection with a 1031 or 1033 exchange involves certain risks including but not limited to tax risks, general real estate risks, risks relating to the financing on the properties, risks relating to the ownership and management of the properties, risk relating to the fact that they are private offerings and there is a lack of liquidity, and risks relating to the trust structure.

This brochure includes a brief and general description of certain 1033 guidelines. Prospective investors should consult with their own tax advisors regarding an investment in an Inland Real Estate Investment Corporation (Inland Investments)-sponsored program.

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