**8579. What are the tax consequences of an involuntary conversion?**

IRC Section 1033 applies to cases where property is compulsorily or involuntarily converted. This provision recognizes that a taxpayer who has suffered an involuntary conversion has experienced an economic hardship and may not have the ability to pay taxes on any gain resulting from the conversion. This is because any proceeds in excess of the taxpayer’s basis in the converted property would generate taxable gain. Thus, IRC Section 1033 postpones recognition of the gain to the extent the proceeds obtained in the conversion, whether through insurance or otherwise, is reinvested in replacement property (see Q 8580).[[1]](#footnote-1)

An "involuntary conversion" may be the result of the destruction of property (whether in whole or in part, see Q 8582 for a discussion of partial conversions), the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation.

On the other hand, he taxpayer is required to recognize any gain that exceeds the amounts reinvested in replacement property following the involuntary conversion.[[2]](#footnote-2)

*Example*: Patrick received $500,000 in insurance proceeds when his warehouse with an adjusted basis of $100,000 was destroyed in a hurricane. If Patrick decided to retire and keep the insurance proceeds, he would have a gain of $400,000 (it is as if he sold the warehouse to the insurance company for $500,000) However, in evaluating his financial situation, Patrick decides to downsize his business and purchase a new warehouse for $350,000. Because Patrick reinvested $150,000 *less* than he actually received, he must recognize $150,000 of the $400,000 gain.

**Planning Point:** All the details of an involuntary conversion of property at a gain (including information about the replacement of the converted property, a decision not to replace it, or the expiration of the period for replacement) must be reported in the return for the year or years in which any of the gain is realized.[[3]](#footnote-3)

Section 1033 applies only with respect to gains. If a taxpayer experiences a loss as a result of an involuntary conversion, Section 1033 is inapplicable and the loss is recognized or not recognized in accordance with the general rules applicable to loss recognition. See, for example, Q 8617 to Q 8628, which explain the rules applicable when a taxpayer has experienced a casualty loss.

1. . IRC Sec. 1033(a). [↑](#footnote-ref-1)
2. . IRC Sec. 1033(a)(2). [↑](#footnote-ref-2)
3. . Treas. Reg. §1.1033(a)-2(c)(2). [↑](#footnote-ref-3)