**8580. How does the type of property into which the lost or destroyed property is converted into impact whether the taxpayer can claim nonrecognition treatment as the result of an involuntary conversion?**

**Conversion into Similar Property**

Whether or not the taxpayer is required to recognize gain resulting from an involuntary conversion of property depends upon the type of property into which the lost or destroyed property is converted.[[1]](#footnote-1) If, as explained below, the replacement property is similar or related in service or use with the lost or destroyed property, no gain is recognized (losses are always recognized). For nonrecognition treatment to apply, no election is required.

The determination of whether property is similar for purposes of IRC Section 1033 is not the same for determining whether property is “like-kind” property for purposes of IRC Section 1031. The taxpayer’s *use* of the replacement property must be similar to the use of the converted property.[[2]](#footnote-2) For example, if a taxpayer’s principal residence is replaced by rental property, it would not be considered a similar use.

In the business context, the following factors are relevant in determining whether the taxpayer has replaced converted property with similar property:

(1) Whether the properties provide a similar service to the taxpayer;

(2) The nature of the business risks connected with the properties; and

(3) The demands of the properties upon the taxpayer, including management, required services or relations to tenants.[[3]](#footnote-3)

**Conversion into Money or Dissimilar Property**

 The result is different when the original property is converted into money or dissimilar property. In such cases the proceeds arising from the disposition of the converted property must (within the time limits specified, see Q 8581) be reinvested in similar property (as described above) in order to avoid recognition of any gain realized.[[4]](#footnote-4) If the taxpayer reinvests the entire proceeds into replacement property, no gain will be recognized. However, if the taxpayer only invests part of the proceeds, the taxpayer can elect to recognize the gain only to the extent that the cost of the replacement property exceeds the reinvested proceeds. Obviously, if the taxpayer fails to make the election the entire gain would be recognized.[[5]](#footnote-5)

 *Example:* In 2014, a warehouse Asher used in his trade or business was totally destroyed by fire. At the time of the destruction of the warehouse, the warehouse had an adjusted basis of $100,000. The insurance company promptly paid Asher $500,000 for the loss. As a result, Asher realizes a gain of $400,000. Later that year, Asher purchases a new warehouse for $350,000. Thus, the insurance proceeds exceeded the cost of the replacement property by $150,000 ($500,000 minus $350,000). If Asher fails to make an election pursuant to IRC Section 1033(a)(2), the entire realized gain, $400,000, would be included in his gross income. On the other hand, if Asher makes the election, only $150,000 (the amount of the proceeds he did not reinvest) of the $400,000 gain would be included in gross income.

1. . IRC Sec. 1033(a). [↑](#footnote-ref-1)
2. . Rev. Rul. 70-466, 1970-2 CB 165. [↑](#footnote-ref-2)
3. . Rev. Rul. 64-237, 1964-2 CB 319. [↑](#footnote-ref-3)
4. . IRC Sec. 1033(a)(2)(A). [↑](#footnote-ref-4)
5. . Treas. Reg. §1.1033(a)-2(c)(1). [↑](#footnote-ref-5)