**8582. Must a taxpayer’s property be completely destroyed to qualify for nonrecognition treatment under the rules for involuntary conversions?**

The involuntary conversion of a taxpayer’s property does not need to occur as a result of one sudden event (e.g., a natural disaster) in order for the taxpayer to qualify for nonrecognition treatment under IRC Section 1033.[[1]](#footnote-1) For example, the IRS ruled that the progressive pollution of a taxpayer’s water supply with salt water constituted an involuntary conversion for purposes of IRC Section 1033.[[2]](#footnote-2) Similarly, the IRS has ruled that chemical contamination of property, which did not destroy the property per se, but made it unsafe for its intended use, qualified as a Section 1033 “destruction.”[[3]](#footnote-3)

Despite this, if the taxpayer disposes of partially destroyed property that could have been repaired, nonrecognition treatment under IRC Section 1033 could be denied. This is because the decision not to repair is “voluntary” as compared to an “involuntary conversion.” For example, the Tax Court denied nonrecognition treatment when the taxpayer sold a ship damaged in a collision and invested both the sale proceeds and insurance proceeds in another vessel. Because the taxpayer could have used the insurance proceeds to repair the ship, but instead *chose* to purchase a second ship, the conversion was not involuntary. Although the court recognized that it may have been a sound business decision to replace rather than repair, having the choice negated the possibility that the conversion was involuntary. The taxpayer was, therefore, required to recognize all the gain realized in the transaction.[[4]](#footnote-4)

Conversely, the IRS has ruled privately that when the cost of repairs exceeded the value of the property prior to its destruction, there was no practical alternative other than selling the property and purchasing replacement property. Under these circumstances, the taxpayer was entitled to nonrecognition treatment under IRC Section 1033 although, theoretically, the property *could* have been repaired.[[5]](#footnote-5)

Based on these rulings, a taxpayer whose property is partially destroyed will generally qualify for nonrecognition treatment under IRC Section 1033 if the economics of selling the property outweigh the cost of repairing it.

1. . Rev. Rul. 59-102, 1959-1 CB 200. [↑](#footnote-ref-1)
2. . Rev. Rul. 66-334, 1966-2 CB 302. [↑](#footnote-ref-2)
3. . Rev. Rul. 89-2, 1989-1 CB 259. [↑](#footnote-ref-3)
4. . *Willis v. Commissioner*, 41 TC 468 (1964). [↑](#footnote-ref-4)
5. . Let. Rul. 8928011. [↑](#footnote-ref-5)