

Casualty gains

We wish to advise you on how to defer or avoid tax on gains which may result from casualties. While most taxpayers think of casualties as causing losses (which is more typically the case), in some situations gains may result from insurance payments in excess of the taxpayer's basis in the damaged property.

Example. Ellen's home is destroyed by fire. She had purchased the home years ago for just \$100,000 and this amount remained her tax basis (i.e., she made no capital improvements to the home). The home's value had risen to \$300,000 and she had it adequately insured. After the fire, her insurance company paid her \$260,000. For tax purposes, Ellen has a gain of \$160,000 on the casualty (\$260,000 insurance payment minus \$100,000 tax basis).

Tax on a casualty gain may be deferred under the involuntary conversion rules. Furthermore, where the property that suffered the casualty is the taxpayer's principal residence, the gain may be avoided altogether, as discussed below.

Involuntary conversions. If a taxpayer uses all of the insurance proceeds received from a casualty to purchase replacement property within two years (five years for Hurricane Katrina-related conversions), the casualty gain will not be taxed. However, the basis of the replacement property is reduced by the untaxed gain. Thus, the gain is deferred but not avoided, i.e., it is "built in" to the replacement property. For example, if the taxpayer has a \$20,000 casualty gain and within two years uses all of the insurance proceeds to buy replacement property for \$100,000, his basis in the replacement property is only \$80,000. Property qualifies as replacement property if it's "similar or related in service or use" to the property that was destroyed.

Gain will be recognized to the extent the cost of the replacement property is less than amount of the insurance proceeds. Say the taxpayer has a \$50,000 basis in an asset which is destroyed in a casualty and he receives \$80,000 in insurance proceeds. The casualty gain is \$30,000. Within two years he buys replacement property for \$70,000: \$10,000 less than the insurance payment he received from the casualty. In this case, the taxpayer will have to include \$10,000 of his \$30,000 casualty gain in gross income: the amount of the insurance payment not spent on replacement property. (Note, under the basis rule discussed above, the taxpayer's basis in the replacement property in this example would be \$50,000: the \$70,000 cost minus the \$20,000 of untaxed gain.)

Principal residences. Where the property damaged by the casualty is the taxpayer's home it may be even easier to avoid tax on a casualty gain. As you may be aware, if you used your home as your "principal residence" (e.g., not merely as a vacation home) for at least two years out of the previous five, you can exclude up to \$250,000 of gain on its sale (\$500,000 for married couples filing jointly, as long as the use tests are met by both spouses). This exclusion cannot be used more than once in a two-year period.

Significantly, for our purposes, these exclusion rules apply to gains from the destruction of the home as well. Thus, casualty gains of up to \$250,000 (\$500,000 for married couples) can be excluded from gross income if the destroyed property is a principal residence.

If the casualty gain on a home exceeds the amount of the exclusion, the excess amount can be deferred under the involuntary conversion rules. In this case, to defer the remainder of the gain, the cost of the replacement property need only be equal to the insurance proceeds minus the excluded amount.

Example. A single taxpayer's home is destroyed by a hurricane and he is paid \$400,000 by his insurance company. The taxpayer's basis in the home was \$100,000 so the casualty gain is \$300,000. The first \$250,000 of this gain is excluded from gross income under the rules that apply to sales or exchanges of principal residences. The remaining \$50,000 of gain is deferred under the involuntary conversion rules as long as \$150,000 of the insurance payment is spent on replacement property: the \$400,000 amount received minus the \$250,000 exclusion.

Finally, additional tax help may be available if your home is destroyed by a casualty that is part of a Presidentially declared disaster. Special rules make it easier to avoid gain on insurance payments you receive for your personal property damaged in the disaster. And the involuntary conversion timing rules are expanded to allow you a four-year period (five-year period for Hurricane Katrina-related conversions) to get the replacement property instead of the usual two-year period.