**Tax Tips**

**Casualty Gains (Part 1 of 2)**

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

However, the gain resulting from insurance payments for casualty might not be immediately, or ever, taxed. Specifically 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 a required period (described below), 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 the required period uses all of the insurance proceeds to buy replacement property for $100,000, the taxpayer's basis in the replacement property is only $80,000. The required period begins at the time of the casualty event and ends, generally, two tax years after the tax year in which the first payments resulting in gain are received (the two-year period), but might end later because of a taxpayer request or in the case of certain disasters (see below). 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 the amount of the insurance proceeds. Say the taxpayer has a $50,000 basis in an asset which is destroyed in a casualty and receives $80,000 in insurance proceeds. The casualty gain is $30,000. Within the required period the taxpayer buys replacement property for $70,000: $10,000 less than the insurance payment received from the casualty. In this case, the taxpayer will have to include $10,000 of the $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.)

If you have any questions concerning casualty gains, please do not hesitate to call me at (562) 698-9891.

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