Involuntary Conversions

Handling Insurance Payouts

1031
Knowledge

WHAT IS AN INVOLUNTARY CONVERSION?

Certain involuntary dispositions of appreciated property are eligible for income tax deferral under Internal Revenue Code Section 1033. Events that result in an involuntary conversion include theft, damage resulting from an "act of God" (such as a casualty), or the government taking a taxpayer's property for public use. The essential elements of an involuntary conversion are a property loss caused by destruction (either complete or partial), theft, seizure or condemnation.

If the taxpayer replaces the involuntarily converted property with property that is of equal or greater value and is similar or related in use within a specified time, the taxpayer can defer recognition of the gain (and the tax on it). To qualify for deferral, the replacement property must be purchased within two years of the close of the tax year in which the gain was realized. A larger three year replacement period applies for condemned property. Taxpayers can apply with the IRS for extensions of these replacement periods.

The gain that would result on the receipt of insurance proceeds or compensation paid by the government on a taking for public use is automatically deferred if the property is replaced with other property which is similar or related in use.

The foregoing rules apply to property used in a taxpayer's trade or business or held for investment purposes and personal use property. The deferral rules do not apply to losses. In most cases, however, losses are deductible as casualty losses.

An Example: Jennifer had a basis of $150,000 in a vacation home she owned in Breckenridge, Colorado which appreciated in value since she purchased it. The vacation home was completely destroyed by fire and she subsequently received an insurance payment of $300,000. She purchased a new vacation home for $290,000 in Sarasota, Florida, within two years of the end of the year in which she received the insurance payment.

Jennifer's realized gain on the involuntary conversion is $150,000 ($300,000 insurance payment minus the $150,000 basis). If Jennifer elects gain-deferral, she will only recognize $10,000 of gain. Because she received an insurance payment of $300,000, but only spent $290,000 on the replacement property (vacation home she purchased in Florida), the $10,000 is the excess of the amount she received from the insurance payment. Her basis on the new property will be $150,000. This is the cost of the replacement property in Florida ($290,000) minus the deferred gain ($140,000). If Jennifer purchased a replacement property for $300,000 or more, she would not have to report any gain.

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