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Dealing with the tax implications of an involuntary conversion

Properly planned, a taxpayer can avoid the financial double dip of the loss of property and the resulting tax consequences related to reimbursement or recovery from insurance policies.

A property owner who receives insurance proceeds or other compensation for property lost by a casualty (i.e. flood, fire or theft) or condemnation ordinarily must report as income any excess of the compensation received over his adjusted basis in the property lost. These events are typically referred to as "involuntary conversions" and in many cases, an election can be made to defer the gain realized to the extent that the proceeds are reinvested in similar property.

If the property is involuntarily converted directly into other property which is similar or related in use, the gain is automatically deferred. But direct conversions don't often happen. Normally, the lost property is converted into cash (insurance proceeds or a condemnation award) or into other property which isn't similar or related in use.

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In these situations, the taxpayer must comply with the guidelines provided in the tax law to ensure that gain deferral is accomplished. There are also special rules for business or investment property destroyed by a Presidentially-declared disaster, which treats any tangible business property as similar or related in use to the property converted.

The timing of the election and the acquisition of the replacement property are important. The election to defer gain must be filed with the tax return for the year in which the involuntary conversion occurred. Additionally, to qualify for gain deferral, the property lost as a result of a casualty must be replaced within two years of the close of the tax year in which the gain was realized. A three-year period applies for condemned property and in both situations property owners can apply to IRS for extensions of the replacement periods. A five-year period applies to Hurricane Katrina-related involuntary conversions.

Keep in mind that in situations where you qualify and elect gain deferral, you will still have to recognize a taxable gain to the extent that the replacement property costs less than the amount you received as compensation. Note that the basis of the new property will be reduced by the amount of gain deferred.

A property owner who has already reported and paid the tax on a gain from an involuntary conversion may still be eligible to defer gain recognition and obtain a tax refund. This can be accomplished by making the election to defer the gain resulting from the involuntary conversion and by reinvesting in replacement property within the specified time period. A claim for credit or refund of any overpayment of tax attributable to such an election may be filed at any time before the expiration of the applicable statute of limitations.

These rules apply to real property as well as property used in your trade or business or held for investment purposes. Note that the deferral rules don't apply to losses, which must be recognized immediately. However, a property owner may be able to recover part of the casualty loss through tax savings. In most cases, losses are deductible as casualty losses, subject to the limitations and special rules.

Planning is a vital tool in these circumstances. Please contact us with questions we will be happy to assist you in developing a comprehensive strategy to minimize the tax burden associated with any potential recovery.

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