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Involuntary Conversions From Storm Losses and Other Casualties

-by Neil E. Harl

The huge losses suffered this year as a result of hurricanes, especially Hurricane Katrina, have focused a great deal of attention on the options available to property owners in the wake of a casualty.\(^1\) The discussion below emphasizes involuntary conversions, particularly with respect to the time for reinvestment and the latitude for selecting reinvestment property.\(^2\) A future article will deal with casualty losses.\(^3\)

General

An involuntary conversion takes place when property is destroyed, stolen, taken by condemnation or eminent domain or is disposed of under threat or eminence of condemnation and the property owner receives other property or money in payment.\(^4\) Losses from an involuntary conversion are deductible only if the converted property is used in a trade or business or held for the production of income.\(^5\)

Non-recognition of gain

In two situations, gain is not recognized if the conditions for involuntary conversion treatment are met.

Proceeds reinvested. If property is involuntarily converted into money and property is acquired which is “similar or related in service or use,”\(^6\) no gain is recognized.\(^7\) For purposes of determining what constitutes “similar or related in service or use,” where the property converted was owned and used by the taxpayer and the replacement property is to be owned and used by the taxpayer, the IRS generally requires that the replacement property have a close “functional” similarity to the converted property.\(^8\) Under this test, property is not considered similar or related in service or use to the converted property unless physical characteristics and end uses of the converted and replacement property are very similar.

An involuntarily converted business or investment property may be replaced by the purchase of a controlling interest in a corporation directly owning\(^9\) property similar or related in service or use to the converted property if specified conditions are met.\(^10\)

Real estate held for productive use in a trade or business or for investment purposes, which is involuntarily converted by condemnation or threat or imminence of condemnation, may be replaced with like-kind property without recognition of gain.\(^11\) The term “like-kind” has taken on a broader meaning than “similar or related in service or use” and generally means that real property can be replaced with any other real property.\(^12\) Note that this more liberal reinvestment rule does not apply to involuntary conversions by fire.

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storm or other casualty or to acquisitions of 80 percent or greater control of a corporation owning such property.\(^{13}\)

In the event of a Presidentially-declared disaster, if property held for productive use in a trade or business or for investment is involuntarily converted, any tangible property of a type held for productive use in a trade or business is treated as similar or related in service or use to the property converted.\(^{14}\)

If the taxpayer’s principal residence or any of its contents is compulsorily or involuntarily converted as a result of a Presidentially-declared disaster, no gain is recognized on receipt of insurance proceeds for personal property which was part of the contents of the residence and which was not scheduled property for purposes of insurance.\(^{15}\) Other insurance proceeds for the residence or its contents are treated as similar or related in service or use to the residence so converted with a four-year reinvestment period.\(^{16}\)

In general, careful attention should be given to assuring that the replacement property is owned the same as the property involuntarily converted.\(^{17}\) Thus, the purchase of replacement property by a partnership was not eligible for non-recognition treatment where the original property was owned by individual partners.\(^{18}\) Likewise, where tenancy by the entirety property was involuntarily converted, but the spouse’s name was omitted on title to replacement property, the spouse’s portion was taxable.\(^{19}\)

Stock or other assets acquired from a related person by a C corporation or a partnership in which a C corporation has more than a 50 percent interest does not qualify as replacement property.\(^{20}\) That rule on acquisition of replacement property from related parties also applies to any other person, including individuals, who do not meet a $100,000 de minimis exception.\(^{21}\)

The period for replacement begins on the date of disposition of the converted property, or the earliest of the date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending two years after the close of the taxable year in which any part of the gain upon the conversion is realized.\(^{22}\) The Katrina Emergency Tax Relief Act of 2005 substituted five years for two years for replacing property in the Hurricane Katrina disaster area which was involuntarily converted on or after August 25, 2005, by reason of Hurricane Katrina if substantially all of the use of the replacement property is in the Hurricane Katrina disaster area.\(^{23}\) If real property used in the taxpayer’s trade or business or for investment is involuntarily converted by condemnation or threat or imminence of condemnation, the replacement period is three years instead of two.\(^{23}\) Note that the additional year is not available for loss of property because of fire, storm or other casualty or theft.\(^{24}\)

**Conversion to property similar or related in service or use.**

The other circumstance in which gain is not recognized is where property is converted involuntarily or by compulsion into other property that is similar or related in service or use.\(^{25}\) The income tax basis of the property given up is transferred to the new property. This provision applies regardless of the owner’s intent and there is no right to recognize the gain.\(^{26}\)

**Reporting requirements**

A taxpayer who has realized gain from an involuntary conversion must report the details of the conversion on the income tax return for the year in which the gain is realized.\(^{27}\) Taxpayers are required to attach a statement to the return including such information as the date and details of the involuntary conversion and the insurance or any other reimbursement received. In the event replacement property was acquired before the return was filed, the date of acquisition and the cost are to be included along with a description of the replacement property.\(^{28}\) If replacement is to occur after the year in which gain is realized, the statement should also state that the taxpayer intends to replace the property within the replacement period.

The election not to recognize gain is deemed made if the gain is not reported in gross income, such as by deleting the property from Form 4797.\(^{29}\)

### Footnotes

2. I.R.C. § 1033.
5. See Treas. Reg. § 1.1033(a)-1(a).
11. I.R.C. § 1033(g)(1). See Treas. Reg. § 1.1033(g)-1(a). See also Ltr. Rul. 200109005, November 20, 2000 (taxpayer operated two retail businesses with one on owned property and one on leased property; purchase of leased property under lease option using proceeds of insurance covering loss of the other property from fire was eligible for involuntary conversion treatment with taxpayer the owner-user of one retail business and was the owner-user of the retail business on the property acquired).
13. See I.R.C. § 1033(g)(1), (2).
18. Id.
20. I.R.C. § 1033(i).
25. Id.
27. Treas. Reg. § 1.1033(a)-2(b).
29. See Treas. Reg. § 1.1033(a)-2(c)(2).