**Tax Tips**

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

As you may recall, in last month’s Tax Tips we began a discussion concerning the IRS rules applicable casualty gains. In this article, we’ll wrap up our discussion of the IRS rules concerning casualty gains.

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 the taxpayer 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 ($400,000 minus $250,000) of the insurance payment is spent, within the required period, on replacement property.

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 calculated similarly to the two-year period described above. Further, a five-year period calculated similarly to the two-year period described above applies for certain disasters designated by statute.

In summary, while casualty gains may be taxable, a variety of rules can be used to defer or avoid tax in many cases. The rules can be complex, however, and frequently large amounts are at stake.

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

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