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#### McQuadeBrennan Launches New Website

McQuadeBrennan, LLP is proud to announce the launch of its newly redesigned website today. The new website offers users a more open and advanced browsing experience.

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#### McQuadeBrennan 2012 Year End Tax Planning Guide -- Part 2

This is the second of three newsletters we are devoting to our clients 2012 tax planning -- probably the most challenging and important tax planning taxpayers have ever undertaken.

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#### IRS Relaxes Rules on Retirement Account Loans for Sandy Victims



In an effort to get victims of Hurricane Sandy back on their feet, the IRS is permitting loans and hardship distributions from employer-sponsored retirement plans. Keep reading to learn the details directly from the IRS.

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#### Business Interruption Claims May Require Financial and Legal Assistance



**Business interruption** insurance typically pays for income that is lost while operations are suspended after a natural or man-made disaster. However, these claims can be difficult and even contentious if there are differences of interpretation about the calculations, projections or the meaning of policy provisions. This article explains how forensic accountants and attorneys are often needed to assist with the claims.

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#### Tax Implications of Disaster-Related Casualties



**Hurricane Sandy** left many homeowners and businesses with major damage. Here are the rules involved in claiming tax deductions after a hurricane or other casualty such as a fire, earthquake, tornado, flood, car collision or theft.

**If a neighbor's tree falls in your yard, who pays for the damage? Click "Full Article" for the answer, along with an important step to minimize potential tree liability.**

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## Business Tax

### Handle Payroll Taxes With Kid Gloves



**Here's a business rule** you don't *ever* want to break: Don't borrow from payroll taxes withheld from employees. The IRS views this money as sacred. That's why the penalties involving these funds are severe. Read the "Full Article" for an important heads-up.

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## Personal Tax

### How to Set Up an IRS-Approved Family Loan



**It's not unusual** to lend money to relatives and friends, but if the loans aren't properly structured with an "adequate" interest rate, you could run into trouble with the IRS. Here are the current interest rates and how your family can benefit.

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### McQuadeBrennan Launches New Website

"The new website is designed with state-of-the-art features, but also to be easy to navigate," said Brian McQuade, Managing Partner. "McQuadeBrennan is committed to adding value to our clients with regular news and information updates," he continued.

The new design provides clearer links, video components and a back-office editing system that will allow for regular updates, news stories and more effective information delivery to our clients.

Creative. Innovative. Imaginative. You'll find McQuadeBrennan is uniquely built to provide customized solutions that exceed expectations.

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## McQuadeBrennan 2012 Year End Tax Planning Guide -- Part 2

### Roth Conversion and the 3.8 Percent Surtax

Net investment income for purposes of the 3.8 percent surtax does not include distributions from qualified plans or IRAs, but taxable distributions count towards the income threshold amount. A Roth conversion now in 2012 will not only ensure being taxed at the Bush-era income tax rates, but will also lower taxable income during the upcoming years in which the 3.8 percent tax is in play. (Contributing the maximum allowed to a qualified retirement plan once 2013 arrives also may prove to be a good retirement strategy two ways, first in reducing AGI in the year of contribution and then being exempt from the surtax when eventually distributed.)

### Resetting Basis

Wash sales are sales of stock or securities in which losses are realized, but not recognized, because the seller acquires substantially identical stock or securities 30 days before or after sale. Nonrecognition, however, applies only to losses; gains are recognized in full. As a result, both a higher capital gains rate and the 3.8 percent surtax rate may be avoided by selling before year-end 2012 and then immediately re-investing. To buy back the same or substantially similar securities both in kind and amount, of course, there is the upfront cost of finding the cash elsewhere to pay the immediate tax, or lowering the amount re-invested. While there is no wash sale rule for gains, a true sale must nevertheless take place to successfully accelerate income. Outside the context of marketable securities, this rule prevents "basis resetting" without further substance behind it. For example, selling real estate to a straw man who then sells it back to the taxpayer does not accomplish a resetting of basis since there must be an underlying true sale to support it. A leaseback, however, would work unless other than a true lease is otherwise apparent. While arguments of sham transaction and economic substance are more likely raised when a loss is involved, courts have nevertheless often looked to determine whether or not the parties intended that the purchaser retain title in the property. The benefits and burdens of ownership must be transferred for a sale to occur.

Further, while a sale must be final or closed to determine gain or loss, determining what is final or closed for tax purposes is not always intuitive. Despite the general rule that a sale occurs when title is transferred to a buyer, a sale for tax purposes can occur before or without the transfer of title. For example, once the parties have reached a binding agreement, the transfer of possession of property to a buyer usually closes a sale for tax purposes.

In selling to reset basis, looking ahead to 2014 also requires building in the flexibility of being able to sell at long-term capital gain rates at the end of 2013 to take advantage of any Bush-era extended rates on capital gains that may not last into 2014. Long-term capital gain rates are only available to assets held for more than one year. The holding period starts the day after a capital asset is acquired and ends on the date of its disposition. The holding period of securities generally begins on the trade date if they are publicly traded or upon receipt of title if not publicly traded.

### Advance Payments

Accelerating income, especially within the business setting, has been made easier by published policy from the Internal Revenue Service (for example, Revenue Ruling 66-347) that generally taxes prepaid income in the year of receipt, whether the income is derived under contracts to furnish services or is prepaid rent, royalties, bonuses, etc. This blanket rule applies regardless of whether the period of the recipient's performance under the contract is definite or indefinite.

Generally, the IRS's interest has been at the other end of the income recognition argument, in opposing taxpayers who seek deferrals. In both cases, the IRS usually maintains that, for both cash and accrual method taxpayers, payments received in advance are income in the year received, provided no restriction has been placed upon their use. The IRS has ruled that this holds true even though the advances may be returnable upon the happening of some specific condition.

Of course, one practical challenge to receiving advance payments is persuading the other party to make the payment in advance. If there is little negotiating room, a discount may be required, the extent of which may vitiate the extent to which taxes are saved.

### **Mandatory Nonrecognition**

A taxpayer cannot recognize gain or loss that is otherwise realized when an income tax provision of the Internal Revenue Code specifically excludes the gain or loss from being recognized. This list of nonrecognition transactions includes:

- Contributing property to a corporation in exchange for its stock under Code Section 351;
  
- Contributing property to a partnership in exchange for an interest in the partnership under Code Section 721;
  
- Exchanging, distributing or receiving stock or debt securities of a corporation pursuant to a plan of re-organization under Code Section 368;
  
- Exchanging property used in a trade or business or held for investment for property of like kind under Code Section 1031;
  
- Replacing involuntarily converted property under Code Section 1033;
  
- Selling a principal residence within the gain exclusion limit under Sec. 121; and
  
- Transferring property to a spouse or incident to divorce under Code Section 1041.

Techniques are available to "bust" certain mandatory recognition provisions, for example as a contribution to capital or like-kind exchanges. Taxpayers can look for techniques no further than within the many cases in which taxpayers have tried unsuccessfully to obtain nonrecognition treatment. However, awareness of these restrictions is first necessary, and those attempting to accelerate income should heed the cautionary tales of both those taxpayers and the IRS when on the losing side.

### **Miscellaneous Items**

In reviewing opportunities to accelerate income in 2012, taxpayers should also keep in mind the following rules:

#### **Installment Sales**

Installment-method reporting applies to gain on a sale if at least one payment is to be received after the tax year of the closing. An installment sale that qualifies for use of the installment method is reported using that method, unless the tax-payer elects to have the provisions not apply to a particular transaction. A taxpayer elects out of installment sale treatment by not reporting a transaction as an installment sale. This election may be revoked only with the consent of the IRS. However, installment reporting may be effectively revoked by selling the installment obligation to a third party or negotiating with the purchaser to accelerate payments, thus accelerating income in either instance.

#### **Certificates of Deposit**

A cash-basis taxpayer recognizes interest income on a CD based on the terms of the certificate. The rules in this regard will generally favor recognizing CD income in 2012; if the terms require that interest be paid currently (that is, at least annually), or be credited currently and made available to the depositor without penalty, the taxpayer reports interest income as it is received or credited. If interest is not paid currently and the term of the instrument is more than one year, the original issue discount rules require the depositor to report the amount of interest income earned, even if it is not paid, in a manner similar to that used by accrual-basis taxpayers. Thus, even if interest is not paid, the taxpayer must report interest income throughout the term of the instrument, based on the effective interest rate of the instrument.

### Discharge of Indebtedness Income

If a debtor acquires his own debt, the cancellation of indebtedness income is recognized at the time of the purchase. However, in situations in which a debt is claimed to be cancelled or forgiven, an "identifiable event" to indicate that a debt will not be paid may in fact not be so easy to identify. An overt act by the taxpayer is evidence of the time the debt is discharged; however, such an act is not necessary.

### Liquidations

Corporate liquidations are on the uptick as some owners attempt to get taxed on distributions at the Bush-era rates before the end of the year. The general timing rule that applies requires each shareholder of a liquidating corporation to recognize and report gain or loss in accordance with his method of accounting.

### Deferred Compensation

The employee's control of an enterprise requires that a bonus or other form of contingent compensation be included in their income in the year it is authorized unless special facts indicate that payment is not fully possible or authorized in that year. Starting in 2013, high-income individuals will pay another 0.9 percent on earned income over \$200,000 (\$250,000 for joint filers) in addition to the 1.45 percent portion of the high-income (Medicare) tax now paid.

### Conclusion

The fate of the Bush-era tax rates for higher-income individuals likely will not be put to a vote until a lame-duck session of Congress convenes after the November elections. That Congress might punt the decision into January 2013, instead. More tenuous still, if efforts to repeal the 3.8 percent Medicare tax gain momentum, a decision on whether to keep the surtax may not take place until later in 2013, if at all. Given the present uncertainties, accelerating a little more income than is otherwise required into 2012 through a variety of strategies might improve a conservative approach worth considering for many taxpayers.

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### IRS Relaxes Rules on Retirement Account Loans for Sandy Victims

**The IRS announced that 401(k)s** and similar employer-sponsored retirement plans can make loans and hardship distributions to victims of Hurricane Sandy and members of their families.

401(k) plan participants, employees of public schools and tax-exempt organizations with 403(b) tax-sheltered annuities, and state and local government employees with 457(b) deferred-compensation plans may be eligible to take advantage of these streamlined loan procedures and liberalized hardship distribution rules. Though IRA participants are barred from taking out loans, they may be eligible to receive distributions under liberalized procedures.



Retirement plans can provide this relief to employees and certain members of their families who live or work in the disaster area. To qualify for this relief, hardship withdrawals must be made by Feb. 1, 2013.

The IRS is also relaxing procedural and administrative rules that normally apply to retirement plan loans and hardship distributions. As a result, eligible retirement plan participants will be able to access their money more quickly with a minimum of red tape. The six-month ban on 401(k) and 403(b) contributions that normally affects employees who take hardship distributions will not apply.

In addition to Sandy victims being able to take a loan or a hardship distribution from eligible retirement plans, an individual who lives outside the disaster area can also take out a retirement plan loan or hardship distribution and use it to assist a son, daughter, parent, grandparent or other dependent who lived or worked in the disaster area.

Ordinarily, retirement plan loan proceeds are tax-free if they are repaid over a period of five years or less. Under current law, hardship distributions are generally taxable. Also, a 10 percent early-withdrawal tax usually applies.

To learn more see the announcement on the IRS Website.

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## Business Interruption Claims May Require Financial and Legal Assistance

**When disasters such as Hurricane Sandy occur**, a need for a forensic accountant and an attorney can arise. Although many of the insurance claims that result from such a storm are relatively straight forward, policy claims for business interruption insurance may require detailed proof of the losses.

**Insurance basics:** Most insurance claims involve determining what costs and replacement values of equipment and materials were lost or damaged in the disaster, proving the losses and values and submitting a claim.

Business interruption insurance typically pays for income that is lost and expenses that are incurred while operations are suspended. A business interruption policy typically covers expenses including:



- **Profits** that would have been earned if it were not for the loss (usually limited to 12 months).
- **Continuing costs** - Operating expenses and other fixed costs still being incurred by the business (these expenses must be ordinary and necessary such as salaries and related payroll costs during the interruption period).
- **Replacement** of inventory and machinery.
- **Temporary location** - The extra expenses for moving to, and operating from, a temporary location may be covered. (The expenses for permanent relocation, if necessary, may also be included).
- **Other expenses** - Businesses are reimbursed for reasonable expenses (beyond the continuing costs) that allow the business to continue operating while the damage is being repaired.

Business interruption coverage that insures you against 100 percent of losses can be costly. More typically, policies might cover 80 percent of losses while the business shoulders the remaining 20 percent.

*Important:* This type of insurance is arguably one of the most complicated on the market today, and submitting a claim is time consuming and takes careful consideration. Claims can be delayed or denied if there are differences of interpretation about the loss calculations, income projections or the meaning of policy provisions.

A business may approach its accountant or attorney for advice on how to approach a claim for business interruption coverage, especially if the business has already filed a claim and is experiencing push back or denial from the insurance company. The business may also need professional help to get the insurer's attention -- especially after a major disaster when insurance companies can be overwhelmed with claims.

A forensic accountant and an attorney can work with the business to determine the losses and prove them in a claim. When it comes to business interruption claims, it is important to properly

calculate losses upfront.

Forensic accountants, particularly those experienced in business valuation and litigation, have skills that are important in determining losses for business interruption claims such as forecasting, modeling and properly presenting damages and losses. Working with an attorney, who can aid in the legal interpretation of the policy, a forensic accountant can quickly and efficiently assemble the information and calculations needed for a viable business interruption claim. Filing a well-crafted claim can help in a quick and easy resolution with the insurance company.

### Before a Disaster

There is more that businesses and their advisers can do to proactively prepare for the potential of a business interruption claim. According to George Stratts, President of AIG's Property Casualty Global Property Division:

*"More and more, forensic accountants are being brought in before the loss to help companies evaluate their potential exposure, and provide additional insight that they may have not been building into their coverage. We're seeing more specific coverage being sought and different limits than companies have used before. Companies have expanded their limits where they've been able to identify the exposure ... So companies have to make sure they have the best understanding of their business and the best understanding of the exposures to it. In commercial insurance, contracts can be manuscripted so they are unique to the individual insurance."*

The idea is to structure a policy that anticipates the most likely losses that would occur if your business suffers a catastrophe.

Filing a business interruption claim requires companies to assemble financial records, such as receipts, utility bills, salaries, vendor information and more. The insurer will want to know the income the business was generating before and after the loss. The business must analyze, identify and segregate revenues and expenses, as well as review its profit projections to help ensure they are accurate and solid enough to hold up to a potential dispute. Consult with your accounting firm and attorney for assistance to help ensure a successful claim.

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### Tax Implications of Disaster-Related Casualties

**Every year, disasters in the U.S.** cause billions of dollars in property damage. Hurricane Sandy is the latest well-known example. In addition to dozens of lives lost in several states, New York City alone may have suffered more than \$30 billion in property damage.

Disasters also have tax implications. Here's a quick summary of what victims need to know.

#### Personal Casualty Loss Write-Offs

In theory, you can claim tax deductions for personal casualty losses to the extent they are not covered by insurance. For federal income tax purposes, you suffer a casualty loss when the fair market value of your property is reduced or obliterated by a sudden event such as a hurricane, flood, storm, fire, earthquake, volcanic eruption, or sonic boom -- among other things. Property losses due to theft or vandalism also count as casualty losses.

**The Deduction Won't Be as Big as You Might Think.** In reality, your deduction for a personal casualty loss will probably be significantly less than what you expect -- or maybe nothing at all. Here's why.

- You must reduce the amount of your loss (after offsetting it by applicable insurance proceeds) by \$100. This is no big deal.
- What *is* a big deal is the tax-law requirement that you must further reduce the amount of your loss by 10 percent of your adjusted gross income (AGI) for the year you would claim the loss on your tax return (more on which year to claim a loss later). Basically, AGI includes all your positive taxable income items with offsets for specified deductible items such as IRA contributions, alimony paid to an ex-spouse and self-employed retirement plan contributions.
- You get no deduction at all unless

#### Fallen Trees and Insurance

**Q.** During a recent storm, a neighbor's large tree fell into my yard, and it will cost thousands of dollars to clean up. The neighbor tells me he is not responsible for the part of the tree in my yard. Shouldn't his homeowners insurance cover the cost?

**A.** In general, a standard homeowner's policy does *not* cover the removal of a fallen tree due to a storm unless it damages insured property.



This includes your house and other items, such as a fence or garage. If a tree simply falls during a storm, doesn't hit anything, and leaves a big mess, the cost of removing it is generally not covered.

If your neighbor's tree did hit your house, you have to file a claim under *your* homeowner's policy even though you were not the owner of the tree. Unfortunately, there is probably a deductible and possibly a limit on the amount your insurer will pay. (The Insurance Company Institute states "most insurance companies will pay up to \$500 for the removal of trees or shrubs that have fallen on your home.")

These are the general rules. Check your policy or

you itemize.

**Example:** You incur a \$30,000 personal casualty loss this year and have AGI of \$150,000. Your allowable deduction is only \$14,900 (\$30,000 minus \$100 minus \$15,000). But if your loss is \$15,100 or less, you get no write-off at all. You also get nothing if you don't itemize deductions.

#### **Special Rule for Federally Declared**

**Disaster Areas.** Despite the restrictions explained above, let's assume you have a deductible personal casualty loss from a 2012 event. If the loss was caused by a disaster in a federally declared disaster area, a special rule allows you to claim your deduction either this year (when the casualty occurred) or last year (the year *before* the casualty occurred).

consult with your agent to see what's covered. For example, some policies pay for removal if a fallen tree was struck by lightning or is blocking a driveway.

*Another exception:* Let's say your neighbor's tree was dying and leaning precariously toward your property. You notified him in writing and asked that the hazard be removed. He ignored the request. Since the tree later fell, you may have some recourse against your neighbor's insurance company.

Keep records of this correspondence in case you have to recover damages. High winds and heavy rains can topple trees and cause massive, expensive damage. Look around your property to ensure there are no potential hazards -- and if there are, notify your neighbor in writing.

For instance, Hurricane Sandy victims can file amended 2011 returns to claim personal casualty loss deductions last year and get tax refunds. This rule allows disaster victims to obtain quick federal income tax savings instead of having to wait until after filing a 2012 return next year.

*Note:* This special deduction timing rule is only available for losses in federally declared disaster areas. You can find a by-state listing of these areas by using the map on the Federal Emergency Management Agency website at [www.fema.gov](http://www.fema.gov).

### **Business Casualty Loss Write-Offs**

If you have disaster-related losses to business property, you don't need to worry about the \$100 subtraction rule or the 10 percent-of-AGI subtraction rule. You can deduct the full amount of the uninsured loss as a business expense on your business entity's tax return or on the appropriate Form 1040 schedule if you operate as a sole proprietor. As with personal casualty losses, you can opt to claim 2011 deductions for 2012 losses that occur in a federally declared disaster area.

### **Beware of Taxable Involuntary Conversion Gains**

When you have insurance coverage for disaster-related property damage -- under a homeowners, renters, or business policy -- you might actually have a taxable gain instead of a deductible casualty loss. *Reason:* If the insurance proceeds exceed the tax basis of the damaged or destroyed property, you have a taxable profit under the Internal Revenue Code. This is the case even if the insurance company doesn't fully compensate you for the pre-casualty value of the property. These gains are called involuntary conversion gains because the casualty causes your property to suddenly be converted into cash from insurance proceeds.

**Example:** Your valuable vacation home is destroyed by fire. The insurance company pays \$500,000 for the loss. Your tax basis is only \$200,000 because you bought the property years ago. For tax purposes, you have a \$300,000 involuntary conversion gain.

*Note:* The tax basis of property usually equals original cost, minus any depreciation write-offs for business or rental usage, plus the cost of improvements. If you acquired property in a tax-deferred Section 1031 exchange, your basis could be lower than you think. Consult your tax pro if you have questions about basis.

When you have an involuntary conversion gain, you generally must report it as taxable income unless you:

1. Make sufficient expenditures to repair or replace the property; and
2. Make a special tax election to defer the gain.

If you make the gain deferral election, you'll have a taxable gain only to the extent the insurance proceeds exceed what you spend to repair or replace the property. The repair or replacement expenses generally must occur within the period beginning on the date the property was damaged or destroyed and ending two years after the close of the tax year in which you have the involuntary conversion gain.

### Special Rules for Principal Residence Involuntary Conversion Gains

For federal income tax purposes, special taxpayer-friendly rules apply to principal residence involuntary conversion gains. For this purpose, the term *principal residence* means the place that has been your main home for at least the last two years.

- **For a home you own** - For a principal residence, you can probably use the well-known federal exclusion break to reduce or eliminate any involuntary conversion gain. The maximum gain exclusion is \$250,000 for unmarried homeowners and \$500,000 for married joint-filing couples. To qualify for the maximum exclusion, you must have owned and used the property as your main home for at least two out of the last five years. If you still have a gain after taking advantage of the gain exclusion break, you have four years (instead of the normal two years) to make sufficient expenditures to repair or replace the property and thereby avoid a taxable involuntary conversion gain -- if your residence was damaged or destroyed by an event in a federally declared disaster area.
- **For a home you own own or rent** - If contents in your principal residence were damaged or destroyed by an event in a federally declared disaster area, there is no taxable gain from insurance proceeds that cover losses to uncheduled personal property (called "contents coverage"). In other words, you do not need to repair or replace contents to avoid a taxable involuntary conversion gain. You can do whatever you want with insurance money from uncheduled personal property coverage without any tax concerns. This beneficial rule applies whether you own your principal residence or not.

### Conclusion

If you suffer a major personal or business casualty loss, consult with your tax adviser for a full explanation of the implications. This article summarizes the federal income tax rules that most commonly come into play, but there could be additional considerations in your situation. This area of the tax law can be complicated and the tax dollars involved can be significant.

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