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Involuntary Conversion of Business Assets*

Guido van der Hoeven, *Extension Specialist/Senior Lecturer*
Department of Agricultural and Resource Economics, NC State University

Introduction

During the course of operating a farm or ranch, operators will get rid of, lose, or dispose of property used in the business in a variety of ways. Sometimes events beyond the control of the business result in disposition of property. The purpose of this discussion is to illustrate correct income tax reporting when business properties are disposed of due to an involuntary conversion or casualty that may occur suddenly and is beyond management's control.

This discussion will focus on the involuntary conversion of tangible personal property (i.e., equipment and vehicles), which may be the result of a casualty loss event. The point of the discussion is to enhance the reader's understanding of correct income tax reporting of sales and replacement purchases as a result of an involuntary conversion. Involuntary conversions of real estate are discussed briefly.

Involuntary Conversion of Tangible Personal Business Property

An involuntary conversion is the conversion of a taxpayer's property into similar or dissimilar property due to condemnation (actual or threatened), theft, seizure, requisition (generally by a jurisdiction of government), or destruction [IRC Section 1033(a)].

Business property that is tangible, such as pickups, tractors, machinery, and breeding livestock and dairy cattle are classified as Internal Revenue Code (IRC) Section 1245 property. Occasionally farm and ranch operators suffer a loss of these items due to an unforeseen event such as an accident, storm, flood, drought, or fire. In general, the farmer/rancher and tax professional should understand that IRC Section 1033 discusses involuntary conversions of property to cash as a "tax-free event" for the taxpayer; which is conditional upon replacement of the lost property.

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Weather conditions, such as a prolonged drought, may force a livestock producer or dairyman to reduce his animal numbers much below his normal stocking rate. The occurrence of drought is beyond the producer's control and the producer can therefore receive involuntary conversion treatment of some of the livestock sales. (See discussion of weather-related sales of livestock on this website for correct treatment of excess animal sales.)

However, the proper treatment and reporting of these involuntarily converted assets is important to defend the correct tax treatment should the tax return be reviewed.

Involuntary conversions can be similar to a like-kind exchange (discussed in another article); however, while the like-kind exchange is planned by the taxpayer, the involuntary conversion is not. The IRC definition for "like-kind" under involuntary conversion is narrower or more restrictive regarding replacement property with an involuntary conversion compared to a like-kind voluntary exchange. Dissimilar properties involved in an involuntary conversion generally do not result in tax-free recognition of the gain due to the replacement or cash receipt (i.e., insurance payment) for the lost property.

Like-Kind or Similar for the Purposes of an Involuntary Conversion

Qualifying business property is defined and explained under the Internal Revenue Code Section 1033 and the Treasury regulations. The presumption of this part of the IRC is that the business will replace the involuntarily converted property with the same type of property as that which was subject to the conversion (e.g., a tractor replacing another tractor). Using insurance proceeds from a combine destroyed by fire to purchase brood cows is an example of dissimilar property replacement. In this case, the farmer/rancher must recognize the tax consequence of the combine fire by calculating either a gain or loss determined by the remaining cost basis and the insurance proceeds received. The tax reporting will be as a sale of the combine to the insurance company and is illustrated in the discussion of *Sale of Business Assets* found on www.RuralTax.org.

Replacement Period

To postpone reporting the gain from a condemnation, replacement property must be purchased within a certain period of time, called the replacement period. The replacement period for a condemnation begins on the earlier of the following dates:

- The date on which the taxpayer disposed of the condemned property.
- The date on which the threat of condemnation began.

The replacement period generally ends two years after the end of the first tax year in which any part of the gain on the condemnation is realized.

Example 1: Rose Hipps manages a successful cut flower farm. On May 1, 2016, a wind storm destroyed her packing shed and cool storage facility. Rose's insurance company paid for 100% of the loss. Rose has until December 31, 2018, to replace the packing shed and cool storage using the insurance proceeds she received. Rose is not required to report the insurance proceeds on her 2016 income tax return.

Three-year replacement period for certain property. If real property held for use in a trade or business (such as farm land) or for investment (not including property held primarily for sale) is condemned, the replacement period ends three years after the end of the first tax year in which any part of the gain on the condemnation is

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realized. However, this three-year replacement period cannot be used if the taxpayer replaces the condemned property by acquiring control of a corporation owning property that is similar or related in service or use.

Postponement of Gain

Do not report the gain on condemned property if the property received is similar to or related in service or use to the condemned property. The taxpayer's basis for the new property is the same as his basis for the old.

Money or unlike property received. Ordinarily a taxpayer must report the gain if money or unlike property is received. A taxpayer can elect to postpone reporting the gain if the purchased property is similar or related in service or use to the condemned property (i.e., real estate) within the replacement period, discussed above.

To postpone reporting all the gain, a taxpayer must buy replacement property costing at least as much as the amount realized for the condemned property. If the cost of the replacement property is less than the amount realized, the gain up to the unspent part of the amount realized must be reported as income.

The basis of the replacement property is its cost, reduced by the postponed gain.

Example 2: Knight N. Gale operates a ranch which has a main product of feeder calves. During the year Knight lost a self-propelled mower/conditioner due to a fire caused by an overheated bearing; remaining cost basis was $10,000. Knight's insurance company sent a check for $55,000 to replace the burnt mower/conditioner. Knight used all the insurance proceeds to purchase a replacement mower/conditioner. Knight does not report the $55,000 as income because this is an example of an involuntary conversion. Further, the new mower/conditioner is treated as being the "old" machine for depreciation purposes, meaning that the basis of the old machine transfers as the depreciable value, $10,000 in this case.

Example 2 above illustrates the replacement of an asset with $10,000 of basis remaining. The burnt mower/conditioner can be removed from the depreciation schedule, as this mower/conditioner is abandoned in the farm's scrap pile.

Condemnations

Example 3. A local government authorized to acquire land for public parks informed Dusty Rhodes that it wished to acquire his property. After the local government took action to condemn Dusty's property, Dusty went to court to keep it, but the court decided in favor of the local government, which took Dusty's property and paid Dusty an amount determined by the court. This is a condemnation of private property for public use.

A condemnation via eminent domain is the process by which private property is legally taken for public use without the owner's consent. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take it. The owner receives a condemnation award (money or property) in exchange for the property taken. A condemnation is like a forced sale, the owner being the seller and the condemning authority being the buyer.

Since this involuntary conversion concerns real estate, Dusty has up to three years to reinvest the cash received in other like or similar land with no tax consequences.

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Threat of condemnation. A threat of condemnation exists if a representative of a government body or a public official authorized to acquire property for public use informs you that the government body or official has decided to acquire your property. A taxpayer must have reasonable grounds to believe that the property will be condemned if not sold voluntarily.

The sale of this property to someone other than the condemning authority will also qualify as an involuntary conversion, provided there are reasonable grounds to believe that the property will be condemned. If the buyer of this property knows at the time of purchase that it will be condemned and sells it to the condemning authority, this sale also qualifies as an involuntary conversion.

Reports of condemnation. A threat of condemnation exists if a taxpayer learns of a decision to acquire his property for public use through a report in a newspaper or other news medium and this report is confirmed by a representative of the government body or public official involved. A taxpayer must have reasonable grounds to believe that they will take necessary steps to condemn the property if it is not sold voluntarily. If the taxpayer relied on oral statements made by a government representative or public official, the Internal Revenue Service (IRS) may ask for written confirmation of the statements.

Example 4. Muddy Watters owns property that lies along public utility lines. The utility company has the authority to condemn Muddy's property. The company informs Muddy that it intends to acquire his property by negotiation or condemnation. A threat of condemnation exists when Muddy receives the notice.

Related property voluntarily sold. A voluntary sale of property may be treated as a forced sale or involuntary conversion if the property had a substantial economic tie or relationship to property owned that was condemned. A substantial economic relationship exists if both properties were part of one economic unit. The taxpayer must also show that the condemned property could not reasonably or adequately be replaced. An election can be made to postpone reporting the gain by buying replacement property.

Conclusion

Examples 1, 2, 3, and 4 are simplified to illustrate involuntary conversions that may occur in the normal course of the operator's farm or ranch management. Operators are encouraged to properly record these transactions in their business records so that they or their tax professionals can correctly and accurately report income on the individual's income tax returns. Notations that reference these transactions, during the tax year, can provide invaluable information as income tax returns are being prepared and filed.

IRS Publications

To access IRS Publications, go to www.irs.gov and click on "Forms and Publications." Then click on "Publication number" under "Download forms and publications by." Type the publication number in the find box to search for the publication. Publications may be viewed online or downloaded by double clicking on the publication.

- **IRS Publication 225, Farmer's Tax Guide**. Chapter 9 discusses disposition of assets.
- **IRS Publication 547**. This publication provides more detail relative to gains or losses from the destruction or theft of business property.

Additional Topics

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This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets, and additional information related to agricultural income tax, please see RuralTax.org.

Fact sheets that might be of interest include

- Weather-Related Sales of Livestock
- Like-Kind Exchange (Trade) of Business Assets
- Sale of Business Property

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