**8589. In the case of an involuntary conversion of a primary residence, how does the nonrecognition treatment under IRC Section 1033 and the exclusion of gain under IRC Section 121 interact?**

If a taxpayer’s principal residence is destroyed and the proceeds from insurance are used to purchase a replacement residence, IRC Section 1033 and IRC Section 121 interact as follows:

1. For purposes of determining potential gain for purposes of IRC Section 1033, the amount realized is the fair market value of the relinquished property;
2. Next, the amount of gain that would have been excluded pursuant to IRC Section 121 is subtracted from that amount; and
3. Gain would be recognized to the extent that amount computed pursuant to 2), above exceeded the cost of a replacement home.[[1]](#endnote-1)

*Example:* In 2014, Asher, a single taxpayer has a primary residence with a fair market value of $600,000 and a basis of $250,000. In a storm, Asher’s home is totally destroyed. Asher uses $300,000 of the $600,000 insurance proceeds to purchase a new primary residence. Asher’s regular realized gain would be $350,000 ($600,000 minus $250,000). Of that gain, since Asher is a single taxpayer, he may exclude $250,000.

Step 1 and Step 2. $600,000 insurance proceeds minus the $250,000 gain Asher can exclude pursuant to IRC Section 121 equals $350,000.

Step 3. Asher used $300,000 of the insurance proceeds to purchase a replacement home. However, since $350,000 (Step 1 and Step 2 amount) exceeds that amount by $50,000, the latter amount is included in gross income. [[2]](#endnote-2)

Asher’s basis should be computed as follows:

1. Original basis in home - $250,000
2. Gain recognized - $50,000
3. Gain Excluded - $250,000
4. New Basis- $550,000 (1 plus 2 plus 3).

Thus, Asher’s new home has a fair market value of $300,000 and a basis of $550,000. The difference between the fair market value of the home and the basis reflects the $250,000 of excluded IRC Section 121 gain. In essence, with this higher basis, Asher’s exclusion is preserved. So, if Asher sells the home for up to $550,000, there would be no realized gain.

1. IRC Sec. 121(d)(5)(B). [↑](#endnote-ref-1)
2. Rev. Proc. 2005-14, 2005-7 IRB 492. [↑](#endnote-ref-2)