CASUALTY LOSS PRACTICE GUIDE

Updated September 2014
NOTICE TO READERS

This Guide is designed as educational and reference material for the members of the AICPA and others interested in the subject. It does not establish policy positions, standards, or preferred practices. This study is distributed with the understanding that the AICPA Tax Division is not rendering any tax or legal advice.

For the most current information available on all tax aspects of disaster-specific relief including up-to-the-minute rulings, pronouncements and information, please consult the following IRS resources:

- Tax Relief in Disaster Situations
- Disaster Relief Resource Center for Tax Professionals

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PURPOSE
The primary purpose of this Casualty Loss Practice Guide (Guide) is to assist practitioners in dealing with certain tax problems that arise when a client is affected by a natural disaster. This Guide will discuss rules for casualty losses and deductions for involuntary conversions, and it will provide information on relevant Internal Revenue Service (IRS) publications, as well as other useful material. The Guide also includes references to certain aspects of related events, the tax treatment of which is similar. The Guide covers the general rules on casualty losses and taxpayers should consult Code section 165 and related provisions for temporary law changes. The Guide is designed as educational and reference material for AICPA Tax Section members and is distributed with the understanding that the AICPA is not rendering any tax or legal advice.

PREFACE
Tax practice requires a working knowledge of tax laws and existing federal tax reference material. The Guide is intended to provide information that is current and accurate as of the date of this publication. As such, users of the Guide should review all references to ensure that any subsequent statutory changes, interpretations, guidance, or court decisions are considered in light of the advice being rendered to their clients.

ACKNOWLEDGEMENTS
This Guide was developed and compiled by the following members of the Individual and Self-Employed Tax Technical Resource Panel (ISETRP) of the AICPA Tax Division:

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III. CASUALTY DEFINED

The development of the concept of what constitutes a casualty loss comes primarily from court decisions and revenue rulings. Neither the Internal Revenue Code nor the Treasury Regulations adequately define the term “casualty”, and controversy as to the meaning of this term certainly exists.

To qualify as a casualty, a loss must result from an identifiable event of a sudden, unexpected or unusual nature. Some examples would be a fire, automobile collision, storm, flood, hurricane or other similar natural disaster. The loss need not be caused by natural forces; losses such as vandalism, theft and human cause also may qualify as casualty losses. Minor accidents may be casualties, as magnitude has no relevance. Progressive deterioration is not regarded to be a casualty. The event must be identifiable, damaging to property, and sudden, unexpected or unusual in nature.

Additionally, in computing casualty losses, the type of property involved must be ascertained, as the tax treatment for personal property is not the same as that for business use property.

IV. PERSONAL CASUALTY LOSSES

In the aftermath of a natural disaster, taxpayers are often confused about what they may or may not claim as a loss on their tax returns. Losses caused by events like Hurricane Sandy in Oct. 2012, the storms, tornadoes, and flooding disasters in 2014 in the southeastern states, and the Washington mudslides of March 2014 are considered casualty losses in the tax law. Despite the casualty and expectation of a loss, many victims may be stunned to find that they have a taxable gain, due to the nature of their insurance coverage or other relief received. The rules for personal losses are in some ways different from and in some ways the same as, those for business losses.

To claim a casualty loss deduction for non-business property, you must file Form 1040 and itemize your deductions on Schedule A. When the President of the United States declares that sections of the country are Federal Disaster Areas, casualty losses can be deducted either (1) on the original return for the year of the loss; or (2) on an amended return filed for the tax year immediately preceding the year in which the disaster occurred (see Disaster Losses, page 14). Victims may reduce their remaining current-year estimated tax payments or withholding in anticipation of a current-year casualty loss deduction.

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1 If a gain is realized due to a casualty, consider the application of Section 1033 to determine if the gain can be deferred.
2 Section 165(i)(1). Unless otherwise indicated, “section” refers to sections of the Internal Revenue Code or its associated regulations.
B. **DETERMINE THE AMOUNT OF LOSS**

To deduct a casualty loss, the taxpayer must first calculate the loss and then determine any limits on the amount of loss that may be deducted. A casualty loss is calculated by subtracting any insurance or other reimbursement received or expected from the smaller of:

- The decrease in fair market value of the property as a result of the casualty; or
- The adjusted basis in the property before the event.

1. **DECREASE IN FAIR MARKET VALUE (FMV)**

The decrease in FMV is the difference between the property’s value immediately before and immediately after the casualty.\(^3\) The term “immediately after” the casualty is important, because two or three years may pass before an IRS audit. Even if there are no interim improvements, general appreciation in value may mask some of the loss incurred.

To calculate the decrease in FMV caused by a casualty, make a determination of the actual price which the property could have sold for immediately before and immediately after the loss. Reliable appraisals of the value of the property immediately before and after the casualty are generally regarded as the best evidence of the decline in value. The taxpayer does not need to make a distinction between real property values in land, landscaping, and structure in documenting the pre-casualty and post-casualty fair market value.\(^5\) The worksheets in IRS *Publications 584*, *Casualty, Disaster, and Theft Loss Workbook*, and *Publication 584B*, *Business Casualty, Disaster, and Theft Loss Workbook*, provide assistance with the loss calculation. Once the separate calculations are made, the disaster loss rules, if elected, allow the taxpayer to combine the losses.

In general, *do not consider* the following items when attempting to establish the FMV of the property:

- Sentimental value;
- General decline in market value;
- Cost of protection;
- Related expenses (e.g., temporary housing, personal injury, rental car); and,
- Repair and replacement costs.

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\(^3\) Treas. Regs § 1.165-7(b)(1).

\(^4\) Treas. Regs. §1.165-7(b)(1)(i).

\(^5\) Treas. Regs §1.165-7(b)(2)(ii).
The cost of cleaning up or of making repairs after a casualty can be used as a measure of the decrease in FMV if all the following conditions are met:  

- The repairs are necessary to bring the property back to its condition before the casualty;
- The amount spent for repairs is not excessive;
- The repairs take care of the damage only; and,
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

The cost of restoring landscaping to its original condition after a casualty may also be an indication of the decrease in its FMV. Measure loss by the amount spent on the following:

- Removing destroyed or damaged trees and shrubs, minus any salvage received;
- Pruning and other measures taken to preserve damaged trees and shrubs; and,
- Replanting necessary to restore the property to its approximate condition before the casualty.

**Example A**

Assume that Taxpayer lost her home and all of its landscaping from a fire caused by the Arkansas storms of 2014. The basis of the residence, which includes the cost of the landscaping, is $700,000. The fair market value of the home and landscaping before the fire was $800,000 and after the fire was $0. The cost to remove the damaged trees and replant is $10,000. For purposes of determining the amount of the loss, only the adjusted basis of $700,000 and the loss in value of $800,000 are considered since the landscaping was part of the fair market value of the home. Thus, the amount of the loss is $700,000.

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Example B

Assume instead that Taxpayer’s home was spared in the fire but all the trees were destroyed. One way to determine the loss attributable to the landscaping is to compare the fair market value of the entire residence before the casualty and the fair market value after the casualty. The difference is the loss in value caused by the loss of landscaping. Alternatively, the $10,000 cost to remove the damaged trees and replant in order to “return the property to its condition before the casualty” may be used as evidence of the decrease in fair market value. In measuring the loss in value, be sure you do not include loss due to decline in value caused by the fact that the home is in an area damaged by fires or due to fear of future fires in the area. The loss must be calculated based on the physical damage.⁸

The importance of good valuations to demonstrate a loss cannot be emphasized enough. The IRS has traditionally challenged appraisals, so documentation and credibility are very important. It is often difficult to value a damaged property before and after the casualty. In many cases, taxpayers fail to obtain a casualty loss deduction – not because the existence of a casualty could not be established – but because they cannot establish the additional facts needed to sustain the deduction, such as a decline in FMV, the basis of the asset and sometimes the mere fact of ownership.

The difference between the FMV of the property immediately before a casualty and immediately afterwards should be determined by a competent appraiser. Selecting an appraiser is one of the most important steps to take in determining the loss. The appraiser must recognize the effects of any general market decline that may have occurred separately from the casualty so that any deduction is limited to the actual loss resulting from damage to the property. Choose an appraiser whose credentials are well-established and who has years of experience.

Penalties for overvaluation of a casualty loss can be significant. For example, an overvaluation which results in a substantial understatement of tax (one that exceeds the greater of 10 percent of the tax due or $5,000) will incur a 20 percent penalty on the underpayment.⁹ A 20 percent penalty could also apply if the value of property claimed is more than 150 percent of the correct value.¹⁰

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⁸ Treas. Regs. §1.165-7(b)(2)(i); Brandon v. U.S., 42 AFTR2d 78-5963, 78-2 USTC ¶9687 (DC Mo); Thornton v. Comm’r., 47 T.C. 1 (1966); Butschky v. U.S., 49 AFTR2d 82-957, 82-1 USTC ¶9139 (DC Md).
⁹ Section 6662(b)(2), section 6662(d).
¹⁰ Section 6662(b)(3), section 6662(e)(1)(A).
An independent appraisal by a qualified appraiser is mandatory in most situations. Minimum guidelines for appraisal formats have been issued by the IRS in Rev. Proc. 66-49, 1966-2 C.B. 1257, and in IRS Publication 561, *Determining the Value of Donated Property*. The appraiser should be a recognized expert in the field relating to the property being valued. Even though appraisal fees can be expensive, the absence of qualified appraisals can subject the taxpayer to undervaluation penalties and a myriad of other problems.

The IRS maintains a list of appraisers whose work they have found fault with. It is appropriate to check with the IRS and ask the appraiser about the appraiser’s standing with the IRS. Appraisers have a variety of certifications available to them and can be members of different licensing organizations. Professional architects, Member Appraisal Institute (MAI) appraisers and various realtor organizations may be appropriate sources of information for recommendations for qualifying appraisers.

Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged. Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful. The cost of photographs obtained for this purpose is not a part of the loss, but can be claimed as a miscellaneous itemized deduction subject to the two percent of adjusted gross income threshold on Schedule A (Form 1040). If the photos are required for insurance purposes, the taxpayer may be able to net the cost against insurance reimbursements received.

Information supplied by various automobile organizations, as well as information found on the internet, may be useful in demonstrating the value of a car. Use the retail values and modify them by factors such as the mileage and condition of the car to estimate its value. While these prices are not “official,” they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in the area. A dealer’s offer for the car as a trade-in on a new car is not usually a good measure of its true value.

The appraisal fee is an expense in determining tax liability, and it is not a part of the casualty loss. Therefore, appraisal fees are deductible as a miscellaneous itemized deduction subject to the two percent of adjusted gross income threshold on Schedule A (Form 1040).

To take a deduction for a casualty, the taxpayer must show that (1) the loss was a direct result of the destructive event; and (2) the taxpayer was the owner of the property or – if the property was leased from someone else – the taxpayer was contractually liable to the owner for the damage.

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11 Treas. Regs. §1.165-7(a)(2)(i).
General deterioration of the property should not be confused with a casualty. It is important that records are maintained that will prove the deduction. If actual records to support the deduction are not available, use other satisfactory evidence that is sufficient to establish the deduction.

Guidance for use in estimating real property casualty losses is available as part of the AICPA’s Statements on Standards for Tax Services (SSTS).

2. **ADJUSTED BASIS**
   
   Basis is the measure of the investment in the property. For property acquired by purchase, basis is usually its cost. Basis for casualty loss purposes is the same as the basis that would be used for calculating gain or loss on sale of the property. For property acquired in some way other than purchase, such as through inheritance, gifting, or a tax-free exchange, special rules apply.

   During the period the property is owned, various events may take place that change the basis. Some events, such as additions or permanent improvements to the property, increase basis. IRS Publication 551, Basis of Assets, provides more information on calculating the basis of a property.

3. **INSURANCE AND OTHER REIMBURSEMENTS**

   If the property is covered by insurance, a timely insurance claim for reimbursement of a loss should be filed. Otherwise, no deduction as a casualty loss is allowed.

   Insurance proceeds or other types of reimbursement must be subtracted from the tentative loss (lower of decrease in FMV or adjusted basis). No casualty loss deduction is allowed to the extent the loss is reimbursable. If the reimbursement exceeds the tentative loss, the taxpayer may have taxable income (see It May Be Taxable Income, page 16). The taxpayer needs to account for the insurance proceeds received or receivable and the extent to which they are included in taxable income. If reimbursement is expected, but has not yet been received, the taxpayer must still subtract the expected reimbursement.

   Insurance is the most common way to be reimbursed for a casualty loss. But the victim may be reimbursed in some other way. The following items are generally considered reimbursements:

   - The forgiven part of a Federal Disaster Loan under the Disaster Relief and Emergency Assistance Act;

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13 Treas. Regs §1.165-7(b)(1)(ii).
14 Section 165(h)(4)(E).
15 Treas. Regs §1.165-1(c)(4).
16 Treas. Regs §1.165-1 (d)(2)(ii).
• The repayment and the cost of repairs by the person who leases the taxpayer’s property;
• Court awards for damages for a casualty (the amount collected minus lawyers’ fees and other necessary expenses);
• The repairs, restoration, or cleanup services provided by relief agencies.

Insurance, grants, gifts, and other payments received to help after the disaster are considered reimbursements only if they are specifically designated to repair or replace the property. If the money is designated for other purposes, or if there are no conditions on its use, the money is not a reimbursement even if used to restore the property.

Generally, gifts are excluded from income. What if, however, the proceeds of a gift from a relative are used to replace property or pay for living expenses following a casualty? The IRS has ruled that the receipt of a gift from a relative or a friend does not reduce a casualty loss provided there is no limitation or directive relating to the manner in which the money is used by the recipient. This revenue ruling distinguishes an earlier ruling which held that money received by employees from an emergency disaster fund (which was gratuitously established by their employer to aid in the rehabilitation of homes after a tornado) must be taken into consideration by the employees in computing the casualty loss deduction, to the extent such money was used by the employees to replace their destroyed or damaged property. This conclusion is generally applicable where the facts disclose that the money received must be used by the recipient to rehabilitate or replace the property that is the subject of the claimed casualty loss deduction. Nevertheless, employers may not make excludable gifts to employees and should restrict the use of funds.

Therefore, donors other than employers should be advised not to put restrictions on the use of the gift funds. Furthermore, donors should not make payments directly to pay for repairs, rehabilitation costs, or living expenses of the donee.

17 Section 102.
20 Section 102(c).
4. **EXACT AMOUNT OF INSURANCE/REIMBURSEMENT UNKNOWN**

It often may be necessary to file a taxpayer’s return before the exact amount of insurance or other reimbursement is unknown. The law addresses these situations as follows.

- Where there is a reasonable prospect that there will be an additional reimbursement for part or all of a casualty loss at some time in the future, the expected reimbursement must be taken into consideration in computing the loss or gain for involuntary conversion\(^{21}\) (see *It May Be Taxable Income* page 16). The taxpayer should make his or her best estimate of the reimbursement and file the return claiming the loss for the year of the casualty (gain may be reported in the year reimbursement is received).

- If the actual reimbursement received is smaller than the estimate, the difference is claimed as a loss in the year the smaller amount is received.\(^ {22}\) Do not amend the original return to reflect this difference. If the original calculation resulted in a deferred gain (as discussed below), the difference in reimbursement will require an adjustment to the basis of the replacement property.

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**Example C**

A motorboat is destroyed in a hurricane in 2013. The loss was $5,000. The taxpayer files an insurance claim for and reasonably expects to receive reimbursement for the entire loss. Therefore, he does not have a casualty loss in 2013. The insurance claim is eventually rejected by the insurance company. The taxpayer starts a lawsuit, and, in 2014, the taxpayer and the insurance company agree on a settlement of $3,000. A casualty loss deduction of $2,000 would be claimed in 2014, subject to the $100 and 10 percent of AGI limitations (see *Deduction Limits*, below).

If the total reimbursement eventually received exceeds the amount originally estimated, the difference must be reported as income in the year received (not on an amended return), but only to the extent that the taxpayer received a prior tax benefit.\(^ {23}\) The amount reportable is calculated pursuant to the tax benefit rules of section 111. Where the original transaction resulted in a gain which was deferred, the difference in reimbursement will require an adjustment to the basis of the replacement property.

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\(^{21}\) Treas. Regs. §1.165-1(d)(2)(i).
\(^{22}\) Treas. Regs §1.165-1(d)(2)(ii).
\(^{23}\) Treas. Regs §1.165-1(d)(2)(iii).
Example D

An automobile is destroyed in a fire in 2014. The loss was $5,000 and the taxpayer files an insurance claim for $4,000 and reasonably expects to receive it in the future. Because of the 10 percent of AGI limitation, the taxpayer does not have a deductible casualty loss in 2014. When the claim is finally settled in 2015, the taxpayer actually receives a $4,600 reimbursement. The additional $600 would not be reportable in 2015 because no tax benefit was received in the year of the loss.

C. DEDUCTION LIMITS
After the loss has been computed, the deductible amount must be determined. If the loss was to property held for personal use, there are two limits on the deductible amount:

- Reduce the loss by $100. If the taxpayer had more than one casualty, reduce each loss by $100.24
- Further reduce the loss by 10 percent of adjusted gross income. If there is more than one casualty or theft loss, this 10 percent rule does not apply if casualty gains for the year are more than casualty losses.25

D. LEASED PROPERTY
If the tenant is liable for damage to leased property, the loss is the amount necessary to repair the leased property.26

V. DISASTER LOSSES IN FEDERALLY DECLARED DISASTER AREAS
A disaster loss is a loss that is attributable to a casualty occurring in an area that the President declares a disaster area entitled to federal assistance. For example, in 2014 several states were declared eligible for assistance from the federal government under the Disaster Relief and Emergency Assistance Act.27 FEMA maintains an updated listing of the disaster declarations by year on their website (https://www.fema.gov/disasters/grid/year).

A. RECORD RECONSTRUCTION AS A STARTING POINT
One of the first major hurdles in assisting victims of disasters is in determining and documenting what assets were lost or damaged, the original cost and tax basis (if applicable) of those items, and their FMV. The IRS has a Record Reconstruction page to assist taxpayers with reconstructing their records after a casualty loss is incurred.

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24 Section 165(h)(1).
25 Section 165(h)(2).
27 FEMA-1731-DR.
B. TAX TREATMENTS AND ELECTIONS INVOLVING DISASTER LOSSES

Disaster loss treatment is extended to a personal residence (owned or rented) that has been rendered unsafe in a disaster area and that has been ordered to be demolished or relocated by the state or local government.\(^\text{28}\)

A taxpayer who suffers such a loss can take the deduction in the tax year in which the disaster occurred, or make an election to deduct the loss in the tax year immediately preceding the tax year in which the disaster occurred.\(^\text{29}\) The election to take the deduction in the earlier tax year must be made on or before the later of the due date for filing the income tax return, without regard to any extensions, for the taxable year in which the disaster actually occurred or the due date for filing the income tax return, including extensions, for the taxable year immediately preceding the taxable year in which the disaster actually occurred.\(^\text{30}\)

For example, if a disaster occurred in Sept. 2014 the taxpayer has until the later of: Oct. 15, 2014, including extensions, or April 15, 2015, to decide whether to claim the disaster loss deduction on an original or amended 2013 return. If the taxpayer decides not to claim the loss deduction on the 2013 return, the loss deduction may be claimed under the normal rules on the 2014 return. Under certain circumstances, taxpayers who miss the section 165(i) election filing date may request a filing extension from the IRS. For example, in Private Letter Ruling 9622020,\(^\text{31}\) the Service granted an extension to a taxpayer who was given erroneous information by an IRS employee.

The loss is claimed by filing an amended return for the preceding year – or an originally filed return if filed before the extended due date. The return must include a signed statement that the taxpayer elects to deduct the loss in the prior year. According to the regulations, this election may be revoked within 90 days after the date the election is made, but only if: (1) any credit or refund received as a result of the election is paid back to the IRS within 90 days after the election; and (2) the revocation is made within 90 days after the election is made. In the case of a revocation made before receipt by the taxpayer of a refund claimed pursuant to such election, the revocation shall be effective if the refund is repaid within 30 calendar days after such receipt. After 90 days, the election is irrevocable.\(^\text{32}\) However, the Tax Court\(^\text{33}\) has held that the 90-day limit for revoking this election was unreasonable and contrary to the intent of the law, because the 90-day limit could expire before the statutory deadline for making the election. Therefore, it appears that taxpayers have until the due date (excluding extensions) of the income tax return for the tax year in which the disaster occurred to revoke their election.

\(^{28}\) Section 165(k).
\(^{29}\) Section 165(i)(1).
\(^{30}\) Treas. Regs § 1.165-11(e).
\(^{31}\) Issued February 28, 1996.
\(^{32}\) Treas. Regs § 1.165-11(e).
The calculation of the deduction for a disaster loss follows the same rules as any other personal casualty loss. However, if the taxpayer elects to claim the loss on the return immediately preceding the year of the disaster, the loss to which the election applies is deemed to have been sustained in the preceding tax year.34

Casualty losses in excess of income – whether related to business or non-business property – are considered deductions attributable to a trade or business for purposes of computing the net operating loss deduction.35

Despite the seeming attractiveness of amending the prior year return and getting cash back quickly, it may be advisable for the taxpayer to wait if a larger tax benefit could be available in the current tax year. A number of inquiries should be made. First, what is the taxpayer's expected AGI in each of the two years? A casualty loss deduction is available only to the extent the loss exceeds 10 percent of AGI, so the year with the smaller AGI may be preferable. Second, what is the marginal tax rate in each year? Finally, are other tax considerations or personal situations so overriding as to sway the decision?

In addition to the election to claim disaster losses on the current or prior year return, taxpayers in disaster areas are often allowed extended deadlines for any returns, not only those reporting losses. Extensions may also apply to employment and other tax filing obligations. On Jan. 15, 2009, the IRS issued TD 9443, Postponement of Certain Tax-Related Deadlines by Reason of a Federally Declared Disaster or Terroristic or Military Action. These final rules expand and clarify the definition of “affected taxpayer” and provide detailed examples on their application. Tax professionals should consult the IRS website for the most current information on filing deadlines in disaster areas.

VI. IT MAY BE TAXABLE INCOME

Many homeowners are insured for casualties and, as a result, receive money from insurance companies to settle claims. They also may receive cash payments for living expenses, excess living expenses, or both. Taxpayers and their advisors need to be very careful to understand what is and is not income subject to taxation. The rules are different for federally declared disasters.

For non-“federally declared” disaster area casualties, insurance proceeds from property losses are gains to the extent the reimbursement exceeds the adjusted basis in the property.36 The gain realized must be recognized as income for tax purposes, unless the taxpayer elects to defer recognition.

34 Treas. Regs § 1.165-11(d).
35 See section 172(d)(4)(C); Treas. Regs § 1.172-3(a)(3)(iii); and Smith v. Commissioner, 48 T.C.M. 135.
36 Generally, section 1001.
A. INVOLUNTARY CONVERSIONS – NO FEDERALLY DECLARED DISASTER

To postpone all of the gain on destroyed or partially destroyed property, qualifying replacement property must be acquired within a certain time.\(^{37}\) The cost of the replacement property must be at least as much as the reimbursement received.\(^{38}\) Many taxpayers find that the reimbursement for losses from the insurer is more than needed to rebuild. When this is the case, a portion of the proceeds will be recognized as income. There is no requirement that the actual cash received from the insurance company be traced into the replacement property. If property is converted directly into other property that is similar or related in service or use to the original property, no gain is recognized.\(^{39}\)

Example E

Watson’s home is partially destroyed by an earthquake in 2014. She purchased the home in 1984 for $40,000, and added an addition in 1989 at a cost of $20,000 for a total basis of $60,000. In 2014, when the earthquake struck, the house had a fair market value of $300,000. Following the earthquake, the house had a fair market value of $190,000. The insurance company issued her a check for $110,000 to compensate for the partial destruction of the house. Watson has a realized gain of $50,000 ($60,000 basis minus $110,000 insurance proceeds). If she spends only $80,000 to replace the property and uses the remaining $30,000 for another purpose, then she must recognize $30,000 as a gain in the year the cash is received.

The taxpayer may elect involuntary conversion treatment by including gain in gross income on his or her return to the extent it is recognized under the above rules. The tax for the year the election is made must be recomputed and an amended return filed if:

1. the converted property is not replaced within the time limit;
2. replacement is made at a cost lower than anticipated at the time of the election; or,
3. a decision is made not to replace.

A taxpayer who fails to make the election on the return may make it later (but within the time limit for replacement) by filing a claim for a credit or refund.\(^{40}\)

\(^{37}\) Section 1033(a)(2)(B).
\(^{38}\) Section 1033(a)(2)(A) and Treas. Regs § 1.1033 (a)-2(c)(1).
\(^{39}\) Section 1033(a)(1).
\(^{40}\) Treas. Regs § 1.1033(a)-2(c)(2).
When property is converted directly into money, or into property that is not similar or related in service or use, time limits apply for replacement with qualified property.\(^{41}\) The replacement period must begin with the date of destruction. It must end within two years after the close of the first tax year in which any conversion gain is realized, or a later date if one is set by the IRS.\(^{42}\)

To qualify as replacement property in involuntary conversions, the property must meet all of the following conditions:

- It must be similar or related in service or use to the converted property;
- It must be held on the disposition date of the old property if it was acquired before that date;
- It must be bought, constructed, or be a restoration of a partially converted property to replace the old property; and,
- It must not be acquired by gift.

The destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of property for purposes of the section 121 exclusion\(^{43}\) on the sale of a principal residence. Therefore, if the taxpayer otherwise qualifies (that is, during the five-year period ending on the date of the involuntary conversion, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more)\(^ {44}\) part of the gain ($250,000 for single taxpayers and $500,000 for married filing jointly taxpayers)\(^{45}\) may be excluded. The amount of excluded gain reduces the “amount realized” from the involuntary conversion.\(^{46}\)

\(^{41}\) Section 1033(a)(2)(B).
\(^{42}\) Treas. Regs § 1.1033(a)-2(c)(3).
\(^{43}\) Section 121(d)(5)(A).
\(^{44}\) Section 121(a).
\(^{45}\) Section 121(b).
\(^{46}\) Section 121(d)(5)(B) and Reg. 1.121-4(d)(1)-(4).
Example F

Mr. and Mrs. Taxpayer's personal residence and landscaping are completely destroyed in a fire. The taxpayer’s have owned and lived in the residence for 10 years. They have decided to “downsize” when replacing the destroyed property.

Facts:

<table>
<thead>
<tr>
<th></th>
<th>Residence</th>
<th>Landscaping</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value before</td>
<td>$1,300,000</td>
<td>$20,000</td>
<td>$1,320,000</td>
</tr>
<tr>
<td>Fair market value after</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Decline in value</td>
<td>$1,300,000</td>
<td>$20,000</td>
<td>$1,320,000</td>
</tr>
<tr>
<td>Net cost basis</td>
<td>$600,000</td>
<td>$10,000</td>
<td>$610,000</td>
</tr>
<tr>
<td>Insurance recovery</td>
<td>$1,200,000</td>
<td>$5,000</td>
<td>$1,205,000</td>
</tr>
<tr>
<td>Replacement cost of new residence</td>
<td>$750,000</td>
<td>$10,000</td>
<td>$780,000</td>
</tr>
</tbody>
</table>

Calculations:

\[
\text{Insurance proceeds} = 1,205,000 \\
\text{Less: Exclusion under section 121} < 500,000 \]
\[
\text{Amount realized from insurance recovery} = 705,000
\]

Calculations (Components disregarded):

\[
\text{Measure of loss, lower of decline in value or basis} = 610,000 \\
\text{Amount realized from insurance recovery} < 705,000\]
\[
\text{Net gain from involuntary conversion} = 95,000
\]

If the property is replaced within two years with replacement property costing at least $705,000, the entire gain may be excluded. Since the replacement property cost $780,000, no gain is recognized. The basis of the new residence is reduced by the amount of the deferred gain and is $685,000 ($780,000 - $95,000).

B. INVOLUNTARY CONVERSIONS – FEDERALLY DECLARED DISASTER

When insurance proceeds are received after a taxpayer's principal residence or any of its contents are damaged or destroyed in a federally declared disaster, special rules apply.

1) No gain is recognized upon receipt of insurance proceeds for personal property contents which are not scheduled property for insurance purposes. 47 Unscheduled property consists of all items not itemized on the homeowner’s insurance policy.

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47 Section 1033(h)(1)(A)(i).
2) This means that the proceeds do not have to be re-invested in order to postpone recognition of gain. However, the law does not change the provisions for calculating a casualty or disaster loss. The taxpayer must make a rough calculation to see if the proceeds create a gain or loss, and document the result. If a loss occurs, this special rule will not apply.

3) Insurance proceeds for the residence and any scheduled personal property may be lumped together and treated as conversion of a single item of property. Additionally, replacement property similar in use to the damaged or destroyed principal residence will be considered similar in use to the “single item” for replacement purposes.48 This treatment effectively allows taxpayers to replace their home and contents with items of their choosing, not restricting them to replacing artwork with artwork or dining room furniture with similar furniture. In fact, taxpayers can use the artwork or other scheduled property proceeds to replace or rebuild their home.

4) The time period within which replacement property should be obtained to postpone recognition of gain is extended from two years to four years after the close of the first tax year in which any gain is recognized,49 unless extended by IRS upon application by the taxpayer.

Example G

Q’s principal residence and all its contents were destroyed as the result of a federally declared disaster. The destroyed household contents included jewelry and sterling silverware, which were each separately scheduled for insurance purposes. Q received total insurance proceeds of $310,000 as compensation for the destruction of the residence ($300,000) and its scheduled contents ($7,000 for the jewelry and $3,000 for the silverware). Thus, Q’s common pool of funds for purposes of the above rule was $310,000. Within the prescribed replacement period, Q spent $300,000 to build a new residence, $40,000 to purchase home furnishings and clothing as replacements for those lost in the disaster, and $10,000 to buy a painting to hang in the new residence. Only the painting was separately scheduled for insurance purposes. Q did not replace the jewelry or silverware. Because Q spent $350,000 to purchase a replacement residence and contents, which is in excess of the $310,000 common pool of funds that Q received, Q will not be required to recognize any gain upon the destruction of the residence and its contents.50

48 Section 1033(h)(1)(A)(ii).
49 Section 1033 (h)(1)(B).
50 See IRS Publication 547 for a complete discussion of this issue.
5) As discussed earlier, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of property for purposes of the section 121 exclusion on the sale of a principal residence. Therefore, if the taxpayer otherwise qualifies (that is, during the five-year period ending on the date of the involuntary conversion, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more)\(^{51}\) part of the gain ($250,000 for single taxpayers and $500,000 for married filing jointly taxpayers)\(^{52}\) may be excluded. The amount of excluded gain reduces the "amount realized" from the involuntary conversion.\(^53\)

### Example H

**Single taxpayer's personal residence and landscaping are completely destroyed in a fire. The taxpayer has owned and lived in the residence for 10 years.**

**Facts:**

<table>
<thead>
<tr>
<th></th>
<th>Residence</th>
<th>Landscaping</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value before</td>
<td>$800,000</td>
<td>$ 20,000</td>
<td>$820,000</td>
</tr>
<tr>
<td>Fair market value after</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Decline in value</td>
<td>$800,000</td>
<td>$ 20,000</td>
<td>$820,000</td>
</tr>
<tr>
<td>Net cost basis</td>
<td>$450,000</td>
<td>$ 10,000</td>
<td>$460,000</td>
</tr>
<tr>
<td>Insurance recovery</td>
<td>$745,000</td>
<td>$ 5,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Replacement cost of new residence</td>
<td>$720,000</td>
<td>$ 10,000</td>
<td>$730,000</td>
</tr>
</tbody>
</table>

**Calculations:**

- **Insurance proceeds**
  - $750,000

- **Less: Exclusion under section 121**
  - $<250,000>

- **Amount realized from insurance recovery**
  - $500,000

**Calculations (Components disregarded):**

- **Measure of loss, lower of decline in value or basis**
  - $460,000

- **Amount realized from insurance recovery**
  - $<500,000>

- **Net gain from involuntary conversion**
  - $40,000

If the property is replaced within four years with replacement property costing at least $500,000, the entire gain may be excluded. Since the replacement property cost $720,000, no gain is recognized. The basis of the new residence is reduced by the amount of the deferred gain and is $680,000 ($720,000 - $40,000)

\(^{51}\) Section 121(a).

\(^{52}\) Section 121(b).

\(^{53}\) Section 121(d)(5)(B) and Reg. §1.121-4(d)(1) – (4).
If the taxpayer reinvests in a home costing $400,000, the entire $40,000 gain must be recognized. The basis of the new residence is $400,000.

If the taxpayer decides not to replace the property, a gain of $40,000 is recognized.

C. MAKING THE 1033 ELECTION FOR NON-RECOGNITION OF GAIN

All of the details in connection with an involuntary conversion of property at a gain must be provided on the return, and those details should include what replacement property was acquired, the date it was acquired, and the cost of the property to the taxpayer.\(^\text{54}\)

An owner elects non-recognition of gain on an involuntary conversion by not reporting the gain on the return for the first year in which gain is realized. However, all of the details of the conversion, including description of the property, date and type of conversion, computation of gain, decision to replace, etc., must be reported in a statement attached to the return (see Illustration 1, sample statement, below) for each year in which gain is realized. The statement should include the amount of insurance proceeds reinvested on a yearly basis, which may be beneficial to both practitioners and taxpayers in tracking the expenditures on a yearly basis to accurately account for the insurance proceeds.

\(^{54}\) Treas. Regs. §1.1033(a)-2(c)(2)
Illustration 1, Sample Section 1033 Election Statement

Election Statement Under Section 1033
Taxpayer Name
Statement to Accompany Form 1040
Taxable Year 2014

914-16 Main Street

On April 28, 2014, taxpayers’ building at 914-16 Main Street was damaged by tornadoes in Alabama. Taxpayers received $34,037.18 from Insurance Company for damage.

Taxpayers elect, in accordance with the provisions of Section 1033(a)(2) of the Internal Revenue Code of 1986, not to have any gain recognized with respect to the insurance proceeds received on its damaged building and hereby designates replacement property within the meaning of Section 1033(a)(2) as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$11,277.50</td>
</tr>
<tr>
<td>2016</td>
<td>$16,287.50</td>
</tr>
<tr>
<td>2017</td>
<td>$ 6,522.18</td>
</tr>
</tbody>
</table>

All insurance proceeds reinvested in 2017.

This election statement also includes the amount of insurance proceeds reinvested on a yearly basis. This may be beneficial to both practitioners and taxpayers in tracking the expenditures on a yearly basis to accurately account for the reinvestment of insurance proceeds. The insurance proceeds must be reinvested by the taxpayer in the period prescribed in the Code to avoid non-recognition of a gain.

Extension of 1033 Period Business Property

IRS has the power to grant additional time for reinvestment under 1033. The request should be made before the expiration of the replacement period and filed with the Service Center where the return is filed.55

Extensions are generally granted only for a period of one year and are approved only if there is reasonable cause for the taxpayer’s failure to make timely replacement. The high cost or scarcity of replacement after the disaster is not sufficient grounds for obtaining an extension.

55 1033(a)(2)(B)(ii), Treas. Reg. §1.1033(a)-2(c)(3)
D. LIVING EXPENSES
If an insurance company pays for any living expenses after the use of the home is lost because of the casualty, the insurance payments are not considered a reimbursement, which affects the calculation of a casualty loss. In fact, the taxpayer will be required to report as income any insurance payments covering normal living expenses. However, the portion of the insurance payments covering a temporary increase in living expenses during this period does not have to be reported as income. The same rule applies to insurance payments for living expenses if the taxpayer is denied access to his or her home by government authorities because of a casualty or the threat of a casualty.

The increase in living expenses is the excess of actual living expenses over normal living expenses. Regulations require that decreases in living expenses are to be taken into account as well as increases. Do not include in income any payment received for extra expenses for renting suitable housing and for transportation, food, utilities, and miscellaneous services during the period the taxpayer is unable to use the home because of the casualty.

Food, medical supplies, and other forms of assistance received do not reduce the casualty loss, unless they are replacements for lost or destroyed property. They also are not taxable income.

Disaster unemployment assistance payments are unemployment benefits that are taxable.

V. BUSINESS OR INCOME-PRODUCING PROPERTY
Section 1231 controls the character of any gain or loss that is recognized with respect to any trade or business assets or capital assets held in connection with a trade or business. Generally, these gains or losses simply go into the netting process under section 1231, offsetting other section 1231 gains and losses.

Net section 1231 gains are treated as long-term capital gains (unless they are made ordinary by the five-year look-back rule) and net section 1231 losses are treated as ordinary losses. However, if a taxpayer has a net loss from the conversion of such assets, they are not included in the section 1231 netting process and generally qualify for ordinary loss treatment.

A. CASUALTY LOSSES – TRADE OR BUSINESS REAL PROPERTY
If business or income-producing property, such as rental property, was completely destroyed or lost because of a disaster, the loss deduction is:

The adjusted basis in the property
MINUS
Any salvage value
MINUS
Any insurance or other reimbursement, received or expected
This formula should be used only for total losses. Partial losses on business or rental property are calculated in the same manner as they are for personal casualties – the loss is the decline in the value of the property, limited to the adjusted basis of the property, reduced by any salvage value, insurance reimbursements and other recoveries.

If insurance proceeds exceed the adjusted basis in the property, a gain is realized. Businesses may, like individuals, postpone the gain by investing the proceeds in qualified replacement property. Any depreciation taken and the cost of business personal property expensed under section 179 reduces the cost basis in the property. Thus, the amount of the casualty loss is reduced by the amount of depreciation claimed or the amount expensed under section 179.

B. BUSINESS VERSUS NON-BUSINESS REAL PROPERTY

A basic difference exists between the calculation of casualty losses for non-business real property and real property used in a trade or business. In calculating a casualty loss on non-business real property, the entire property (including any improvements, such as buildings, trees, and shrubs) is treated as one item. The casualty loss on all business property (both real and personal) is calculated separately on each individual identifiable asset damaged or destroyed. This can produce very different results.

If there is a loss, the character of the losses can vary. While a personal loss is deductible under section 165 as a casualty loss (ordinary deduction, $100 floor, 10 percent of AGI reduction), a business loss is usually controlled by section 1231 and offsets gains in the netting process with an excess resulting in an ordinary deduction.

If there is a gain, the gain would generally be a capital gain for personal assets and a section 1231 gain for business assets (if there is no replacement). If there is a gain and replacement, the involuntary conversion provisions apply, deferring the gain into the replacement property. Again these rules are applied on an aggregate (per event) basis for personal losses and an asset-by-asset basis for business property. Consider the following examples:

56 Section 1033(a).
**Example I – Non-Business Property**

Personal residence and landscaping are completely destroyed in a hurricane.

**Facts:**

<table>
<thead>
<tr>
<th></th>
<th>Residence</th>
<th>Landscaping</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value before</td>
<td>$150,000</td>
<td>$20,000</td>
<td>$170,000</td>
</tr>
<tr>
<td>Fair market value after</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Decline in value</td>
<td>$150,000</td>
<td>$20,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Net cost basis</td>
<td>$85,000</td>
<td>$17,500</td>
<td>$102,500</td>
</tr>
<tr>
<td>Insurance recovery</td>
<td>$145,000</td>
<td>$5,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Replacement cost</td>
<td>$150,000</td>
<td>$20,000</td>
<td>$170,000</td>
</tr>
</tbody>
</table>

**Calculations (Components disregarded):**

- **Measure of loss, lower of decline in value or basis**: $102,500
- **Insurance recovery**: $150,000
- **Net gain from involuntary conversion**: $47,500

Total gain is deferred as replacement cost exceeds insurance recovery. Note that the taxpayer could have also used the section 121 exclusion as discussed earlier in Examples F and H.
**Example J – Business Property**

Business office building and landscaping are completely destroyed by hurricane.

**Facts:**

<table>
<thead>
<tr>
<th></th>
<th>Building</th>
<th>Landscaping</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value before</td>
<td>$150,000</td>
<td>$20,000</td>
<td>$170,000</td>
</tr>
<tr>
<td>Fair market value after</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Decline in value</td>
<td>(Not applicable for complete destruction of business property)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net cost basis (after depreciation)</td>
<td>$85,000</td>
<td>$17,500</td>
<td>$102,500</td>
</tr>
<tr>
<td>Insurance recovery</td>
<td>$145,000</td>
<td>$5,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Replacement cost</td>
<td>$150,000</td>
<td>$20,000</td>
<td>$170,000</td>
</tr>
</tbody>
</table>

**Calculations:**

| Measure of loss-basis   | $85,000 | $17,500 | N/A     |
| Insurance recovery      | <145,000> | <5,000> | N/A     |
| Net gain from involuntary conversion (casualty loss) | $60,000 | <12,500> | N/A |

The gain on the building is deferred as replacement cost exceeds insurance recovery. The casualty loss on the landscaping is deductible in the year of the casualty, or the prior year if the property is in a federally declared disaster area and the proper election is made.
C. SPECIAL RULE FOR DISASTER AREAS

Generally, investment property must be replaced with similar investment property in a tax-deferred involuntary conversion. However, to lessen the hardship of business interruption, a special rule allows the taxpayer to reinvest the proceeds from the destruction of any trade or business property and any investment property in trade or business assets if the loss is in a federally declared disaster area.57

Example K

Phyllis received $200,000 in insurance proceeds in connection with the complete destruction of 20 pedi-cabs (replacement cost, $225,000, basis $0 due to section 179) that were destroyed by fire. Unfortunately, she also stored her collection of baseball memorabilia with a very low basis at the office. Insurance paid $50,000 for the baseball collection. Phyllis may defer her gains by reinvesting at least $200,000 in new pedi-cabs or similar property and $50,000 in new investment assets that are similar.

Assuming the fire was part of the Oklahoma wildfires (a federally declared disaster) Phyllis may also defer the gain on the recoveries related to both types of property to the extent she reinvests the $250,000 in trade or business property.

D. BUSINESS INTERRUPTION INSURANCE

The tax treatment of the proceeds from business interruption insurance turns on what the payments compensate. If the proceeds compensate for lost profits, then they are ordinary income to the recipient.58 However, if the proceeds reimburse for lost use of the property, they may constitute recovery of capital and result in gain to the extent they exceed basis. These gains are on the disposition of a property right and can be deferred under the involuntary conversion rules if the proceeds are reinvested in qualified replacement property. If an insurance settlement provides payments for both the loss of the use of property and for the loss of profit, the payments must be allocated between ordinary income and property payments.

The proceeds of a policy insuring against lost profits are not proceeds for the use of property, and since they are ordinary income, do not qualify for involuntary conversion treatment. The Eight Circuit Court of Appeals, in Marshall Foods,59 identified the following factors that were relied on to determine that the policies insured against lost profits:

- In addition to the business interruption insurance policies, additional insurance contracts compensated losses sustained from direct damage to physical property;

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57 Section 1033(h)(2).
58 Miller v Hocking Glass Co., 80 F.2d 436 (6th Cir. 1935).
Suspension of business, not destruction of the asset, was the event that triggered payment;

The policy was extended to cover another plant which supplied materials, which could only mean coverage for a loss of the other plant’s earnings from failure to have a market for its production;

The insurance was written on information based totally on gross earnings;

On the business interruption worksheet requested by the insurer, the actual loss sustained figures were to be equated with the loss of net profits; and,

The IRS has issued similar guidance in Treas. Regs §1.1033(a)-2(c)(8).

The IRS ruled that gain produced through a “lost use” policy could be deferred under the involuntary conversion rules. According to this technical advice memorandum, the following factors were relied on in concluding that the policy compensated for lost use:

- The amount payable under that policy roughly approximated replacement cost;
- The per diem rate was fixed in advance and contained no limitation based on profitability; and,
- A related policy expressly covered lost profits and there was no indication this related coverage did not approximate the profit loss.

The most conservative advice available in structuring insurance protection is to purchase loss value coverage (for example, a “lost use” policy) to the extent value loss would result. To the extent there are remaining potential losses, the policy should reimburse on a flat per diem basis, and consider adjusting for inflation. The policy should not make reference to or impose limits based on prior profits.

E. PROOF OF LOSS

The business taxpayer must show that the loss was the direct result of a destructive event, and that he or she is the owner of the property. If the property is leased from someone else, he must demonstrate a contractual liability for the damage. Even though decline in fair market value is not a factor in calculating total loss for business property, salvage value is a fair market value determination (see Determine the Amount of Loss, on page 14, for a discussion of valuations).

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60 TAM 8315007.
61 See, for example, LTR 200730010 dated Jan. 23, 2007, where the taxpayer LLC was obligated to replace property damaged or destroyed by a casualty.
F. TAX PLANNING
Proper income tax planning is important in making several decisions. First is the decision as to the type of insurance to carry. Second are decisions related to the tax treatment of insurance proceeds and other recoveries received in connection with a business casualty loss. In deciding whether to replace, the owner should consider the tax effects. Then, if replacement is made, the decision as to whether to elect deferral must be made. The following example is provided to illustrate the alternatives available in planning the tax treatment of the insurance proceeds received.

Example L

M received $500,000 of insurance proceeds in connection with the complete destruction of their manufacturing plant in an earthquake. At the time of the earthquake, the plant had an adjusted basis of $300,000. The replacement cost of the plant is estimated at $600,000.

M has a choice of either electing to defer the gain under the involuntary conversion rules, or recognizing the $200,000 gain for tax purposes. Either choice would have to be reported on M’s tax return for the year that the proceeds are realized.

Whether or not a taxpayer should elect deferral of the gain depends on several factors, including the form of the business (corporate versus non-corporate). If a taxpayer has net operating losses or capital losses, any resulting gain could be offset by these losses. However, if the taxpayer does not have any losses, any gain would be taxed at ordinary income rates.

Furthermore, the “cost” of non-recognition is that the basis in any replacement property must be reduced by the deferred gain, thereby reducing any depreciation deductions available to the taxpayer. Of course, in the event of a subsequent sale, the deferred gain will be recognized. Taxpayers should consider their likely tax situations in the current year versus those in subsequent years.

VI. SPECIAL SITUATIONS

A. PONZI SCHEMES
In 2009, given the rash of fraud being perpetrated by financial planners, including the notorious Bernard Madoff. Taxpayers were attempting to determine how to treat their unrecovered investment and any fictitious income reported in prior years. There was no clear guidance as to the ability of a taxpayer to utilize the theft loss rules under section 165 on these types of losses. Additionally, as taxpayers had the ability to deduct these losses they may have been in situations where net operating losses were created. Guidance was needed here too.
As a result, the IRS issued guidance to assist taxpayers in determining if they had deductible losses attributable to Ponzi schemes. Rev. Rul. 2009-9, 2009-14 I.R.B. 735, addressed several issues, including what constitutes a loss, what limitations the loss is subject to, how the loss is determined and the timing of the loss. Rev. Proc. 2009-20, 2009-14 I.R.B. 749, provides an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be criminally fraudulent.

To determine if a taxpayer has been the victim of a Ponzi scheme, Rev. Proc. 2009-20 and Rev. Rul 2009-9 should be consulted. The IRS calls a Ponzi scheme a "specified fraudulent arrangement." It is defined as an arrangement in which (i) a party (the lead figure) receives cash or property from investors; (ii) purports to earn income for the investors; (iii) reports income amounts to the investors that are partially or wholly fictitious; (iv) makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and, (v) appropriates some or all of the investors' cash or property.

1. CHARACTER OF LOSS
According to Rev. Rul. 2009-9, in the case of a Ponzi scheme the intent was to deprive investors of money by criminal acts and therefore, the action constitutes a theft from the investor as defined by section 165. Accordingly, the loss is a theft loss, not a capital loss.

The IRS also concludes that the investor entered into a transaction for profit and that their theft loss is therefore deductible under section 165(c)(2) and is not subject to the limitations of section 165(h). Section 165(c)(2) covers losses incurred in any transaction entered into for profit, but not connected with a trade or business. Section 165(h) imposes two limitations. First, the loss is limited to amounts that exceed $100 ($500 for taxable years beginning in 2009 only). Second, if personal casualty losses for any taxable year exceed personal casualty gains for the taxable year, the losses are allowed only to the extent of the sum of the gains, plus so much of the excess as exceeds 10 percent of the individual's adjusted gross income.

Guidance further provides that the theft loss is an itemized deduction that is not subject to the limits on itemized deductions in sections 67 and 68. Section 67 provides that miscellaneous itemized deductions may be deducted only to the extent the aggregate amount exceeds two percent of adjusted gross income. Under section 67(b)(3) losses deductible under section 165(c)(2) or (3) are excepted from the definition of miscellaneous itemized deductions.

Additionally, section 68 provides an overall limit on itemized deductions based on a percentage of AGI or total itemized deductions, but under section 68(c)(3) losses deductible under section 165(c)(2) or (3) are excepted from the limit. Accordingly, the theft loss is an itemized deduction not subject to the limits on itemized deduction in sections 67 and 68.
2. **Timing of Loss**

With respect to timing of the deduction, the taxpayer may deduct the loss in the year of discovery, provided that the loss is not covered by a claim for reimbursement or other recovery as to which there is a reasonable prospect of recovery. To the extent that the deduction is reduced by such claim, recoveries in later taxable years are not includible in gross income. If a greater amount is recovered, it is includible in gross income under the tax benefit rule. If the recovery is less than the amount that was used in the original calculation, then an additional deduction is allowed in the year the amount of recovery is ascertained with reasonable certainty.

3. **Amount of Loss**

The amount of the theft loss is the initial amount invested, plus any additional investments, less amounts withdrawn, reduced by reimbursements or other recoveries and reduced by any claims as to which there is a reasonable prospect of recovery. In addition, any amount that was reported to an investor as income in years prior to the theft, and that was included in gross income and reinvested in the arrangement is also a deductible theft loss.

For purposes of computing the NOL, any deduction for casualty or theft losses allowable under section 165(c)(2) or (3) is treated as a business deduction. Because section 172(d)(4)(C) treats any deduction for casualty or theft losses allowable under section 165(c)(2) or (3) as a business deduction, a casualty or theft loss sustained by an individual after Dec. 31, 2007 is considered a loss from a sole proprietorship and the individual may elect either a three, four, or five year NOL carryback for an applicable 2008 NOL, provided the gross receipts test of section 172(b)(1)(H)(iv) is met.

This section provides that the term "eligible small business" has the meaning given by section 172(b)(1)(F)(iii), except that section 448(c) is applied by substituting 15 million for five million each place it appears. section 172(b)(1)(F) provides that a small business is a corporation or partnership that meets the gross receipts test of section 448(c) for the taxable year in which the loss arose (or in the case of a sole proprietorship, that would meet such test if the proprietorship were a corporation) (see Rev. Proc. 2009-19, 2009-14 I.R.B. 747). The test of section 448(c) states that a corporation or partnership meets the $5,000,000 test for any prior taxable year if the average annual gross receipts of such entity for the three taxable year period ending with such prior taxable year does not exceed $5,000,000. Applying it in this case the taxpayer's average gross receipts could not exceed $15,000,000 for the year in which the loss occurred and the prior two years.
4. **CLAIM OF RIGHT**
Section 1341 provides an alternative tax computation formula intended to mitigate against unfavorable tax consequences that are a result of including an item in gross income in a taxable year and taking a deduction for the item in a different year when it is established that the taxpayer did not have a right to the item. To satisfy the requirements of section 1341(a)(2) a deduction must arise because the taxpayer is under an obligation to restore the income. If an investor incurs a loss from criminal fraud or embezzlement in a transaction entered into for profit, any theft loss deduction to which the investor may be entitled does not arise from an obligation to restore income, therefore, the investor is not entitled to the tax benefits of section 1341.

5. **MITIGATION**
Sections 1311 through 1314 permit the IRS or a taxpayer to correct an error made in a closed year by adjusting the tax liability in years otherwise barred by the statute of limitations. section 1311(b)(1) provides in part that an adjustment may be made under sections 1311-1314 only if the determination adopts a position maintained by the Secretary that is inconsistent with the erroneous prior tax treatment referred to in section 1312. The mitigation provisions cannot be used to adjust tax liability in closed years because there is no inconsistency in the Service’s position with respect to the taxpayer’s prior inclusion of income in those years.

6. **SAFE HARBOR**
While Rev. Rul. 2009-9 describes the proper income tax treatment for losses resulting from Ponzi schemes, Rev. Proc. 2009-20 provides an optional safe harbor treatment. The allowable deduction is limited to 95 percent for a qualified investor that does not pursue any potential third-party recovery or 75 percent for a qualified investor that is pursuing or intends to pursue any potential third-party recovery.

This Rev. Rul. also describes the required procedure to use the safe harbor and includes marking the return "Revenue Procedure 2009-20" at the top of Form 4684, *Casualties and Thefts*, for the federal income tax return for the discovery year, completing and signing a statement provided in Appendix A of the revenue procedure and attaching an executed statement that is provided in Appendix A of the revenue procedure to the qualified investor’s timely filed (including extensions) federal income tax return for the discovery year.

The revenue procedure applies to losses for which the discovery year is a taxable year beginning after December 31, 2007.

Any taxpayer that does not use the safe harbor is subject to all of the generally applicable provisions governing the deductibility of losses under section 165.
7. **Making an Election of a Carryback Period**

Rev. Proc. 2009-19 provides guidance as to the time and manner for making an election under section 172(b)(1)(H), including the election of a three, four, or five-year carryback period and an election to apply section 172(b)(1)(H) to an NOL for a taxable year beginning in 2008, instead of an NOL for a taxable year ending in 2008.

A taxpayer that has not filed a return for the taxable year in which the applicable 2008 NOL arises makes the election under section 172(b)(1)(H) by attaching a statement to the taxpayer's federal income tax return for the taxable year in which the applicable 2008 NOL arises. The statement must (a) Clearly state that the taxpayer is electing to apply section 172(b)(1)(H); (b) Describe the length of the NOL carryback period elected by the taxpayer (three, four, or five years); and (c) If applicable, state that the taxpayer is electing to apply section 172(b)(1)(H) to the taxpayer's taxable year that begins in 2008.

If a return has been filed for the applicable 2008 NOL taxable year and there was no election to forgo the NOL carryback period then the election under section 172(b)(1)(H) is made by filing the appropriate form including a statement of the carryback period the taxpayer elects (three, four, or five years). The appropriate form is - (A) For corporations, Form 1139, *Corporation Application for Tentative Refund*, or Form 1120X, *Amended U.S. Corporation Income Tax Return*; (B) For individuals, Form 1045, *Application for Tentative Refund*, or Form 1040X, *Amended U.S. Individual Income Tax Return*; and (C) For estates or trusts, Form 1045, or amended Form 1041, *U.S. Income Tax Return for Estates and Trusts*.

The taxpayer that makes the election by filing an amended return must file the return for the earliest taxable year to which the taxpayer is carrying back the applicable 2008 NOL. The taxpayer should not file an amended return for the applicable 2008 NOL taxable year. Additionally, the taxpayer should type or print across the top of the appropriate form "2008 NOL Carryback Election Pursuant to Rev. Proc. 2009-19."

The Service subsequently issued Rev. Proc. 2009-26, *2009-19 I.R.B. 935*, which modifies Rev. Proc. 2009-19. It was issued because, according to Rev. Proc. 2009-26, "The Service has received many claims from taxpayers that seek a three, four, or five year carryback but that inadvertently have not made a valid election in accordance with Rev. Proc. 2009-19. These inadvertent failures may be due to the fact that the enactment of section 1211 and issuance of Rev. Proc. 2009-19 occurred midway through the current tax return filing season."
Section .03 of Rev. Proc. 2009-26 provides that an Eligible Small Business, (ESB), may elect a three, four, or five year carryback period simply by filing a Form 1045, Form 1139, or amended return that carries back the NOL for three, four, or five years. "Although Forms 1045 and 1139 are ordinarily due within 12 months after the taxable year of the NOL, §172(b)(1)(H)(iii) requires that the taxpayer elect a three, four, or five year carryback within six months after the due date (excluding extensions) of the return for the taxable year of the NOL. Thus, a taxpayer that seeks to make a timely §172(b)(1)(H) election using Form 1045, Form 1139, or an amended return must file the form in advance of its ordinary due date."

Section 3 of the Revenue Procedure defines the scope as applying "to any taxpayer that is an ESB, a partner of a partnership that is an ESB, a shareholder in an S corporation that is an ESB, or a sole proprietor of a business that is an ESB, and that incurred an NOL for any taxable year ending in 2008 or beginning in 2008."

Section 4 addresses the time and manner of making the election under section 172(b)(1)(H) and provides two procedures that can be used. First, Section 4.01(2) provides that a taxpayer may elect on the original return. This is done by attaching a statement to the taxpayer's timely filed federal income tax return for the taxable year in which the applicable 2008 NOL arises. The statement must state that the taxpayer is electing to apply section 172(b)(1)(H) and specify the length of the NOL carryback period elected by the taxpayer (three, four, or five years). If the taxpayer's taxable year of the applicable 2008 NOL ends before February 17, 2009, the taxpayer must make the election on or before the later of the due date (including extensions of time) of the taxpayer's return for the taxable year or April 17, 2009.

Alternatively, a taxpayer that did not make the election under section 172(b)(1)(H) using the procedure of section 4.01(2) of the revenue procedure, and did not elect to forgo the NOL carryback period under section172(b)(3), may make the election under section172(b)(1)(H) by filing the appropriate form applying the NOL carryback period chosen by the taxpayer. No statement or label is required with the appropriate form. The appropriate form is: (A) For corporations: Form 1139, Corporation Application of Tentative Refund, or Form 1120X, Amended U.S. Corporation Income Tax Return. (B) For individuals: Form 1045, Application for Tentative Refund, or Form 1040X, Amended U.S. Individual Income Tax Return. (C) For estates or trusts: Form 1045, or amended Form 1041, U.S. Income Tax Return for Estates and Trusts. A taxpayer that makes the election under section 172(b)(1)(H) by filing an amended return must file the return for the earliest taxable year to which the taxpayer is carrying back the applicable 2008 NOL. The taxpayer should not file an amended return for the applicable 2008 NOL taxable year.
Section 4.01(3)(b) addresses when to file. "The appropriate form must be filed on or before the later of the date that is six months after the due date (excluding extensions) for filing the taxpayer's return for the taxable year of the applicable 2008 NOL or April 17, 2009 (2009-19 I.R.B. 937).

8. **REPORTING WITH FORM 4684**

Beginning in 2013 is the use of Section C of Form 4684. It must be completed if a theft loss deduction is being claimed due to a Ponzi-type investment scheme, and if Rev. Proc. 2009-20 (as modified by Rev. Proc. 2011-58), is being used. Take note that Section C of Form 4684 replaces Appendix A in Rev. Proc. 2009-20. Appendix A does not need to be completed. For further details, refer to the Theft chapter of IRS Publication 547, which includes a discussion on losses from Ponzi-type investment schemes.

B. **CORROSIVE DRYWALL**

Due to the widespread use of corrosive drywall and the serious health and financial implications, the IRS received numerous requests from taxpayers about the tax implications of the resulting economic loss. On Sept. 30, 2010, the IRS issued Rev. Proc. 2010-36 in response to the confusion over how to treat the losses, providing guidance on the tax treatment of amounts paid to repair damage to personal residences resulting from corrosive drywall.

1. **Basics**

The notice addresses "whether a loss resulting from corrosive drywall constituted a deductible casualty loss within the meaning of section 165 of the Internal Revenue Code, the taxable year any such loss would be deductible, and how the amount of the loss would be computed."\(^{62}\)

Rev. Proc. 2010-36 provides the requested guidance specifically related to the treatment of losses from corrosive drywall and provides a safe harbor method for determining the amount of the loss. If a loss is determined and reported as provided in the revenue procedure then the Service will not challenge the treatment.\(^{63}\) This revenue procedure "applies to any individual who pays to repair damage to that individual's personal residence or household appliances that results from corrosive drywall."\(^{64}\)

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\(^{62}\) Rev. Proc. 2010-36(2)(.02)

\(^{63}\) Rev. Proc. 2010-36(2)(.07)

\(^{64}\) Rev. Proc. 2010-36(3)
In order to fall under the safe harbor the taxpayer must first pay for repairs, as the loss does not rely on the decline in fair market value as it does under section 165. There are additional limitations imposed under the new guidance. The safe harbor only allows taxpayers to claim a loss "for 75% of the unreimbursed amounts paid during the taxable year to repair damage to the taxpayer's personal residence and household appliances that resulted from corrosive drywall."\textsuperscript{65} Under the general guidelines of section 165 there is no such limitation on the amount of the loss.

2. \textbf{HOW TO CLAIM THE LOSS}

A casualty loss is claimed as an itemized deduction on Schedule A of Form 1040 and Form 4684, \textit{Casualties and Thefts}. The Rev. Proc. 2010-36 requires taxpayers taking advantage of the safe harbor to include the heading "Revenue Procedure 2010-36" at the top of Form 4684. For corrosive drywall losses incurred in prior years taxpayers may file an amended return. Taxpayers must reduce the basis in their home by the amount of the casualty loss deduction and any insurance or other reimbursement.

If a taxpayer does not have a pending claim for reimbursement and does not plan to seek reimbursement then his or her gross casualty loss is equal to the full amount of costs incurred for repairs. The loss must then be reduced by $100 under the rules of section 165(h)(1). The loss is then further reduced by an additional 10 percent of the taxpayer's AGI. The result is the allowable casualty loss deduction.

If the taxpayer does have a claim pending for reimbursement, for example from the builder or insurance company, then the gross casualty loss is equal to 75% of the amount of costs incurred in the current year. That amount is further reduced by $100 under section 165(h)(1) and then by an additional 10 percent of the taxpayer's AGI. The result is the allowable casualty loss deduction for tax purposes.

The revenue procedure finally provides clear guidance on how to treat losses from corrosive drywall, but only those taxpayers able to pay for repairs can take advantage of it. Therefore, it prevents any taxpayer who cannot pay for the repairs from claiming any loss.

\textsuperscript{65} Rev. Proc. 2010-36(4),(02)
VII. COMPREHENSIVE EXAMPLES

PRINCIPAL RESIDENCE

EXAMPLE 1

Facts:
On Oct. 1, 2014, Anderson’s principal residence, a dwelling owned by Anderson, no part of which was rented to others or used for nonresidential purposes, was extensively damaged by fire. The damaged residence was under repair during the entire month of October making it necessary for Anderson and his spouse to obtain temporary lodging and to take their meals at a restaurant. Anderson and his spouse incurred expenses of $2,000 for lodging at a motel, $480 for meals which customarily would have been prepared in his residence, and $25 for commercial laundry service which customarily would have been done at home by Anderson.

Anderson makes (directly or through mortgage insurance,) the required March mortgage payment of $1,900. Anderson’s customary commuting expense of $40 for bus fares to and from work is decreased by $20 for the month because the motel is closer to his place of employment. Other transportation expenses remain stable. Finally, Anderson did not incur customary expenses of $150 for food obtained for home preparation, $75 for utilities expenses, and $10 for laundry cleansers.

The mortgage payment results from a contractual obligation and has no relationship to the casualty and is not considered as a living expense resulting from the loss of use of the residence. Because Anderson’s customary bus fare has been reduced, normal transportation expenses are considered not to have been incurred to the extent of the decrease.

Calculations:

The limitation on the excludable amount of an insurance recovery for excess living expenses is $2,250 per month, computed as follows:
<table>
<thead>
<tr>
<th></th>
<th>Actual Living Expense Resulting from Casualty</th>
<th>Normal Expenses Not Incurred</th>
<th>Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing</td>
<td>$2,000</td>
<td>$0</td>
<td>$2,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>-0-</td>
<td>75</td>
<td>(75)</td>
</tr>
<tr>
<td>Meals</td>
<td>480</td>
<td>150</td>
<td>330</td>
</tr>
<tr>
<td>Transportation</td>
<td>-0-</td>
<td>20</td>
<td>(20)</td>
</tr>
<tr>
<td>Laundry</td>
<td>25</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$2,505</strong></td>
<td><strong>$255</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Maximum excludable monthly amount:** $2,250

**Example 2**

**Facts:**
Assume the same facts as in Example 1, except that the damaged residence was not owned by Anderson but was rented by him for $850 per month and that the risk of loss was on the landlord.

**Calculations:**
Since Anderson would not have incurred the normal rental of $850 for October, the excludable amount is limited to $1,400 ($2,250 from Example 1, less $850 normal rent not incurred).

**Example 3**

**Facts:**
Smith’s home, which cost $164,000 including land, was damaged in 2014 by a hurricane. The FMV of the property (both building and land) immediately before the storm was $220,000 and its FMV immediately after the storm was $190,000. Household furnishings were also damaged. The separately figured loss on each damaged household item resulted in a total loss of $600. The insurance company paid $24,000 for the damage to the home, but the household furnishings were not insured. Smith’s adjusted gross income was $44,000.
**Calculations:**

Smith’s casualty loss deduction from the hurricane is figured in the following manner:

1. Adjusted cost basis of real property $164,000
2. FMV of real property before hurricane $220,000
3. Subtract FMV of real property after hurricane <190,000>
4. Decrease in FMV of real property $30,000
5. Loss on real property (smaller of 1 or 4) $30,000
6. Subtract insurance reimbursement <24,000>
7. Loss on real property after reimbursement $6,000
8. Loss on furnishings $600
9. Subtract insurance reimbursement -0-
10. Loss on furnishings after reimbursement $600
11. Total loss (7 plus 10) $6,600
12. Subtract $100 statutory amount <100>
13. Loss after $100 rule $6,500
14. Subtract 10% of $44,000 AGI <4,400>
15. Casualty loss deduction $2,100

**EXAMPLE 4**

**Facts:**

Assume the facts as in Example 3, and that Smith’s home is in a federally declared disaster area. Smith’s adjusted gross income was $35,000 in 2013. Can Smith claim the loss deduction on the 2013 return?

**Calculations:**

The casualty loss deduction is $3,000 in 2013 computed as follows:

- Loss after $100 rule $6,500
- Subtract 10% of $35,000 AGI <3,500>
- Casually loss deduction $3,000
Smith can elect to claim a disaster loss deduction for the prior year tax return until the later of Oct. 15, 2014 or April 15, 2015, (i.e., the later of the due date, excluding extensions, of the income tax return for the tax year in which the disaster occurred, or the due date of the income tax return, including extensions, for the preceding tax year.)\(^{66}\)

**Example 5**

**Facts:**

Johnson receives an insurance check in 2014 for $100,000 after her principal residence is destroyed by an earthquake. She expects to receive an additional $150,000 in 2015. Johnson lives in a federally declared federal disaster area. The fair market value of the home was $500,000 before the earthquake and $200,000 immediately thereafter. Johnson’s adjusted basis in the property is $140,000, and she expects (but has not done so) to spend $175,000 to replace the destroyed home. Does Johnson have a gain or a loss in 2014?

**Calculations:**

For purposes of determining the 2014 gain or loss, the taxpayer must consider all claims for insurance. Consequently the calculation will be:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis</td>
<td>140,000</td>
</tr>
<tr>
<td>Decrease in fair market value</td>
<td>300,000</td>
</tr>
<tr>
<td>Smaller of basis or FMV</td>
<td>140,000</td>
</tr>
<tr>
<td>2014 reimbursement</td>
<td>100,000</td>
</tr>
<tr>
<td>Expected 2015 reimbursement</td>
<td>150,000</td>
</tr>
<tr>
<td>Gain</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

*Note:* As discussed earlier in Examples F and H, an involuntary conversion of a principal residence is treated as a sale, eligible for the section 121 gain exclusion. If Johnson, who is single, chooses either not to replace her home or to replace it without using the entire $250,000 proceeds, the “amount realized from insurance” may be reduced by up to $250,000 provided she meets the ownership and use requirements. This scenario is illustrated in example 7 below.

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\(^{66}\) Treas. Regs §1.165-11(e).
**EXAMPLE 6**

**Facts:**
Can Johnson (in Example 5, above) use the disaster relief rules to get a refund of her 2013 taxes?

**Answer:**
No, because the disaster relief rules apply only if there is a loss. Johnson may, however, use the extended period of time to reinvest her proceeds in a replacement property.

**EXAMPLE 7**

**Facts:**
Assume the facts as in Example 5. If Johnson spends, as expected, $175,000 to restore her property, then uses the remaining cash from insurance to pay down her mortgage, will she have a gain or a loss?

**Calculations:**
She will have a gain of $75,000 (excess of insurance proceeds over cost to restore the property). The pay down of the mortgage is not considered a reinvestment of the insurance proceeds.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total insurance reimbursement</td>
<td>$250,000</td>
</tr>
<tr>
<td>Amount reinvested</td>
<td>&lt;175,000&gt;</td>
</tr>
<tr>
<td>Recognized Gain</td>
<td>$75,000</td>
</tr>
</tbody>
</table>

Of course, if Johnson meets the requirements of sections 1033 and 121 as illustrated in Examples F and H, there is no gain as illustrated below. Assume that Johnson is single. This is true whether or not she reinvests in another principal residence.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis</td>
<td>$140,000</td>
</tr>
<tr>
<td>Decrease in fair market value</td>
<td>$300,000</td>
</tr>
<tr>
<td>Smaller of basis or FMV</td>
<td>$140,000</td>
</tr>
<tr>
<td>2014 reimbursement</td>
<td>$100,000</td>
</tr>
<tr>
<td>Expected 2015 reimbursement</td>
<td>150,000</td>
</tr>
<tr>
<td>Exclusion under section 121</td>
<td>&lt;250,000&gt;</td>
</tr>
<tr>
<td>Amount realized from insurance proceeds</td>
<td>$-0-</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>$-0-</td>
</tr>
</tbody>
</table>
EXAMPLE 8

**Facts:**

Assume the facts as in Example 5. Johnson spends an additional $50,000 to restore her home after she reports the gain of $75,000.

**Calculations:**

Johnson can postpone reporting the gain at any time before the end of the replacement period by filing an amended return. An explanation should be attached showing the previously reported gain. Johnson now wants to report only part of the gain – $25,000 – equal to the part of the reimbursement not spent for replacement property.

EXAMPLE 9

**Facts:**

Assume the facts as in Example 5. Johnson lives in an area where contractors are scarce, and it may take three years to complete restoration of her home. Will the delay affect her 2014 taxable income?

**Calculations:**

Generally, the replacement of involuntarily converted property must be completed by the end of the second year following the calendar year of the event. However, the special rule for principal residences converted in a disaster area applies to Johnson, and the period is extended from two years to four years, in her case until Dec. 31, 2018.

EXAMPLE 10

**Facts:**

Williams’ home was destroyed in 2014 by Washington mudslides. The home and all of its contents were a complete loss. Williams had purchased the house for $110,000, made improvements totaling $5,000, and had approximately $20,000 of personal property in the home. At the time of the mudslides, Williams’ house was valued at approximately $130,000. Immediately after the disaster, the property was valued at approximately $20,000.

Williams received insurance proceeds of $80,000 in settlement of the loss incurred in connection with the house. In addition, he received insurance proceeds of $25,000 in connection with the personal property washed away or destroyed. Williams applied this $105,000 to rebuilding his house and replacing the contents which were destroyed.
Calculations:

<table>
<thead>
<tr>
<th>Personal Use Real Property</th>
<th>Unscheduled Personal Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost basis</td>
<td>Cost basis $20,000</td>
</tr>
<tr>
<td>FMV before flood</td>
<td>FMV before flood $25,000</td>
</tr>
<tr>
<td>FMV after flood</td>
<td>FMV after flood $0</td>
</tr>
<tr>
<td>Decline in FMV</td>
<td>Decline in FMV $25,000</td>
</tr>
<tr>
<td>Lesser of basis or decline in FMV</td>
<td>Lesser of basis or decline in FMV $20,000</td>
</tr>
<tr>
<td>Insurance proceeds received</td>
<td>Insurance proceeds received $25,000</td>
</tr>
<tr>
<td>Casualty Loss</td>
<td>Casualty Gain $5,000</td>
</tr>
</tbody>
</table>

Williams is allowed an exclusion from recognizing gain on the insurance proceeds he received for the unscheduled personal property. Replacement is not required to exclude gain on unscheduled personal property.

Williams can claim a casualty loss deduction of $30,000. This loss may be taken on the tax return for the year in which the casualty occurred or he can elect to take the loss in the immediately preceding year. This loss is also subject to the limitations on casualty losses: (1) it must be greater than $100; and (2) it is deductible only to the extent it exceeds 10 percent of adjusted gross income after reducing the casualty loss by $100.

Example 11

Facts:
Assume the same facts as in Example 10, except the insurance proceeds for the residence were $140,000.

Calculations:

<table>
<thead>
<tr>
<th>Personal Use Real Property</th>
<th>Unscheduled Personal Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost basis</td>
<td>Cost basis $20,000</td>
</tr>
<tr>
<td>FMV before flood</td>
<td>FMV before flood $25,000</td>
</tr>
<tr>
<td>FMV after flood</td>
<td>FMV after flood $0</td>
</tr>
<tr>
<td>Decline in FMV</td>
<td>Decline in FMV $25,000</td>
</tr>
<tr>
<td>Lesser of basis or decline in FMV</td>
<td>Lesser of basis or decline in FMV $20,000</td>
</tr>
<tr>
<td>Insurance proceeds received</td>
<td>Insurance proceeds received $25,000</td>
</tr>
<tr>
<td>Casualty Gain</td>
<td>Casualty Gain $5,000</td>
</tr>
</tbody>
</table>
Johnson will have a gain of $30,000 on the residence. This gain can be deferred if the $140,000 is spent on a replacement residence or personal property by the last day of the fourth year following the receipt of the insurance proceeds. The four-year period and the flexibility related to reinvestment in residence or contents apply only if an area is declared as a disaster area by the President. The gain may also be excluded if Johnson meets the requirements of section 121 as discussed earlier.

**Example 12**

**Facts:**

Franklin’s home is destroyed by an earthquake. The home must be demolished, and a new home will be built in its place. During 2014, the lot is vacant for six months before construction begins. Franklin continues to make mortgage payments on the property. Is the interest paid to carry an empty lot deductible as home mortgage interest?

**Answer:**

When a qualifying residence is destroyed by an earthquake (or a tornado) the property continues to be treated as a qualified residence from the destruction of the dwelling portion of the residence to the date the reconstructed residence is occupied. This rule also applies if the property is sold within a reasonable period of time. Although not addressed, presumably this rule would apply to other casualties.

If the home was covered by insurance and Franklin had a gain, she would be able to defer her gain from this “involuntary conversion” under section 1033 if she reinvests within the reinvestment period (generally ending at the end of the second year after the casualty; fourth year if in a presidentially-declared disaster area).

**Rental Properties**

**Example 13**

Duncan & Howe, law partners, own two rental houses, in different locations, through a partnership. One house was destroyed by a hurricane in a Federal Disaster Area. The partners each want to elect to claim a loss on their prior year’s return for this destroyed property.

---

**Question:** Can a passive activity casualty loss qualify for disaster relief (i.e., is the loss subject to the normal passive activity loss limitations)?

**Answer:** Treas. Regs. §1.469-2(d)(2)(xi) excludes from treatment as a passive activity deduction any “deduction for a loss from fire, storms, shipwreck, or other casualty, or from theft (as such terms are used in section 165(c)(3)).”

**Question:** Does the partnership have to make the election?

**Answer:** Consistent with the entity concept for the treatment of partnerships, section 703(b) provides that the partnership shall make elections affecting how taxable income derived from a partnership is computed (except for three specified elections to be made by the partners not applicable here). Consequently the partnership would make the election under section 165(i)(1) to treat the loss as having occurred in the prior year.

**Question:** If one partner makes an election, must all partners do so?

**Answer:** Since the partnership would make the election, all partners would be required to follow the election and deduct their respective share of the loss in the preceding year.

**Employer Provided Benefits for Employees Who Are Victims of Disaster Losses**

**Example 14**

**Question:** A business wants to establish a fund for its employees whose homes were destroyed, without creating tax problems for the business or the employees. What are the starting points for this endeavor?

**Answer:** A business should be able to establish a trust which provides for certain employees in need. Of greatest concern is the chance that funds may be taxed as compensation to employees. Employers should restrict release of benefits to assist only in rehabilitation and replacement of property. The reimbursements will reduce realized loss calculated by the taxpayer.

**SEC 179 Deduction and Casualty Losses**

*The following examples illustrate the effect of a casualty on the section 179 election.*

**Facts:**

Assume the cost of the destroyed equipment was $10,000 and the taxpayer was eligible to, and in fact did, expense the entire cost. Subsequently, the equipment was completely destroyed in an earthquake. What is the gain or loss in each of the following cases?
EXAMPLE 15

**Question:** The equipment was not insured and not replaced.

**Answer:** The taxpayer would not be entitled to a deduction for a casualty loss because the section 179 deduction had reduced his basis to zero ($0.00).

EXAMPLE 16

**Question:** The equipment was not insured but was replaced. Assume replacement cost of $9,000.

**Answer:** The taxpayer would have no gains to report. The basis in the new equipment would be $9,000.

EXAMPLE 17

**Question:** The equipment was insured but the taxpayer did not use the proceeds to replace the equipment.

**Answer:** The taxpayer would have income to report equal to the insurance proceeds because his basis in the equipment is zero as in (a), above. If the insurance proceeds are less than the original cost, the gain would be ordinary income under section 1245. If the insurance proceeds are more than the original cost, the excess over the original cost would be a gain under section 1231, while the balance of the gain up to the original cost would be ordinary income under section 1245.

EXAMPLE 18

**Question:** The equipment was insured and the taxpayer replaced the equipment. Assume insurance proceeds of $8,000 and replacement cost of $6,500.

**Answer:** The taxpayer would have ordinary income under section 1245 of $1,500 to report. The basis in the new property would be zero, replacement cost of $6,500 less gain deferred of $6,500.
EXAMPLE 19

**Question:** The equipment was insured and the taxpayer replaced the equipment. Assume insurance proceeds of $10,000 and replacement cost of $10,500.

**Answer:** The taxpayer would have no gain to report because replacement cost exceeds insurance proceeds. The basis in the new property would be $500, replacement cost of $10,500 less gain deferred of $10,000.

EXAMPLE 20

**Question:** The equipment was insured and the taxpayer replaced the equipment. Assume insurance proceeds of $9,000 and replacement cost of $9,000.

**Answer:** The taxpayer would have no gain to report and the basis in the new property would be zero ($0.00).

BUSINESS LOSSES REIMBURSED BY GOVERNMENT GRANTS

*The following examples relate to government grants.*

**Facts:**

As result of an earthquake, David submitted an application under a state’s program to reimburse losses that the qualifying business incurred for damage or destruction of real and personal property. Assume the adjusted basis was $10,000 and the FMV of the property was $60,000.

EXAMPLE 21

**Question:**
Are there any limitations imposed on the grants?

**Answer:**

Generally, the grants are limited to the fair market value of the property prior to the disaster and are reduced by any other compensation the qualifying business received to compensate for the property losses. The business must continue its operations for a minimum of five years in or near the disaster area. Check the IRS Web site for any exceptions to these general rules for your specific disaster.
EXAMPLE 22

**Question:**
Assume David received a grant of $50,000.

**Answer:**
David cannot deduct the $10,000 loss and realizes a gain of $40,000. The gain will be deferred if all of the requirements of section 1033 are met. The grant proceeds must be used to timely purchase property similar or related in service or use to the destroyed or damaged property.  

EXAMPLE 23

**Question:**
David claimed the $10,000 loss in the prior year on an amended tax return.

**Answer:**
In the year the grant is received, section 111 and the tax benefit rule requires David to include in ordinary income $10,000 of the $50,000 gain realized from the receipt of the grant.  

EXAMPLE 24

**Question:**
Due to the earthquake, David lost his job and received disaster unemployment assistance payments of $2,500. In addition, he received $2,000 governmental payments to help in paying his principal residence mortgage. Friends and relatives made cash gifts of $1,000 to him.

**Answer:**
The $2,500 disaster unemployment assistance payments are unemployment benefits that are taxable. The $2,000 is excluded under section 139 for qualified disaster relief payments to individual to reimburse personal expenses. The cash gift is excluded under section 102.

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69 Treas. Regs § 1.165-1(d)(2)(iii).
**PRINCIPAL RESIDENCE LOSS – WITH PARTIALLY UNINSURED PROPERTY**

**EXAMPLE 25**

**Facts:**
Taxpayer’s principal residence and furnishings were destroyed in a disaster in 2014. The cost of the home and land was $300,000; the fair market value before the disaster was $450,000 and after the disaster was $100,000. The cost of the furnishings was $20,000; the fair market value of the furnishing before the disaster was $15,000 and after was $10,000. The taxpayer received $200,000 from the insurance company for the home (the specific disaster was only partially covered by insurance) and nothing from the insurance company for the furnishings. Assume that taxpayer’s AGI (adjusted gross income) for the current year is $150,000; the adjusted gross income for the previous year, 2013, was $180,000.

What is the amount of taxpayer’s casualty loss deduction for 2014?

**Calculations:**

<table>
<thead>
<tr>
<th>Personal Use Real Property</th>
<th>Unscheduled Personal Property – Furnishings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost basis</td>
<td>Cost basis ( $300,000 )</td>
</tr>
<tr>
<td>FMV before disaster</td>
<td>FMV before flood ( $450,000 )</td>
</tr>
<tr>
<td>FMV after disaster</td>
<td>FMV after flood ( &lt;100,000 ) &gt;</td>
</tr>
<tr>
<td>Decline in FMV</td>
<td>Decline in FMV ( $350,000 )</td>
</tr>
<tr>
<td>Lesser of basis or decline in FMV</td>
<td>Lesser of basis or decline in FMV ( $300,000 )</td>
</tr>
<tr>
<td>Insurance proceeds received</td>
<td>Insurance proceeds received ( &lt;120,000 ) &gt;</td>
</tr>
<tr>
<td>Casualty Loss</td>
<td>Casualty Gain ( $100,000 )</td>
</tr>
</tbody>
</table>

Total Casualty Loss before $100 Floor \( \$105,000 \)
Less: $100 floor per event \( <100 \)>
Casualty Loss after $100 Floor \( \$104,900 \)
Less: 10% of $150,000 AGI \( <15,000 \)>
Casualty Loss deduction on Schedule A of Form 1040 \( \$89,900 \)
**EXAMPLE 26**

**Facts:**
Assume that the disaster occurred in a federally declared disaster area. What options does the taxpayer have with regard to claiming a casualty loss deduction?

**Answer:**
The taxpayer has the option of claiming the casualty loss deduction on the 2013 tax return—that is, the tax return for the year prior to the disaster.

**EXAMPLE 27**

**Facts:**
Assume the taxpayer has the option from Example 26, above. Should the taxpayer use that option in this case?

**Answer:**
There are a number of variables to be considered. Claiming the deduction on the 2013 return (either by claiming it on the original return filed before the due date or on an amended return) will reduce the tax liability immediately resulting in cash flow to the taxpayer to assist in rebuilding. However, in this case, since the taxpayer’s AGI was higher in the previous year, the taxpayer would get a casualty loss deduction of $86,900 rather than $89,900 on the 2013 return as illustrated below.

<table>
<thead>
<tr>
<th>Casualty Loss after $100 Floor</th>
<th>$104,900</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: 10% of $180,000 AGI</td>
<td>&lt; 18,000</td>
</tr>
<tr>
<td>Casualty Loss deduction on Schedule A of Form 1040</td>
<td>$86,900</td>
</tr>
</tbody>
</table>

The taxpayer’s marginal tax rate is also a consideration. The “value” of a casualty loss deduction is greater in the year in which the taxpayer has a higher marginal tax rate. Finally, the time value of money should be considered.

**EXAMPLE 28**

**Question:**
Does the taxpayer have to invest the proceeds from the insurance company in a replacement principal residence in order to claim the casualty loss deduction?

**Answer:**
No, since the disaster resulted in a casualty loss, rather than a casualty gain, there is no requirement that the insurance proceeds be reinvested in similar or related property.
REAL ESTATE WITH MIXED RESIDENTIAL AND BUSINESS USAGE

EXAMPLE 29

Facts:
Taxpayer owned a two-story building with 50% of the square footage used for her trade or business and the other 50% used as her principal residence. The building originally cost $500,000. To date, she has depreciated $50,000 of the business portion. The building was damaged by fire in 2014. Prior to the fire, the fair market value of the building was estimated at $700,000; the fair market value after was $400,000. The insurance company paid $250,000 in damages. Her AGI in 2014 was $150,000.

What are the taxpayer’s business loss (ordinary loss) and personal loss (itemized deduction on Schedule A) with regard to the building? (Note, of course, that there would also be losses on the contents. Refer to earlier problems for these calculations).

Calculations:

<table>
<thead>
<tr>
<th></th>
<th>Business Part</th>
<th>Personal Part</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of asset</td>
<td>$250,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Less: Depreciation to date</td>
<td>&lt; 50,000&gt;</td>
<td>&lt; 0&gt;</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$200,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Fair market value before</td>
<td>$350,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>Fair market value after</td>
<td>&lt; 200,000&gt;</td>
<td>&lt; 200,000&gt;</td>
</tr>
<tr>
<td>Decline in value</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Lesser of basis or decline</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Less: Insurance proceeds</td>
<td>&lt; 125,000&gt;</td>
<td>&lt; 125,000&gt;</td>
</tr>
<tr>
<td>Casualty loss before limits</td>
<td>$ 25,000</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>$100 limit on personal</td>
<td>_____-0-</td>
<td>&lt; 100&gt;</td>
</tr>
<tr>
<td>Loss after $100 limit</td>
<td>$ 25,000</td>
<td>$ 24,900</td>
</tr>
<tr>
<td>10% AGI limit on personal</td>
<td>_____-0-</td>
<td>&lt; 15,000&gt;</td>
</tr>
<tr>
<td>Casualty loss</td>
<td>$ 25,000</td>
<td>$ 9,900</td>
</tr>
</tbody>
</table>
EXAMPLE 30

Facts:
Assume the same facts as Example 29 above, except that the property is totally destroyed and that the insurance proceeds are $400,000. What are the taxpayer’s business loss (ordinary loss) and personal loss (itemized deduction on Schedule A) with regard to the building? (Note, of course, that there would also be losses on the contents. Refer to earlier problems for these calculations).

Calculations:

<table>
<thead>
<tr>
<th></th>
<th>Business Part</th>
<th>Personal Part</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of asset</td>
<td>$250,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Less: Depreciation to date</td>
<td>&lt; 50,000&gt;</td>
<td>&lt; 0&gt;</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$200,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Fair market value before</td>
<td>$350,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>Fair market value after</td>
<td>&lt; 0&gt;</td>
<td>&lt; 200,000&gt;</td>
</tr>
<tr>
<td>Decline in value</td>
<td>$350,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Loss on business portion: Adjusted basis for totally destroyed business property</td>
<td>$200,000</td>
<td></td>
</tr>
<tr>
<td>Loss on personal portion: Lesser of basis or loss in value</td>
<td></td>
<td>$250,000</td>
</tr>
<tr>
<td>Less: Insurance proceeds</td>
<td>&lt; 200,000&gt;</td>
<td>&lt; 200,000&gt;</td>
</tr>
<tr>
<td>Casualty loss before limits</td>
<td>-0-</td>
<td>$50,000</td>
</tr>
<tr>
<td>$100 limit on personal</td>
<td>-0-</td>
<td>&lt; 100&gt;</td>
</tr>
<tr>
<td>Loss after $100 limit</td>
<td>-0-</td>
<td>$49,900</td>
</tr>
<tr>
<td>10% AGI limit on personal</td>
<td>-0-</td>
<td>&lt; 15,000&gt;</td>
</tr>
<tr>
<td>Casualty loss</td>
<td>$-0-</td>
<td>$34,900</td>
</tr>
</tbody>
</table>

EXAMPLE 31

Facts:
Assume the same facts as in Example 31 above, except that the property is totally destroyed and that the insurance proceeds are $700,000. What is the taxpayer’s business gain or loss (ordinary loss) and personal gain or loss (itemized deduction on Schedule A) with regard to the building? (Note, of course, that there would also be losses on the contents. Refer to earlier problems for these calculations).
<table>
<thead>
<tr>
<th></th>
<th><strong>Business Part</strong></th>
<th><strong>Personal Part</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of asset</td>
<td>$250,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Less: Depreciation to date</td>
<td>&lt; 50,000&gt;</td>
<td>&lt; 0&gt;</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$200,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Fair market value before</td>
<td>$350,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>Fair market value after</td>
<td>&lt; 0&gt;</td>
<td>&lt; 0&gt;</td>
</tr>
<tr>
<td>Decline in value</td>
<td>$350,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

- **Loss on business portion:** Adjusted basis for totally destroyed business property: $200,000
- **Loss on personal portion:** Lesser of basis or loss in value: $250,000
- **Less:** Insurance proceeds: < 350,000> < 350,000>
- **Business casualty gain:** $150,000
- **Personal casualty gain:** $100,000

As was the case in earlier examples, the taxpayer should consider the application of Section 1033 to determine if the gains can be deferred or excluded.
VIII. IRS AND STATE TAX AGENCY REFERENCE MATERIALS

Direct links to specific information:

- Disaster Assistance and Emergency Relief for Individuals and Business
- Disaster Relief Resource Center for Tax Professionals
- IRS Topic 515 - Casualty, Disaster, and Theft Losses (including Federally Declared Disaster Areas)
- Previously Issued Disaster Relief Around the Nation
- Disaster Assistance and Emergency Relief for Individuals and Businesses
- Revenue Procedure 2005-27 – Details postponements of a variety of tax-related deadlines for taxpayers affected by a federally declared disaster, terrorist attack or military action
- IRS Publication 547: Casualties, Disasters, and Thefts – Provides details on how to figure and claim a disaster loss
- IRS Publication 584: Casualties, Disasters, and Theft Loss Workbook (Personal-Use Property)
- IRS Publication 584B: Business Casualties, Disasters, and Theft Loss Workbook
- IRS Publication 1450: How to Request a Certificate of Release of Federal Tax Lien
- IRS Publication 2194: Disaster Resource Guide for Individuals and Businesses – Contains various IRS publications and forms related to claiming disaster losses
- IRS Publication 3833: Disaster Relief: Providing Assistance through Charitable Organizations – Explains how the public can use charitable organizations to help victims of disasters, and how new organizations may obtain tax-exempt status
- IRS Publication 4492: Information for Taxpayers Affected by Hurricanes Katrina, Rita and Wilma – Contains various IRS publications and forms related to claiming disaster relief under these particular hurricanes.
- Form 4684 and Instructions Casualties and Thefts – Form for reporting gains and losses from casualties and thefts.

IX. OTHER SOURCES FOR DISASTER RECOVERY INFORMATION

AICPA Disaster Recovery Resources – the AICPA is working to create materials that would be of use to its members regarding this topic. An example of such resource can be found here.

- Local Red Cross Chapters
- Federal Emergency Management Agency (FEMA)
- List of disaster areas of year and by state
- SBA Disaster Recovery