

## HOW THE TAX LAW HELPS VICTIMS OF DISASTERS PART I

The many victims of Hurricanes Harvey, Irma and Maria, as well as other recent storms, doubtless are now preoccupied with salvaging what they can and seeing what their insurance will cover. When the extent of their losses becomes clear, victims will want to know what tax help they're entitled to.

In addition to recent specifically targeted hurricane tax relief legislation and specific IRS administrative hurricane relief (both discussed below), relief is also provided in the current Code and regulations for disaster victims. Some of these provisions are available for the victim of any casualty, such as a storm or flood. Others are available only for those in a federally declared disaster area. This *Hot Topic* (in two parts) explains these relief provisions. This article, Part I, deals with the postponement of time-sensitive acts; the exclusion for qualified disaster relief payments; the casualty loss deduction in general; and the casualty loss deduction rules that are unique to individuals and those that are unique to businesses.

*Recent legislation.* On September 28, Congress passed the "Disaster Tax Relief and Airport and Airway Extension Act of 2017," which would reauthorize the Federal Aviation Administration (FAA) for six months and deliver temporary tax relief to the victims of Hurricanes Harvey, Irma and Maria. Tax provisions in the bill would make it easier for people with hurricane losses to write them off on their taxes, eliminating a requirement that personal losses must exceed 10% of adjusted gross income to qualify for a deduction. It would also give hurricane victims penalty-free access to retirement funds and temporarily suspend limitations on the deduction for charitable contributions to hurricane relief made before year-end. The bill is awaiting President Trump's expected signature.

*IRS administrative relief.* Specific administrative hurricane relief granted by IRS includes:

- providing taxpayers in federal disaster areas, including areas impacted by Hurricanes Harvey, Irma and Maria, more time to make tax payments and file returns,
- encouraging leave-based donation programs for victims of Hurricane Harvey and Irma,
- allowing retirement plans to make loans and hardship distributions to Harvey victims and Irma victims,
- providing relief to victims of Hurricanes Harvey and Irma in connection with certain employee benefit plans,
- waiving the penalty that would otherwise apply when dyed diesel fuel is sold for use (or used) on the highway for areas affected by Hurricane Harvey and Hurricane Irma,
- providing temporary relief to controlled foreign corporations moving inventory located in areas affected by Hurricane Irma and Hurricane Maria to the U.S. to escape damage,

- temporary relief from certain low-income housing tax credit requirements in order to facilitate emergency housing for individuals who are displaced from their principal residences

## POSTPONEMENT OF TIME-SENSITIVE ACTS

Under the Internal Revenue Code, the IRS may permit taxpayers affected by a disaster loss to postpone for a fixed period of time the filing of returns, the submission of tax payments and the performance of other time sensitive acts. The postponement applies to "affected taxpayers," which includes (1) individuals whose principal residences are located in a disaster area; (2) business entities or sole proprietors whose principal place of business is located in a disaster area; (3) taxpayers who aren't included in (1) or (2) but whose records necessary to meet the deadline for performing an act are located in a disaster area; (4) any estate or trust which has tax records necessary to meet a filing or payment deadline in a covered disaster area; and (5) any spouse of an affected taxpayer, solely with regard to a joint return of the husband and wife. The complete list of possible postponements is carried in Rev Proc 2005-27, 2005-20 IRB 1050.

## EXCLUSION FOR QUALIFIED DISASTER RELIEF PAYMENTS

Under the Code individuals may exclude a qualified disaster relief payment. Such a payment also isn't earnings for self-employment tax purposes or wages for employment tax purposes.

A qualified disaster relief payment includes an amount (to the extent not compensated by insurance or otherwise) paid to or for the benefit of an individual:

- (1) to reimburse or pay reasonable and necessary personal, family, living or funeral expenses incurred as a result of a qualified disaster (which includes a federal disaster),
- (2) to reimburse or pay reasonable and necessary expenses incurred to repair or rehabilitate a personal residence (including a rented residence) or repair or replace its contents to the extent that the need for the work results from a qualified disaster, and
- (3) if the amount is paid by a federal, state or local government or an agency or instrumentality of those governments, in connection with a qualified disaster in order to promote the general welfare (but not if payments are made to businesses or for income replacement or unemployment compensation).

The IRS has ruled that the Code exclusion applies to grants made by employers for unreimbursed medical, temporary housing and transportation expenses of employees who are affected by a flood that is a Presidentially declared disaster.

Observation: Effective for disasters declared in tax years beginning after December 31, 2007, the term "federally declared disaster" replaced the previously used "presidential disaster area" term. The new term is substantially the same as the definition of "presidentially declared disaster" under former law.

Other excludable payments. The IRS also has ruled that individuals who are victims of a flood which is a federally declared disaster may exclude: (1) state grants for unreimbursed medical, temporary housing and transportation expenses; and (2) charitable grants.

## CASUALTY LOSS DEDUCTION

Businesses, as well as individuals, which suffer losses as a result of a natural disaster such as Hurricane Harvey are entitled to deduct a casualty loss.

The manner of determining the amount of a casualty loss allowable as a deduction in computing taxable income generally is the same whether the loss was incurred in a trade or business, or whether it was a personal casualty loss. Determining the amount of a casualty involves finding the amount of the casualty loss and reducing the casualty loss amount by insurance or other compensation.

There are rules which are unique to calculating the deduction for personal casualty losses, principally the \$100 per casualty floor and the 10%-of-AGI floor. And there are some rules which are unique to casualty losses involving business or investment property, such as the special rule which applies if property is completely destroyed.

Amount of the casualty loss. The amount of a casualty loss generally is the lesser of:

- (1) the difference in fair market value (FMV) of the property immediately before and immediately after the casualty, or
- (2) the adjusted basis for determining loss from the sale or other disposition of the property.

Establishing drop in property's FMV by appraisal. The difference in FMV of property immediately before and after the casualty should be determined by competent appraisal. The appraiser's knowledge of sales of comparable property and conditions in the area, his familiarity with the damaged property before and after the casualty, and his method of determining the amount of the loss are important in proving the deductible amount. An appraisal must recognize the effects of any general market decline, i.e., a decline that would affect undamaged as well as damaged property, which may occur simultaneously with the casualty, so that the casualty loss deduction will be limited to the actual loss resulting from damage to the property.

Appraiser's fees for valuing the amount of a casualty loss aren't part of the casualty loss; they are treated as expenses of determining tax liability. Individuals deduct these fees as miscellaneous itemized deductions, subject to the 2%-of-AGI floor. Appraiser's fees associated with trade-or-business casualty losses should be deductible as business expenses.

Repair costs as measure of casualty loss. The costs of repairing, replacing or cleaning up after the casualty aren't, in themselves, deductible as casualty losses. However, the cost of repairs is acceptable evidence of the loss of value if the taxpayer shows that:

- (1) the repairs are necessary to restore the property to its condition immediately before the casualty,
- (2) the amount spent for repairs isn't excessive,
- (3) the repairs don't repair more than the damage suffered, and
- (4) the value of the property after the repairs doesn't, as a result of the repairs, exceed the value of the property immediately before the casualty.

Where the taxpayer relies on the cost of repairs (and not a competent appraisal, see discussion above) to measure the amount of a casualty loss, the repairs and associated expenditures must actually be made. (See, e.g., Abrams, Paul, (1981) TC Memo 1981-231; Goodfriend, Marvin, (1986) TC Memo 1986-519.)

Reduction for insurance or other compensation. The casualty loss amount is reduced by the amount of any insurance, other compensation, or reimbursement received.

Reimbursement includes:

- repairs, restoration, or cleanup provided by relief agencies (Instructions to Form 4684, Casualty Losses (2016),
- the forgiven part of a federal disaster loan ((Instructions to Form 4684, Casualty Losses (2016),
- the receipt of a debris removal reimbursement,
- money received as an employee from an employer's emergency disaster fund to the extent the cash is used to replace damaged or destroyed property for which a casualty loss deduction is being claimed, and
- payments granted under a state eminent domain code to allow for full compensation to property owners for losses sustained when their residences were destroyed by flood. (Mager, Morris v. U.S., (1980, DC PA) 45 AFTR 2d 80-979)

However, disaster relief such as food, medical supplies, and other forms of assistance doesn't reduce the casualty loss unless they are replacements for lost or destroyed property.

## CASUALTY LOSS DEDUCTION RULES UNIQUE TO INDIVIDUALS

An individual's deductions for casualty losses are subject to special rules regarding how the loss is calculated for realty and personal property. Additionally, each personal casualty is reduced by \$100; all personal casualty, disaster and theft losses for the year are deductible by itemizers only to extent they cumulatively exceed 10% of adjusted gross income (AGI); and an additional 2% of AGI floor applies to "employee property."

Loss for real property. When figuring a casualty loss on personal-use real property, an individual treats the entire property (including any improvements, such as buildings, trees and shrubs) as one item. The loss is the adjusted basis of the property or the decrease in FMV of the entire property.

*Illustration:* In 2014, Mr. Able bought his family's home for \$900,000. He planted trees and ornamental shrubs on the grounds at a cost of \$12,000. In 2017, a hurricane damages the home, trees and shrubs. At the time of the casualty, the adjusted basis of the entire property is \$912,000 and its FMV value immediately before the casualty is \$1,000,000. Immediately after the casualty the entire property's FMV is \$700,400. In 2017, Able receives \$50,000 of insurance to cover the building damage.

The amount of the loss (before application of the \$100 floor and the 10%-of-AGI floor) with respect to the entire property (land, house, trees, and shrubs) for '97 is \$249,600, calculated as follows:

- The difference in the FMV immediately before the casualty (\$1,000,000) and the FMV immediately after the casualty (\$700,400) is \$299,600 (the amount of the property destroyed).
- The loss to be taken into account is \$299,600 (lesser of \$299,600 amount of property destroyed or \$912,000 adjusted basis); and
- The \$299,600 loss must be reduced further by the amount of insurance received (\$50,000) to \$249,600.

Losses for items of personal property. Where more than one item of personal property held for personal use is damaged by casualty, the taxpayer, in computing the total loss, must determine the decrease in the FMV or adjusted basis of each item claimed to have been lost or damaged. These separate losses are then combined to determine the total loss resulting from the casualty.

\$100 per-casualty floor for personal losses. A casualty (or theft) loss of personal use property is allowed only to the extent that the amount of the loss from each event exceeds \$100. For purposes of this limit, events closely related in origin give rise to a single casualty. Thus, if a single storm damages a person's house and car parked in his driveway, the loss is from a single casualty.

In general, where a loss from a single casualty is sustained in more than one year, only a single \$100 reduction is required. The \$100 floor applies to the entire loss from each casualty.

Where the same casualty (or theft) damages an item of property owned by two or more persons, the \$100 floor applies separately to each person. Only a single \$100 floor applies with respect to any particular casualty in the case of a husband and wife if they file a joint return, whether the loss is to property jointly or separately owned. But if the spouses file separately, the \$100 floor applies separately to each spouse even if the property is owned jointly.

If property is held for both personal and business (or profit) purposes, the \$100 floor applies only to the personal part of the loss.

*10%-of-AGI floor beneath personal losses.* If a taxpayer has personal casualty losses but no personal casualty gains for a tax year, the losses are allowed as an itemized deduction only to the extent that they exceed 10% of the taxpayer's adjusted gross income (AGI). The 10%-of-AGI floor is applied only after each separate loss has first been reduced by the \$100 floor.

*Illustration 1:* Sarah sustains an \$25,000 casualty loss to her home in a tax year in which she has AGI of \$120,000. The \$100 per casualty floor reduces the deductible amount to \$24,900. Since 10% of Sarah's AGI is \$12,000, the amount of the loss that's deductible on Schedule A, Form 1040, is \$12,900 (\$24,900 - \$12,000).

*Illustration 2:* This year, Fred's home sustained \$6,000 of damage from a spring flood and \$8,000 in fall hurricane damage. If Fred's AGI is \$100,000, he can deduct only \$3,800 of the loss: \$14,000 less \$200 (\$100 per loss floor), less \$10,000 (10% of AGI).

The following rules apply if the taxpayer has both personal casualty gains and losses for a tax year:

- Compare total gains to total losses after reducing each loss by reimbursements and the \$100 floor.
- If personal casualty losses exceed personal casualty gains, the excess of the losses over the gains is subject to the 10%-of-AGI floor.
- If personal casualty gains exceed personal casualty losses, the excess of the gains over the losses is treated as capital gain, and the 10%-of-AGI floor does not apply.
- *Observation:* The taxpayer may be able to avoid a tax on casualty gains by taking advantage of the involuntary conversion rules.

*2%-of-AGI floor.* A casualty loss deduction for employee property - i.e., property such as an auto used in performing services as an employee - when added to other job expenses and most other miscellaneous itemized deductions on Schedule A (Form 1040), Schedule A, must be reduced by 2% of AGI. Casualty losses of employee property are not subject to the \$100-per-casualty floor, or the 10%-of-AGI floor.

## CASUALTY LOSS DEDUCTION RULES UNIQUE TO BUSINESSES

The manner of determining the amount of a casualty loss involving business property generally is the same as it is for personal property. However, the casualty loss rules for business property differ from the casualty loss rules for personal property in a number of ways (besides not being subject to the \$100 or 10%-of-AGI floors that apply to casualty losses of personal property).

The key casualty loss rules that are unique to business property are summarized below.

*Total destruction of property.* If property used in a trade or business or held for the production of income is totally destroyed by casualty, the amount of the loss is the adjusted basis in the property, less any salvage value, less any insurance or other recovery or

reimbursement. The decrease in the property's FMV is not taken into account.

**Basis of converted property.** A taxpayer may own property which was converted from personal use to business use or income-producing use and then was destroyed or damaged by a casualty. In such a case, the FMV of the property on the date of conversion, if less than the adjusted basis of the property at such time, is used, after making proper adjustments in respect of basis, as the basis for determining the amount of loss.

**Aggregating business properties for casualty loss purposes.** A loss incurred in a trade or business is determined by reference to the single, identifiable property damaged or destroyed. Thus, where a business building with ornamental or fruit trees or shrubs suffers storm casualty damage, the decrease in value before and after the casualty is measured separately for the building and the trees. The loss is not measured by treating them together as an integral part of the realty. This method is mandatory for losses to business or for-profit property. (Carloate Industries Inc v. U.S., (1966, CA5) 17 AFTR 2d 59 )

*Illustration:* Several years ago, ABX Corp. bought land containing an office building. The purchase price (\$3,600,000) was allocated between the land (\$720,000) and the building (\$2,880,000) for purposes of determining basis. After the purchase, ABX planted trees and ornamental shrubs on the grounds surrounding the building. This year, the building, trees, and shrubs are damaged by a hurricane. At the time of the casualty, the building's adjusted basis was \$2,640,000 and the trees and shrubs had a basis of \$48,000. The building's FMV immediately before the casualty was \$2,800,000 and immediately after the casualty it was \$2,080,000. The FMV of the trees and shrubs immediately before the casualty was \$80,000 and immediately after the casualty it was \$16,000. This year, ABX received \$200,000 of insurance to cover losses to its building.

*Deduction for building.* The building's FMV immediately before the casualty (\$2,800,000) less its FMV after the casualty (\$2,080,000) is \$720,000 (value of the property destroyed). The loss to be taken into account is \$720,000 (lesser of the \$720,000 of property destroyed or the \$2,640,000 adjusted basis). The loss is reduced by the \$200,000 insurance received, resulting in a deduction of \$520,000.

*Deduction for trees & shrubs.* The amount of the deduction allowable for the trees and shrubs is \$48,000. The \$80,000 FMV immediately before the casualty less the \$16,000 FMV immediately after the casualty is \$64,000 (value of the property destroyed). The loss to be taken into account is \$48,000 (lesser of the amount of property destroyed (\$64,000) or the adjusted basis in that property of \$48,000).

Where realty is destroyed and there is damage only to the buildings, the computation of the before-and-after FMV is based on the improvements alone and doesn't include the land. Thus, the deduction is limited to the adjusted basis of the building alone. (Keefer, Ray, (1975) 63 TC 596)

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