HOW THE TAX LAW HELPS VICTIMS OF DISASTERS PART II

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 disaster tax relief legislation and specific IRS administrative hurricane relief, relief is also provided in the current Tax 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 II, deals with the election to deduct disaster losses in the preceding year; presumptions where a home is demolished; eased rules for homes damaged in a federal disaster; qualification for the reduced homesale exclusion; voluntary sale of the remainder of property after a portion is destroyed/condemned; liberal replacement rules for destroyed business property; and the deferral of state disaster relief grants to a business.

ELECTION TO DEDUCT DISASTER LOSSES IN PRECEDING YEAR

A taxpayer who suffers a disaster loss can take the deduction in the tax year in which the disaster occurs, or can elect to deduct the loss in the immediately preceding tax year.

> Observation: Claiming the disaster loss for the year before the loss occurred saves taxes immediately, without having to wait until the end of the year in which the loss was sustained. In some cases, the deduction may result in a net operating loss, which will bring a refund by a carryback to an earlier year. On the other hand, deducting the loss in the year the loss actually occurred may result in bigger tax savings if the taxpayer is in a higher bracket that year. Because of the 10% adjusted gross income (AGI) floor for deductibility, taxpayers weighing the value of an early disaster loss deduction must also consider the relative amounts of AGI they have or expect to have for the two tax years.
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> Illustration: Jill lives in a county hit by severe flooding damage as a result of Hurricane Harvey and is designated a federal disaster area. The flooding caused $40,000 of uninsured damage to her home. Jill estimates that her AGI for 2017 will be $100,000; for 2016, it was $80,000. She had no personal casualty gains in either year.
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> If Jill claims the loss on her 2017 return, the loss would first be reduced by the $100-per-occurrence floor to $39,900 and then reduced by 10% of her 2017 AGI ($10,000) to $29,900. If she files an amended return for 2016 and claims the loss in that year, the loss would be reduced by the $100 threshold to $39,900 and then reduced by 10% of her 2016 AGI ($8,000) to $31,900. That's $2,000 more than the loss she could deduct in 2017. If Jill also sustained casualty losses in 2016, deducting the current loss in that year could magnify her deduction. For example, if she sustained a casualty loss of $8,000 in 2016 (exactly equal to 10% of her AGI for that year), then she could deduct $39,900 of her

disaster loss by filing an amended return for 2016.

Making the election. The election to deduct a disaster loss in the year before the year in which the loss occurs is made on or before the date that is six months after the unextended regular due date for filing the original return for the tax year in which the disaster actually occurs.

> Observation: A calendar-year taxpayer has until October 15, 2018, to amend his 2016 return to claim a casualty loss that occurs in 2017.

The return or claim should specify the name or description of the disaster which resulted in the loss, date or dates of the disaster that caused the loss, and the city, town, county, state and zip code where the property was located at the time of the disaster.

> Recommendation: An individual taxpayer who suffers a casualty loss in 2017 but doesn't need an immediate tax refund may find it preferable to wait until he or she files the 2017 return before deciding. Then the taxpayer can make an informed judgment as to which tax year produces the greater tax saving from the deduction and choose that year to claim the loss.

Taxpayers have 90 days in which to change their minds after making an election to deduct a disaster loss for the year before the year in which the loss occurs. The election becomes irrevocable after 90 days following the date the election was made.

DISASTER LOSS PRESUMPTION WHERE HOME IS DEMOLISHED

A taxpayer whose residence is located in a federal disaster area may deduct any loss attributable to the disaster as a casualty loss if:

(1) the taxpayer is ordered by the state or local government in which the residence is located to demolish or relocate the residence,

(2) the order is made no later than the 120th day after the date of the President's determination that the area warrants federal disaster assistance, and

(3) the residence was rendered unsafe for use as a residence because of the disaster.

> Observation: The Code creates a conclusive presumption that certain losses attributable to a federally declared disaster are casualty losses for and qualify for tax relief as disaster losses deductible either in the tax year in which the disaster occurred, or in the preceding year. The taxpayer doesn't have to prove that the disaster loss qualifies as a casualty loss. Losses under this rule are still subject to the $100 and 10%-of-AGI limitations.

> Illustration: Over a number of years, a series of hurricanes and generally severe winter weather cause extensive beach erosion in an area, resulting in a danger of flooding. This year, the President determines that the area is a federal disaster area. In order to rehabilitate the area and protect its residents, the governor orders the demolition of certain residences which have been rendered unsafe for use as residences as a result of the beach erosion. Mark's residence is affected by the governor's order. He is entitled to

a disaster loss deduction (which he can claim either on his return for the year the order was signed, or on the previous year's return) attributable to the erosion leading to the demolition of his residence without having to prove that he suffered a casualty loss. Since damage to property caused by erosion might be considered damage from progressive deterioration which would not qualify as a casualty loss, Mark would probably not be entitled to any loss deduction.

Observation: The Code doesn't say the taxpayer's residence must be his primary residence. Presumably, therefore, this provision also applies to a taxpayer's vacation home or second home.

EASED RULES FOR HOMES DAMAGED IN FEDERAL DISASTERS

The Code section relating to the involuntary conversion rules generally provide that gain from an involuntary conversion is deferred if the proceeds of the converted property are timely reinvested in eligible replacement property (generally, property similar or related in service or use to the converted property).

Under the Code, a taxpayer whose principal residence or contents is compulsorily or involuntarily converted due to a federal disaster is entitled to the following tax breaks:

(1) Gain realized from the receipt of insurance proceeds for unscheduled personal property (property in the home but not scheduled property for insurance purposes) is not recognized.

Illustration: After a federally declared disaster, an insurance company reimburses policyholders a flat amount for spoilage of food stored in refrigerators and freezers due to loss of electricity. The policyholders aren't required to itemize the spoiled food or file a claim. They recognize no gain if the reimbursement exceeds the original cost of the food.

(2) Insurance proceeds for the conversion of the principal residence and any of its contents other than unscheduled personal property are treated as a common fund for purposes of the involuntary conversion rules.

Illustration: Anne's principal residence and all its contents were destroyed as the result of a federal disaster. The destroyed household contents included jewelry and sterling silverware, each of which was separately scheduled for insurance purposes. Anne 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, Anne's common pool of funds is $310,000. Within the replacement period for involuntarily converted property (see below) she spends $300,000 to build a new residence, $40,000 to buy 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. Anne did not replace the jewelry or silverware.

Because Anne spent $350,000 to buy a replacement residence and contents, which is in excess of the $310,000 common pool of funds that she received, Anne will not be required to recognize any gain upon the destruction of the residence and its contents.

(3) The taxpayer gets a longer period of time in which to replace a principal residence under the Code Sec. 1033 involuntary conversion rules. In general, the replacement period ends four years (instead of the usual two years) after the close of the first tax year in which any part of the conversion gain is realized.

Observation: Under the Code, the involuntary conversion of a principal residence is treated as a sale for purposes of the up-to-$250,000/$500,000 home-sale exclusion. However, any excess of the gain on the involuntary conversion over the available exclusion may be deferred under the involuntarily conversion rules. The amount realized for purposes of the involuntary conversion rules of is the amount realized less the excluded gain.

Illustration: When his long-time principal residence was involuntarily converted, George, a single taxpayer, received $350,000 for the property. George realized $300,000 of gain on the conversion, $250,000 of which is excluded. George can avoid a current tax on the remaining $50,000 of realized gain if he timely purchases a replacement residence costing at least $100,000 ($350,000 amount realized less $250,000 excluded gain). Moreover, George's basis in his new home would be reduced by only the $50,000 of gain not taxed due to the involuntary conversion rules—there's no reduction on account of the excluded gain on the old residence. Thus, if George timely purchased a replacement residence for $350,000, his basis in it would be $300,000.

QUALIFICATION FOR REDUCED HOME-SALE EXCLUSION

A taxpayer can exclude from income up to $250,000 of gain ($500,000 for certain joint filers) from the sale of a home owned and used by the taxpayer as a principal residence for at least 2 of the 5 years before the sale. The exclusion doesn't apply if, during the 2-year period ending on the sale date, the exclusion applied to another home-sale by the taxpayer.

Under the Code, a reduced home-sale exclusion may apply to a taxpayer who fails to qualify for the full home-sale exclusion because he doesn't meet the two-out-of-five-year ownership and use rule, or previously sold another home within the two-year period ending on the sale date of the current home in a transaction to which the exclusion applied.

Under the Code, the failure to meet either rule must result from the home being sold (or exchanged) due to (1) a change of place of employment, (2) health, or (3) to the extent provided by regulations, other unforeseen circumstances. Under regulations, unforeseen circumstances include the involuntary conversion of a residence, and a natural or man made disaster (or act of war or terrorism) resulting in a casualty to a principal residence. These events are treated as unforeseen circumstances whether or not the home is located in a federal disaster area.

Under these circumstances, the maximum gain that can be excluded is equal to the full $250,000 or $500,000 exclusion times a fraction having as its numerator the shorter of (a) aggregate periods of ownership and use of the home by the taxpayer as a principal residence during the 5 years ending on the sale date, or (b) the period of time after the last sale to which the exclusion applied, and before the date of the current sale, and having 2 years (or its equivalent in months) as its denominator.

> Illustration: Arnold buys a house that he uses as her principal residence. Twelve months after the purchase, the home is destroyed by a hurricane and the insurance company pays him cash for the home. Arnold has not excluded gain on an earlier sale or exchange of property within the last two years. He is eligible to exclude up to $125,000 of the gain from the sale of his house (12/24 × $250,000).

VOLUNTARY SALE OF REMAINDER OF PROPERTY AFTER PORTION IS DESTROYED/CONDEMNED

An event such as a storm, flood, or hurricane may destroy only part of a taxpayer's property, or a condemning authority may only acquire part of a larger unit, thereby forcing the owner either to find a substitute for the destroyed or condemned portion in the vicinity, or to dispose of the remainder and replace the entire unit. A voluntary sale of a portion of such a unit, if forced on the taxpayer as an incident to involuntary conversion of a part of his property, is, for tax purposes, treated as an involuntary conversion.

In general, a taxpayer can treat such a voluntary sale as incident to an involuntary conversion only if a two-pronged test is satisfied:

(1) The involuntarily converted property reasonably can't be adequately replaced; and

(2) there must be a substantial economic relationship between the condemned property and the property sold so that together they constitute one economic unit.

To demonstrate that the second prong of the above test is satisfied, the taxpayer must show that the property sold could not practically have been used without replacement of the converted property.

More liberal rule for residences: When the dwelling portion of a residence is destroyed, e.g., by a tornado, a later sale of the land portion of the residence within the replacement period for the property will be treated as part of a single involuntary conversion occurring on the date the dwelling was destroyed. This rule applies to a taxpayer's principal residence, or a taxpayer's second residence, such as a vacation home.

> Observation: The rule treating land sold after the destruction of a principal or second residence as part of the involuntary conversion of the residence applies if the land is sold within the replacement period. There is no need for the sale to also satisfy the two-pronged test (see discussion above).

> Illustration: In 2017, Mr. and Mrs. Anderson's principal residence was destroyed by Hurricane Harvey. Their adjusted basis in the home (building and land) was $100,000. In 2017, they receive $320,000 in insurance proceeds for the structure, but choose not to rebuild. Instead, they sell the land for $50,000 in 2018. Since under Code Sec. 121(d)(5)(A), the involuntary conversion of a home is treated as a sale for purpose of the Code Sec. 121 exclusion, their entire $270,000 gain ($320,000 insurance proceeds +$50,000 land sale proceeds – $100,000 adjusted basis) ought to be eligible for the up-to-$500,000 exclusion for married filing jointly.

> Observation: If there were any excess of gain on the overall involuntary conversion over the available exclusion, it may be deferred under the involuntarily conversion rules (see

discussion above).

LIBERAL REPLACEMENT RULE FOR DESTROYED BUSINESS PROPERTY

In general, no gain is recognized when property is compulsorily or involuntarily converted into property similar or related in service or use. However, tangible property acquired and held for productive use in a trade or business is treated as similar or related in service or use to property that (a) was held for investment or for productive use on a trade or business (including inventory), and (b) was involuntarily converted as a result of a federally declared disaster.

Illustration: X Corp receives $20,000 in insurance proceeds for a production machine (in which it has a basis of $10,000) destroyed in a federally declared disaster. X Corp replaces the machine with a $20,000 delivery truck and does so on a timely basis (generally, within two years after the close of the first tax year in which any part of the gain on the involuntary conversion is realized). X Corp's $10,000 of gain due to the involuntary conversion is not recognized currently. Under the regular involuntary conversion replacement rules, X Corp would have had to replace with a production machine similar in service or use to the destroyed machine.

Observation: To be eligible for the treatment allowed by the above rules, the replaced property (i.e., the property that was converted as a result of a federally declared disaster) may be either property held for productive use in a trade or business or property held for investment. However, the replacement property must be tangible property held for productive use in a trade or business. It may not be intangible property, and it may not be property held for investment.

DEFERRAL OF STATE DISASTER RELIEF GRANT TO BUSINESS

A state may have a program to reimburse uncompensated business losses for disaster-related damage to real and personal property. IRS has held that such a grant is not excludable if made to aid in the economic recovery of an area, and conditioned on qualifying businesses continuing operations for a minimum of 5 years in or near the area affected by the disaster. However, IRS said a business may elect to defer the gain realized from receipt of the grant to the extent that an amount equal to the grant proceeds is used to timely purchase property similar or related in service or use to the destroyed or damaged property.