

Casualty Losses and Gains

How Do You Measure a Casualty Loss?

Your loss is measured by the *lesser* of

- (i) the difference between the fair market value of the asset before the casualty and the fair market value immediately after the casualty, or
- (ii) your adjusted basis (depreciated cost) in the asset.

In other words, you can deduct the decline in the value of the damaged asset, limited to your adjusted basis in the asset. Note that, regardless of how large your *economic* loss ((i) above) is, your *tax* loss can never exceed your basis (cost).

Completely destroyed property - If your property is completely destroyed, the loss deduction for business property is your adjusted basis in the property. The loss for personal-use property is also your adjusted basis; in this latter case, however, you can deduct no more than the property's fair market value before the casualty.

Example: A desk at your personal residence was destroyed by the storm. You had paid \$1,000 for it, but it was worth only \$150 when the storm hit. Your casualty loss is limited to \$ 150. On the other hand, if you had used the desk in your business and its adjusted basis after depreciation was \$325, you can deduct the entire \$325, even though it was worth only \$150.

Your personal residence - When determining the fair market value of your personal residence after the storm, you cannot consider any change in the overall market value of homes in your area. For example, if the value of your home decreased by \$45,000 due to damage to your house and it decreased another \$10,000 due to the fact that people are not buying homes in your area, your tax casualty loss includes only the \$45,000. You cannot count the \$10,000 reduction caused by market conditions, even though the decline in market value is a direct result of the storm.

If personal-use property was destroyed or stolen, you can use IRS Publication 584, *Casualty, Disaster, and Theft Loss Workbook*, to help you catalog your property. If the property was business or income-producing property, refer to IRS Publication 584B, *Business Casualty, Disaster, and Theft Loss Workbook*. For more information regarding casualty losses of personal-use property and how to deduct them, you can consult IRS Publication 547, *Casualties, Disasters, and Thefts*, or call your Hienz & Macaluso professional. These publications can be found on our website at <http://www.hienzmacaluso.com/test/hurricane/index.html>.

What if You Receive Insurance Proceeds or Other Reimbursements?

You must reduce the casualty loss as determined above by any insurance proceeds. In addition, you must reduce your loss by any other reimbursements or payments from government or other sources, specifically awarded to restore or rehabilitate the damaged property. Gifts from family members, charities or other agencies will not reduce the casualty loss if there is no limitation on the use of the donated funds.

Example: Your personal vehicle is destroyed by the storm. You paid \$36,000 for it, but it was-worth only \$20,000 at the time the storm hit. Your insurance company pays you \$15,000 for your loss. Under the rules discussed above, your casualty loss is \$20,000, the lesser of the amount you paid for the car or its fair market value. However, you must reduce this amount by the insurance reimbursement. Your casualty loss deduction for tax purposes is \$5,000 (\$20,000 - \$15,000).

If the property is covered by insurance, you must file a claim. Any loss covered by insurance is not deductible whether or not you file a claim. The courts have also said that you cannot deduct any loss you could have collected from your insurance company if you had pursued the matter.

The amount of your casualty loss is not necessarily limited to the loss determined by your insurance adjuster. However, the IRS will require objective evidence that the loss is greater.

How Do You Determine the Amount of Your Loss?

You need to be able to substantiate the amount of any loss you claim on your tax return. An accurate appraisal of the property before and after the casualty is the best evidence. The value of completely destroyed property is, of course, zero following the event. Keep in mind, however, that your flooded residence has some value. If for the land, if nothing else, its post-storm value will not be zero. *We strongly encourage you to get appraisals if you believe your loss will be substantial.* Your appraiser should understand that the value of the house after the storm is the value the house would have before the storm, but with the damage specifically caused by the storm. This approach eliminates the general decline (or increase) in the overall market value.

As an alternative to getting appraisals, the cost of restoring damaged property to its original condition can be acceptable evidence of the decline in the property's value if all of the following conditions are met:

1. The repairs only restore the property to its pre-casualty condition,
2. The amount spent is not excessive, and
3. The repairs do not increase the value of the property over the value it had immediately before the casualty.

Any additional expenditure to protect the property from future damage is not part of the casualty loss. *You must actually have the repairs done to use this approach;* mere estimates of the cost to repair are not sufficient.

The cost of debris removal and clean-up work can also be evidence of the amount of the casualty loss.

In the case of an automobile, the "blue book" value can be a reasonable approximation of the loss as long as the value is adjusted for the pre-casualty condition of the car.

Keep in mind that your loss cannot exceed your basis (cost) in your property. However, even if your deduction is limited to your basis, you must still be able to prove that your actual loss was at least that much.

What is My Basis in My Damaged or Destroyed Property?

Basis is the same as cost, except that the basis for a business asset decreases as you claim depreciation deductions. We need this information because your casualty loss can not exceed your basis in the damaged or destroyed asset.

Normally, you start with your original purchase price and add the cost of any improvements or additions you have made to the asset since then.

If you received the asset as a gift from someone, generally your basis would be the same as the donor's basis when the gift was made. *Example:* You were given an antique desk by your mother. She paid \$500 for the sofa forty years ago, but it was worth \$20,000 when she gave it to you. Your basis would be \$500.

If you inherited the asset, your beginning basis normally will be the value of that asset on the date the decedent died (or on the date six months after the decedent's death if the estate made a special election). Look for the asset on the estate tax or inheritance tax return filed by the estate to see what value was determined for the asset.

When Do You Report the Loss?

Normally, a casualty loss is deductible in the year the casualty occurs. However, if you have made insurance or other claim for which you have a reasonable prospect of recovery, that part of the loss cannot be deducted until the year the claim is resolved. *Example:* Your loss from the flooding of your house is \$325,000. You have filed a claim for \$250,000 on your flood insurance policy. You should deduct \$75,000 (\$325,000 - \$250,000) as your casualty loss in 2005. If, in 2006, you receive only \$215,000 from your flood policy, you can deduct an additional casualty loss of \$35,000 (\$250,000 - \$215,000) in that year.

Disaster Area - A casualty loss sustained in an area declared a disaster area by the President can be deducted in the year the loss is sustained or in the immediately preceding tax year. *Example:* You incur an individual casualty loss from Hurricane Katrina or Rita. You can deduct the loss either on your 2005 income tax return or your 2004 return (subject to the insurance reimbursement rule above).

If you have already filed your return for the preceding tax year, the loss may be claimed in the preceding year by filing an amended return, Form 1040X for individuals and Form 1120X for regular "C" corporations.

You must normally make the decision to carry your individual loss back to the preceding tax year by April 17, 2006 (March 15, 2006 for corporations). This deadline has been extended by the IRS until October 16, 2006 for both individuals and corporations. If you do not file an amended return by this date, you must report the loss on your 2005 return.

Part 2 - Casualty Gains

You can actually realize a reportable *gain* from your insurance settlement, even if the settlement does not exceed the amount of your economic loss.

What is a Casualty Gain?

A casualty gain occurs when insurance proceeds and other reimbursements exceed the taxpayer's adjusted basis in the damaged or destroyed property. *Example:* You bought your flooded house for \$20,000 thirty years ago. Immediately before the storm, it was worth \$300,000. It is worth \$50,000 after the storm. You receive \$100,000 from your flood insurance. Your economic loss is \$150,000 (\$300,000 - \$50,000 - \$100,000). However, remember that, for tax purposes, your basis is controlling. You received \$100,000 insurance proceeds for a house in which your basis is only \$20,000. You have a casualty gain of \$80,000 (\$100,000 - \$20,000).

Casualty gains are normally taxable, although some are tax-free and recognition of the gain can be deferred for others.

Is a Casualty Gain Related to My Residence Taxable?

Under a special rule, a casualty gain related to a principal residence damaged or destroyed in a disaster area can be excluded under the general rule that allows a taxpayer to exclude up to \$250,000 of gain (\$500,000 for a married couple filing a joint return) upon the sale of a residence. To qualify for the exclusion, you must have owned and occupied the house as your principal residence for at least two out of the last five years. Lower exclusion limits can apply if you owned and lived in the residence for less than two years.

Other special rules applicable to principal residences are discussed below.

How Can I Avoid Paying Tax on a Casualty Gain?

You can defer recognizing a casualty gain if you reinvest the insurance or other proceeds in similar property within a period set by law. This is called an involuntary conversion.

The Internal Revenue Code does not define the term "similar". Essentially, the replacement property must be similar or related in use to the property damaged or destroyed. If your destroyed business or income-producing property was located in a presidentially-declared disaster area, there are special rules regarding replacement property. Contact your Hienz & Macaluso professional if you need more information about what constitutes similar property.

Normally, you have two years from the end of the year of the casualty to reinvest the proceeds in similar property. However, in the case of a loss in a Presidentially-declared disaster area, the reinvestment period is extended to four years.

In the case of a loss in the Katrina, Rita and Wilma disaster areas, the reinvestment period has been extended to five years, if substantially all of the use of the replacement asset is in the disaster area.

Principal Residence - Certain other special rules apply to principal residences in Presidentially-declared disaster areas. You do not need to report the gain on any insurance reimbursement of household contents not itemized on your homeowner's policy (unscheduled property). Real property doesn't qualify for this exclusion. Another special rule allows you to group your residence and any scheduled

personal property as one asset both to determine whether you have a casualty gain and for reinvestment purposes.

This written advice is not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

Information that we need to determine if you have a casualty loss or gain:

Description of asset damaged or destroyed (if more than six, make copies of this form as needed):

(A) Principal Residence: _____

Date acquired: _____

(B) Household Contents - Principal Residence: _____

Date acquired: _____

(C) Other Assets: _____

Date acquired: _____

		(A)	(B)	(C)
1.	Cost or Basis of Asset:	\$	\$	\$
2.	a) FMV <u>Before</u> Disaster: b) How did you determine this value (appraisal, personal estimate, other)?	\$	\$	\$
3.	a) FMV <u>After</u> Disaster: b) How did you determine this value (appraisal, personal estimate, other.)?	\$	\$	S
4.	Actual cost to repair and/or restore the asset:	\$	\$	\$
5.	Did the above repairs increase the fair market value of the asset over its pre-storm market value?	Yes or No	Yes or No	Yes or No
6.	Insurance Proceeds: (estimate if necessary)	\$ Received: Y or N	\$ Received: Y or N	\$ Received: Y or N

(D) Other Assets: _____

Date acquired: _____

(E) Other Assets: _____

Date acquired: _____

(F) Other Assets: _____

Date acquired: _____

		(D)	(E)	(F)
1.	Cost or Basis of Asset:	\$	\$	\$
2.	a) FMV <u>Before</u> Disaster: b) How did you determine this value (appraisal, personal estimate, other)?	\$	\$	\$
3.	a) FMV <u>After</u> Disaster: b) How did you determine this value (appraisal, personal estimate, other.)?	\$	\$	S
4.	Actual cost to repair and/or restore the asset:	\$	\$	\$
5.	Did the above repairs increase the fair market value of the asset over its pre-storm market value?	Yes or No	Yes or No	Yes or No
6.	Insurance Proceeds: (estimate if necessary)	\$ Received: Y or N	\$ Received: Y or N	\$ Received: Y or N