

Casualty Loss Deductions for Tax Purposes

Taxloss.cas

by

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The tremendous property damage caused by hurricanes Charley and Frances, to homeowners and businesses has spawned numerous tax-related questions. Property owners, looking for some economic relief to their situation, are asking what they can or should do to properly claim an income tax deduction for their losses. The following is a general summary of the income tax rules and regulations regarding casualty loss deductions. It is a useful starting point for clarifying tax-related questions that are commonly asked. Because individual circumstances vary, however, taxpayers are encouraged to seek additional advice from their professional tax preparer and other detailed IRS publications.

Business or Nonbusiness Property:

The first distinction that must be made is whether the damaged property was owned for business or nonbusiness (i.e. personal use) purposes. The limits on the amount of the tax deduction allowed and the methods of reporting are different. Also, timber held for investment has some unique tax-related characteristics.

Nonbusiness Property

For nonbusiness property--such as a house used as a personal residence, trees on a residential lot, personal property, car, etc. --- the amount of casualty loss is the **smaller** of the **decrease in the fair market value (FMV)** of the property caused by the casualty, or the **adjusted basis** (i.e. remaining cost) of the property. In other words, a taxpayer cannot deduct more than their cost invested in the property. This amount is then reduced by an insurance claim payment or other reimbursement received. The costs of cleaning up after the property, repairing or replacing the property, temporary housing, rental car expenses, or other incidental expenses **are not** part of the casualty loss.

Determining the loss in fair market value of the property is the hard part. FMV before and after the casualty must be proven and documented. This is commonly done through a property appraisal by a competent, experienced professional. Photographs taken before and after the casualty along with other property records are useful in this process. Establishing the FMV loss of trees is more difficult than for houses, cars, and personal property. However, there are well-established guidelines for doing so used by arborists, professional foresters, tree and landscape appraisers. Landscape and forestry specialists in the Cooperative Extension Service can direct homeowners to publications related to tree valuation and appraisal.

Although certain costs mentioned previously are not part of the casualty loss itself, they can be used as a measure of the loss in FMV in lieu of an appraisal. The cost of cleaning up, making repairs, and restoring property or the landscape as near as possible to its condition prior to the casualty may be used as a measure of the decrease in FMV. If the repairs are not excessive, are for the damage only, and do not increase the FMV beyond its value prior to the casualty, these expenses

may be used as a measurement of FMV loss.

Thus, it is important for property owners to document the loss in fair market value as soon as possible, to know their cost basis in property, and to record insurance payments as well as expenses related to the casualty.

Limit on Deductions

The amount of casualty loss after insurance reimbursements are figured in is not the amount of **deductible** loss for tax purposes. The loss after insurance reimbursement must be reduced by \$100 and 10% of the taxpayers adjusted gross income. In other words, the first \$100 cannot be deducted, (\$100 rule) and only the amount of loss that exceeds 10% of a taxpayers adjusted gross income is deductible (10% rule). Adjusted gross income is the amount reported on line 33 of the taxpayer's 1040 form.

Furthermore, casualty losses above the \$100 rule and 10% rule must be calculated using Form 4684 and listed as an itemized deduction on Schedule A of the taxpayer's return. For taxpayers who do not normally itemize their deductions, this may have the effect of further reducing the effective deduction they may be entitled to from a casualty loss.

The bottom line, in practical terms, is that numerous homeowners who suffered an economic loss of property not fully covered by insurance will not have a deductible loss for tax purposes. The 10% rule and requirement to itemize wipes out their tax deduction. It is also possible, in the case of two taxpayers who have nearly identical amounts of casualty loss, that one will have a tax deduction and the other will not because their incomes are different. Renters, who often don't itemize, are at an additional disadvantage.

Federal Disaster Area Designation

Does living in a declared federal disaster area change the rules? Not much. The only difference this makes to a taxpayer for casualty loss purposes is that the taxpayer is allowed to take the loss, if any, in the prior tax year. In other words, instead of waiting until 2004 tax returns are filed (in 2005) to deduct a 2004 casualty loss, the taxpayer can choose to amend the 2003 return if they wish and file for whatever refund would result from having an additional tax deduction. The other rules for calculating the loss, the \$100 rule, and 10% rule remain the same.

The other effect is for a taxpayer who actually has a gain from the casualty (strange as that may sound), the two-year period for replacing property in order to postpone taxation of the gain is extended to four years for the replacement of the principal residence.

For individuals living in an area declared a disaster by the President, the IRS will abate interest on income tax for the length of any extension granted for filing income tax returns and paying income tax. For other taxpayers (corporations for example) the same abatement rules apply if these taxpayers are in a federally declared disaster area.

Business Property

If the casualty causes damage to property held for business purposes, i.e., for producing

income, the casualty loss is calculated in the same way with one important exception. There is no deduction limit, no \$100 or 10% rules, and the loss is not reported as an itemized deduction. The entire casualty loss, after insurance reimbursement, is deductible. In addition, incidental expenses for cleanup, temporary rentals, and minor repairs may be deducted as ordinary business expenses. Major repairs and replacement costs may have to be capitalized, however, and deducted as depreciation over time. If the loss occurs in a federal disaster area, the same rules for deducting the loss early and postponing any gain apply.

Therefore, the owner of business property must also determine the loss in fair market value and the cost basis of the property. Losses of property that has no cost basis, such as growing crops and raised livestock are not deductible; the ordinary expenses in raising them are deducted. Purchased products and products held in inventory that are lost due to a casualty may or may not be deductible depending on whether the cash or accrual method of reporting taxes is used.

Example

Hurricane Frances caused damage to a taxpayer's property that reduced its FMV by \$25,000. The adjusted cost basis of the property is \$85,000, and the insurance company reimbursed the owner \$20,000 for the loss. Since the loss in FMV is less than the adjusted basis, the \$20,000 insurance payment is subtracted from \$25,000 for a tentative casualty loss of \$5,000. If the property was used in a business, the entire \$5,000 is deductible.

If the property is nonbusiness property, the \$5,000 is reduced further by the \$100 rule to \$4,900. If the taxpayer has \$49,000 or more adjusted gross income (AGI), the net casualty loss is zero since 10% of \$49,000 equals \$4,900. If the taxpayer has less than \$49,000 AGI, the casualty loss is \$4,900 minus 10% of AGI. This amount would be listed as an itemized deduction on Schedule A of the tax return. Total itemized deductions would have to be greater than the taxpayer's standard deduction to realize any benefit from the casualty loss.

The taxpayer could wait to take the deduction on his upcoming 2004 tax return or, if located in a federal disaster area, amend the 2003 tax return, apply the deduction there, and seek a tax refund now.

Timber

The loss of standing timber from the hurricanes resulted in major economic losses to owners of timberland. However, this economic loss does not result in a casualty tax loss of equal amount for most taxpayers. Indeed, for many, there is little if any deductible loss. In many instances, where the downed timber is salvaged and sold, there is actually a taxable gain rather than a taxable loss. That is certainly not the news that most timber owners are anticipating.

The most important piece of information that must be documented in determining the gain or loss on timber is the adjusted basis in the timber. This is, in a broad sense; the amount of money invested in the timber itself but not the amount in the land on which the timber stands. On timber that has been previously cut by the current owner, the basis would be the cash outlay incurred in previous years to reforest cutover woodland or to plant bare land to trees. If the landowner allowed the land to reforest naturally with no cash outlay, the timber stand has no basis. If the landowner has no record of cash outlays, there is no documented basis. Since a casualty loss cannot exceed the basis in the timber, owners with no basis or a low basis have little or no casualty loss to deduct.

When a tract of land has been purchased after it was last cut and reforested, the timber basis is the portion of the purchase price allocated to the timber apart from the land, buildings, fences,

wells, and other items of value. Timberland acquired by inheritance has a basis equal to the fair market value of the timber as appraised at the time of the deceased's estate settlement. The basis of property received by gift is generally the same as the basis of the person who gave the gift.

In situations where a landowner acquired a parcel of land at some past time and never documented a basis, an estimate of the volume and value of the timber at the time of acquisition (purchase, inheritance, or purchase by the donor of a gift) must be made. The procedure for arriving at this estimate is called a back cruise. However, back cruising is permissible in determining basis only if done while trees are standing. Once trees are cut, tax laws prohibit back cruising.

If a casualty completely destroys a timber stand with no opportunity for salvage, the amount of basis minus insurance recovery is the maximum casualty loss that can be claimed. If the insurance recovery exceeds the basis, the taxpayer has a taxable gain instead of a loss.

Timber that is damaged but not completely destroyed may often be salvaged. If salvage is not possible, the taxpayer is allowed a partial casualty loss. The owner must determine what percentage of the timber stand has been lost (depleted) and then must multiply that percentage times the timber basis. Insurance reimbursement is applied against this depletion amount, resulting in the final amount of casualty loss or taxable gain. In the case of timber being salvaged after the casualty, the amount received from salvaged timber is treated as a sale, along with insurance proceeds. The total sales amount minus any costs of selling minus part of the basis (the depletion amount) gives the amount of gain or loss. Timber salvaged often results in a taxable gain rather than a casualty loss, not the result a taxpayer is anticipating.

Because gains and losses depend on the amount of timber basis individual taxpayers have, the same damage done to adjacent tracts of timber may produce a large casualty loss for one owner, a small loss for another, no loss for another, and a gain for yet another timber owner.

Tax Deferral of Gain

A casualty may result in a gain rather than loss. For business property, this is most often the case when the insurance proceeds exceed the remaining basis of the property lost. For timber, this is most often the case when timber is salvaged after the casualty. With nonbusiness property, gain is less likely, though not impossible, to occur from a casualty. If a net gain does result in either of the cases, income taxes on the gain can be deferred if the gain is reinvested in certain "like-kind" property. The taxpayer has a two year time period to make the like-kind replacement.

Reduction of Basis

When a casualty loss is deducted, the taxpayer must reduce the basis in the property by the same amount. In a total loss of property, this is a moot point, but in a partial loss where the property still exists, this becomes part of the property records a taxpayer must keep.

Summary

Economic relief from losses due to hurricanes Charley and Frances through the Internal Revenue Service may not be as easy to get as taxpayers would like to believe. Or, as they may be led to believe by incomplete information coming from taxpayer word-of-mouth, some tax preparers, and even pronouncements of some public officials. While some taxpayers suffering losses may indeed be able to claim a casualty loss and amend last year's tax return to claim a tax refund, most will find little if any tax relief in a process that is not simple to complete. Property owners who think they may have a loss beyond the amount they were paid from insurance reimbursement should study the casualty loss rules carefully. They should also seek further advice, especially in determining the reduction in fair market value and in interpreting the cost basis of their property.

Information

Further information on casualty losses can be found in IRS Publication 17, "Tax Guide for Individuals, 2003", IRS Publication 547, "Casualties, Disasters and Thefts, 2003", IRS Publication 334, "Tax Guide for Small Businesses, 2003", and IRS Publication 225, "Farmers Tax Guide, 2003". These may be obtained by calling 1-800-829-1040 or 919-733-4684. Information on timber may be found in a publication of the North Carolina Cooperative Extension Service, publication AG-296, "Federal Income Taxes for North Carolina Timber Growers. Professional tax preparers may have additional information.