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Taking Some Sting out of the Loss: Casualty Loss Deductions on Individual Income Tax Returns

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Major storms recently have caused massive destruction across broad areas of the United States. Many who live and work in the affected areas have suffered significant losses as a result. When such disasters occur, there are tax provisions available that can provide some relief for losses to property.

This article focuses on the casualty loss provisions available to individual taxpayers.

Casualty Losses

A casualty loss can occur when property is damaged or destroyed as a result of a sudden, unexpected, or unusual event such as the recent storms and floods in Texas, Louisiana, Florida, and Puerto Rico. The rules for calculating a casualty loss depend on the type of property that was damaged or destroyed.

Personal-Use Property

A taxpayer may have experienced a loss with respect to his home and furnishings, which is personal-use property. To determine the amount of the casualty loss for personal-use property, the taxpayer must first determine the adjusted basis of the property before the disaster, as well as the decrease in fair market value ("FMV") of the property as a result of the disaster.[1]

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[1] Section 1.165-7(b)(1). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

The decrease in FMV is the FMV of the property immediately before the casualty *less* the FMV of the property immediately after the casualty.[2] Thus, the decrease in FMV is measured just after the loss has taken place and before cleanup has begun.

To determine the decrease in FMV,***** a taxpayer generally needs a competent appraisal.

However, the cost of repairs may be accepted as evidence of the change in value, but only if:

- The repairs were actually made,
- The repairs were necessary to bring the property back to its condition before the casualty,
- The amount is not excessive,
- The repairs take care of damage only, and
- The value of the property after the repairs is not more than the value of the property before the casualty, simply as a result of the repairs.[3]

***Items not considered when figuring decrease in FMV:**

- Amounts spent to insure or protect property against a storm
- Related expenses (temporary housing, rental car) but may be deductible business expense if damaged property is business property
- Replacement cost of property
- Sentimental value
- General decline in market value of property in or near casualty area
- Cost of photos and appraisals used as evidence of property's value and condition (but may be claimed as a miscellaneous itemized deduction subject to the 2% floor)

The costs of cleaning up a home before repairs can be made are not deductible as part of the casualty loss, but they may be used as a *measure* of the loss. For example, if the taxpayer is using the competent appraisal approach, actual clean-up costs can be used as a measure of the loss.[4] If the taxpayer is using the cost of repairs method to determine the decrease in FMV, then the clean-up costs can be added to the cost of repairs.[5]

2 Section 1.165-7(b)(1)(i).

3 Section 1.165-7(a)(2).

4 Walton v. Commissioner, T.C. Memo. 1961-130 (May 12, 1961) (The decrease in FMV is measured immediately after the loss has taken place and before clean up. Thus, the amount of the loss equals the permanent decrease in the property's value plus the amount to be spent for cleaning up the damage. This is because the price the property owner could receive for the property immediately after the casualty would be its bargained-for value less the cost of cleaning up the damage.)

5 IRS Publication 547.

KPMG Note: A taxpayer may not use the property value stated in his most recent property tax statement to establish the FMV of the property before the casualty. A taxpayer must establish the FMV of the property before the casualty by either an appraisal or the cost of repairs method discussed above.[6]

Then, from the smaller of the adjusted basis or the decrease in FMV, the taxpayer must subtract any insurance or other reimbursement received (or reasonably expects to receive). The difference is the amount of the casualty loss.

KPMG Note: Money received from an employer's emergency disaster relief fund that must be used to restore or replace the taxpayer's damaged property reduces the taxpayer's unreimbursed loss, similar to an insurance reimbursement. However, any excludable cash gifts that a taxpayer receives that have no restrictions on their use (for example, from relatives and friends) do not reduce the taxpayer's casualty loss, even if the money was used to pay for repairs to property damaged in the disaster.

After the amount of the casualty loss has been determined, the next step is to determine how much is actually deductible. Losses on personal-use property are generally subject to a $100 deductible per event, as well as a 10 percent of adjusted gross income ("AGI") reduction.[7] However, under recently enacted legislation, the deductible is changed to $500 for taxpayers affected by Hurricanes Harvey, Irma, and Maria, and the 10 percent of AGI reduction has been eliminated.[8]

Generally, if a single casualty affects more than one item of property then the loss is calculated separately for each item damaged or destroyed, but a special rule applies to personal-use real property, such as a taxpayer's home. When figuring a loss for personal-use real property, the entire property including improvements, trees, and shrubs are considered together.[9] The loss is figured separately for other items of property such as furniture.

❖ *An Example to Help Illustrate*

A hurricane damaged Sandy's principal residence and several furnishings inside the home. She purchased the home, which included the land for $320,000 many years ago. The FMV of the property immediately before the storm was $350,000 and its FMV immediately after the storm was $150,000. Sandy collected $100,000 from the insurance company with respect to the home.

As mentioned, her household furnishings were also damaged. She separately calculated the loss on each household item and arrived at a total loss of $12,000. She received $2,000 in insurance reimbursements for the furnishings.

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6 IRS FAQs for Disaster Victims - Casualty Loss (Valuations and Sections 165 (i)).

7 Section 165(h); section 1.165-7(b)(4).

8 Disaster Tax Relief and Airport and Airway Extension Act of 2017, H.R. 3823, 115th Congress, section 504(b)(1)(B) (Sept. 29, 2017).

9 Section 1.165-7(b)(2)(ii), IRS Publication 547.

As discussed above, the first step in determining the casualty loss is to calculate the lesser of the adjusted basis or the decrease in FMV. In Sandy's case, this is $200,000. Then, she must subtract insurance reimbursements ($100,000) to determine the total loss on the real property—$100,000.

The next step is to determine the loss on the furnishings by taking the total loss minus insurance reimbursements ($12,000 – $2,000 = $10,000), and then adding the total loss on real property with the loss on the furnishings together to determine the total casualty loss of $110,000.

KPMG Note: Use IRS Publication 584 to help determine the loss on all the furnishings in the home. This is a workbook that contains schedules to help the taxpayer figure the loss on the main home, contents and motor vehicles.

From there, the limits with respect to personal-use property should be applied, so the $500 deductible must be subtracted. As illustrated below, the allowable casualty loss deduction for Sandy's home and furnishings is $109,500.

Adjusted basis	$320,000
FMV before storm	$350,000
FMV after storm	$150,000
Decrease in FMV	$200,000
Loss (smaller or Adjusted Basis or Decrease in FMV)	$200,000
Subtract insurance	$100,000
Loss on home after reimbursement	$100,000
Loss on furnishings	$12,000
Subtract insurance	$2,000
Loss on furnishings after reimbursement	$10,000
Total loss	$110,000
Subtract $500	$500
Casualty Loss Deduction	$109,500

Rental Properties

A taxpayer may also have experienced a loss with respect to a home that was used as a rental that is business or income-producing property.

For rental properties, the determination of the casualty loss is the same as for personal-use property, taking the lesser of the adjusted basis or FMV decline as a result of the casualty. However, if the property was completely destroyed, and if the FMV of the property immediately before the casualty is less than the adjusted basis, then the loss is calculated by taking the adjusted basis in the property and subtracting any salvage value. Then, any insurance or other reimbursement must also be subtracted.[10]

As mentioned previously, if a single casualty affects more than one item of property, then the loss is calculated separately for each item damaged or destroyed. We discussed how a special rule applies for personal-use real property so that all items (i.e., buildings, trees, shrubbery, etc.) are added together, but this rule does not apply to business-use properties.[11]

KPMG Note: Use IRS Publication 584-B to help determine the loss on business-use property.

The resulting casualty loss is *not* further reduced by any deductible or AGI limitations.[12]

Reporting

The resulting casualty loss for the personal-use property is reported on Form 4684, *Casualties and Thefts*, and the allowable loss flows to Schedule A as an itemized deduction, not subject to the two percent floor.[13] It is important to note that typically in order to claim the casualty loss, the taxpayer must itemize deductions. However, under the recent disaster relief legislation taxpayers affected by Hurricanes Harvey, Irma, and Maria can add their casualty loss to the standard deduction.[14]

For rental properties, a casualty loss is reported on Form 4684 and Form 4797, *Sales of Business Property*. Losses are not limited by the passive activity loss rules.[15]

Timing of the Deduction

A casualty loss may be claimed in the tax year the loss occurred although taxpayers in a Federal Disaster Area have the option of claiming disaster-related casualty losses in the preceding tax year.[16] This allows taxpayers to accelerate the loss and receive a cash refund quicker, which can be used to repair or replace damaged property.

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[10] Section 1.165-7(b)(1).

[11] Section 1.165-7(b)(2).

[12] Section 1.165-7(b)(4).

[13] Section 67(b)(3).

[14] H.R. 3823, section 504(b)(1)(C).

[15] Section 1.469-2(d)(2)(xi); Notice 90-21, 1990-1 CB 332.

[16] Section 165(i); section 1.165-11.

Victims of Hurricanes Harvey, Irma, and Maria have until October 15, 2018, to amend their 2016 tax returns and claim the casualty loss that occurred in 2017. [17] Taxpayers who haven't yet filed their original 2016 returns because they had an extension until October 15, 2017, will have until January 31, 2018, to file their original 2016 tax returns due to the IRS provided relief.[18]

KPMG Note: If a taxpayer has not yet filed his 2016 return and he can gather all the information needed to claim the casualty loss by January 2018, he could claim the casualty loss on an originally filed 2016 return by January 31, 2018. Otherwise, he can amend the 2016 return by October 15, 2018, to claim the casualty loss on the 2016 return. Or, because the disaster occurred in 2017, he can claim the casualty loss on his 2017 return.

KPMG Note: If a taxpayer owns several parcels of real estate that are damaged by a federally declared disaster, all related losses that qualify for the election must be reported on the 2016 year tax return (original or amended). The taxpayer may not elect to claim a casualty loss on one property on the 2016 tax return and a casualty loss on other property on the 2017 tax return.[19]

Casualty Gain

It is important to know that it is possible for a taxpayer to realize a gain if an insurance payment or other reimbursement is more than the taxpayer's adjusted basis in the property. The gain is the amount received minus the adjusted basis in the property.

If the taxpayer's principal residence was destroyed and the insurance proceeds resulted in a gain, the taxpayer can treat this as a sale of residence and the gain can be excluded as if the taxpayer sold the home, subject to the rules of Internal Revenue Code section 121.[20]

If the gain is more than the section 121 exclusion amount and the property is located in a Federally Declared Disaster Area, the taxpayer can postpone the gain if a new home is purchased within four years of the end of the year the disaster occurred.[21]

The gain is reported as income in the year the reimbursement is received on both Form 4684 and Schedule D of the Form 1040.

For business use property, a taxpayer has two years from the close of tax year when the gain is realized to replace the property and defer the gain.[22]

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[17] Section 1.165-11T; IRS Publication 547.

[18] IR-2017-135 (Aug. 28, 2017); IR-2017-150 (Sept. 12, 2017); PR 2017-02 (Sept. 22, 2017); Tax Relief in Disaster Situations on the IRS website.

[19] Section 1.165-11T(c).

[20] Section 121(d)(5)(A); section 1.121-4(d)(1); IRS Publication 547.

[21] Section 1033(h)(1)(B); IRS FAQs for Disaster Victims – Realized Gain on Main Home; Form 4684 Instructions.

[22] Section 1033(a)(2)(B); IRS Publication 547.

Adjusted Basis

It is important to note that the taxpayer's basis in damaged or destroyed property must be reduced by the allowable casualty loss deduction. Basis is further reduced by any insurance or other reimbursement received. Amounts spent to repair or restore a property to its pre-casualty condition increases the taxpayer's basis in the property.[23]

New basis calculation

Basis before casualty
- *Less:* Casualty loss deduction
- *Less:* Insurance or other reimbursements received
- *Plus:* Cost of restoration or repairs

= Basis after casualty

Conclusion

Many taxpayers may find themselves with insufficient insurance coverage (if any) to fully compensate for the damage they have suffered when a natural disaster strikes, like the recent hurricanes. In these cases, it is particularly important to carefully document and substantiate their financial losses, and talk to a trusted tax adviser to determine if a casualty loss deduction may be available. While the devastation and destruction caused by major storms and casualties can be difficult to overcome emotionally and physically, the available tax relief may take some of the sting out of the loss.

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[23] Rev. Rul. 71-161, 1971-CB 76; IRS Publication 551, Basis of Assets.