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Update: Casualty Loss Deductions on Individual Income Tax Returns

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Last year, *What's News in Tax* published an article about casualty losses. The article, "Taking Some Sting out of the Loss: Casualty Loss Deductions on Individual Income Tax Returns," described in detail how taxpayers should account for losses incurred on personal real property and belongings as a result of the 2017 hurricanes and tropical storms. Since its publication, the IRS issued guidance providing alternative ways to calculate the amount of the loss. This article is an update to the earlier one.

If an individual incurred losses to personal-use residential property or personal belongings as a result of major storms or natural disasters, a specific method must be used to calculate the amount of the casualty loss that can be taken on a tax return. Generally, to calculate the amount of the casualty loss, a taxpayer must determine the decrease in the fair market value ("FMV") of the damaged property using either a competent appraisal or the cost of repairs actually made.

Safe Harbor Methods

However, in 2018, the IRS released Revenue Procedures 2018-09 and 2018-08, which provide safe harbor methods that allow the taxpayer to determine the decrease in the FMV of the personal-use residential real property in other ways. The safe harbor methods summarized below are subject to additional rules and exceptions. Please see the applicable revenue procedures for more information.

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Revenue Procedure 2018-09[1]

Revenue Procedure 2018-09 provides a safe harbor method, under which individual taxpayers may use one or more cost indexes to determine the amount of loss to their homes as a result of specific hurricanes and tropical storms in 2017—Hurricane and Tropical Storm Harvey, Hurricane Irma, and Hurricane Maria. The cost indexes provide tables with cost per square foot for Texas, Louisiana, Florida, Georgia, South Carolina, Puerto Rico, and the U.S. Virgin Islands.

The cost indexes safe harbor method may be used if a taxpayer suffered any of the following:

- A total loss of a personal residence
- A near total loss of a personal residence
- Interior flooding over one foot in a personal residence
- Structural damage from wind, rain, or debris to a personal residence
- Roof damage from wind, rain, or debris to a personal residence
- Damage to a detached structure
- Damage to decking

Tables and calculation methods are provided to determine the decrease in the FMV for each category based on the cost per square foot or percentage of damage, the size of the property, and the geographic location.

Revenue Procedure 2018-08[2]

Revenue Procedure 2018-08 also provides safe harbor methods for taxpayers to use in determining the amount of their casualty and theft loss to a personal use residential real property and personal belongings and is not for any specific geographic area as a result of a specific hurricane or tropical storm.

Personal-Use Residential Real Property

The following safe harbor methods are available through Revenue Procedure 2018-08:

- Estimated repair cost method
- De minimis method
- Insurance method

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[1] https://www.irs.gov/forms-pubs/cost-indexes-safe-harbor-method-to-calculate-hurricane-related-losses-to-personal-use-residential-real-property-updated

[2] https://www.irs.gov/forms-pubs/rda-2017-12-14-2018-rev-proc-08

- Federally declared disaster method—contractor safe harbor
- Federally declared disaster method—disaster loan appraisal

The estimated repair cost safe harbor method allows a taxpayer to determine the decrease in the FMV of property using the lesser of two repair estimates prepared by separate and independent licensed contractors. The estimates must detail the itemized costs to restore the property to its condition immediately before the casualty. This method is limited to casualty losses of $20,000 or less before the application of the limits under section 165(h).[3]

The de minimis safe harbor method allows the taxpayer to determine the decrease in the FMV of property based on a written good faith estimate of the cost of repairs required to restore the property to its condition immediately before the casualty. This method is available for casualty losses of $5,000 or less before the application of the limits under section 165(h).

The insurance safe harbor method allows the taxpayer to determine the decrease in the FMV of property based upon the estimated loss in reports prepared by the taxpayer's homeowners' or flood insurance company. These reports must set forth the estimated loss sustained from the damage to or the destruction of the property.

If the loss occurred in a disaster area and was due to a federally declared disaster then the taxpayer may use the contractor safe harbor method or the disaster loan appraisal method.

Under the contractor safe harbor method, the taxpayer may use the contract price for the repairs specified in a contract prepared by an independent and licensed contractor to determine the decrease in FMV of property. This method does not apply unless the taxpayer is subject to a binding contract signed by the taxpayer and the contractor setting forth the itemized costs to restore the property to its condition immediately before the casualty.

Under the disaster loan appraisal safe harbor method, the taxpayer may use an appraisal prepared to obtain a loan of federal funds or a loan guarantee from the federal government that identifies the estimated loss from a federally declared disaster to determine the decrease in FMV.

Personal Belongings

The safe harbor methods for personal belongings are the de minimis method and the replacement cost safe harbor method for federally declared disasters. Under the de minimis method, the taxpayer can make a good faith estimate of the decrease in the FMV of personal belongings. The taxpayer must maintain records describing the affected personal belongings as well as the methodology used for estimating the loss. This method is limited to losses of $5,000 or less before the application of the limits under section 165(h).

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[3] 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 replacement cost safe harbor method for federally declared disasters allows the taxpayer to determine the FMV of personal belongings located in a disaster area immediately before a federally declared disaster to calculate the amount of the loss. To use this method, the taxpayer must first determine the current cost to replace the personal belonging with a new one and then reduce that amount by 10 percent for each year the taxpayer owned the personal belonging.[4] If the taxpayer chooses to use this method, then the method must be applied to all personal belongings for which the taxpayer is claiming losses under section 165, with certain exceptions identified in Revenue Procedure 2018-08.

Proof and Documentation

If a taxpayer qualifies for and uses the safe harbor methods discussed above, the IRS will not challenge the determination.

The use of these safe harbor methods is not mandatory. A taxpayer may decide to use the actual reduction in the FMV of personal-use residential real property or personal belongings, pursuant to section 1.165-7(a)(2) if the individual has proper substantiation.

Reporting

If a taxpayer uses a safe harbor method described in Revenue Procedure 2018-09 or 2018-08, a statement must be attached to Form 4684, *Casualties and Thefts*. That statement should indicate that Revenue Procedure 2018-09 or Revenue Procedure 2018-08 was used to determine the amount of the casualty loss and should indicate the specific table number or specific safe harbor method used. When completing Form 4684, the taxpayer should not enter an amount on line 5 or line 6 for each property, but should instead enter the decrease in the FMV determined under the safe harbor method on line 7.

[4] See "Personal Belongings Valuation Table" in Revenue Procedure 2018-08 in the replacement cost safe harbor method.