Casualty and Theft Losses

INTRODUCTION

Taxpayers may deduct both business and personal casualty or theft losses. Business casualty and theft losses are taken as a business deduction. Casualty losses are an itemized deduction for individuals. There are limitations on the deductible amount for individuals. Employee casualty losses, are not deductible. One of the primary benefits of casualty losses is that personal use property can be deducted.

The Tax Cut and Jobs Act of 2017 (TCJA) limits the deduction for personal casualty and theft losses to those attributable to federally declared disasters, effective for losses incurred in taxable years beginning after December 31, 2017, through December 31, 2025. Business casualty and theft losses do not have to be part of a federally declared disaster.

The Disaster Tax Relief and Airport and Airway Extension Act of 2017 created special provisions for the Hurricanes Harvey, Irma, and Maria disasters.

Specifically, it waives the 10%-of-AGI floor and raises the $100 threshold to $500. It also allows the casualty loss to be added to the standard deduction if the taxpayer does not itemize deductions. The TJCA has expanded these special provisions to include all 2016 and 2017 disasters.

Sec. 165(i)(1) permits individuals who suffer a federally declared disaster area loss to elect to take the loss in the taxable year immediately preceding the taxable year in which the disaster occurred. The purpose of this provision is to expedite the tax savings from the loss deduction.

Taxpayers report gains and losses from casualties and theft on Form 4684.

QUALIFYING EVENTS

A **casualty** is an event that is sudden, unexpected, or unusual. A qualified casualty loss is deductible in the year sustained. Examples include losses arising from a fire, storm, or shipwreck.

A sudden event is swift and abrupt. Gradual or progressive deterioration, whether from exposure to the elements or standard operation, does not give rise to a casualty loss. Progressive deterioration includes rust, rot, gradual erosion, and insect infestation.

EXAMPLE: Craig has a business shed that was destroyed in an avalanche. An avalanche qualifies as a sudden event because the timing is nearly immediate. If the shed were destroyed due to long-term exposure to winds, the loss would be due to gradual deterioration and would not qualify as sudden. However, the adjusted basis would be deductible as a business loss.

An unexpected event is unanticipated and unintended. Unexpected events include accidents and damage from faulty equipment.

An unusual event is (1) both extraordinary and nonrecurring and (2) neither a day-to-day occurrence nor typical in the activity in which the taxpayer is engaged.

EXAMPLE: A taxpayer owned 40 ornamental pine trees that were considered healthy. In 10 days, southern pine beetles infested and killed all 40 trees. This pine beetle attack was the first in the region, which qualifies the event as unusual, allowing the taxpayer to deduct the casualty loss [Rev. Rul. 79-174]. This loss would have to have been a business loss to be deductible unless part of a federally declared disaster.

Casualty losses must be considered permanent in nature, not merely a decline in value.

EXAMPLE: A taxpayer's well is contaminated during a declared federal disaster, resulting in the loss of drinking water for 3 months. The casualty is considered temporary and is not deductible [Dow, 16 TC 1230].

EXAMPLE: A series of storms, declared a federal disaster, caused erosion of a sandy beach in front of a taxpayer's residence. While the series of storms may be considered sudden events, the casualty loss was disallowed, in part, because the loss was temporary and the sandy beach is expected to naturally regenerate [Beyer, TC Memo 1993-313].

A taxpayer is subject to special rules if a loss is sustained in a federally declared disaster area. Disaster loss treatment is available when a personal residence is rendered unsafe due to the disaster in the area and is ordered to be relocated or demolished by the state or local government.

QUALIFYING PROPERTY

Proof of Loss

To deduct a casualty or theft loss, a taxpayer must be able to show that there was a casualty or theft. The taxpayer must be able to support the amount taken as a deduction. All of the following must be shown for a casualty loss:

- The type of casualty (e.g., car accident, fire, storm) and when it occurred.
- That the loss was a direct result of the casualty. The cause of the casualty need not be proved [Dvorkovitz, TC Memo 1966-11].
- That the taxpayer was the owner of the property or, if the property is leased from someone else, that the taxpayer was contractually liable to the owner for the damage.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Additionally, a taxpayer should have records to prove the deduction. If the actual records to support the deduction are not available, other satisfactory evidence to support the deduction can be used.

Ownership Requirement

In general, a taxpayer must own or lease the damaged property in order to claim a casualty loss.

Except for property held by spouses, losses of property owned by more than one person are allocated between the owners on the basis of their proportionate interests in the property.

When spouses file a joint return, it does not matter which spouse owned the property. If married taxpayers file separate tax returns, each spouse takes a deduction according to his or her ownership interest. If spouses own property as tenants by entirety, each spouse is entitled to claim half of the loss. If the property is owned solely by one spouse, the owner may claim the entire deduction. In community property states, a deduction on a separate return is allowed only to the extent of that spouse's community interest.

The ownership requirement ordinarily prevents a parent from taking a deduction for a casualty or theft of his or her child's property. Under the laws of some jurisdictions, parents retain title to clothing and similar items given to a child in the absence of proof of a gift. This ownership interest, coupled with the legal obligation of the parent to support the minor and replace such items, has been found to support a casualty loss deduction by a parent when these items were destroyed.

CALCULATING THE REALIZED LOSS

To determine the deduction for a casualty or theft loss, the realized loss must first be determined. The **realized gain or loss** is the actual amount of benefit or loss incurred by the taxpayer. Once the realized loss is determined, additional adjustments may be made for calculating the deductible (or recognized) loss, which may be deducted on the tax return.

The realized loss is calculated by determining the lesser of (1) the taxpayer's adjusted basis in the property or (2) the property's decrease in fair market value (FMV) caused by the casualty and subtracting any insurance or other reimbursement received or expected to be received.

EXAMPLE: Judy has a painting that was destroyed by a fire. Judy purchased the painting for $10,000, it had a value of $12,000 before the fire, and the value after the fire is $50. Judy receives $8,000 from her insurance company. When calculating the loss, the asset's adjusted basis of $10,000 is less than the decrease in FMV of $11,950 ($12,000 – $50), so the adjusted basis is used. The $8,000 insurance proceeds are applied against the $10,000 adjusted basis to calculate a $2,000 realized loss.

Decrease in FMV

The decrease in FMV used to figure the amount of the casualty or theft loss is the difference between the property's FMV immediately before and immediately after the casualty or theft. **FMV** is the price at which the property would be sold between a willing buyer and a willing seller, each having knowledge of the relevant facts. The FMV of property immediately after a theft is considered to be zero.

A casualty loss deduction is allowed only for actual physical damage to property; a decrease in value to property because of the possibility of a future casualty is not deductible [Fryer, TC Memo 1974-77; Peterson, 30 TC 660 (1958); Kendall, TC Memo 1958-163; Landy, TC Memo 1979-354].

EXAMPLE: The 9th Circuit Court of Appeals denied a deduction for the decrease in FMV of a home. A landslide ruined three houses close to Harvey's property, but it did not damage his property. Harvey attempted to deduct a casualty loss for the decrease in FMV, which was denied by the court [*Pulvers v. Comm.*, 407 F2d 838].

However, the 11th Circuit ruled that when a flood permanently reduced the market value of a home, the reduction in market value, as well as the physical damage to the home, was deductible as a casualty loss. The permanent loss in value was because the flood, by totally destroying a number of homes near the taxpayer's home, changed the character of the neighborhood [*Finbohner v. U.S.*, 788 F2d 723].

-- Considerations

A competent appraisal is generally needed to determine the decrease in FMV because of a casualty or theft. The appraisal must recognize the effect of any general market decline that may occur, along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property. Several factors are important in evaluating the accuracy of an appraisal, including (1) the appraiser's familiarity with the property before and after the casualty or theft, (2) the appraiser's knowledge of sales of comparable property in the area, and (3) the appraiser's method of appraisal. A real estate tax assessment from the local taxing authorities is usually not accepted as a competent appraisal when determining the value of a loss with regard to real property [Emmett, 11 TC 90; Williams, TC Memo 1960-19].

The cost of repairing damaged property is not part of a casualty loss, and neither is the cost of cleaning up after a casualty. However, one court held that, in addition to the decline in value of the property before and after the casualty and cleanup, the amount of expense involved in cleaning up the wreckage and repairing the property could be added as a deductible loss because a third-party purchaser of the property would certainly reduce the offering price by the cost of such cleanup and repairs [*Smithgall v. U.S.*, D GA, 1980].

The cost of cleaning up or making repairs after a casualty can be used as a measure of the decrease in FMV if all of the following conditions are met: (1) the repairs are actually made, (2) the repairs are necessary to bring the property back to its condition before the casualty, (3) the amount spent for repairs is not excessive, (4) the repairs take care of the damage only, and (5) the value of the property after the repairs is not, due to the repairs, more than the value before the casualty [Reg. 1.165-7(a)(2)(ii)].

To use the cost-of-repairs method to substantiate a casualty loss, repairs expenditures must actually be made. Estimates cannot be used [Schmidt, TC Summ. Op. 2002-23].

The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. A loss may be measured by what was spent on (1) removing destroyed or damaged trees and shrubs, minus any salvage received; (2) pruning and other measures taken to preserve damaged trees and shrubs; and (3) replanting necessary to restore the property to its approximate value before the casualty.

For determining the decrease in FMV for a vehicle, automobile trade publications (e.g., Kelley Blue Book) may be useful in figuring the value of the taxpayer's car. The books' retail values can be used and modified by factors such as the mileage and condition of the car to figure the value. While the prices are not official, they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in the area.

-- Items Not Considered Casualty Losses

Losses sustained or amounts expended on the demolition of any building are not considered casualty losses; the cost must be added to the basis of the property on which the demolition occurred.

The cost of protecting property against a casualty or theft is not part of a casualty or theft loss. Additionally, the amount spent on insurance or to board up a house against a storm is not part of a loss. If the property is business property, these expenses are deductible as business expenses. If permanent improvements are made to property to protect it against a casualty or theft, add the cost of these improvements to the basis in the property. An example would be the cost of a dike to prevent flooding [Rev. Rul. 70-90].

Incidental expenses due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of a casualty or theft loss. However, they may be deductible as a business expense if the damaged or stolen property is business property or medical expense on Schedule A (Form 1040).

The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.

Sentimental value is not considered when determining a loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, the loss must be based only on its FMV.

Photographs taken after a casualty will be helpful in establishing the condition and value of the property. Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful. The costs of photographs and appraisals used as evidence of the value and condition of property damaged as a result of a casualty are not part of the loss; they are expenses in determining the tax liability. These costs can not be claimed as they are part of the prior miscellaneous itemized deduction subject to the 2%-of-AGI limit.

Insurance and Other Reimbursements

If an insurance or other type of reimbursement is received, the reimbursement must be subtracted when the loss is figured. There is no casualty or theft loss to the extent of reimbursement.

If the taxpayer expects to be reimbursed for part or all of the loss, the expected reimbursement must be subtracted when figuring the loss. The loss must be reduced even if payment is not received until a later tax year.

If property is covered by insurance, a timely insurance claim must be filed for reimbursement of the loss. When no claim is filed, no deduction is allowed for the portion of the loss that would otherwise be deductible.

EXAMPLE: Becky has an insurance policy on a business auto with a $500 deductible. If Becky is in an accident, because her insurance does not cover the first $500 of an auto collision, the $500 insurance deductible is considered a casualty loss. This is true even if she does not file an insurance claim because her insurance policy would never have reimbursed her for the deductible.

If money is received from an employer's emergency disaster fund and that money must be used to rehabilitate or replace a property on which the taxpayer is claiming a casualty loss deduction, the money must be taken into consideration in computing the casualty loss deduction. Take into consideration only the amount used to replace the destroyed or damaged property.

EXAMPLE: Kevin's home was extensively damaged by a tornado in a federal disaster area. His loss after reimbursement from his insurance company was $10,000. His employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. Kevin received $4,000 from the fund and spent the entire amount on repairs to his home. In figuring his casualty loss, Kevin must reduce his unreimbursed loss ($10,000) by the $4,000 he received from the employer's fund. His casualty loss before applying the deduction limit is $6,000.

Cash gifts received by a taxpayer are not included in taxable income. In general, any amounts received from an employer do not qualify as a gift. If cash gifts are received by a disaster victim and there are no limits on how the money can be used, the casualty loss is not reduced by these excludable cash gifts. This applies even if the money is used to pay for repairs to property damaged in the disaster.

Tax preparers should be aware that online crowd funding websites such as gofundme make it easier for victims of disasters or thefts to raise money from friends and family. The host may report the amounts received via a Form 1099-K if the amount reaches a certain threshold, e.g., $20,000. The tax preparer must determine how to report the information from the Form 1099-K. If the gift amount from Form 1099-K is not reported on the tax return, the computer flagging system used by the IRS will likely flag the return for review because there are payments reported to the IRS that are not on the taxpayer's return. There is no clear IRS guidance for how to report the gift. The taxpayer may elect to not report the amount on the face of the return and attach a statement that shows that the amount reported on Form 1099-K was a nontaxable gift. Alternatively, the taxpayer can treat the amount as other income and then add an offsetting line for nontaxable gifts.

EXAMPLE: Jean's home was damaged by a hurricane. Relatives and neighbors made cash gifts to her through a crowd funding website, and she received a Form 1099-K showing the receipt of payment. Jean used the cash gifts to pay for repairs to her home and other property damages. The amounts received as gifts are excludable from her income and do not reduce her casualty loss on the damaged home. Jean decides not to directly report the amounts received on her tax return but attaches a statement showing that the amount reported on the Form 1099-K she received is a nontaxable gift from friends and family.

Insurance proceeds that cover living expenses are not used for the casualty loss calculation if (1) the use of a primary residence is lost because of a casualty or (2) government authorities do not allow access to the principal residence because of the casualty or threat of one.

Any amount received by an individual as a qualified disaster relief payment is excluded from gross income under Sec. 139. A qualified disaster relief payment is any amount paid to or for the benefit of an individual

- To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster;
- To reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for the repair, rehabilitation, or replacement is attributable to a qualified disaster;
- By a person engaged in the furnishing or sale of transportation as common carrier by reason of death or personal physical injuries incurred as a result of a qualified disaster; or
- By a federal, state, or local government or agency or instrumentality thereof in connection with a qualified disaster in order to promote the general welfare.

The income exclusion rule does not apply to payments made by a governmental agency with respect to income replacement, e.g., lost wages, unemployment compensation insurance, or business income replacement payments. The exclusion does not apply to amounts received from insurance to cover expenses. Payments from a charitable organization whose purpose is to provide assistance to individuals affected by disasters may not fall under Sec. 139. However, such payments are treated as gifts and are therefore excluded from the recipient’s taxable income by virtue of Sec. 102(a) [Rev. Rul. 2003-12].

Loss on Business or Income-Producing Property

The decrease in FMV is not considered for business or income-producing property, such as rental property, that is stolen or completely destroyed. The taxpayer calculates the loss on business property as follows: adjusted basis in the property minus any salvage value minus any insurance or other reimbursement received or expected to be received.

EXAMPLE: Sue purchased a machine for use in her business for $20,000. The machine had an adjusted basis of $15,000 and a fair market value of $12,000 when it was destroyed in a fire. The machine was uninsured. Sue has a casualty loss of $15,000, the adjusted basis of the property.

Loss of Inventory

There are two ways a casualty or theft loss of inventory, including items held for sale to customers, can be deducted.

-- Option 1: Using Cost of Goods Sold

Deduct the loss through the increase in the cost of goods sold by properly reporting the opening and closing inventories. When using this method, do not claim this loss again as a casualty or theft loss. Any insurance or other reimbursement received for the loss is included in gross income when received.

-- Option 2: Deduct the Loss Separately

Eliminate the affected inventory items from cost of goods sold by making a downward adjustment to opening inventory or purchases. The amount of the loss is reduced by any reimbursement received. The reimbursement is not included in gross income. If the reimbursement is not received by the end of the year, a loss may not be claimed to the extent there is a reasonable prospect of recovery.

Leased Property

If the taxpayer is liable for casualty damage to leased property, the loss is the amount that must be paid to repair the property minus any insurance or other reimbursement received or expected to be received.

Multiple Assets Affected

Generally, if a single casualty or theft involves more than one item of property, the loss must be figured on each item separately. Then combine the losses to determine the total loss from that casualty or theft.

EXAMPLE: A building and fruit trees were damaged in the same casualty event. In determining the FMV of the property before and after the casualty, the decrease in value is measured by taking the building and trees into account separately, not together as an integral part of the realty, and separate losses are determined for both the building and the trees.

Personal Use Real Property

In figuring a casualty loss on personal use real property, the entire property, including any improvements (such as buildings, trees, and shrubs), is treated as one item. The loss is the smaller of (1) the decrease in FMV of the entire property or (2) the adjusted basis of the entire property after adjusting for any reimbursements.

CALCULATING THE DEDUCTIBLE LOSS

The deduction for casualty and theft losses of employee property and personal use property is limited. The deductible amount of casualty losses depends on the property and is shown as follows:

- A loss on employee property is not deductible; formerly subject to the 2%-of-AGI rule.
- A loss on property owned for personal use is subject to the $100 and 10% rules.
- Losses on business property (other than employee property) and income-producing property are not subject to these rules.
- If a casualty or theft loss involves a home used for business or rented out, the deductible loss may be limited.
- If the casualty or theft loss involved property used in a passive activity, the loss may be limited.

Employee property is property owned by the taxpayer and used in performing services as an employee. The casualty and theft loss deduction for employee property is not deductible.

Personal Use Property

After the casualty or theft loss on personal use property has been figured, that loss must be reduced by $100. This $100 reduction applies to each total casualty or theft loss event regardless of how many pieces of property are involved. Generally, events closely related in origin cause a single casualty. The event is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm. A single casualty may also damage two or more pieces of property, such as a hailstorm that damages both a taxpayer's home and a car parked in the driveway. The determination of whether damage to, or destruction of, property resulted from a single casualty or from two or more separate casualties is based on the particular facts of each case. In one example, a series of severe storms that produced unusual damage within a single month amounted to a single casualty [O'Neill, TC Memo 1983-583].

If more than one casualty or theft loss is incurred during a tax year, each loss must be reduced by $100.

If a taxpayer and spouse file a joint return, they are treated as one individual in applying the $100 rule. This is true even if the property is owned jointly.

If a married couple files separate returns, the allocation of the loss between the spouses is determined by the ownership. If one spouse owns the property, only that spouse can figure a loss deduction on a separate return. If the casualty or theft loss is on property owned as tenants by entirety, each spouse can figure the deduction on only half of the loss on separate returns. Neither spouse can figure the deduction on the entire loss on a separate return. Each spouse must reduce the loss by $100 on a separate return.

If two or more individuals (other than husband and wife filing a joint return) have a loss on property jointly owned, the $100 rule applies separately to each.

EXAMPLE: An unmarried couple live together in a home they own jointly and incur a casualty loss on the home. The $100 reduction applies separately to each individual.

After the amount of loss has been reduced by $100 for each event, the total of all casualty or theft losses on personal use property must be reduced by 10% of AGI. If a joint return is filed, both spouses are treated as one individual in applying the 10% rule. It does not matter if the property is owned jointly or separately. If separate returns are filed, the 10% rule applies to each return on which a loss is claimed.

If two or more individuals (other than husband and wife filing a joint return) have a loss on property that is owned jointly, the 10% rule applies separately to each.

If a taxpayer has casualty or theft gains as well as losses to personal use property, the total gains must be compared to total losses. This should be done after each loss has been reduced by any reimbursements and by the $100 rule, but before the losses have been reduced by 10% of AGI. If losses are more than gains, subtract gains from losses and reduce the result by 10% of AGI. Any remainder is the deductible loss from personal use property. If recognized gains are more than losses, subtract losses from gains. The difference is treated as a capital gain and must be reported on Schedule D (Form 1040). The 10% rule does not apply when there is a net gain.

Generally, a loss must be figured separately for each item stolen, damaged, or destroyed. However, a special rule applies to real property owned for personal use. In figuring a loss to real estate owned for personal use, all improvements (e.g., buildings and ornamental trees) and the land containing the improvements are considered together. When a casualty involves both real and personal properties, the loss must be figured separately for each type of property. However, a single $100 reduction should be applied to the total loss. Then, the 10% rule is applied to figure the casualty loss deduction.

When property is used partly for personal purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the personal-use portion and for the business or income-producing portion because the losses attributed to these two uses are figured in two different ways. When figuring each loss, allocate the total cost or basis, the FMV before and after the casualty or theft loss, and the insurance or other reimbursement between the business and personal use of the property. The $100 rule and the 10% rule apply only to the casualty or theft loss on the personal-use portion of the property.

Deductible personal casualty losses are allowed in determining an individual’s net operating loss (NOL). Net operating losses are carried forward indefinitely. After 2017, NOL carrybacks are allowed only for farmers.

CASUALTY GAINS AND DEFERRALS

Casualty Gains

If an insurance payment or other reimbursement is received that is more than the adjusted basis in the destroyed, damaged, or stolen property, there is a gain from the casualty or theft. If there is a gain, the taxpayer may have to pay tax on it or may be able to postpone reporting the gain.

The gain is the amount received minus the adjusted basis in the property at the time of the casualty or theft. Even if the decrease in FMV of the property is smaller than the adjusted basis of the property, adjusted basis is used to figure the gain. The **amount received** includes any money received plus the value of any property received minus any expenses incurred in obtaining reimbursement. It also includes any reimbursement used to pay off a mortgage or other lien on the damaged, destroyed, or stolen property.

EXAMPLE: Luis received $20,000 in insurance proceeds for his boat that was heavily damaged by a storm. The FMV of the boat before the storm was $25,000, and the FMV after the storm was $3,000. Luis purchased the boat on sale for $11,000. Luis’s adjusted basis of $11,000 is less than the $22,000 decrease in FMV, so the adjusted basis is used in determining the casualty gain or loss. The insurance proceeds of $20,000 create a $9,000 casualty gain. The taxability of the gain is determined by how Luis uses the proceeds.

If there is a gain because the primary residence was destroyed, generally the gain can be excluded from income as if the residence had been sold or exchanged. Taxpayers may be able to exclude up to $250,000 of the gain ($500,000 if married filing jointly). If the gain is more than the amount that can be excluded but replacement property is purchased, the excess gain may be postponed.

Generally, a gain must be reported as income in the year the reimbursement is received. If the personal casualty gains for any taxable years exceed the personal casualty losses for the tax years, all such gains and losses are treated as gains and losses of capital assets.

-- Postponement of Gain

A gain is not reported if the reimbursement is received in the form of property similar to or related in service or use to the destroyed or stolen property. The basis in the new property is generally the same as the adjusted basis in the property it replaces. Replacement property must be purchased for the specific purpose of replacing the destroyed or stolen property. Property acquired as a gift or inheritance does not qualify.

For personal use property, postponing the gain generally eliminates the gain. The gain will not be recognized as long as the replacement property is not sold for more than the adjusted basis in the damaged property.

When money or unlike property is received as reimbursement, reporting the gain can be postponed if property that is similar or related in service or use to the stolen or destroyed property is purchased within a specified replacement period. Reporting of the gain can be postponed if a controlling interest (at least 80%) in a corporation owning property that is similar or related in service or use to the property is purchased. The reporting of a gain on damaged property can be postponed if the reimbursement is spent to restore the property.

To postpone reporting all of the gain, the cost of replacement property must be at least as much as the reimbursement received. If the cost of the replacement property is less than the reimbursement, the gain must be included in income up to the amount of the unspent reimbursement.

Reporting a gain from a casualty or theft cannot be postponed if the replacement property is purchased from a related person. Related taxpayers include C corporations and partnerships in which more than 50% of the capital or profits is owned by C corporations. For all other related parties (including individuals, partnerships, and S corporations), for casualty theft purposes, the transaction is only subject to related party rules if the total realized gains for the tax year on all destroyed or stolen properties on which there are realized gains is more than $100,000. For these other related parties, gains cannot be offset by any losses when determining whether the total gain is more than $100,000. If the property is owned by a partnership or an S corporation, the $100,000 limit applies to the partnership or S corporation and each partner or shareholder. This rule does not apply if the related person acquired the property from an unrelated person within the period allowed for replacing the destroyed or stolen property.

-- Replacement Period

To postpone gain, replacement property must be purchased within a specified period. This is referred to as the replacement period. The replacement period begins on the date the property was damaged, destroyed, or stolen. The replacement period ends 2 years after the close of the first tax year in which any part of the gain is realized.

EXAMPLE: Mary is a calendar-year taxpayer. On May 5, Year 5, the electronics in Mary's entertainment center were destroyed by a lightning strike during a federally declared disaster and she had a casualty gain, which was reported on her Year 5 tax return. Mary may purchase replacement electronics by December 31, Year 7, to defer all or part of the casualty gain.

An extension of the replacement period may be received upon application to the director of the IRS for the taxpayer's area. The application should be made before the end of the replacement period. An application can be filed within a reasonable time after the replacement period ends if there is good reason for the delay. An extension may be granted if it can be shown that there is reasonable cause for not making the replacement within the regular period.

An amended return must be filed for the year of the gain in either of the following situations:

- Replacement property is not acquired within the required replacement period plus extensions. On this amended return, the gain must be reported, and any additional tax due must be paid.
- Replacement property is acquired within the required replacement period plus extensions, but at a cost less than the amount received for the casualty or theft. On this amended return, the portion of the gain that cannot be postponed must be reported and any additional tax must be paid.

If a taxpayer dies after having a gain but before buying replacement property, the gain must be reported for the year in which the decedent realized the gain. The executor of the estate or the person succeeding to the funds from the casualty or theft cannot postpone reporting the gain by buying replacement property.

Living Expenses

If the insurance proceeds are more than the temporary increase in the taxpayer's living expenses, the excess must be included in income (report this amount on line 21 of Schedule 1 of Form

1040). A temporary increase in living expenses is the difference between the actual living expenses the taxpayer and family incurred during the period the primary residence could not be used and the normal living expenses for that period.

Actual living expenses are the reasonable and necessary expenses incurred because of the loss of a primary residence. Generally, these expenses include the amounts paid for renting suitable housing, transportation, food, utilities, and miscellaneous services. **Normal living expenses** consist of these same expenses that the taxpayer would have incurred but did not because of the casualty or the threat of one.

The taxable part of the insurance payment is included in income for the year the taxpayer regains use of the principal residence or, if later, for the year the taxable part of the insurance payment is received. When living expense reimbursements are received in two or more tax years but are due to a casualty event that occurred in one year, the taxpayer can wait until the insurance claim for living expenses is fully settled before determining if there is any taxable income from the reimbursements. Thus, if the total insurance reimbursements for living expenses exceed the total of the increased temporary living expenses, the difference is reported as taxable income in the year the final reimbursements are received.

EXAMPLE: Christina received insurance reimbursements of $1,500 per month for 5 months to cover her temporary living expenses while her home was being repaired after a fire. Her actual monthly living expenses while staying in temporary housing were $2,000 for rent, $600 for food, $500 for transportation, and $800 for utilities and other miscellaneous costs, for a total of $3,900. Before the fire, her monthly expenses were $1,200 for rent, $450 for food, $300 for transportation, and $650 for utilities and other miscellaneous costs, for a total of $2,600. Christina's increased living expenses are $1,300 ($3,900 – $2,600). Christina records $1,000 of income from insurance reimbursements [($1,500 reimbursement – $1,300 increased cost) × 5 months].

Reimbursements Received after Deducting a Loss

The casualty or theft loss is figured using the amount of expected reimbursement. The tax return for the tax year in which the actual reimbursement is received may have to be adjusted. If a taxpayer later receives less reimbursement than expected, include the difference as a loss with the other losses (if any) on the return for the year in which no more reimbursements can be reasonably expected. The return for the casualty event year is not amended. The "new" casualty loss is deemed to be sustained in the year the insurance outcome becomes clear. This new loss is included with any other casualty losses for that year, subject to the $100 and 10% AGI reductions.

If a taxpayer later receives more reimbursement than expected, after claiming a deduction for the lesser amount, the extra reimbursement is included in income for the year in which received. However, if any part of the original deduction did not reduce the tax for the earlier year, do not include that part of the reimbursement in income. The tax for the year the deduction is claimed does not have to be recalculated. If the total of all the reimbursements received is more than the adjusted basis in the destroyed or stolen property, the taxpayer will have a gain on the casualty or theft. If a deduction has already been taken for the loss and the reimbursement is received in a later year, the gain may have to be included in income for the later year. Include the gain as ordinary income up to the amount of the deduction that reduced the tax for the earlier year. Any remaining gain may qualify for postponement.

Recovered stolen property is property that was stolen and later returned to the taxpayer. If the property is recovered after a theft loss deduction has been taken, the taxpayer must recalculate the loss using the smaller of the property's adjusted basis or the decrease in FMV from the time just before it was stolen until the time it was recovered. Use this amount to recalculate the total loss for the year in which the loss was deducted. If the recalculated loss is less than the loss deducted, the difference generally has to be reported as income in the recovery year. But report the difference only up to the amount of the loss that reduced the tax.

EXAMPLE: Jim purchased a motorcycle for $8,000 in Year 1. In Year 2, the motorcycle was stolen during a federal disaster when it had a FMV of $6,000. Jim took a $6,000 theft loss on his Year 2 tax return. In Year 3, the motorcycle was discovered with significant damages and a fair value of $1,200. Because Jim took a $6,000 theft loss in Year 2 and the asset was found in Year 3, the theft loss must be recalculated. The new loss is $4,800 ($6,000 FMV before – $1,200 FMV after). The loss deducted is compared to the recalculated loss, and Jim must include $1,200 in income for Year 3 ($6,000 – $4,800).

DISASTER AREAS

Disaster Area Losses

A presidentially declared disaster is a disaster that occurred in an area declared by the United States President to be eligible for federal assistance under the Disaster Relief and Emergency Assistance Act. A loss incurred in a presidentially declared disaster area can be taken on the return or an amended return for the tax year immediately preceding the tax year in which the disaster happened. If this choice is made, the loss is treated as having occurred in the preceding year, which allows the taxpayer to receive a tax refund in a more timely manner. The election must be made by filing a return or amended return for the prior year and claiming the disaster loss on it by the later of either

- The due date for filing the original return (without extensions) for the tax year in which the disaster actually occurred or
- The due date for filing the original return (including extensions) for the tax year immediately prior to the tax year in which the disaster actually occurred.

A new Section D has been added to Form 4684 to make an election (or revoke a prior election) to deduct a loss sustained in a disaster and attributable to a federally declared disaster in the tax year immediately preceding the disaster year.

The election may be revoked within 90 days by returning to the IRS any refund or credit received from the election. If the election is made before receiving a refund, it must be repaid within 30 days after receipt. For purposes of determining the 10% AGI floor, adjusted gross income is taken from the year in which the deduction is taken, rather than the year of the loss.

If a home located in a presidentially declared disaster area is ordered by a state or local government to be torn down or moved because it is no longer safe to live in, the loss in value is treated as a casualty loss from a disaster. The order to tear down or move the home must have been issued within 120 days after the area was officially declared a disaster area. Use the value of the home before moving in or tearing it down as its FMV after the casualty for purposes of figuring the disaster loss.

If part of a federal disaster loan was canceled under the Disaster Relief and Emergency Assistance Act, it is considered to be a reimbursement for the loss. The cancelation reduces the casualty loss deduction.

Post-disaster relief grants received under the Disaster Relief and Emergency Assistance Act are not included in income if the grant payments are made to help meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses. Casualty losses or medical expenses are not deductible to the extent they are specifically reimbursed by these disaster relief grants. Unemployment assistance payments under the act are taxable unemployment compensation.

Qualified disaster relief payments are not included in the income of individuals to the extent any expenses compensated by these payments is not otherwise compensated for by insurance or other reimbursement. These payments are not subject to income tax (including withholding), self-employment tax, or employer taxes. Qualified disaster relief payments include payments received (regardless of the source) for the following expenses:

- Reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a presidentially declared disaster.
- Reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence due to a presidentially declared disaster. A personal residence can be a rented residence or one owned by the taxpayer.
- Reasonable and necessary expenses incurred for the repair or replacement of the contents of a personal residence due to a presidentially declared disaster.

Qualified disaster relief payments do not include insurance or other reimbursement for expenses or income replacement payments, such as payments of lost wages, lost business income, or unemployment compensation.

-- Gains Realized on Homes in Disaster Areas

The following rules apply if a principal residence was located in an area declared by the President to warrant federal assistance as the result of a disaster, and the home or any of its contents were damaged or destroyed due to the disaster. These rules also apply to renters who receive insurance proceeds for damaged or destroyed property in a rented home that is a principal residence.

No gain is recognized on any insurance proceeds received for unscheduled personal property that was part of the contents of the home.

Any other insurance proceeds received for the home or its contents are treated as received for a single item of property, and any replacement property purchased that is similar or related in service or use to the home or its contents is treated as similar or related in service or use to the single item of property. Therefore, gain is recognized only to the extent the insurance proceeds treated as received for that single item of property exceed the cost of the replacement property.

If the taxpayer chooses to postpone any gain from the receipt of insurance or other reimbursement for a principal residence or any of its contents, the period for purchasing replacement property is extended until 4 years after the end of the first tax year in which any part of the gain is realized.

EXAMPLE: Michael's principal residence and its contents were completely destroyed in 2015 by a hurricane in a presidentially declared disaster area. In 2015, he received insurance proceeds of $200,000 for the home, $15,000 for unscheduled personal property in his home, $5,000 for jewelry, and $12,000 for a stamp collection. The jewelry and stamp collection were kept in his home and were scheduled property on his insurance policy.

No gain is recognized on the $15,000 he received for the unscheduled personal property. If he reinvests the remaining proceeds of $217,000, any gain is recognized only to the extent $217,000 exceeds the amount reinvested in a replacement home, any type of replacement contents (whether scheduled or unscheduled), or both. To postpone gain, the replacement property must be purchased before 2020. The basis of the replacement property equals its cost decreased by the amount of any postponed gain.

-- Postponed Tax Deadlines

The IRS may postpone for up to 1 year certain tax deadlines of taxpayers who are affected by a presidentially declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA.

PERSONAL USE SAFE HARBORS

Rev. Proc. 2018-8 attempts to ease the burden imposed on taxpayers who must determine their casualty loss deduction and wish to avoid time-consuming IRS audits and possible litigation. Seven methods are given that provide safe harbors that individuals can use to determine decreases in fair market value. The IRS will not challenge these safe harbors if they are properly applied.

-- Personal-use residence and belongings defined

To qualify for the safe harbors, a personal-use residence is defined as real property, including improvements, that is owned by the individual who suffered the casualty loss and contains at least one personal residence. It does not include a personal residence if any part of it is used as rental property or contains a home office used in a trade or business or other profit-seeking activity. Furthermore, it must be a single-family residence or residential unit; this does not include a condominium or cooperative unit when the individual does not own the structural components of the building or owns only a fractional interest. It also does not include a mobile home or trailer. Finally, if an individual owns two or more personal-use residences, he or she may use the same or different safe harbors for each residence.

A personal belonging is defined as an item of tangible personal property owned by the individual and not used in a trade or business or other profit-seeking activity. This does not include a boat, aircraft, mobile home, trailer, or vehicle, nor an antique or other asset that maintains or increases its value over time.

Personal-Use Residence Safe Harbors

-- Estimated repair cost method

To determine the decrease in the fair market value of a residence under this safe harbor, an individual may use “the lesser of two repair estimates prepared by two separate and independent contractors, licensed or registered in accordance with state or local regulations.” The two estimates must itemize the costs to restore the individual’s personal-use residence to its condition immediately before the casualty. The cost of any improvements or additions that increase the value of the property beyond its pre-casualty value must be excluded from the estimates. This method is only available for casualty losses of $20,000 or less, calculated prior to the Sec. 165(h) limitations (i.e., $100 and 10%-of-AGI floor).

Example. Alex suffers a loss to his main hone, on which he carries no insurance, as a result of a hurricane and associated flooding. He obtains two qualified and itemized estimates. Contractor 1 estimates the repair to be $18,000. Contractor 2 estimates the repair to be $28,000, but includes $9,000 to elevate the home to meet construction requirements. The $9,000 cost must be excluded from the second estimate, as it is considered an improvement that increased the value of the property. Alex would use $18,000 (the lesser of the two estimates) under this safe harbor as the decrease in the fair market value of his home as a result of the hurricane casualty. Note that the $18,000 loss is under the $20,000 cap for the use of this safe harbor.

-- De minimis method

Under this method, “an individual may estimate the cost of repairs required to restore the individual’s personal-use residential real property to the condition existing immediately prior to the casualty.” Like the first safe harbor, the cost of any improvements or additions that increase the value of the property beyond it pre-casualty value must be excluded from the estimate. The estimate must be a good-faith estimate, and records must be kept detailing the methodology used to determine the loss. This method is only available for casualty losses of $5,000 or less, calculated prior to the Sec. 165(h) limitations.

Example. Blake suffers a casualty loss to the roof of her principal residence as a result of hail damage. She estimated that the cost to repair the roof it its pre-casualty condition is $3,900. Her insurance deductible exceeds $3,900; thus, Blake would be able to use the de minimis method to establish a loss of $3,900, which is under the $5,000 ceiling required for this safe harbor.

-- Insurance method

Under this method, an individual may use the estimated loss detailed in his or her homeowner’s or flood insurance company’s report setting forth the estimated loss sustained as a result of damage to the individual’s personal-use residence. This method may be used for any casualty loss and, unlike the previous two methods, does not have a dollar limit for its use.

Example. Chris’s home suffers severe flood damage as a result of torrential rainfall. He is covered by flood insurance; his coverage limit is $250,000, and the insurance report details a loss of $360,000. Chris may use the $360,000 loss per the report under this safe harbor for a casualty loss after insurance of $110,000 (i.e, the loss minus the coverage limit).

-- Contractor method.

Under this method, “an individual may use the contract price for repairs specified in a contract prepared by an independent contractor, licensed or registered in accordance with state or local regulations, setting forth the itemized costs to restore the individual’s personal-use residential real property to the condition immediately prior to the federally declared disaster.” To use this method, a binding contract must be signed by the contractor and the individual. Like the previous safe harbors, the costs of any improvements or additions that increase the value of the property beyond its pre-disaster value must be excluded from the contract price. This method does not have a dollar limit for its use.

Example. Dana’s home suffers fire damage. The area in which her home is located is a federally declared disaster area. Dana signs a contract with a licensed independent contractor to fix the damage to her home; the itemized cost totals $300,000 and excludes any improvements or additions beyond restoring the home to its pre-fire condition. Her insurance coverage amount is $200,000. Dana may use the $300,000 binding contract cost under this safe harbor for a net loss after insurance of $100,000.

-- Disaster loan appraisal method.

Under this method, an individual may use “an appraisal prepared for the purpose of obtaining a loan of federal funds or loan guarantee from the federal government setting forth the estimated loss the individual sustained as a result of damage to or destruction of the individual’s personal-use residential real property from a federally declared disaster.” This method does not have a dollar limit for its use.

Example. Evan’s home suffers damage as a result of a tornado. The area in which his home is located is a federally declared disaster area. Evan does not have insurance coverage for the damage, so he applies for a disaster loan through the U.S. Small Business Administration (SBA).

An SBA verifier appraises the estimated loss at $120,000. He may use this amount for his casualty loss under the disaster loan appraisal safe harbor method.

Personal Belongings Safe Harbors

In addition to the five safe harbors for an individual's personal residence, Revenue Procedure 2018-8 specifies two additional safe harbor methods for an individual's personal belongings.

-- De minimis method.

Under this method, an individual makes a good faith estimate of the decrease in fair market value of her personal belongings. This method is available for any casualty or theft loss of $5,000 or less, prior to the IRC section 165(h) limitations. In order to use this method, an individual must have records describing the affected personal belongings and detailing the methodology used for estimating the loss.

Example. Frances lost personal belongings in a windstorm. Using thrift shop values, she estimates the value of the items at $7,500. Her contents insurance policy accepts these values and, after applying a $3,000 deductible, reimburses her $4,500. Frances may use $3,000 as her casualty loss relative to her personal belongings under the de minimis method because the amount is $5,000 or less.

-- Replacement cost method.

To use this method, an individual must first determine the current cost to replace a personal belonging with a new one and then determine the pre-disaster market value of the item by reducing the replacement cost by 10% for each year that the individual owned the item. If the item was owned by the individual for nine or more years, the pre-disaster market value is 10% of the current replacement cost.

The fair market value of the item after the disaster is then subtracted from the value before the disaster. If the personal belonging is destroyed or stolen as a result of the disaster, its after-disaster value is deemed to be zero.

The final step in the calculation is to compare the decrease in fair market value with the cost basis of the item, taking the lesser of the two as the casualty loss before any insurance recovery. Any insurance reimbursement received or expected must be subtracted from this amount.

Example. Gerry's personal belongings include a bed destroyed by a hurricane in a federally declared disaster area. He purchased the bed for $900 six years prior to the hurricane. The cost to replace the bed with a similar new one is $1,200. Gerry receives $200 under his insurance coverage. His loss deduction relative to the bed before IRC section 165(h) limitations would be calculated as follows:

- Fair market value before the disaster $1,200 × 40% = $480
- Fair market value after the disaster = $0
- Decrease in fair market value = $480 – $0 = $480
- Cost basis = $900
- Lesser of cost basis or decrease in fair market value = $480
- Less insurance reimbursement = $200
- Net casualty loss deduction = $280

An individual may *not* use this safe harbor method for the following personal belongings: boats, aircraft, mobile homes, trailers, vehicles, or an antique or other asset that maintains or increases its value over time. Vehicles include automobiles, motorcycles, motor homes, recreational vehicles, sports utility vehicles, off-road vehicles, vans, and trucks. Pre-disaster values for these items are instead determined by consulting established pricing sources, such as “blue book” values for automobiles.

An individual who uses any of the safe harbor methods in this revenue procedure must reduce the loss by the value of any no-cost repairs.

Reduction for No-Cost Repairs

The last section of the revenue procedure notes that under IRC section 165(a), a casualty loss must be reduced by insurance or other amounts received. This includes the value of repairs provided by another party at no cost to the individual. No-cost repairs include the repair or rebuilding of an individual’s personal residence by volunteers or repairs made for a token cost, donation, or gratuity.

Example. Hayden suffers damage to her home as a result of a hurricane. She is covered by insurance for the loss. The insurance report details the loss at $300,000; her coverage limit is $250,000. Volunteers from a local church provide help in repairing the damage, which help she values at $15,000. Under the insurance method safe harbor, Hayden may use the $300,000 loss per the report for a casualty loss after insurance of $50,000; however, she must also subtract the $15,000 value of the no-cost repairs provided by the church volunteers, resulting in a net casualty loss of $35,000.

Welcome Relief to Those Who Need It

Revenue Procedure 2018-8 gives taxpayers much-needed help in valuing their casualty losses by providing seven new safe harbors for calculating the deductible amount of the loss. The seven methods will do much to assist taxpayers in calculating their casualty loss deductions now and in the future. Taxpayers and their advisors should, however, still carefully document their disaster losses as well as the methodology employed to compute their deductions.