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Preliminary Thoughts on the Tax Implications of Hurricane Harvey

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Hurricane Harvey has brought about unique circumstances never seen before. We are accustomed to hurricanes as recently experienced with Allison, Katrina, Rita, Wilma, Gustav, Ike and Isaac. The catastrophic flooding from Hurricane Harvey is an event no one anticipated would happen.

This will review topics associated with the filing of returns for taxpayers affected by disasters:

- Basics of a casualty loss
- Individual casualty losses
- Business casualty losses
- Involuntary conversions for personal residences and business property
- Code Section 121 exclusion
- Personal belongings
- FEMA payments
- Code Section 165(i) election

Casualty Losses

Casualty losses result from damage, destruction or loss of property resulting from an identifiable event that is sudden, unexpected or unusual. Some common examples include fire, hurricane, earthquake, tornado, auto accident and drought. There are unusual instances also like a diamond ring that was lost when falling in a sink. The most important item in computing a casualty loss is the taxpayer's basis in the property. For individuals, this can be a difficult amount to determine. For businesses, the basis should be in the taxpayer's records because generally they are claiming depreciation on the business asset. Insurance reimbursements and other similar payments like payments from an employer's emergency disaster fund that must be used to replace damaged property are also used in calculating casualty losses. However, payments from social welfare agencies and in-kind services such as free meals, medical supplies and shelter are generally not taxable.

Individual Casualty Losses

Individual casualty losses will generally include the taxpayer's personal residence, vacation home or homes, and the personal property owned by the taxpayer located in and around the personal residence or vacation home.

The *AICPA Casualty Loss Practice Guide* and the *IRS FAQs for Disaster Victims* (http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/FAQs-for-Disaster-Victims) are the two most important resources in assisting clients to compute their casualty losses.

In addition, a complete listing of property and casualty insurance companies and contact information is available at: http://www.iii.org/articles/insurance-company-claims-filing-telephone-numbers.html.

A personal casualty loss is the smaller of the adjusted basis in the property or the decrease in fair market value of the property as a result of the casualty. The loss must be reduced by the

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amount of insurance the taxpayer expects to receive and other proceeds (including FEMA payments) which may convert the loss into a gain in some instances. An example would be insurance paying replacement cost instead of depreciated value. In addition, an insurance claim must be filed for loss of personal use property. If there is an additional recovery in another year, the recovery is taken in the year of recovery. The taxpayer may have a Code Section 111 tax benefit calculation, where reimbursements received in a subsequent year are actually taxable to the extent that they reverse a casualty loss deduction in a prior year.

The starting point in determining any casualty loss is generally the insurance adjuster's reports. The adjuster's reports will have information detailing the damage to the taxpayer's real and personal property. These reports contain information including the total square feet of the residence, square feet of each damaged room and adjacent buildings, damage to the structure as a whole, and damage room by room. There should also be detailed computations of the nature of repairs required to restore the property to pre-disaster condition.

It should be noted the adjuster's reports are generated by computer software. The computer software takes into consideration the location of the property damaged and costs and prices are indexed according to zip code.

It is beneficial for the homeowner to provide a floor plan, if available. The adjuster and homeowner will then know the exact measurements to be used in the report since many amounts are computed based on square footage. Some parish tax appraiser offices also maintain records of square footage. Another consideration is to have a contractor, architect, engineer or other building professional available when meeting with the adjuster. These professionals will be able to show the adjuster features of the residence that may not be available at first glance and result in larger restoration amounts reported by the adjuster. While these services cost money, they have the potential to increase both the insurance reimbursement and the allowable casualty loss deduction.

The calculation starts with determining the taxpayer's basis in the residence and personal property. Basis is understandable to the CPA but is foreign to the taxpayer. It will be necessary to explain items that increase basis and then continue working with the taxpayer to assemble the necessary information to have the basis amount required for the casualty loss computation. This can be challenging depending on the client's comprehension of the process during this stressful time.

All practitioners assisting taxpayers in casualty loss calculations should have a copy of Code Section 165 and the related regulations and have familiarity with them and the terms used.

Important items to remember are:

- Regulation 1.165-7(a)(2), "the change in fair market value as determined by a competent appraisal that recognizes the effects of any general market decline which may occur simultaneously with the casualty,"
- Regulation 1.165-7(a)(2)(i), "an independent appraisal by a qualified appraiser is mandatory in most situations," and
- Regulation 1.165-7(b)(1)(i), "the decrease in fair market value is the difference between the property's value immediately before and immediately after the casualty."

  The concept of "fair market value immediately before and immediately after" has caused difficulties in all disasters and continues to cause problems for practitioners. After Hurricane Katrina, it was especially difficult to determine these amounts since the property was not accessible for a period of time after the disaster occurred. Also, Katrina damage came from three sources:

- the hurricane,
- widespread, post-hurricane looting, and
- flood damage from the breaking of the levees.

These incidents occurred on different days, but in close proximity and were considered one event.

In the absence of an appraisal, the cost of the repairs will serve as evidence of the amount of the loss. This is called the "cost to cure." If this method is used, the repairs should restore the property to its condition immediately before the disaster, the amount spent must not be excessive, the repairs do not affect more than was damaged, and the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the disaster.

The personal casualty loss will be reported on page one of *Form 4684, Casualties and Thefts*. The residence will be reported on one line of Form 4684. The improvements are considered an integral part of the property with no separate basis apportioned to the improvements.

There also can be casualty gains as a consequence of a disaster. The personal residence exclusion under Code Section 121 may be applicable. If the taxpayer has met the residency requirements under Code Section 121, the gain may be excluded.

There would be no Code Section 121 exclusion on casualty gains on second and vacation homes. Code Section 1033 may be applicable for second and vacation homes. The taxpayer would have two years from the end of the disaster gain year to reinvest the insurance proceeds for these.

If both Code Sections 121 and 1033 apply, it is normally advantageous to use the maximum (Section 121) exclusion first, then defer the rest (under Section 1033).

Businesses Casualty Losses

Business casualty losses should not provide the valuation issues as those associated with individual casualty losses since business assets should be recorded on the entity's tax returns and cost and depreciation figures are available. Even in the absence of double entry books, business assets such as those reported on Schedules C, E and F have the basis generally maintained on a depreciation schedule associated with the tax return.

In instances where double entry books are maintained, the insurance payment is generally put into a suspense account and as repairs are made, the account is reduced.

It should also be noted that the "repair regulations" may enter into calculation of a business casualty loss and should be reviewed.

Involuntary Conversions

When taxpayers receive an insurance payment for the damage to the property in excess of the basis, Code Section 1033 will be applicable and the taxpayer will have two years in the case of business property and four years for a personal residence to reinvest the insurance proceeds in the property or be taxed on the payment. Code Section 1033 is automatic by not reporting the payment on the tax return.

Generally, a statement is included with the return indicating Code Section 1033 treatment is elected. The statement will include the location of the property, date and amount of the insurance payment, and name of the incident causing the casualty. It is a good idea to have the taxpayer sign this statement so the taxpayer understands the requirement for both the amount to be reinvested and the time period for reinvesting.

The IRS has the power to extend these periods upon request by the taxpayer.

Code Section 121 Exclusion

Personal residences damaged in a casualty are covered by the Code Section 121 exclusion of gain available to homeowners who have lived in the residence for two of the last five years. This may be applicable if there is an insurance gain from the casualty. While the gain may be excluded depending on the facts and circumstances, the taxpayer's basis in the residence would be reduced by the amount of the gain.

Personal Belongings

The IRS issued *Publication 584, Casualty, Disaster and Theft Loss Workbook (Personal-Use Property)* (https://www.irs.gov/pub/irs-pdf/p584.pdf), which uses a workbook approach to assist taxpayers in assembling the information necessary to determine their loss for personal belongings.

In addition, the IRS issued *Publication 584-B, Business Casualty, Disaster and Theft Loss Workbook* (https://www.irs.gov/pub/irs-pdf/p584b.pdf), which is also a workbook to assist taxpayers with assembling information for businesses and offices.

The Publication 584 workbook is arranged according to the rooms in a house and provides a list of items that homeowners would normally have in these rooms. For example, the living room page lists blinds, bookcase, chair, chest, coffee table, curtains, desk, drapes, lamps, sofa, TV, stereo, etc., as all the items that would normally be in a living room. This is the same for the other rooms normally in a personal residence.

The Publication 584-B workbook follows the same format as the Publication 584 workbook except it is separated according to the items that would normally be in an office.

The issue of the valuation of the personal belongings is a difficult one and practitioners should exercise professional judgment.

FEMA Payments

All FEMA payments are made under authority of Code Section 139. Generally, FEMA payments have no tax consequences.

Practitioners should be familiar with Code Section 139 and the various subsections since it covers not only the payments received immediately after a disaster but also includes additional payments that may be made subsequent to a disaster (such as elevating a residence).

Code Section 165(i) Election

Another consideration available to taxpayers who have experienced a casualty loss is to deduct the loss on the preceding year tax return. This might be especially attractive to those who extended their 2016 tax return due date to October, as they have not yet filed and will likely get an additional extension to file this return.

Practitioners should be familiar with the procedural aspects of claiming this deduction and make the necessary calculation to determine if it is beneficial for the taxpayer.

The IRS recently issued Revenue Procedure 2016-53 (https://www.irs.gov/pub/irs-drop/rp-16-53.pdf) liberalizing the period available for taxpayers to claim a Code Section 165(i) deduction.

Summary

The tax implications of documenting and claiming a casualty loss is a challenging and difficult process for both taxpayers and practitioners.

The loss of a residence, personal belongings and business can be overwhelming.

Practitioners serve an important role in assisting taxpayers to recover from these disasters.