January 2015 Bar Bulletin

Tax Relief for Natural Disasters

By Amber Quintal

When a disaster strikes, those affected are left to start the sometimes long and painful process of rebuilding and getting back to life as normal. Although taxes are not often front of mind for disaster survivors, the Internal Revenue Code and IRS offer some assistance to taxpayers who have lost property and records in a disaster.

Casualty Loss Deduction

Although deductions for personal expenses are generally not allowed, an itemized deduction may be available for casualty losses that are sustained with respect to personal use property during the taxable year, and are not compensated for by insurance or otherwise are deductible, subject to certain limitations.[1] Casualty losses are losses that result from an identifiable event that is sudden, unexpected or unusual, and has destructive force.[2] These can include fires, shipwrecks, automobile collisions, storms, hurricanes, floods, earthquakes or other similar destructive events.[3]

The amount of the casualty loss may not be the full amount of the economic decline suffered by the taxpayer, as it is limited to the lesser of the decrease in value of the property or the taxpayer's adjusted basis of the property.[4] The adjusted basis generally is what the taxpayer paid for the property, increased or decreased, upon certain events. IRS Publication 551, *Basis of Assets*, explains how to figure the adjusted basis.

For example, if a taxpayer purchased an item for personal use for $500, which later rose in value to $1,000 and is completely destroyed in an uninsured casualty, the full economic loss of $1,000 is not deductible. Instead, the casualty loss is limited to the $500 adjusted basis. If, on the other hand, the item's value prior to the casualty had decreased to $250, the casualty loss would be limited to $250, the decline in value due to the casualty.

For personal use property, two additional limitations decrease the amount of the casualty loss deduction. The first $100 of loss per casualty event is not deductible ("per casualty floor").[5] This per casualty floor applies once per casualty event, not per item. Second, the taxpayer's net casualty loss is only deductible to the extent it exceeds 10 percent of the taxpayer's adjusted gross income.[6]

This 10-percent-of-AGI threshold applies after the per casualty floor and to all casualty losses during the year. If the property is used in performing services, the casualty loss deduction is a miscellaneous itemized deduction and thus subject to a 2-percent-of-AGI threshold for miscellaneous itemized deductions.

A taxpayer claims a casualty loss for personal use property by using IRS Form 4684, *Casualties and Thefts*, to calculate casualty losses and gains for the year, and claims the net casualty loss as an itemized deduction on Schedule A, *Itemized Deductions*.

A taxpayer claiming a casualty loss deduction must be prepared to show:

1. The type of the casualty that caused the loss (car accident, fire, storm, etc.) and when it occurred;

2. The loss was the direct result of the casualty;

3. The taxpayer owned the damaged property or was contractually liable to the property owner for the damage to leased property; and

4. Whether the taxpayer has a claim for reimbursement for the loss with a reasonable expectation of recovery (*e.g.*, an insurance policy that may cover the loss).[7]

It is also a good idea to take pictures to document the extent of the damage as soon as possible after the casualty.

Generally, the casualty loss deduction is taken for the year in which the casualty occurs. However, when the casualty occurs as the result of a federally declared disaster, the taxpayer has the option of claiming the casualty loss deduction in the year the disaster occurred or in the previous year.[8]

If the loss occurs early in the year before the prior year's return is due, electing to include it on the prior year's return may lead to a faster refund. If the prior year's return has already been filed, the taxpayer may elect to file an amended return to include the casualty loss deduction.

Although electing to include the casualty loss deduction on the prior year's return may accelerate the refund, if the taxpayer's income will dip in the year of the casualty, the loss deduction may be more valuable when taken on the return for the year the disaster occurs. In a year where the taxpayer's AGI is lower, the 10-percent-of-AGI limitation will also be lower, potentially allowing a larger casualty loss deduction. It is important to weigh the taxpayer's particular circumstances when determining in which year the deduction should be taken.

If the taxpayer's casualty loss deductions exceed the taxpayer's income for the tax year, the taxpayer may have a net operating loss (NOL).[9] An NOL may be used to reduce the taxpayer's taxable income (and tax due) in prior tax years, resulting in refunds of taxes already paid for prior tax years, or to lower the taxpayer's taxable income in future tax years.[10] See IRS Publication 536, *Net Operating Losses for Individuals, Estates, and Trusts*, for more information on NOLs.

Tax-Free Qualified Disaster Relief Payments

Under I.R.C. 139(a), individuals may exclude "qualified disaster relief payments" from gross income. Qualified disaster relief payments are also not considered wages or net earnings from self-employment for purposes of wage withholding and employment taxes.

A qualified disaster relief payment is an amount paid to or for the benefit of an individual to compensate for a loss not otherwise compensated by insurance or otherwise that also falls within one of four categories:

1. It reimburses or pays "reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster;"

2. It reimburses or pays "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 such repair, rehabilitation, or replacement is attributable to a qualified disaster;"

3. It is supplied "by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster;" or

4. It is paid by a federal, state or local government or governmental agency or instrumentality "in connection with a qualified disaster in order to promote the general welfare."[11]

For this purpose, qualified disasters include: (1) terrorist or military attacks; (2) presidentially declared disasters; (3) accidents "involving a common carrier;" (4) any other event that the IRS determines "to be of a catastrophic nature;" and (5) disasters determined by a federal, state or local authority "to warrant assistance" from a government or governmental agency or instrumentality.[12]

Extended Filing and Payment Deadlines

In conjunction with a federally declared disaster, "affected taxpayers" may be subject to extended deadlines for most federal tax obligations, including filing returns and paying taxes, if the IRS determines that these extended deadlines should apply.[13] Affected taxpayers include individuals whose principal residence is located within the federally declared disaster area, and business entities and sole proprietors whose principal place of business is located inside the federally declared disaster area.[14] In addition, taxpayers whose records needed to meet a tax filing or payment obligation are located within the disaster area, are also affected taxpayers, even if their principal residence or place of business is not located within the federally declared disaster area.[15]

The IRS may specify a postponement period of up to one year of the deadlines for affected taxpayers to perform certain tax-related acts, including filing returns, paying taxes, making estimated tax payments, making contributions to retirement accounts, filing petitions in Tax Court, filing a claim or suit for tax refunds or credits, and any other act specified in guidance published by the IRS.[16] The affected taxpayer is eligible for relief from interest, penalties, additional amounts, or additions to tax during the postponement period.[17]

Check the IRS website for announcements regarding covered disaster areas and postponement periods: http://www.irs.gov/uac/Tax-Relief-in-Disaster-Situations.

Recreating Tax Records

Taxpayers may request copies of their previously filed returns by using IRS Form 4506, *Request for Copy of Tax Return*, and paying a $50-per-return user fee. While copies of previously filed tax returns may be easier to read than the IRS return transcripts, a taxpayer may request transcripts of previously filed returns by using IRS Form 4506-T, *Request for Transcripts of a Tax Return*. Return transcripts include most line items of a return previously filed with the IRS.

A taxpayer may also request transcripts of information on W-2s and 1099s, if those records also have been lost. If the taxpayer is in a federally declared disaster area, write the disaster designation, such as "HURRICANE KATRINA," in red letters across the top of the forms to expedite processing and to waive the normal user fee. Copies of returns and transcripts may also be requested on the IRS.gov website or by calling the IRS at 1-800-908-9946.

For additional information, visit the IRS Disaster Relief Resource Center for Tax Professionals at http://www.irs.gov/Tax-Professionals/Disaster-Relief-Resource-Center-for-Tax-Professionals.

1 I.R.C. 165(a) & (c).

2 Rev. Rul. 79-134.

3 *Id*. and I.R.C. 165(c).

4 Treas. Reg. 1.165-7(b).

5 I.R.C. 165(h)(1).

6 I.R.C. 165(h)(2).

7 IRS Pub No. 17 (2013), p. 171.

8 I.R.C. 165(i)(1).

9 I.R.C. 172(c).

10 I.R.C. 172(b).

11 I.R.C. 139(b).

12 I.R.C. 139(c).

13 Treas. Reg. 301.7508A-1(b).

14 Treas. Reg. 301.7508A-1(d)(1).

15 *Id*.

16 Treas. Reg. 301.7508A-1(c).

17 Treas. Reg. 301.7508-1(b)(2).

Go Back