JOHN TRAPANI, CPA

Disaster Loss Recovery Income Tax Specialist

(805) 497-4411

John@TrapaniCPA.com

TrapaniCPA.com

The Process of Recovery

Income Tax Consequences Of A Disaster

THE PROCESS OF RECOVERY - INCOME AND PROPERTY TAXES

Introduction

The process of recovery after a catastrophic loss involves a number "new" tasks and skills. You will need assistance. The material in this paper is dedicated to assisting taxpayers getting started with an emphasis on the tax compliance and reporting aspects.

The paper includes an eight part discussion of many income tax issues that commonly apply to people who experience a physical catastrophic event. The material is separated into 26 sections. Not all sections will apply to all taxpayers, but many will apply to all those who have lost personal use real estate. Item 26 "BUSINESS AND INVESTMENT LOSSES" is a simple statement that "Many different provisions apply to losses affecting business and investment properties that are not covered in this material. The rules for replacement property are applied somewhat differently than those for personal use real estate. The rules for disasters discussed in section 25 above do not apply to business losses. There is unique relief for businesses in disasters."

Below is a "map" for the eight parts of the material:

PROCESS OF RECOVERING FROM A CATASTROPIC LOSS
INCOME AND PROPERTY TAXES CONSEQUENSES AND REQUIREMENTS
PART 1

1 TOOLS FOR RECOVERY
2 INCOME TAX LAWS AFFECT PEOPLE WHO EXPERIENCE A LOSS
3 INSURANCE vs. OTHER SUPPORT
4 COST BASIS OF PROPERTY DAMAGED
5 DOCUMENTING – A GAIN OR A LOSS?
6 TAX REPORTING FOLLOWS THE INSURANCE PROCEEDS

For Individuals and Businesses and Investors in Tangible Property:
This material is divided into sections that cover specific areas of the tax consequences related to the recovery process from a catastrophic physical property loss. The following is an overview of the concepts that are covered:

The material primarily addresses the losses of individuals for personal, business and investment losses. Where differences arise for businesses not operated in a sole proprietorship, such as partnerships, corporations and LLCs the differences will be separately stated.

Circumstances (Disaster or other Catastrophe)
Type of loss: complete loss or partial loss
Assets lost
Loss or Gain
Computing the loss or gain
Qualified Replacement property
Tracking the recovery / Reporting
Compliance issues
Changes:
Circumstances
“Change of mind”
Complications, Interpretations, Clarifications
Other:
Interest and Property taxes

In the process of recovery, those who have experienced the loss of their homes have to deal with a number of tasks in a short period of time, including:

Settlement / Physical Recovery
- Temporary Housing?
- Dealing with FEMA, SBA and local government agencies
- Proving your loss:
    - Documentation
    - Negotiation with insurance company
    - Public Adjuster –hire one or do it yourself?
- Lender relations!

- Repair (Rebuild) or Replace Decision?
  - Architect / Engineers / Geologist? / Contractor?
  - Insurance company limitations / Resolution of residual land?

The above list does not include any of the tasks related to income tax reporting, the topic o this material. Here is a short list of the tax tasks:

INCOME TAX CONSIDERATIONS:

1. Circumstances / a casualty event occurred – was it a disaster or other event / "Closed Transaction"
2. Determine assets affected / Cost basis / Values
3. Extent / Type of loss: complete loss or partial loss / Primary Residence?
4. Insurance – When Received, For What & How Much?
5. Loss or Gain? Documents, computing the loss or gain
6. Recognize or defer gain?
7. "Qualified Replacement Property"
8. Tracking the Recovery: Compliance Reporting
9. Filing deadlines / Replacement deadline
10. Changes in Circumstances / Change of mind
11. Mortgage Interest / Property tax valuation

For taxes, there are important task that taxpayer must be aware of immediately after the event and if the lost event takes place near the end of the tax year these tasks become more important to deal with:

YOUR TAX IMPACT MAY NOT BE CLEAR BY THE TIME A TAX RETURN IS DUE

- FILE AND REPORT EVENT ON A TAX RETURN:
  - COST BASIS
  - INSURANCE RECEIVED (AND PROJECTED, IF ABLE)
  - REPLACEMENT PLAN – NOT CAST IN STONE
- WHAT LOOKS LIKE A LOSS TODAY… MAY TURN INTO A GAIN NEXT YEAR
- IF YOU FILE A LOSS USING FORM 4684 TODAY AND LATER YOU HAVE A GAIN,
  - THE RESULTS WILL BE A NEW CATASTROPE
- IF YOU DO HAVE A LOSS …
- USE FORM 4684 FOR A LOSS, or
- INCLUDE A SIMPLE STATEMENT IF STATUS IS UNCLEAR
- APRIL 15TH DEADLINE – DECISION…
- The choice of filing an amended 2012 tax return to claim the 2013 loss against your previously reported 2012 taxable income.

BUT …

- "DON'T RUSH TO DEDUCT A LOSS"
  - IT MAY TURN OUT NOT TO BE A LOSS

1 TOOLS FOR RECOVERY

For every job, tools are required. Recovering after a catastrophic event is no different. Whether recovery is assisted by insurance proceeds, income tax benefits or a combination, documentation is required to substantiate both insurance and tax aspects. Anything you do to improve the quality of the documentation will increase your recovery success.

Always keep a diary of all conversations, document the physical aspects of the recovery by photographing everything you can. Photographic documentation is always evaluated in hindsight. We look back and say, “if only I had recorded the status of that damage three months ago.” To avoid this lament, record as often and, in as much detail as you can. Later, you can decide what is no longer useful rather than being sorrowful about what was not recorded.

People who have experienced a major physical catastrophe can be expected to be “angry, confused and vulnerable.” There are normal responses to being subjected to “tremendous stress.” In the usual case homes have been destroyed, these homes have been the prime physical source of family stability and safety. These people are likely in “psychological shock.” In a natural response, taxpayers doing their best will find new creative ways to deal with the complexity of the situation.

For an official list of federally declared disasters go to www.FEMA.gov/disasters.

2 INCOME TAX LAWS AFFECT PEOPLE WHO EXPERIENCE A LOSS

It is imperative to understand that the tax laws related to casualties and disasters are unusual. For one, we have to understand that the basic law involves a claim of taxation of all receipts and non-deductibility of personal casualty losses. Therefore, the two code sections 165 and 1033 and others are unique in that they reduce or eliminate taxation of insurance proceeds and allow deduction for personal losses. It turns out that sometimes even the tax laws can display empathy for the people who have been affected by such things as casualties and disasters.

The tax law differentiates between realization of income or a loss and recognition of the item as a tax return reportable event. Realization refers to the receipt of cash or having experienced a loss (the event). Recognition involves reporting the event on a tax return. Some events are reportable and others are not. Some have several circumstances that must be understood to determine if the realized event has any effects that must be reported to the Internal Revenue Service and state tax authority on a tax return. The material in this document discusses the major aspects of realization and recognition for the bulk of aspects related to a casualty or disaster event.

While it is possible to realize a “gain” or a “loss” as a result of the total event experience, it is best to start with the possibility of a loss as presented in the form of a table that follows the reporting of a transaction on IRS Form 4684. Below is a single transaction that is shown with four possible results due to variations in insurance proceeds and valuations of the damaged property before and after the loss event.

In each case the cost of the property lost or damaged is $176. The receipt of insurance proceeds can have a drastic effect on the outcome. So, in the first three alternatives, the insurance proceeds are varied. Where a loss is indicated, the value of the property before and after the event is necessary. As with the insurance proceeds, these values also have an important role to play and will impact the outcome.

Case:		A	A2	A3	A4
Cost Basis	2	176	176	176	176
Insurance	3	30	150	150	200
Gain	4	-	-	-	24
Value before loss	5	130	130	300	
Value after loss	6	0	0	120	
Loss – (Economic) Line 5 less line 6	7	130	130	180	
Economic loss– smaller of line 2 or line 7	8	130	130	176	
Subtract line 2 from line 8, if zero or less, enter zero -LOSS	9	100	-0-	26	

Starting with the first column, we first notice that the insurance is quite inadequate. The immediate thought a taxpayer would have is that there is a loss of $146 ($176 less $30). But the law states that the deduction cannot be exceed the decrease in the fair market value due to the event. In this case the property was completely lost and therefore has no value after the event. The value at the time of the event is only $130. The decrease in value from $176 to $130 is a personal, non-deductible loss. This decrease in value of $46 that has already occurred prior to the event cannot be transformed into a deductible loss as a result of the event. As the loss of $130 is less than the cost basis, the loss is $130. The loss must be reduced by the insurance proceeds of $30 for a net loss of $100.

In the second case, the insurance proceeds increase to $150. This amount was chosen as an amount greater than the $130 loss in value but lower than the cost basis of $176. The result is that there is no deductible loss; the insurance eliminates the loss in value as it is greater than the loss; but since it is less than the cost basis there is no gain. If a taxpayer had simply sold the assets for $150, there would be no gain.

In the third case, the property had increased in value from its original cost and had some salvage value. The “economic” decrease in value is $180, $4 greater than the cost. Another rule is that the loss cannot exceed the cost basis therefore the “economic loss” is limited to $176. The loss is reduced by the insurance proceeds of $150, for a net loss of $26.

In the last case, the insurance proceeds increase to $200. This case is a clear gain. The only questions are: should it be reported as a taxable gain or should it be deferred as an involuntary conversion, what was lost; was the event a federal disaster? If the event was declared a federal disaster and the assets lost were “personal property,” then the gain is a non-event, see the discussion at the end regarding federal disasters. If that exclusion is not available, and the property was a primary personal residence, then there may be other exclusions that may apply. Finally, if it is a “reportable” gain, then the decision between reporting it and deferring it using the involuntary conversion rules must be examined.

3 INSURANCE vs. OTHER SUPPORT

In addition to insurance proceeds, additional funds may become available to taxpayers as a result of a catastrophic event. For individuals, many of these payments are free of any tax consequences. They can come from FEMA, the state, local governments, non-profit organizations and even employers. Generally, payments given without any "strings" or to reimburse medical, housing, or burial expenses are not subject to tax. Payments requiring the payments be used to repair the home or reimbursement for damages to the home must be treated as additional insurance proceeds. But if they are paid to the taxpayer without any restrictions other than they are assistance in regards to the taxpayer having experienced a specific catastrophic physical event, then they are "tax free."

SMALL BUSINESS ADMINISTRATION LOANS

Securing a Small Business Administration (SBA) loan as part the recovery does not create taxable income. It is a contract that includes an obligation to re-pay money borrowed plus interest. In some cases, the SBA will forgive a portion of the loan once it is reduced to a specified balance. The forgiveness does have income tax consequences. A forgiveness of indebtedness is treated in the same manner as additional insurance proceeds. The treatment of the forgiveness depends on several factors including:

- The time period in which the forgiveness occurs,
- The replacements made by the taxpayer,

The forgiveness may be taxable or simply reduce the Adjusted Cost Basis of the replacement property.

SBA DISASTER DECLARATIONS

The SBA may make disaster declarations without a "Federal Disaster Declaration" being made. The SBA declarations only make their disaster relief loans available to taxpayers; it does not make the event a Federal Disaster that allows taxpayers to take advantage of special disaster tax benefits. Federal disaster declarations are listed at FENA.gov / disasters.

4 COST BASIS OF PROPERTY DAMAGED

Cost basis is only an important component in the recovery process for income tax considerations. For insurance, it is only important that the insured prove the cost to replace the damage, that is not the same cost basis that we are concerned with for tax purposes. Cost can be simple. For a home that was not modified after acquisition, the purchase price plus some of the closing costs would be its cost basis. That rarely is the case. Maintenance expenditures are not part of the cost basis. The cost of mowing the lawn is not an improvement, the cost of planting a tree or a rose bush is an improvement.

Items acquired by gift or inherited have special rules. The "cost" of an item received as a gift is determined differently from items that are received through inheritance.

In prior years, before the recent housing value downturn, we would not be too concerned with the next step as the assumption had been that real estate values are increasing. In fact, for determining a gain, that is where the computation of cost basis does stop. For purposes of determining a loss, an additional consideration comes into the computation: The fair market value of the property immediately before the catastrophic event. If that fair market value is above the actual cost basis, there is no adjustment to the cost basis. If the fair market value is less than the actual cost, the cost is "adjusted" to the fair market value to arrive at the "adjusted cost basis." The decrease in fair market value that results from the difference between the fair market value and the actual cost is considered a personal, non-deductible loss. When the IRS examines a return, they look for personal losses inappropriately deducted in the return.

The following example demonstrates how fair market value below the actual cost affects the computation of a loss.

Cost	$	2,000,000
Value before event		1,700,000
Value after event		1,000,000
Loss in value resulting from loss		700,000
Insurance Proceeds		500,000
Adjusted Loss before deduction limitations	$	200,000

The cost of real estate involves categories such as land, building, landscaping, asphalt driveways, patios, etc. For personal use real estate, the cost of each category is not relevant. If the building burns, the loss is not limited to the cost of the building. For personal real estate, the IRS looks at the cost of the complete property as one “integral unit.” Even though the land does not burn, the loss is computed on the reduction in the value of the whole property. The loss is compared to the adjusted cost of the whole property, including land. Cost is the attributable to the property is the maximum limit of the loss.

The decrease in value before the casualty of $300,000 ($2,000,000 purchase less $1,700,000 value before the event), is not part of the deductible loss, but it still remains part of the cost basis for the asset going forward.

The example below does not include insurance proceeds. The decrease in value is $500,000 (value before the event, $900,000 less the value immediately after, $400,000). The loss is limited to the cost basis ($400,000), which is less than the loss in fair market value ($500,000).

Land	$	100,000
Cost of construction		300,000
Total Cost		400,000
Value before event		900,000
Value after event		400,000
Decrease in value		500,000
Adjusted Loss before limitations – limited to Basis	$	400,000

The above example also demonstrates a concept in the tax code, “integral nature.” The “integral nature” concept makes a distinction between personal use real estate and other real estate. For personal use real estate, there is no need to allocate between land and improvements when determining the loss from a casualty. In other words, based on the above example, although the construction costs were $300,000, the allowed loss was based on the total cost of $400,000. Therefore, while cost is a limit, of the economic loss of $500,000, the taxpayer is allowed to deduct the full cost of $400,000.

The following example demonstrates a gain: The total cost, including the land is $400,000. That is compared to the insurance proceeds of $1,000,000. An exclusion that is discussed later, $500,000 reduces the gain of $600,000 to a $100,000 gain realized. The realized gain may be deferred or reported as a capital gain.

Land	$	100,000
Cost of construction		300,000
Total Cost		400,000
Insurance proceeds		1,000,000
Gain before exclusion		600,000
Sec 121 Exclusion		500,000
Gain to Defer	$	100,000

The last example combines two elements of the above examples.

Land	$	100,000
Cost of construction		300,000
Total Cost		400,000
Value before		900,000
Value after		400,000
Decrease in value		500,000
Insurance Recovery		150,000
Adjusted Loss before limitations – limited to Basis less Insurance proceeds	$	250,000

There are cases where the allocation of cost between land and improvements will be required because both business and personal use are involved.

Gifts have a cost basis that is called “carryover basis.” It is generally the cost basis in the hands of the person making the gift, but it cannot exceed its fair market value at the time of the gift.

Inherited items have a cost basis that is equal to the fair market value, generally, at the date of death of the person who made the bequest.

Assume that Aunt Jenny gives an antique that she purchased 60 years ago for $10.00 that has a value at the time of making the gift of $100.00. The person who receives the gift has a cost basis in the antique of $10.00. On the other hand if Aunt Jenny gifts her car that she paid $15,000 20 years ago that now has a value of $1,000, the person receiving the car has a cost basis of $1,000 for that car. If these items had been received as bequests after the death of Aunt Jenny, these items would have a cost basis to the person receiving them of $100.00 for the antique and $1,000 for the car.

5 DOCUMENTING – A GAIN OR A LOSS?

The IRS does not specify how records should be kept. They do require that the records be kept in a manner that allows the taxpayer to demonstrate to them that the reporting on a tax return results in the "correct tax." Generally, taxpayers do not have to submit documentation with the return when it is filed. The substantiation must be maintained by the taxpayer.

The need for adequate documentation cannot be over-stressed. However, courts have been reasonable where the critical documentation has been destroyed in the casualty event. This does not mean that taxpayers should be loose with their documentation record keeping. In fact, while the courts may show leniency a taxpayer with full documentation will do better than a taxpayer relying on the kindness of a judge.

In addition to the formal records of the home's purchase and major improvements, other materials are often useful to demonstrate cost. It is unlikely that a taxpayer has all the receipts for all the linens in a closet. A photograph of the closet might add some level of proof in addition to the photograph being a memory aid to list all the items stored in the closet. The loss on personal property is limited to the lower of the value of the items just before the event or their cost. The receipt for a custom-made couch is wonderful, but a recent photo will show its condition demonstrating a level of "depreciation" in value due to use.

A list of major items that are important evidence in the documentation process include the following:
Basic acquisition cost, improvements
Adjustments – decrease in value before event
Inherited property
Valuations (before / after)
Appraisal (& Appraiser)
Cost of Repairs methods
Physical location of items lost
Insurance proceeds
Replacements (Repairs and /or Acquisitions)

6 TAX REPORTING FOLLOWS THE INSURANCE PROCEEDS

The payment of insurance proceeds should be documented very carefully, including a photocopy of the check. Retain any materials that the insurance company sends with the payment or as support for the payment. Often, the insurance company will have codes on the check or stub. If the material accompanying the check does not include an explanation of the codes, ask the company for the key to the codes. Verify the codes related to the payment are consistent with your understanding of what was being compensated for in the claim. Note on claim documents when the when the claim was filed, how much was claimed compared to the amount paid, and reasons for differences.

The insurance policy can provide payments for the following:
Real property – Structure (usually Coverage "A")

Real property – "Other Structures" (usually Coverage "B") generally 10% of Coverage "A." Additional coverage can often be acquired.

Personal property (Contents) (usually Coverage "C"), generally 50% to 75% of Coverage "A." Additional coverage can often be acquired.

Additional Living Expenses (usually Coverage "D"), usually based on the quality or living standard as determined by Coverage "A."

Other coverage for "Scheduled Property" items, (specifically listed in the policy).

Medical expenses

Flood insurance is only available through a federal program.

Earthquake coverage is most often a separate policy. Coverage quality can vary over a wide range.

Some insurance proceeds may be income, or be tax-free. They may be subject to partial tax-exclusion and the balance subject to possible tax-deferral.

All evidence related to spending funds to return to a pre-event status, including acquisition of replacement property and the cost of repairs and experts must be retained as evidence of the reinvestment. Using a computer worksheet to summarize the accounting for the funds in addition to maintaining the actual source paperwork is essential. The specific tax treatment of each type of insurance payment is covered in this material.

Vehicles, boats, trailers, etc., all have separate insurance coverage availability and thus are treated separately when reporting a loss for tax purposes.

Business losses are treated separately from personal losses, even when the business is operated from the personal residence.

Reporting a gain or a loss will be based on the taxpayer's receipt of funds in each of the specific categories compared to cost basis or adjusted cost basis of the assets lost or damaged.

“Tax Elections,” Decisions and Tax Consequences		
POSSIBLE OUTCOMES:	7 NO GAIN OR LOSS	
	8	A LOSS
	9	A GAIN

FIRST STEP SECOND STEP
Cost Basis Determine Preliminary FMV
Insurance proceeds
Analysis is completed by category

Allocation between damaged and undamaged property
(Total cost for personal use real estate is available to absorb tax loss)
Area? / Relative value? / Something else?

“Tax elections,” Decisions and Tax Consequences
When an event occurs, the first thing that you need to do for tax purposes is determine if there is a gain or a loss. Your initial analysis may later change, but the initial analysis will assist you the early days of the recovery. However, it is important to keep the possibility of an alternative conclusion in mind.

It is also important to refrain from rushing into a loss claim on a tax return. While the initial benefit may be very enticing, a later recovery that requires a reversal of the original loss can be very costly. The initial benefit may get you $15,000 in tax savings, but the later recovery could easily cost you $25,000 or more.

It is possible to have a gain in one category while having a loss in another category.

7 NO GAIN OR LOSS

The potential and actual tax consequences must be understood prior to making any replacement decisions and the process afterward. There is some flexibility in making changes to decisions later, See “Things Can Get Worse” section 15.

It is possible that the initial analysis results in no gain or loss. Yes that is possible. If insurance is adequate, the loss was not total and the cost basis is the result of a recent acquisition of the property.

Even it there is no gain or loss, it is advised that the following information should be part of the disclosures included in a tax return related to a catastrophe:

- The type of casualty and when it occurred (including, if available, the FEMA identification number).
- The date of the loss.
- That the loss was a direct result of the casualty.
- The information relates to the return for the taxpayer who owns the property (or the taxpayer is leasing and is contractually liable to the owner for the damage.)
- The city, county and state in which the loss event occurred.
- Any replacement costs incurred, appropriately detailed.
- Cost basis of property damaged.
- Insurance proceeds received or expected to be received.

If the gross loss does not exceed $10,100, and the taxpayer’s adjusted gross income is $100,000, no deduction would be allowed. The facts should be disclosed in the return. The above items should be reported.

Odd as it may seem, there are other possible ways to have neither a loss nor a gain. It may even be possible that there is a gain, but due to the application of available exclusions, there is no realized gain. If the cost basis of the property is close to the insurance recovery and the insurance is reasonably adequate, there is a good chance, there will be no loss or gain realized for income tax purposes.

If there is a gain, but the residence qualified as a complete loss, triggering the Internal Revenue Code section 121 exclusion of gain, $250,000 for the taxpayer and $250,000 for the spouse. A gain of less than $500,000 for a married couple eliminates the gain, but it results in no gain or loss. It does require the filing of a complete statement to claim the exclusion. The above items should be reported.

When computing a loss the cost basis that is used is based on the “adjusted cost basis” as described above. Because of that, an initial loss based on actual cost basis may evaporate when the actual cost basis is replaced with the “adjusted cost basis.” If that computation turns into a gain using “adjusted cost basis,” there would be no gain to report and no loss.

8 A LOSS

There are instances where it is necessary to determine who is entitled to claim any deduction for the loss.

When to deduct a loss:
In order to claim a deduction the Code requires that the loss must be sustained. To be sustained, the loss must have occurred and the claims process, settled. There is some vagary in the meaning of settled. Assume a loss of $1,200,000. The maximum possible insurance coverage that is available to pay for the loss is $800,000. The insurance company has paid out only $200,000 by the time that the tax return is due for the year in which the loss occurred. There is every likelihood that the balance of the policy limits will be paid. There is no certainty that any loss in excess of the limits will be recouped from insurance or that any claim for additional loss is even possible. Under this situation, it may be reasonable to take the position that the loss of $400,000 in excess of the policy limits of $800,000 has been settled.

Without going into a long analysis, if the loss is $150,000 and the insurance will only cover $100,000, then it can be argued that $50,000 is sustained even if the claim process is not yet completed. If the insurance company pays only $95,000 on the claim, then an additional $5,000 would be deductible in the year that the $95,000 is finalized.

The loss and cost basis are reduced by insurance proceeds. The loss can be determined using one of two methods discussed below.

APPRAISAL METHOD vs. COST OF REPAIRS METHOD

Documenting a loss is accomplished using the “Appraisal Method” or the “Cost of Repairs Method.”

For the “Cost of Repairs Method” only the cost of the repairs necessary to return the property to its pre-event condition is compared to the Adjusted Cost Basis of the property damaged; the lower of the two amounts is the loss. Using the Cost of Repairs Method, the cost of removing the debris would be one of the amounts leading to the total cost of repairs. The deduction can only be taken once the repairs have been completed. If the repairs are completed in a year subsequent to the year of the event, once they are completed, the taxpayer would file a return for the year of the of completion, claiming the loss. The drawback of the Cost of Repairs Method is that the repairs must be made and only those repairs that return the property to its pre-event condition are permitted to be included in the computation of the loss. Any improvements or betterments, either required or elective, are not allowed as part of the cost of repairs calculation of the loss.

Selecting the “Cost of Repairs Method” does not alleviate the need for an appraisal. The value immediately before the event must still be determined to establish the lower of actual cash investment or appraised value for determining the adjusted cost basis before the loss event.

Using the Cost of Repairs Method also limits the taxpayer from reinvesting the insurance funds in a separate replacement property to qualify as replacement of the damaged property. “Betterments” can and should be incorporated into the repair, but the cost of the betterment do not qualify as a cost for computing the amount of the loss. In some cases, a repair may be called for that is demanded by the building code, but does not duplicate the original construction. Even though it may cost the same as returning the property to substantially its original configuration, it will not count as the IRS will likely view it as a disqualified improvement.

Where a taxpayer has made a decision to epoxy a cracked slab and use the cost savings to upgrade a kitchen, the upgrade would be excluded from the computation of the allowable loss. Since the concrete slab will not be replaced, its cost of replacement included in the insurance claim is not part of the loss computation either.

Under the law the details of the repairs used to quantify the loss using the “Cost of Repairs Method” must be traced to the completion of the repairs within a reasonable period of time after the event, considering the completion of the insurance claims process.

All of the restrictions inherent in the Cost of Repairs Method disappear when using the “Appraisal Method” for determining the loss. Under the “Appraisal Method,” the taxpayer simply gets two appraisals prepared by a competent, qualified real estate appraiser. The first appraisal computes the value immediately before the loss event occurred. The second computes the value giving effect to the fact that the loss has occurred.

The second appraisal should specify and include the detrimental effects on the fair market value due to the debris that is present after the event. It should also specify that i

“The post-event appraisal does not give effect to any temporary buyer resistance that may be impacting the market immediately after the event.”

The appraiser need not compute the difference between the two amounts. To arrive at the Appraisal Loss the requirements are entered on Form 4684. The Appraisal Loss is compared to the “Adjusted Cost Basis,” discussed below. The loss is the lower of the Adjusted Cost Basis or the Appraisal Loss. The loss and cost basis are reduced by any applicable insurance proceeds.

Using the Appraisal Method allows the taxpayer to use insurance funds for the repair and improvement of the damaged property or the acquisition of a replacement property. (The insurance contract may impose separate limitations.) There are no income tax limitations placed on the location of the replacement property. It does not even have to be located in the same state.

Expert personal property appraisers may be able to approximate the original cost and pre-event value of some contents.

Caution: The taxpayer may think that providing the appraiser with a copy of the scope of loss will assist the appraiser in determining the value of the property after the event. The cost of repairs is not necessarily relevant to the appraiser’s valuation analysis for the pre-event value and the destroyed structure is irrelevant to the land value after the event. The appraiser will make an independent determination of the value of a partially destroyed structure.

The risk of providing the scope of loss to the appraiser is that if the appraiser includes any reference directly or indirectly to the scope of loss, while the taxpayer has selected the “Appraisal Method,” the IRS, in an audit may incorrectly assert that the “Cost of Repairs Method” has been selected. The IRS has lost on this allegation. The courts allow the appraiser to use his / her expert judgment to arrive at the estimate of value. But while the IRS has lost on this scenario that does not mean that the auditor you are facing will know that. It potentially adds an additional item that must be dealt with in an audit that can be avoided.

Determining a loss

If there is a loss, the taxpayer must take care in determining the loss including which method of computation to use. Determination of the loss is based on one of the two methods of computation. The choice of method is left to the taxpayer, although the IRS has been known to question the outcome and attempt to use another method. Generally, the taxpayer's choice has been upheld if it has been properly supported. The IRS will prevail over taxpayers who have been loose with the accumulation of proper supporting evidence. The two methods of determining the amount of the loss are quite different. The Appraisal and Cost of Repairs Method s will not provide equivalent results. In fact, it is likely that they will result in quite disparate amounts.

The loss computed using either method cannot exceed the adjusted cost basis of the property.

Reporting a Loss – FORM 4684

It must be determined in what tax year will the loss be reported on a tax return. Assume the loss occurs near the end of the year. The claims process can be complicated and may extend past the end of the year subsequent to the year that the event occurred.

Once the basic amount of the loss is determined, there are two adjustments that reduce the amount of the tax deduction. The first is that $100 for each event during the year is excluded. The amount of income that appears at the bottom of page one of the Form 1040 income tax return is called "Adjusted Gross Income" (AGI). The second adjustment requires that 10% of AGI must be deducted from the total of all casualties reported for the year. If the pre-adjustment losses total $50,000, all from one event, and AGI for the year is $100,000, the deductible loss will be $39,900 ($50,000 less $100, less 10% of $100,000).

The following tables provide a simple example of how to compute a gain or loss on contents. The example is overly simplified to demonstrate the point that grouping items by categories may provide a better result than simply treating all contents as a "single unit."

Line	Description of Item Damaged or Destroyed	Cost	Value Before Event	Value After Event	Condition After Event	Limit of Loss	Loss Before insurance Proceeds
1	Necklace	1,200	1,200	0	Destroyed	Cost	1,200
2	4 Men's suits	2,800	600	0	Destroyed	Pre-event Value	600
	Sub-total	4,000	1,800	0			1,800

The above table reports two items of content, a necklace and 4 men's suits.

Line	Replace-ment Cost	Insurance Limits Applied	Insurance Proceeds 80% *		Gain -Loss	Acquisi-tion of Replace-ments	Gain Not Rein-vested	Loss Real-ized
1	3,000	1,000	1,000	*	-200	0		-200
2	3,600	3,600	2,880		80	0	80	
	6,000	4,600	3,880		-120	0	80	-200
						Net Loss	$120	

In the above table, the computations arrive at a net loss of $120. But if the items are combined on the Form 4684 the result is a zero loss as shown below.

If the remaining two items are combined, the following is the reporting on the Form 4684, resulting in no loss.				Necklace & 4 Men's suits
Cost Basis		2		$4,000
Insurance		3		3,880
Gain		4		-
Value before loss		5		1,800
Value after loss		6		0
Loss – (Economic) Line 5 less line 6		7		1,800
Economic loss – smaller of line 2 or line 7		8		1,800
Subtract line 2 from line 8, if zero or less, enter zero -LOSS		9		0

While the numbers do not change, if the two items are treated as being in separate categories, then the full $120 loss is realized on the form:

If the items are reportable separately, then there is a net loss of $120 before the $100 adjustment and the reduction of 10% of Adjusted Gross Income.				Necklace	4 Men's suits
Cost Basis		2		$1,200	$2,800
Insurance		3		1,000	2,880
Gain		4		-	80
Value before loss		5		1,200	
Value after loss		6		0	

Loss – (Economic) Line 5 less line 6		7		1,200	
Economic loss– smaller of line 2 or line 7		8		1,200	
Subtract line 2 from line 8, if zero or less, enter zero -LOSS		9		Loss 200	Gain 80
Net Loss				Net Loss 120	

IRS Publication 584 “Casualty, Disaster, and Theft Loss Workbook” contains a number of worksheets to assemble data for computing a loss on non-real estate (structure) losses. The worksheets can help in suggesting the way losses are categorized on Form 4684. Here are the way the booklet categorizeds personal property.

Pub 584 ROOMS	Pub 584 SPECIFIC TYPES
Entrance Hall	Sporting Equipment
Living Room	Men’s Clothing
Dining Room	. Women’s Clothing
Kitchen (including appliances)	Children’s Clothing
Den	Jewelry
Bedrooms	Electrical Appliances
Bathrooms	Linens
Recreation Room	Miscellaneous
Laundry and Basement	Motor Vehicles
Garage	

The worksheets in Pub 584 are not inclusive of all possible categories. Some additional classifications include: Computers, Electronics, Cameras, and Art Work.

PROCESS OF RECOVERING FROM A CATASTROPIC LOSS
INCOME AND PROPERTY TAXES CONSEQUENSES AND REQUIREMENTS
PART 3

9 A GAIN
10 QUALIFIED REPLACEMENT PROPERTY
11 SALE OF RESIDUAL LAND / OR HOLD FOR LATER SALE
12 TIME PERIOD TO COMPLETE QUALIFIED REPLACEMENTS
13 STATUTE OF LIMITATIONS

9 A GAIN

"CONVERSION INTO CASH"

In order for a gain to arise, the damaged property must be converted (compensated) into cash or some other property that is not similar to the property lost. Generally this means insurance compensation. Additionally, the compensation must exceed the cost basis of the property damaged. Once a gain arises, two possibilities exist, the taxpayer can pay the tax or make an election to defer the gain by using the proceeds to acquire suitable replacement property. This is consistent with the intent of Congress to return taxpayer to their pre-event condition. If the taxpayer must pay tax on the gain and then use the remaining cash to replace their property, they would have difficulty in that pursuit with inadequate resources.

On the other hand, the taxpayer may see the situation as a way of doing something totally different, paying the tax may be an acceptable alternative.

Determining a Gain

The process of computing a gain is the same as described above except that the taxpayer realizes a gain by using actual cost basis deducted from the insurance proceeds. The gain computation does not need to reduce the cost basis to a potential lower "adjusted cost basis," (Fair Market Value) before event. Completing the computation, an expected loss may result in a "no gain / no loss" result due to the insurance proceeds not exceeding the cost basis of the damaged property, but exceeding the "loss."

The computation may lead to a gain. For example, the anticipated insurance proceeds exceed the actual cost basis of the property. If a "gain" or "no loss" is obvious, there is no need for appraisals.

Once it has been established that there is a gain, a gain is realized in the year that the actual cash proceeds exceed the cost basis of the damaged property. A decision must be made whether that gain will be recognized, reported on a tax return as taxable (essentially treated as a sale), or reported as an involuntary conversion gain to be deferred.

WHAT IS AN INVOLUNTARY CONVERSION?

If insurance and other similar reimbursements in connection with the destruction of real and personal property exceed the cost basis of the property lost, a gain has been realized. Since the transaction was not voluntarily initiated by the party whose property was lost and there is a gain, it is called an "involuntary conversion."

What do you do with that gain? Once a determination has been made that a gain has been realized, a number of considerations must be reviewed and decisions must be made. First, in order for there to be a gain, a transaction must have taken place that converted property into something of value that is not "similar or related in service or use to the converted property," usually this is cash. Next, that conversion must not have been voluntary. That would be an event such as a fire, flood, earthquake or some other "casualty event."

CONVERSION INTO MONEY

In a "like kind exchange" the rules require the taxpayer to maintain the appearance of not handling any funds involved in the sale of the property disposed of and those actual funds are used to acquire the replacement property in order to avoid being taxed on the cash, otherwise called "boot."

Involuntary conversions assume that the taxpayer is in receipt of cash or other property that is not similar or related in service or use to the converted property. Where the conversion is into dissimilar property the nonrecognition of gain becomes an option:

… at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock.

A number of conditions enter into the decision including the following, at a minimum:
1. What is the amount of the gain? Is it so insignificant that recognizing it is the most efficient way to move forward?
2. Are there any capital losses in the prior five years that received preferential tax treatment. Those would cause the recognition of the "casualty gain" to be taxed in an unacceptable manner, at ordinary income tax rates, not the more favorable capital gain rates?
3. Is it possible that there will be additional proceeds that will increase the gain?

TAX ELECTIONS AND DECISIONS

The determination of whether the taxpayer has realized a loss or a gain as the result of experiencing a catastrophic event is often complex. Cost, as discussed above, is subject to multiple determinations. The extent of the loss and the applicable insurance recovery is not always completely known at the time of having to file a tax return. Tax returns have required due dates, some extension of time to file the returns is available, but that may not be adequate for the situation. The taxpayer is placed in a position that the return must be filed with the best information that is available at the time. In some cases, an amended return may be needed later to adjust the original filing, while in other cases the adjustment must be addressed in a subsequent year's filing.

In any case, taxpayers should not delay filing returns that are due. A delinquent return carries with it significant potential for penalties. Even if the original return has a loss and a delinquent return would not have any penalty consequences, a later amendment, reporting taxable income, would generate a penalty.

Reporting a Gain –
Taxable (pay tax currently) or
Deferred (not currently taxed) - no proscribed form

The first critical step is discussed above, determining if a conversion into cash has occurred. If the insurance company provides a replacement, then no conversion has taken place; no tax implications are triggered. This is very unusual. Even when the insurance company provides the contractor, the insured is usually required to sign a contract with the vendor. The insurance company issues checks payable to the insured and the contractor.

"INVOLUNTARY CONVERSION"
CONVERSION INTO

Where money is involved and the proceeds exceed the cost basis, a gain is generated. If a decision is made to defer the gain, the transaction is reported as an involuntary conversion.

Where reinvestment is chosen, the record keeping must be complied rigorously; annual reporting of the status of the reinvestment process, including the disclosure of the insurance proceeds received. These reinvestment reporting rules must be adhered to during the replacement period. As part of this process, it is recommended that the taxpayer schedule out repair plans to estimate if all the required expenditures will be completed in the required time frame or will an extension of the replacement period be needed due to conditions beyond the taxpayer's control.

The involuntary conversion is treated as a "sale transaction" within the tax code The tax code provision allowing an exclusion of up to $250,000 per taxpayer, ($500,000 for married couples) on the "sale" of a primary personal residence may apply. Generally, the law (Revenue Code Section 121) requires:

1. The home must be used as a primary personal residence for 2 of the last 5 years (there are additional requirements that can affect this requirement).
2. The taxpayers must have owned the home for at least 2 years prior to the sale and
3. The taxpayers have not used the rule for at least 2 years.

Additionally, in an involuntary conversion, the home must be "completely destroyed."

An additional requirement must be met for gain resulting from damage to a personal residence. The code demands that the residence be "completely destroyed." However, Congress never defined "completely destroyed." There is an obvious situation where a home has been burned to the ground. But can the home the "completely destroyed" and still have significant structural features remaining. In a 2001 memo the IRS defines a broad spectrum of possible conditions other than a complete burn type situation. Therefore, if your home has had significant damage the possibility of applying the exclusion should be examined very closely.

After a Section 121 gain exclusion is applied to the involuntary conversion gain all remaining gain might be eliminated from current taxation with a deferral election.

For the exclusion to apply, the home must be completely destroyed in the incident. Complete destruction is measured in terms of actual physical destruction. The loss may qualify as complete destruction where the cost to repair is sufficiently high to make it economically unfeasible to make the repairs, regardless of the amount of the actual destruction,

The time to complete the repairs and the complexity of the repairs may also affect the decision to pay the tax or defer the gain.

Total Cost	$ 400,000
Insurance Recovery	900,000
Gain	500,000
§121 Exclusion	500,000
Remaining Gain	$ -0-

Cost basis before repairs	$ -0-
Total repair Costs	900,000
Gain realized	$ -0-
New cost basis after repairs	$ 900,000

What about a partial taxation and a partial deferral of gain? For example, assume the proceeds are $1,000,000 and the gain is some portion of that amount. It is believed that the repairs can be completed for less than the full sum. It is possible to report a portion of the proceeds as taxable, but not in excess of the gain and defer the balance.

If all or a portion of the gain is reported as taxable, it is treated as a capital gain item. To make sure that it is taxed at capital gain rates, it is necessary to determine if there have been any capital losses deducted in the prior five years that were allowed as ordinary losses. These losses will necessitate that the gain be taxed at ordinary rates to the extent of those prior ordinary losses.

Reporting a deferral of the gain

NO PROSCRIBED FORM, INCLUDE IN DISCLOSURE:
The IRS does not have a proscribed form to report a deferral of a gain as there is for reporting a loss (Form 4684). However, the code and regulations do require certain information be included in the disclosures during the post-event, replacement reporting period.

Event identification – clear description including any federal or state disaster declarations
Year(s) gain realized – the gain may be realized in more than one year, each year of realization must be reported
Proceeds received Less Gain excluded = Gain realized

Gain recognized (taxable / partial or full deferral)
Identification of property lost - clear description including address of property for real property, for replacement properties the location, cost investment
Dates of loss, reinvestment
Election to defer gain under indicating the appropriate Code section
Identification of replacement property(ies) or repairs – type of property, location

Total Cost	400,000
Insurance Recovery	1,200,000
Gain	800,000
§121 Exclusion	500,000
Remaining Gain	300,000
ADJUSTED PROCEEDS	700,000

Cost basis before repairs	-0-
Total repair Costs	1,200,000
Gain realized	-300,000
New cost basis after repairs	900,000

What Year is a gain reported? PART TAXABLE / PART DEFERRED

	Year 1	Year 2
Cost Basis	$300,000	$ 0
Insurance	$500,000	$250,000
Gain	$200,000	$250,000
Repairs		$400,000
Taxable	$100,000	$250,000

10 QUALIFIED REPLACEMENT PROPERTY

The law states that in order to defer paying tax on any realized gain from an involuntary conversion, the taxpayer must use the proceeds to purchase qualified replacement property (including repairs to the damaged property). Generally, the replacement property must be "similar or related in service or use to the converted property." This requirement is not the same as "like kind." "Like kind" is a term that applies to tax-free exchange transactions. For personal use real estate, the “similar use” requirement means any improved personal use real estate will qualify. The concept of like kind is seen as being broader (applying to the characteristics of the property) while “similar or related in service or use” relates to how the taxpayer uses the property.

Personal use real estate is not an undeveloped lot. Although a newly acquired lot subsequently improved within the replacement period qualifies. A previously acquired lot that is built on after the catastrophe will not qualify, but the new construction will.

Immediate conversion upon acquisition of a residence into rental property would not meet the standard. Other than those restrictions, as long as it is real estate and functions as “for personal use” the standard is usually met for lost personal use real estate.

It is not necessary to spend the actual cash received from the insurance recovery. In fact, if the taxpayer wishes to borrow funds to complete the reinvestment and take the insurance proceeds and invest them in the stock market, that is acceptable.

MULTIPLE REPLACEMENTS FOR SINGLE LOSS?
For real estate it is permitted to acquire more than one replacement property rather than invest the funds in one single replacement property. The multiple replacements may be acquired over a period of time and not simultaneously. How does the taxpayer allocate the deferred gain. Allocate gain, pro-rata over the total cost of all acquisitions

ORDER OF REINVESTMENT
As replacement funds are being spent on qualified properties, the tax law sets the way the deferred gain and cost basis are affected:

- Replace Original Cost Basis
- Absorb Gain
- Remaining un-invested proceeds are taxable or Additional costs increase the cost basis.

	Prop #1	Prop #2
Cost incurred Min. $950,000 required	$300,000	$700,000
Ratio	30%	70%
Deferred Gain $300,000 (cost times ratio)	$90,000	$210,000
New Adjusted Basis	$210,000	$490,000

The above table demonstrates how the tax rules tell us how to allocate the deferred gain when the reinvestments involve more than one property. The allocation of the gain is computed once the costs are incurred. The deferred gain is then computed as a percentage of the total costs incurred, in this case 30% (deferred gain of $300,000 divided by total costs incurred of $1,000,000). Then the ratio is applied to the cost of each asset.

11 SALE OF RESIDUAL LAND / OR HOLD FOR LATER SALE

"FEASIBLE" TO REPAIR / SALE OF RESIDUAL REAL ESTATE

Another consideration that often arises is an outright sale of the "residual damaged property" that remains after a casualty. The issue is the potential for deferral of the gain on the sale of the combined insurance and sale proceeds including the gain from the land sale in the computation of the IRC Section 121, $250,000/ $500,000 gain exclusion and remaining gain to be deferred. The level of repairs that are required to bring the property back to its pre-event condition must be analyzed. The result of the analysis may affect the ability of the taxpayer to combine the subsequent land sale as part of a single transaction. This situation is best explained by example. The homeowner decides to sell the damaged property instead of repairing / rebuilding. At one extreme, the complete destruction of the home in the loss event would qualify for single transaction treatment. As severity of the loss decreases there is no "bright" line where it is easy to see the point at which the loss is not significant enough to justify the subsequent sale of the residual property as part of the initial casualty. The courts' and IRS rules on the subject of "feasibility" provide assistance. The question is the cost of repairs compared to the resulting fair market value of the property after the repair. The rules do not require that the taxpayer invest in a repair that will cost so much that the repair will be more costly than the resulting value of the property (a value determined prior to the loss event). A flood caused by a water heater exploding inside the home would usually not qualify as damage that qualifies as a major loss and, the insurance proceeds combined with a subsequent sale of the home would not qualify for any deferral of gain.

The following example demonstrates the difference in outcomes where a transaction is split and where it is combined as one "involuntary conversion" transaction:

	Split Transaction	Lot Sale Included
Insurance	$ 600,000	$ 600,000
Lot Sale		300,000
Total proceeds	600,000	900,000
Cost	300,000	300,000
$250,000 / $500,000, Section 121 Exclusion	300,000 (limited to gain)	500,000
Gain subject to deferral	$ -0-	$ 100,000
Unrelated, subsequent sale of land – all taxable gain	$ 300,000	
Possible allowance of $250,000 / $500,000 gain exclusion	200,000	
Taxable gain	$ 100,000	

If the sale of land qualifies as part of the original transaction for tax purposes, (the sale is the result of actions that originated with the casualty event), the gain will be subject to the exclusion benefits and any remaining gain can be deferred.

	Basic	With Lot Sale	Only Lot Sale
Insurance	600,000	600,000	
Lot Sale		300,000	300,000
Total Proceeds	600,000	900,000	300,000
Cost	300,000	300,000	-0-
Sec. 121 Exclusion	300,000	500,000	200,000
			Taxable Gain
Gain subject to deferral	-0-	100,000	100,000
Required Reinvestment	-0-	400,000	na

12 TIME PERIOD TO COMPLETE QUALIFIED REPLACEMENTS

0	1	2	3	4	5	6	7	8
					2 Year Post-Gain Replacement Period		4 Year Replacement Period – Disasters	
Loss Year	$ Rec'd	$0	$0	$ Rec'd	1	2	3	4
^ | Loss	Total proceeds less than cost basis			1st GAIN YEAR *			(For Disasters: Four Years)	

^---------------------Qualified Replacement Period----------^-----Disaster-------^

* Year that Total Proceeds exceed cost basis of property lost

Included in the law's relief provision is the setting of time restrictions in order to take full advantage of the tax deferrals on a gain. The time restrictions have the most impact on taxpayers who have a gain and wish to defer the payment of tax by completing a qualified replacement or repair of the destroyed property. The replacement period begins at the time the catastrophic event occurs. Any acquisitions of what might be considered replacement property acquired prior to the catastrophic event, generally, cannot be counted as qualified replacements. The "replacement period clock" continues to run while the insurance negotiations are in process. During this time, it is possible that the insurance company makes payments that are not in excess of the taxpayers cost basis for the destroyed property. Only after the cumulative insurance proceeds exceed the cost basis will there be a gain realized. Once gain is realized, a “second clock” starts to run. The second clock starts at the end of the year in which any gain is first realized. It continues to run for two years (four years for federally declared disasters) after the end of that year. The whole period from the point of the loss to the end of the “two / four year” period is defined as the replacement period.

Assume a loss on October 10, 20x0.

- The insurance company makes some payments in 20x0.
- These payments do not exceed the cost basis of the property.
- Sometime in 20x1, the insurance company makes a complete settlement of the claim that cumulatively brings the proceeds to an amount in excess of the cost basis.
- A gain has been realized in 20X1 after applying any Section 121 gain exclusion.

The second clock (two / four year), starts to run at the end of 20x1 for a two-year period ending on December 31, 20x3 (two years after the end of the first year in which a gain is first realized).

EXTENSIONS OF TIME TO COMPLETE REPLACEMENT

What if the replacement time clock is running out but the taxpayer is unable to complete the replacement before the end of the replacement period? Congress expects people would be able to comply with the time requirement. Circumstances may arise that are beyond the control of the taxpayer. The law acknowledges the possibility. Congress gave the IRS the power to extend the period to complete the replacement. In fact, this is the only area where the IRS has any authority to allow for time extensions in casualty and involuntary conversion situations.

To qualify for an extension, the taxpayer must have a “credible story.” Simply stating, “I have not gotten around to it” is not a good reason. Some reasons that might be valid would include the delay in settlement of a lawsuit that would affect the type of reinvestment that would be completed by the taxpayer. Availability of building supplies due to the massive rebuilding in the area might also qualify if it can be documented. The taxpayer must demonstrate a reasonable attempt to meet the deadline and the extension requested is due to circumstances that are beyond the control of the taxpayer. The regulations specify the information that needs to be included and the IRS office where the application needs to be sent. The application can be as short as a one-page letter. There is no specified form.

13 STATUTE OF LIMITATIONS

Under normal conditions, a tax return is subject to IRS scrutiny for a period of three years after it has been filed. A return for 20x0 filed on April 15, 20x1 will be subject to examination until April 15, 20x4, three years after April 15, 20x1. In the case of an involuntary conversion, the period from the event to the year of the final reoccupation of the residence may span three or more years. This period includes the receipt of insurance proceeds and the reinvestment of the proceeds up to the end of the statutory replacement period, including granted extensions. All the returns for all the years in which any of these activities occur remain “open” for examination for the period that ends three years after the final notification to the IRS that the reinvestment has been completed. In the case where the event occurred in 20x0 and the replacement period and final completion of the reinvestment are completed in 20x3, followed by filing the 20x3 return on April 15, 20x4, all returns for 20x0 through 20x3 are open for examination through April 15, 20x7 (three years after April 15. 20x4).

0	1	2	3	4	5	6	7	8	9	10	11	12
					2 Year Post-Gain Replacement Period		4 Year Replacement Period – Disasters		Year 8 T/R filed April 15			April 15 Stat-ute Ex-pires
Loss Year	$ Rec'd	$0	$0	$ Rec'd	1	2	3	4				

PROCESS OF RECOVERING FROM A CATASTROPIC LOSS
INCOME AND PROPERTY TAXES CONSEQUENCES AND REQUIREMENTS
PART 4

14 INSURANCE *vs.* INCOME TAX

The emphasis in this material is on personal use real estate (generally the primary residence) and its contents (personal homes, not rentals or property used in a business).

Application of the tax benefit rules also apply to people who pay rent for their home. Renters can use the tax relief provisions that apply to personal property lost, as well as additional living expense insurance benefits that a renter's policy provides.

Income tax deductions are not a substitute for filing an insurance claim. If no insurance claim is submitted for a loss covered by insurance, a tax deduction cannot be claimed for the loss as a substitute. In most cases, insurance is not required to be purchased as a prerequisite to reporting a loss on a tax return. A loss may still exist after considering the insurance coverage that may be allowed as an income tax deduction.

The "reporting" of damages to an insurance company is not the same as the income tax reporting. The insurance company does not have any right to see how the insured reports the outcome on a tax return. They only have a right to see documentation that directly affects the claim of loss. The IRS has the right to see all relevant documentation which may include some or all of the insurance documentation.

Insurance recovery is generally based on the value of the property lost, often the cost of replacing an item is the measure of the reimbursement. The insured must establish within some basic parameters ownership of the property lost. The fact that the item was purchased for $20.00, twenty years ago is of little relevance. For income taxes the cost is relevant and its value prior to the loss is also relevant. Replacement cost might be useful, but is not directly relevant.

15 THINGS CAN GET WORSE

Unfortunately, there are decisions or events subsequent to the initial loss event that can make the situation more difficult for taxpayers. Some of these additional events are well within the taxpayer's control and some are not within the taxpayer's control.

NOT REPORTING A GAIN

What if no reporting is made of the proceeds or the reinvestment to the IRS? The law states, where no reporting is submitted to the IRS the <u>law assumes</u> that where a gain has been realized a qualified replacement has been elected and will be completed within the required period. The statute of limitations requires reporting to the IRS in order that the statute can expire with the normal passage of time. That requirement is not met if there is no reporting. The IRS continues to have the ability to examine the applicable returns "forever."

If the reinvestment is not made, then a tax liability along with penalties and interest hang over the head of the taxpayer.

A 2001 IRS position poses a problem for taxpayers who fail to report a gain from an involuntary conversion. If the taxpayer does make the reinvestment, but does not report the results to the IRS, any acquisitions or repairs can be excluded by the IRS as qualified replacements upon audit.

The 2001 IRS position makes a distinction between the deferral transaction and the reinvestment transaction. The IRS acknowledges that the deferral is automatic if no report is made. However, in the 2001 IRS position the IRS is very clear that a reinvestment does not meet the qualified reinvestment rules unless it is reported to the IRS in a return for the year that the reinvestment is actually made. A taxpayer who is not aware of the rules and has made an unreported deferral decision is put in a potential penalty position because the reinvestment has not been made according the IRS since it has not been reported. And since it has not been reported, the statute of limitations remains open indefinitely.

PROPERTIES TAXPAYER DECIDES ARE NOT ACQUIRED AS REPLACEMENT PROPERTIES

In some cases the taxpayer may purchase a temporary home after the event while the primary home is being repaired or it appears that the settlement process is going to be very protracted. What to do? A solution may be purchasing a temporary home that will be sold after the home is reconstructed. But if time passes without resolution, the temporary home may end up being the replacement home. How do you deal with all this when you are required to file a tax return on an annual basis? Annually, you have to commit, is the home purchased a temporary home or a permanent replacement? Keeping in mind that reporting is the prime responsibility it may or may not matter if you treat the temporary home as a part of your replacement plan. Let's look at several scenarios.

Purchasing Temporary Home, turns out not to be part of permanent replacement plan:

If the home is not declared as part of the permanent replacement plan, then no portion of the deferred gain is allocated to the purchase reducing the cost basis. Since the home is intended to be held for only a small period of time, it is unlikely that its value will not change significantly, but the taxpayer gets to deduct the mortgage interest and property taxes. The sale may have a small or no tax impact. If the home value does go up and the home is held for at least 2 years, then the gain may be eliminated by the IRC Section 121 exclusion.

Purchasing Temporary Home, turns out to be part of permanent replacement plan:

If the temporary home is not declared as part of the replacement, and it turns out to be the permanent replacement due to a change in circumstances, the deferred gain has no asset to be attached to and it will become taxable.

Purchasing Temporary Home, treating it as part of permanent replacement plan:

If the temporary home is declared as part of the replacement plan, deferred gain will be subtracted from the cost basis. Keeping in mind that the gain may have been reduced by the IRC Section 121 exclusion, up to $500,000 may already be excluded. If the home is sold before it has been owned for at least 2 years and occupied for at least 2 years, then all deferred gain will be taxed. If it does meet the 2 year requirements, then the exclusion can reduce or eliminate the tax impact. If the taxpayer does acquire an actual permanent replacement home or repairs the damaged home (within the required replace period restrictions), then the deferred gain can be allocated to both the temporary and permanent homes on a proportional basis related to the value of each, not necessarily the time of acquisition.

The process of recovery must include a clear planning process of how to proceed. Selection of how the taxpayer protects the family and at the same time make reasonable decisions that incorporate all the situations that can arise should be thought trough.

	Prop #1	Prop #2
Cost incurred Min. $950,000 required	Property Not Included $300,000	$700,000 Cost basis +
Deferred Gain $300,000	Not personal use	$50,000 replaced
New Adjusted Basis	$300,000	$650,000
Gain: Taxable income	$250,000	

NOT REPORTING A LOSS

The tax law includes a concept: “Allowed or allowable.” How this affects people who decide not to report a loss is that a loss is allowed to be deducted for losses that actually occur. If the loss is not claimed, the IRS can claim that it should have been claimed and that non-recognized loss is assumed to have been claimed without the taxpayer actually gaining the tax benefit. In other words, the cost basis of the property is reduced by the IRS when it is later sold to reflect the loss that was not claimed.

Death and divorce create special problems when they occur after the catastrophic event and prior to the completion of all the recovery process. The prime issue is that any gain realized by a taxpayer “follows” that taxpayer. The deferred gain cannot be transferred to another taxpayer to complete a replacement. It must be dealt with by the taxpayer who realized the gain.

DEATH OF AN OWNER

If the taxpayer dies after the event, that person is not available to complete the reinvestment and the taxes must be paid on any gain that the taxpayer realized prior to dying that was not reinvested. In one case, a jointly owned property was destroyed. A lawsuit was filled and settled many years later generating a gain. The husband’s health started to fail .The family’s concentration was placed on the health issue. The reinvestment was put on the back burner. The husband passed away two weeks before the wife closed the purchase of a replacement residence. The portion of the gain attributable to the husband was required to be reported on an amended joint return for the prior year in which the lawsuit was settled.

DIVORCE

Divorce can create significant tax consequences if the divorce occurs during the replacement period or the consequences are not thought out prior to the divorce settlement becoming final. In a simple case where the gain is attributable to a residence, the solution may be that each party takes half of the proceeds and make separate qualifying reinvestments. What if the assets lost are business assets of one of the spouses?

Assume that a business operating a machine shop burns, destroying all the equipment. The business had been operated by the husband. The wife had no interest or involvement in the business. The business had been operated as a sole proprietorship and operations were reported on the joint tax return of the husband and wife. The business was located and the taxpayers lived in a community property state such as California. For tax purposes, each taxpayer owned half of the business and realized half of the gain. A divorce ensues during the replacement period. The wife is held to have realized half of the gain and is responsible for paying the tax on that portion or making the reinvestment. The wife will have to stay involved until the replacement is completed and all the community property can then be allocated between the divorcing parties.

16 CHANGES AND "CORRECTIONS"

CIRCUMSTANCES CHANGE

CHANGE OF MIND

What if the taxpayer simply has a change of mind regarding a prior reporting decision? Some decisions are reversible and some are not.

Not going to reinvest after making election to reinvest proceeds:

- "I deferred gain. I want to pay tax and not rebuild, not reinvest."

– Taxpayer must wait until the end of the reinvestment period, file an amended return for the year the election was made and pay tax. IRS will bill for interest, but not underpayment penalties.

Once an election has been made to replace the property lost and defer the gain, only the expiration of the replacement period without fulfilling the commitment to complete the replacement can reverse that decision. Unfortunately, that requires the filing of an amended tax return years later with the payment of the tax and interest.

TAXPAYER DECIDES TO REINVEST AFTER TAX HAS BEEN PAID ON A GAIN:

· "I want to reinvest. I originally reported a gain and paid the tax."

– Amend original returns to "un-recognize" gain reported that is reinvested

The taxpayer may have reported a gain in the year the original receipt of proceeds and later decides that deferral is a better decision. The law allows the taxpayer to change the decision in this case. The taxpayer goes back and files an amended return, pays the tax and interest and completes the required reinvestment. The reinvestment still must be completed within the required reinvestment period based on the date the proceeds created a gain situation. However, see the discussion of the IRS requirements for reporting reinvestments timely at the end of this section.

RECOVERING A PRIOR LOSS DUE TO ADDITIONAL PROCEEDS RECEIVED:

- "I originally reported a loss and then received additional proceeds."

– No amended return, report the additional proceeds in year of receipt,

– Recapture prior losses to the extent of prior benefits not to exceed additional proceeds received §111 applies. Recovered loss is ordinary income.

– May elect deferral on gain realized after recapturing loss.

There are situations where the taxpayer has received funds that are not adequate to cover the loss, a loss is claimed on a tax return. Later additional proceeds are received. The additional proceeds have to be evaluated on a cumulative basis. Reversal of the prior loss deduction must be reported as income in the year the additional proceeds are received to the extent of the lower of the deduction benefit of the prior loss deduction or the additional proceeds received. The "income" generated from the reversal of the loss is reported as ordinary income in the year the additional proceeds are received, not capital gains. If the prior loss is totally eliminated resulting in a gain, that gain may be deferred. The two-year replacement period clock begins to run at the end of the year the gain is realized. Again, see the discussion of the IRS requirements for reporting reinvestments timely at the end of this section.

CORRECTIONS:
- Original tax return filings incorrectly filed
- Corrections of previously filed returns can generally be amended as proscribed for all returns

In a 2001 memo, the IRS specifies that once a tax return has been filed, if reinvestments are not reported on that return that took place during that year, they are "forever" assumed that they were not intended to be declared as "qualified replacement properties." Therefore, it is recommended that even for loss situation, it is sometimes possible that because subsequent proceeds may change the situation, that these properties be reported on each return in the form of a statement that the property is being acquired as a replacement for the damaged property.

17 PART PERSONAL USE / PART BUSINESS – IRS Rev. Proc. 2005-14

SPECIAL EXCLUSION OF GAIN INTERNAL REVENUE CODE SECTION 121 TRANSACTIONS:

MIXED USE PROPERTIES AND PARTIAL USE OF SECTION 121
Mixed use refers to property that includes both business and personal use portions. The business use might be part of the main residence structure or located in a separate building located on the property. The Section 121 gain exclusion discussed above comes into play for mixed-use real estate. The exclusion rules are both restrictively and liberally applied. On the restrictive side, the IRS has limitations on what is considered applicable personal residence and transaction limitations.

Where an involuntary conversion of a primary personal residence involves part of the home being used for business purposes such as renting out a room or using a room for business, the application of the exclusion is very favorable. The gain on the business portion qualifies for exclusion. If the business use property is a separate structure from the main residence, an allocation of cost must be made. The gain on the business portion does not qualify for the exclusion, but may qualify for deferral if repaired or replaced with other business property.

If at the time of the catastrophe:
The taxpayer has met all the Section 121 requirements, except that it was owned and occupied less than two years as a personal residence, relief is provided. The taxpayer may prorate the exclusion for the period that the qualification has been met. If, for example, 18 months of the two years' requirements have been met then, 75% (18 divided by 24) of the exclusion may be used. In such a case, if the gain is less than $375,000 (75% of $500,000), the taxpayers will be able to exclude all of the gain.

PROCESS OF RECOVERING FROM A CATASTROPIC LOSS
INCOME AND PROPERTY TAXES CONSEQUENSES AND REQUIREMENTS
PART 5

18 AFFECT OF CHANGING USE AFTER REPLACEMENT

Conversion of Personal Use Real Estate to Rental Property After Rehabilitation
BEFORE: Property used for personal use
AFTER: Change in use to rental after rebuilding
Qualified replacement has not taken place in this case.
Property was not kept for personal use.

If the home is rented after the repair, the destroyed personal use real estate replacement has not been completed as the use of the property has changed.

Home not re-occupied. But not converted to other business or rental use
In some cases, the taxpayer may repair the damaged home, but decides not to re-inhabit it upon completion of the repairs. The question arises: “Has a qualified replacement taken place?”

As long as the residence remains a personal use home and not a business or rental home, the requirements have been met. The sale of the home “immediately after completion of the repairs” raises the question of whether the repairs were made to a personal use residence or a property held for investment. There is no definitive regulation or ruling on the subject. The taxpayer should be able to make rational decisions about the economic decisions related to the best way to recover from a catastrophe. If the value of the home will be greater after the repairs are complete than the cost of the repairs, there is an economic reason to complete the repairs. Additionally, the insurance company may not “allow” the use of the proceeds to be applied to acquire a replacement home without the insured being paid a reduced amount. This may be a factor forcing the taxpayer to complete the repairs to realize the best economic result. A clear intention to convert the property into an investment would be a problem. The replacement of the personal residence did not take place in that case. Timing and access to other financial resources may affect the ability of the taxpayer to follow such a plan.

Another way of dealing with this situation where the taxpayer desires to dispose of the property upon completion would be not to designate the home as the qualified replacement property; complete the repairs, sell the property and acquire the replacement property all within the required replacement period.

	Prop #1	Prop #2
Cost incurred Min. $950,000 required	Property Converted $300,000	$700,000 Cost basis less
Deferred Gain $300,000	Not personal use	$300,000 deferred
New Adjusted Basis	$300,000	$400,000
Intended Deferral:	$90,000	$210,000

19 ALE – ADDITIONAL LIVING EXPENSE REIMBURSEMENTS

Additional living expenses are the costs incurred in excess of the “normal expenses” of food, habitat and commuting expended prior to the event. These additional expenses are not part of the catastrophic loss. There is no allowance in the tax law to deduct these costs. Most residential property casualty insurance policies include a provision to reimburse policyholders these additional expenses. The tax law does not tax these proceeds as long as they are used to pay qualified additional living expenses. If the money is not all spent on additional living costs, the unspent funds are taxable as ordinary income in the year that the taxpayer no longer incurs any additional living expenses.

The question is regularly asked:
“The insurance company is willing to pay me $3,000 a month rent reimbursement for 12 months.
“What if I take a lump sum of $36,000 and use that to invest in a mobile home or use the money to make a down payment on a temporary home?”

The answer is not good news. The use of the funds to acquire an asset such as a mobile home or to purchase a home are not “expenses,” they are “investments.” While it may be a good economic decision, the money used in this manner is taxable.

Another inquiry arises:
- The taxpayer already owns a rental home.
- The insurance company’s additional living expense proceeds are used to “reimburse” the taxpayers for “rent” on their own rental home, used as temporary housing.

The taxpayer must report these ALE insurance proceeds as rental income on the rental property that is being occupied as temporary housing.

20 “EXPERTS” –TAX REPORTING

Homeowners usually hire many experts to assist in the recovery process. Clearly, payments to an architect and a contractor to rebuild the destroyed home are qualified replacement costs. The payment of “soft costs” is part of the replacement. There are other costs. There are four categories that these costs can fall into as detailed below:

1. Proving and documenting the Insurance Claim of Loss
2. Rebuild / Repair / Replace expenditures
3. Tax Reporting Compliance
4. Other Settlement Action expenses

The major areas of expenses that are likely to be incurred in connection with the settlement and recovery process include the following.

1. Preparing a Scope of Loss
2. Public Adjusters to assist the homeowner in negotiation of insurance claim
3. Attorney fees as an intermediary or part of a legal action
4. Appraisers
5. Engineers / Geologist
6. Architect
7. General Contractor
8. Accountant

Some of the experts may only be involved in one category in the list below. Some experts may be involved in multiple categories.

The general classifications of proceeds that can arise out of the settlement / recovery process include the following:

1. Payment for property damage (home, personal property, vehicles and boats).
2. Payment for additional living expenses
3. Payment for medical expenses
4. Payment for burial costs
5. Payment for other personal injuries Involving physical injury or not involving physical injury, including bad faith
6. Other costs and expenses

Payments to any consultant / expert to document the amount of the loss, proving the loss (item 1 above) would be an offset to any applicable proceeds received. This is true whether it is a payment to an engineer or a public adjuster in the normal course of the settlement process including payments to an attorney as a result of settling a legal action related to the property settlement.

Payments to an engineer or a general contractor in connection with the actual repair or reconstruction of the damaged property are part of the reinvestment in the property. An engineer's report that was originally prepared for settlement of the claim, but is later used by the architect to design the replacement / repair, would be part of the replacement costs.

Assume the following facts:
A lawyer is hired on a contingency basis; no fees are due unless the action is successful and then 30% of the gross proceeds are paid to the attorney out of the proceeds received. The action is successful and the proceeds are paid as follows:

	Gross	Legal fees 30%	Costs		See Tax Accounting
Structure	$ 600,000	$ 180,000	$ 60,000	1	$ 360,000
Contents (Personal Property)	160,000	48,000		2	112,000
Additional living expenses – actual costs	100,000	30,000		3	70,000
Medical expenses – actual costs	40,000	12,000		4	28,000
Personal injury caused by Insurance company or its agents	600,000	180,000		5	420,000
Punitive damages awarded by Jury	600,000			6	600,000
		180,000		7	-180,000
Total gross proceeds	2,100,000	$ 630,000	$ 60,000		$ 1,410,000
Legal fees 30%	630,000				
Costs of prosecuting					
Costs of prosecuting Action all attributable to determining structural loss	60,000				
Net proceeds to insured	$ 1,410,000				

The tax accounting would be as follows:

		Tax Accounting
Structure – amount subject to possible reinvesting in qualified replacement property, subject to reinvestment rules with deferral of tax on realized gain ($600,000 proceeds reduced by $240,000 legal costs)	1	$ 360,000
Personal property – amount subject to possible reinvestment rules to defer any tax on realized gain ($160,000 proceeds reduced by $48,000 legal costs)	2	112,000
Additional living expenses – actual costs ($100,000 less $30,000 fee) The actual expenses were $100,000 less the net reimbursement of $70,000 results in a non-net non-deductible expense of $30,000	3	-0-
Medical expenses – actual costs ($40,000 less $12,000) offset of actual net medical costs of $12,000 results in medical expenses deduction that may be reported on Sch. A of Form 1040	4	12,000
Personal injury caused by		
Insurance company or its agents – no actual physical injury (an allegation of bad faith on the part of the insurance company in processing the claim) – All Taxable	5	600,000
Legal expenses related to bad faith claim, deductible on Sch. A, Form 1040 as a Miscellaneous Itemized Deduction subject to a 2% of Adjusted Gross Income reduction	5	- 180,000
Punitive damages awarded by Jury – Same as bad faith: – All Taxable	6	600,000
Legal expenses related to punitive damage award, deductible on Sch. A, Form 1040 as a Miscellaneous Itemized Deduction subject to a 2% of Adjusted Gross Income reduction	7	- 180,000
As to the last two items, since the $600,000 will be part of Adjusted Gross Income, a minimum of $12,000 (2% of $600,000) will reduce the Miscellaneous Itemized Deduction		

PROCESS OF RECOVERING FROM A CATASTROPIC LOSS
INCOME AND PROPERTY TAXES CONSEQUENSES AND REQUIREMENTS
PART 6

21 LAW SUITS, EXPENSES INCURRED

In some situations, people who experience a catastrophic loss find it is necessary to bring a legal action against the insurance company or a contractor to force proper performance. The process will culminate in a settlement or a court decision. The homeowner will be successful or unsuccessful in the action. The law states that where the suing party is successful, the costs, including attorney fees are treated as a cost of collection. The tax treatment is discussed in the previous section. However, come special circumstances may arise as described below.

Lack of success on the part of the plaintiff bars any deduction of incurred legal costs.

Assume a homeowner sues the insurance company for additional money for the actual loss. The suit also includes a claim for acting in “bad faith” during the claim settlement process. The way the suit is structured can affect the manner in which it is treated for tax reporting later. The homeowner’s claims in the suit might be as follows:

Contract issues – additional payment for actual damages to real and personal property	$ 250,000
Bad faith	1,000,000

The suit settles for $350,000. The insurance company refuses to allocate the total proceeds between contract and bad faith issues. Generally, the IRS position has been that the contract issues in this situation were 20% of the total damage claim of $1,250,000, therefore only $70,000 (20% of the settlement) is for contract issues with the remaining $280,000 allocated to settlement of the bad faith claim. This result is a major problem for the homeowner. The $70,000 less any attorney fees (approximately $49,000) can be used to make replacements to the home and defer or eliminate any tax consequences. The $280,000 (much of it needed to complete repairs) is all taxable, related legal costs being allowed only as a “Miscellaneous Itemized Deduction.” The net proceeds after taxes on the $280,000, less deduction for attorney fees of at least 30% might be as little as $112,000, a total of approximately $140,000. This is a terrible result that could have been avoided, if the original claim was structured follows:

Contract issues – additional payment for actual damages to real and personal property	Amount to be determined at trial
Bad faith	Amount to be determined at trial

The $280,000 would be reduced by 30% for legal fees, netting $196,000. The full $280,000 is taxable, the $84,000 legal costs are treated as Miscellaneous Itemized Deductions subject to a 2% of Adjusted Gross Income (AGI) reduction.

Bad faith proceeds are taxable at ordinary tax rates. These proceeds are not subject to deferral or lower capital gains tax rates. The attorney fees related to the bad faith settlement and judgments are not offset against the proceeds, they are reported as “Miscellaneous Itemized Deductions” the tax benefits of which are often lost due to several adjustments and limitations that will come into the computation.

Assuming total AGI is $320,000 including other income $60,000 and deductions including the Miscellaneous Itemized Deductions reduced by $6,400 (2% of $320,000) total $90,000. Taxable income could be $226,000 ($320,000 less $90,000 and one exemption). But due to the amount of the Miscellaneous Itemized Deductions, it is likely that the Alternative Minimum Tax would come into the mix. Federal and state income tax applicable to the only the $280,000 portion of the AGI, could total $78,000. Thus the $350,000 less 30% legal fees and taxes of $78,000, leave the taxpayer only $167,000 to repair the damaged property.

With the above allegation format, there is no roadmap left for the IRS. The taxpayer can take a reasonable allocation. This results in about $81,000 more that is available to the homeowner to rebuild. Additional facts may come out at trial that might affect the allocation.

Bad faith and psychological trauma caused by the defendant are treated the same for tax purposes.

22 MORTGAGE INTEREST

The home damaged in the catastrophic event is not being occupied while it is being repaired or rebuilt. The interest on the mortgages is still deductible to the extent it was deductible prior to the event. As long as the taxpayer demonstrates the property is intended to continue to be a qualified personal residence or is being held for sale.

Where the taxpayer acquires temporary housing with a mortgage, the interest on that mortgage may also be allowed. The total interest that can be deducted cannot exceed the interest defined as qualified home mortgage interest. Generally, this is limited to the interest on total debt not to exceed $1,100,000 ($1,000,000 of basic debt and $100,000 of “home equity” debt). No more than two personal use residences may be combined for this computation.

If the damaged real estate turns into investment property, the “investment interest deduction limitation” would govern the deductibility of the interest.

23 IRS AUDITS – GOOD FAITH REPORTING

The United States tax system is considered a voluntary compliance system. No tax collector comes to our door and goes through our records each year to determine the tax liability. We prepare a return and pay any tax due or request a refund for overpaid taxes. On occasion, after a return has been filed the IRS or state income tax authority may request additional information to substantiate (sometimes clarify) a position or resolve a reporting discrepancy.

In cases where the taxpayer has acted in good faith and made reasonable determinations in the preparation of the return only the additional tax and interest on the later payment will be assessed in most situations after a change has been determined. The law requires for most cases where there is a substantial underpayment the imposition of penalties on audit differences. If the tax authority determines that an unreasonable or unsupportable position has been taken to avoid the payment of taxes, additional substantial penalties can be imposed. In cases where a large adjustment is made to a tax return due to a faulty disaster loss deduction, the adjustment can be very large and therefore automatically trigger additional penalties.

Because the amounts involved in the settlement of an insurance claim and a possible disaster loss may be substantial, it is important that the reporting of the proceeds on a tax return be consistent with the documentation as well as the law and that the tax preparer be made aware of the details of the payments and other key amounts. Excessive estimates and unreasonable allocations and descriptions may result in audit adjustments, ending in substantial costs and penalties.

In some cases, the item will be a flag to the IRS on its own merits. In other cases, the tax return is simply selected at random for examination. In either cases if there is a substantial item related to the settlement of a casualty loss claim and the explanation on the return is adequate, there may be no call from the IRS to provide substantiation. However, if the item is not adequately disclosed and reported, the IRS will start by asking for additional information and then look for inconsistencies and discrepancies. This is not an area to be handled by an inexperienced person.

24 PROPERTY TAX ISSUES - CALIFORNIA

Several property tax issues arise after a catastrophic event. First, the remaining property is not "worth" as much as it was before the event. In the case of a complete loss, the structure no longer exists. In large-scale events involving a number of homes, the property tax assessor will likely make blanket revaluations to compensate for the destroyed improvements. Their reassessments are open to questioning by the homeowner. Once the improvements are replaced, the assessed values will be returned to the pre-loss values with normal adjustments that would have occurred.

In cases where the property has been held for long periods in a state such as California where there are only small annual adjustments to valuations unless the property is sold, it is possible that the assessed value before the event may still be lower that the value of the remaining land after the loss. In that case, there is likely no revaluation.

In most cases, the assessor assigns a split in the total valuation between land and structures that usually weighs the structure more heavily than the land. It is usually assumed the primary value is in the structure, not the land. Where site characteristics are valuable, the land may have a disproportionally higher value than the norm. When a catastrophic event strikes, the assessor may reduce or eliminate all of the value assigned to the structure, acknowledging that the structure has been destroyed. However, the land valuation remains, possibly because the assessor determines that the long-term value of the land itself has not been impacted. Unfortunately, the owner does not receive the tax reductions that may have been expected. After the catastrophe occurs, it is probably not the optimal time to challenge the assessor's valuation split made in a year past. For this reason, when the assessor's valuation split is first made, the owner should examine that allocation closely and if it is too heavily weighted toward the land, it may be worthwhile to challenge it immediately.

In California, over 30 years ago the electorate passed a referendum that placed serious limitation on the increase in the annual valuation of real estate. Subsequent referendums added additional benefits. One of them specifically addresses the situation where a taxpayer has experienced a major loss that has been declared a disaster by the governor. It is important to note that for this provision, it is the governor's declaration that counts, a federal disaster declaration is not required. (A federal declaration can only be requested by the governor after a state declaration.) If the state has made the declaration then it is possible for a homeowner to transfer the pre-loss assessed value attributable to the damaged property to a replacement home. Generally, the replacement must be in the same county as the damaged property unless the county in which the replacement property is located has enacted an ordinance allowing for cross-county replacements. If the damaged property has not been sold at the time the replacement property is acquired it will continue to be assessed as it had been without the taxpayer having acquired replacement property.

FEDERAL DISASTER AREAS:

25 TAX CODE PROVISIONS AVAILABLE FOR TAXPAYERS IN FEDERAL DISASTER AREAS:

The contents of this material prior to this point applies to all casualty and involuntary conversions. There are additional provisions that apply where the federal government has made a declaration that the catastrophic event is a Federal Disaster.

The Process:

The federal government may determine that an incident qualifies as a federal disaster area. Generally, these are major losses. People who experience a Federal Disaster are able to realize financial and tax benefits provided by various agencies of the federal government.

The income tax “benefits” are different for those who realize a gain and those who realize a loss.

ALL AFFECTED TAXPAYERS

Deferral of many federal tax filing, compliance and enforcement actions due dates for tax matters not directly related to the loss *are extended* under IRC Section 7508A.

LOSSES

Year to Deduct Loss:

Taxpayers may claim the loss on the tax return for the year of the loss or the return for the year immediately preceding the year of the loss.

This allows taxpayers who experienced the actual loss in 20x1 to deduct the loss on their 20x1 income tax return or their 20x0 (the preceding year) return. Where the 20x0 return has already been filed, an amended return may be filed. Generally, the amended return must be filed no later than April 15, 20x2 for 20x1 disaster losses claimed on a 20x0 tax return. No extensions are permitted.

An Order to Demolish:

An order to demolish the remaining improvements issued within 120 days of a disaster event which would increase the loss can be included as part of the original loss. This is especially useful if the order to demolish occurs in a year subsequent to the original loss.

Non Itemizers

For taxpayers who don’t itemize deductions on Schedule A of Form 1040, Congress passed legislation that allows these taxpayers to add to their standard deduction the net amount of the disaster casualty loss.

GAINS (Involuntary Conversions)
The tax on the gain can be deferred *just* as *it can be deferred* for non-disasters with additional benefits.

Personal property (contents)
In non-disasters, contents are the most difficult aspect of a casualty loss. In the case of a catastrophe such as a fire that consumes the whole home including all contents, it is almost impossible to determine all the relevant data to make an intelligent determination of a gain or loss. In the case of a *federally declared disaster only*, the insurance proceeds received for personal property do not have to be reported and no computation *of gain* for tax purposes need be determined. This does not preclude claiming a loss if the insurance proceeds are less than the adjusted cost basis of the personal property lost.

"Qualified Replacement Property" for Real Property and Scheduled Property
The rules concerning reinvestment of insurance proceeds also apply. What is "Qualified Replacement Property" (QRP) is expanded.

The proceeds received for the personal use primary home structure and "scheduled personal property" are considered a common pool of funds that may be reinvested in otherwise *qualified replacement* real property defined as personal use land and structure as well as scheduled property. Additionally, general household contents also qualify for inclusion in this amount.

Replacement Period
The number of years is four years not two years *for computing* the reinvestment period.

Structure Proceeds	1,000,000
Net of & §121 Adjustment	500,000
Scheduled Property Proceeds	100,000
Total Proceeds to Reinvest	600,000
Replace structure	950,000
Purchase scheduled property	50,000
Purchase general household items	100,000
Total reinvested	1,100,000

26 BUSINESS AND INVESTMENT LOSSES DISASTER LOSSES:
The provisions above applicable to primary personal residence losses apply to losses of business and investment properties lost in federally declared disasters.

There is a unique provisions for involuntary conversion disaster gains as there are for primary personal residences as described above. Below are the special rules for business and investment property.

The rules for replacement property are applied somewhat differently than those for personal use real estate. The rules for disasters discussed in section 25 above do not apply to business losses.

In the case of business and investment property, “qualified replacement property is defined as:

“Tangible property of a type held for productive use in a trade or business”

This means that if you have lost your business property in disaster, you can replace it with any business property. This is an expansion of the usual replacement rules. However, as this also applies to investment property, allowing the replacement of investment property with business property. If the taxpayer want to replace the investment property with other investment property, then that taxpayer would simply apply the general rules. For business and investment property the replacement period remains two years.

The IRS has a number of useful booklets for taxpayers who experience a catastrophic physical event. The IRS has combined a number of these separate publications in two publications, 2194 for individuals and 2194b for businesses. The booklets can be accessed on the IRS website at www.irs.gov.

This material was developed by John Trapani, a Certified Public Accountant who has assisted taxpayers since 1976, in analyzing and reporting transactions of the type covered in this material.

Internal Revenue Service Circular 230 Disclosure

This is a general discussion of tax law. The application of the law to specific facts may involve aspects that are not identical to the situations presented in this material. Relying on this material does not qualify as tax advice for purpose of mounting a defense of a tax position with the taxing authorities The analysis of the tax consequences of any event is based on tax laws in effect at the time of the event. This material was completed January 2014.

JOHN TRAPANI

Certified Public Accountant

Thousand Oaks, CA 91362

(805) 497-4411

E-mail John@TrapaniCPA.com

Website: www.TrapaniCPA.com

Blog: www.AccountantForDisasteRrecovery.com

It All Adds Up For You