

TAX SERVICES

CASUALTY LOSSES AND GAINS

Area residents have incurred immense losses from Hurricanes Katrina and Rita. The Internal Revenue Code provides a number of special rules applicable to casualty losses. It also allows taxpayers realizing casualty *gains* to defer the tax on the gains or even, in one circumstance, to avoid tax altogether. This memo will help you understand these special rules.

Special legislation was enacted in September to benefit Katrina victims. As of the date of this summary, proposed legislation has been introduced in Congress to extend these benefits to Victims of Hurricanes Rita and Wilma, but this legislation has not been enacted.

As always, Bourgeois Bennett is ready to answer your questions or help you in any way. Contact your Bourgeois Bennett professional or call Ted Stacey or Ken Franz in our New Orleans office.

CASUALTY LOSSES

WHAT IS A CASUALTY LOSS?

A casualty loss is a loss from an identifiable event such as a hurricane or other natural disaster, accident, theft, or fire. The event must be sudden, unexpected or unusual in nature; progressive deterioration does not qualify.

You can deduct casualty losses to both business property and personal use property.

HOW DO YOU MEASURE A CASUALTY LOSS?

This depends upon whether the loss is to business or personal use property. The rule is the same for property that is partially damaged, but different for property totally destroyed by the casualty.

Partially damaged property – When property is partially damaged, the loss is measured by the *lesser* of

the difference between the fair market value of the asset before the casualty and the fair market value immediately after the casualty, or

the taxpayer's adjusted basis (depreciated cost) in the asset.

In other words, you can deduct the decline in the value of the damaged asset, limited to your adjusted basis in the asset.

Completely destroyed property – If your property is completely destroyed, the loss deduction for business property is your adjusted basis in the property. The loss for personal use property is also your adjusted basis; in this latter case, however, you can deduct no more than the property's fair market value before the casualty. *Example:* One of your bookcases at your personal residence was destroyed by the storm. You had paid \$1,000 for it, but it was worth only \$150 when the storm hit. Your casualty loss is limited to \$150. On the other hand, if you had used the bookcase in your business and its adjusted basis after depreciation was \$325, you can deduct the entire \$325, even though it was worth only \$150.

Your personal residence - If your home is located in a Presidentially declared disaster area and your state or local government orders you to tear it down or move it because it is no longer safe to live in, any resulting loss in value is treated as a casualty loss from a disaster. Figure your loss in the same way as any other casualty loss of personal-use property. For this rule to apply, the order must be issued within 120 days after the area is declared a disaster area by the President.



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WHAT IF YOU RECEIVE INSURANCE PROCEEDS OR OTHER REIMBURSEMENTS?

You must reduce the casualty loss as determined above by any insurance proceeds. In addition, you must reduce your loss by any other reimbursements or payments, from government or other sources, specifically awarded to restore or rehabilitate the damaged property. Gifts from family members, charities or other agencies will not reduce the casualty loss if there is no limitation on the use of the donated funds. *Example:* Your personal automobile is destroyed by the storm. You paid \$22,000 for it, but it was worth only \$10,000 at the time the storm hit. Your insurance company pays you \$8,000 for your loss. Under the rules discussed above, your casualty loss is \$10,000, the lesser of the amount you paid for the car or its fair market value. However, you must reduce this amount by the insurance reimbursement. Your casualty loss deduction for tax purposes is \$2,000 (\$10,000 - \$8,000).

If the property is covered by insurance, you must file a claim. Any loss covered by insurance is not deductible whether or not you file a claim.

Visit
www.bourgeoisbennett.com
 for more Hurricane related
 financial information.

HOW DO YOU REPORT A CASUALTY LOSS ON YOUR TAX RETURN?

Where the loss is deducted depends upon the nature of the damaged or lost asset and whether the asset is personal-use or business property.

Casualty losses are reported on IRS Form 4684, *Casualties and Thefts*. Section A is used for personal-use property and Section B is used for business and income-producing property.

If personal-use property was destroyed or stolen, you can use IRS Publication 584, *Casualty, Disaster, and Theft Loss Workbook*, to help you catalog your property. If the property was business or income-producing property, refer to IRS Publication 584B, *Business Casualty, Disaster, and Theft Loss Workbook*. For more information regarding casualty losses of personal-use property and how to deduct them, you can consult IRS Publication 547, *Casualties, Disasters, and Thefts*, or call your BB professional. These publications can be found at the IRS web page, www.irs.gov

Personal-use property - A casualty loss for personal-use property is an itemized deduction, reportable on Schedule A of your return. Generally, a personal casualty loss must be reduced by two amounts. First, the loss must be reduced by \$100 for each separate event. Second, the total of all casualty losses related to personal use property must be reduced by 10% of your adjusted gross income (that's the amount on the

bottom of page one of your Form 1040). *Example:* Your total casualty loss from a fire in your house is \$12,000. Your adjusted gross income for the year is \$75,000. You receive no insurance reimbursement. Your deductible casualty loss is \$4,400 (\$12,000-\$100-\$7,500).

Katrina exception: Personal casualty losses caused by Hurricane Katrina are deductible in full; they do not have to be reduced by the \$100 and the 10% of adjusted gross income (AGI). This exception does not apply to Hurricane Rita. Losses caused by Rita must be reduced by the \$100 and the 10% of AGI.

Business property—Where you report a casualty loss from business property depends upon the type of property (whether it is property used in a trade or business or for rental or it is income-producing or employee-used property) and what kind of entity is claiming the loss (regular corporation, partnership, etc.).

WHEN DO YOU REPORT THE LOSS?

Normally, a casualty loss is deductible in the year the casualty occurs or, if an insurance claim is filed, in the year the amount of the insurance proceeds are reasonably determined.

Disaster Area – A casualty loss sustained in an area declared a disaster area by the President can be deducted in the year the loss is sustained or in the immediately preceding tax year.

CASUALTY LOSSES AND GAINS (CONT'D)

A CASUALTY GAIN OCCURS WHEN INSURANCE PROCEEDS AND OTHER REIMBURSEMENTS EXCEED THE TAXPAYER'S BASIS IN THE DAMAGED OR DESTROYED PROPERTY.

Example: You incur an individual casualty loss from Hurricane Katrina or Hurricane Rita. You can deduct the loss either on your 2005 income tax return or your 2004 return.

If you have already filed your return for the preceding year, the loss may be claimed in the preceding year by filing an amended return, Form 1040X for individuals and Form 1120X for regular "C" corporations.

Generally, you must make the decision to use the preceding tax year by the due date of the current year's return, without extensions. For example, the election to deduct a 2005 disaster loss on your 2004 return must be made on or before the due date (without extensions) of the 2005 return. This is April 17, 2006 for calendar year individuals and March 15, 2006 for calendar year corporations. You can revoke this election within 90 days after making it by returning to the IRS any refund or credit you received from making the choice. If you revoke your election before receiving a refund, you must return the refund within 30 days after receiving it for the revocation to be effective.

HOW DO YOU DETERMINE THE AMOUNT OF YOUR LOSS?

You need to be able to substantiate the amount of any loss you claim on your tax return. An accurate appraisal of the property before and after the casualty is the best evidence. The value of destroyed property is, of course, zero following the event. If you do not have an appraisal of the property before the event, you should at least get an appraisal of partially damaged property after the event. In the case of an automobile, the "blue book" value can be a reasonable approximation of the loss as long as the value is adjusted for the pre-casualty condition of the car.

The cost of restoring damaged property to its original condition can be acceptable evidence of the decline in the property's value if the repairs are only to restore the property to its pre-casualty condition, the amount spent is not excessive and the repairs do not increase the value of the property over the value it had immediately before the event. Any additional

expenditure to protect the property from future damage is not part of the casualty loss.

The cost of debris removal and clean-up work can be evidence of the amount of the casualty loss.

CASUALTY GAINS WHAT IS A CASUALTY GAIN?

A casualty gain occurs when insurance proceeds and other reimbursements exceed the taxpayer's adjusted basis in the damaged or destroyed property.

Example: Redco receives a \$2,000 insurance settlement for a fully depreciated machine destroyed by fire. Redco has realized a \$2,000 casualty gain. Casualty gains are normally taxable, although some are tax-free and recognition of the gain can be deferred for others.

IS A CASUALTY GAIN RELATED TO MY RESIDENCE TAXABLE?

Disaster Area - A special rule applies to a casualty gain related to a principal residence damaged or destroyed in a disaster area. This gain can be excluded under the general rule that allows a taxpayer to ex-

of gain (\$500,000 for a married couple filing a joint return) upon the sale of a residence. To qualify for the exclusion, you must have owned and occupied the house as your principal residence for at least two out of the last five years and the residence must have been in an area declared a disaster area by the President. Lower exclusion limits can apply if you owned or lived in the residence for less than two years.

Other special rules applicable to principal residences are discussed below.

HOW CAN I AVOID PAYING TAX ON A CASUALTY GAIN?

You can defer recognizing a casualty gain if you reinvest the insurance or other proceeds in similar property within a period set by law. This is called an involuntary conversion. *Example:* In the above example, Redco could avoid paying tax on the gain by spending at least \$2,000 on a machine similar to the one that was destroyed.

The Internal Revenue Code does not define the term “similar”. Essentially, the replacement property must be similar or related in use to the property damaged or destroyed. Contact your Bourgeois Bennett professional if

you need more information about what constitutes similar property.

Normally, you have two years from the end of the year of the casualty to reinvest the proceeds in similar property. However, in the case of a loss in a Presidentially-declared disaster area, the reinvestment period is extended to four years.

Katrina exception: In the case of a loss in the Katrina disaster area, the reinvestment period has been extended to five years, if substantially all of the use of the replacement asset is in the disaster area. For a loss in the Hurricane Rita disaster area, the reinvestment period remains four years.

Principal Residence—Certain other special rules apply to principal residences in Presidentially-declared disaster areas. You do not need to report the gain on any insurance reimbursement of household contents not itemized on your homeowner’s policy (unscheduled property). Real property doesn’t qualify for this exclusion. Another special rule allows you to group your residence and any scheduled personal property as one asset both to determine whether you have a casualty gain and for reinvestment purposes. *Example:* Your residence was severely damaged by the hurricane. In addition, you lost valuable artwork that was separately listed on your insurance policy.

You can add the insurance proceeds for the residence to the reimbursement for the artwork to determine whether you have a casualty gain. If you do, you could, for example, choose to reinvest the entire proceeds (for both the residence and the artwork) in restoring the residence or buying a new one. You are not required to invest any of the proceeds in new artwork if you don’t want.

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