Tax Deductions for Casualty & Theft Losses

Recent law changes limit the deduction, but in some cases losses can still reduce a tax bill

The deduction for casualty & theft losses was temporarily repealed, with an exception for federally-declared disaster areas.

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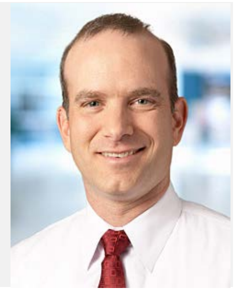

Among the many tax law changes included in the Tax Cuts & Jobs Act was a temporary modification of the personal casualty loss rules. While the casualty loss deduction may be unavailable in most cases now, the window is not completely closed on this tax benefit, and it can provide a bit of relief in an otherwise difficult time.

QUALIFYING EVENTS

Taxpayers are allowed to deduct a loss that occurs as a result of a casualty or theft. A “casualty loss” generally means the damage, destruction or loss of property resulting from an identifiable event. That event must be sudden, unexpected and unusual, not something that is gradual, anticipated or typical. These are usually things like earthquakes, fires or hurricanes, but can also include terrorist attacks, vandalism or car accidents (as long the owner’s willful negligence didn’t cause the accident). Damages due to a family pet, a fire set by the property owner or the accidental breakage of something under normal circumstances are generally not considered deductible losses.

Theft losses involve the removal of money or assets in a way that is illegal under state law and is done with criminal intent. It can include things like burglary, blackmail, extortion or kidnapping for a ransom. The simple disappearance of money or property isn’t considered a theft – like with a casualty, it must be a sudden, unexpected and unusual event.

Under the 2017 tax act, the types of allowable losses were narrowed significantly. Under current law, only personal casualty losses attributable to a federally-declared disaster are deductible for federal tax purposes. These disasters are those determined to warrant assistance from the federal government under the Stafford Disaster Relief and Emergency Assistance Act. This limitation only applies to losses incurred in 2018 through 2025. Casualties or thefts occurring before 2018 or after 2025, barring any future changes to the rules, do not have to meet this higher standard. Other types of casualty losses may still be deducted, but only to the extent of casualty gains (see below).

QUANTIFYING A LOSS

If a qualifying casualty or theft has occurred, the value of the loss is generally limited to the owner’s cost basis in the property – in other words, what they paid for it, not what it was worth. The following steps are used to determine the net value of the loss:

1. Determine the <u>lesser</u> of:
    a. The adjusted basis of the property before the event (in other words, what was paid for it, plus or minus adjustments for improvements or depreciation, for example) and
    b. The decrease in Fair Market Value (FMV) of the property after the event.
2. Reduce the amount from Step 1 by any insurance proceeds or other reimbursement received.

The net loss from an event is the amount by which Step 1 above exceeds Step 2. If the reimbursement amount exceeds the amount determined in Step 1, the excess is a "casualty gain" and may be considered taxable.

- **Example 1a** – A taxpayer purchased a home for $200,000. The home was recently appraised for $275,000 before it was damaged in a hurricane. An appraiser determined the home was worth $175,000 after the storm. The homeowner's insurance company reimbursed them $80,000.
  - The loss is limited to $100,000, the lesser of the adjusted basis of the home ($200,000) or the lost FMV ($100,000). This is then reduced by the $80,000 of insurance coverage for a net loss of $20,000.
- **Example 1b** – Assume the same facts as above, except that the home in this case was completely destroyed.
  - An appraiser determined the land itself was still worth $60,000, meaning the decline in the FMV of the home was $215,000. In this case, the loss was limited to $200,000, the adjusted basis of the home. This is offset by the $80,000 insurance proceeds for a net loss of $120,000.

To determine the decrease in the FMV of the property due to an event, the IRS generally recommends getting an appraisal, but because that's not always practical other options are available. For example, owners may also refer to the cost of cleaning up or repairing damage. While those costs aren't considered part of the total casualty loss, they can be relied on if the owner meets a variety of conditions, such as actually making the repairs and not improving the value of the property beyond what it was worth before the event.

For personal-use residential properties specifically, there are several "safe harbor" methods for calculating the lost FMV. These methods can only be used by an owner of real property (including improvements such as landscaping) that contains at least one personal residence, and no part of that residence can be used as a rental or home office for a business. These safe harbor methods only cover single family homes, townhomes or duplexes, and not to multi-owner properties such as a condominium. If used correctly, these valuation safe harbors won't be challenged by the IRS.

- **De Minimis Method** – This method of valuing the loss is based on a single written good-faith estimate of the cost of repairs needed to return the property to its pre-event condition. This method can only be used for losses of $5,000 or less.
- **Estimated Cost Method** – Under this method, the decrease in FMV can be determined by using the lesser of two repair estimates done by separate, independent licensed contractors. This method can only be used for losses of $20,000 or less.
- **Insurance Method** – The loss in this method is equal to the estimated loss set forth in reports prepared by the homeowner's or flood insurance company. There is no loss threshold for this method.
- For losses in disaster areas and due to a federally declared disaster, two other safe harbors that available:
  - **Contractor Method** – Under this method, a homeowner can rely on the price in a signed, binding contract for repairs by an independent, licensed contractor.
  - **Disaster Loan Appraisal Method** – This method allows an owner to use the loss identified in an appraisal used to apply for federal loan assistance.

There are also safe harbors available to determine the lost FMV for personal belongings:

- **De Minimis Method** – This method of valuing the loss is based on the owner's good-faith estimate of the lost FMV of the belongings. Owners must maintain records describing the items and the method for determining their value. This method can only be used for losses of $5,000 or less.
- **Replacement Cost Method** – This method allows an owner to determine the FMV of personal belongings by starting with the cost to replace the items with a new one, and then reducing that cost by 10% for each year the original item was owned (with a maximum reduction of 90%).

All of these safe harbor methods are subject to additional rules and exceptions. In addition, the loss on the real property or personal belonging is still limited to the lesser of the lost FMV or the adjusted basis of the items, even when using a safe harbor method to determine the lost FMV.

These methods do not apply to items used in a trade or business or items that maintain or increase their value over time. Cars, boats, motor homes, trailers, aircraft and other vehicles are also specifically excluded from these safe harbors. Instead, owners must rely on other established pricing guides or sources.

CALCULATING THE TAX DEDUCTION

If a single casualty causes damage to multiple items, the owner must first determine the net loss for each individual item. However, there is an exception to this rule for real estate owned for personal use. In that case, all improvements to the property – such as attachments or landscaping – can be considered together with the main property itself as one item.

- **Example 2a** – A taxpayer purchased a home for $200,000. They later spent $50,000 on an addition to the home and another $10,000 on landscaping, bringing their total adjusted basis to $260,000. The entire home as well as the landscaping was later was damaged by a wildfire, causing a loss in value of $225,000. The insurance company reimbursed the owner $175,000. The net loss in this case is $50,000, which is $225,000 (lesser of lost FMV or adjusted basis) reduced by the $175,000 of insurance coverage.
- **Examples 2b –** In that same fire, the homeowner's two cars were also destroyed. One was purchased for $25,000 and was worth $10,000 at the time of the fire. The insurance company paid $7,000 for the loss. The second car was a collector car purchased for $30,000 and was now worth $50,000, but it was uninsured.
  - The gross loss on the first car was $10,000 (lost FMV was less than adjusted basis). The insurance proceeds of $7,000 offset this amount, leaving a net loss of $3,000.
  - The gross loss on the second car was $30,000 (adjusted basis was less than lost FMV), but with no insurance proceeds the net loss was also $30,000.

To determine the actual tax deduction for these losses, there are two other rules that must be applied. The first of these is the $100 Rule, which says that each casualty must be reduced by $100. If multiple items are damaged or lost in events that are closely related, the $100 rule will apply to the total loss. If the events are unrelated, however, each loss must be reduced by $100.

- **Example 3a** – In Examples 2a and 2b, the total net loss was $83,000. Because these were all damaged in the same wildfire, they are considered one event. Therefore, the net loss is reduced by just $100, for a new net loss of $82,900.
- **Example 3b** – Assume that the loss in example 2b was not from the wildfire, but instead was due to a tornado that hit the home months later. Because this is a separate event from the wildfire, a separate $100 floor is applied. This is only applied once for the two cars, however, as they were damaged in the same event. The total $83,000 loss is reduced by $200, for a net of $82,800.

The second rule that applies is the 10% Rule. This rules states that the total loss across all events, after applying the $100 Rule, is reduced by 10% of the Adjusted Gross Income (AGI) of the taxpayer. Any loss in excess of 10% of AGI is then tax deductible.

- **Example 4a** – Building off Example 3a above, assume the taxpayer's total AGI was $150,000. Their loss would be reduced by $15,000 (10% of AGI), leaving a net deduction of $67,900 ($82,900 loss less $15,000).
- **Example 4b** – Building off Example 3b above, assume the taxpayer's total AGI was $150,000. Their loss would be reduced by $15,000, leaving a net deduction of $67,800 ($82,800 loss less $15,000).

- **Example 4c** – Building off Example 3b again, assume instead the taxpayer's AGI was $1 million. In this case, 10% of AGI is $100,000, which is more than the $82,800 loss, meaning they are not eligible for a casualty deduction.

The net deduction amount, after applying both the $100 Rule and the 10% Rule, is then treated as an itemized deduction. This amount is combined with other expenses – such as deductible state and local taxes, interest expense and charitable contributions – to determine the total itemized deductions. If this amount exceeds the standard deduction for the taxpayer, the itemized deductions are then used to compute taxable income.

SPECIAL PROVISIONS FOR DISASTER AREA LOSSES

Losses incurred in designated disaster areas are afforded an extra level of flexibility when it comes to claiming a tax deduction. In these cases, taxpayers are able to claim the tax deduction in the year the event was sustained or they can elect to accelerate the deduction into the prior year. This special provision is only available to areas designated as eligible for federal relief under the Stafford Disaster Relief and Emergency Assistance Act. A list of eligible locations is available at www.FEMA.gov/Disasters.

Disaster losses are typically "sustained" in the year of the event itself. However, it's possible the loss will be considered sustained in a following year. For example, if a disaster loss in incurred but there is a reasonable prospect for recovery, the loss that may be reimbursed is not considered sustained until after that reimbursement amount becomes reasonably certain. This is true even if that extends into the next calendar year.

Once the reimbursement is finalized and the year the loss is sustained is determined, taxpayers have an option to elect to report the loss on the tax return for that year or the prior tax year. The deadline for making this election is six months after the original due date, excluding extensions, for filing that prior year tax return. If that prior-year return has already been filed, an amended return containing the election can be filed.

- **Example 5** – A taxpayer's home was damaged in by a wildfire in March 2018, and the insurance company reimbursed the owner the next month. That taxpayer will have until October 15, 2018 to elect to report the loss on their 2017 federal income tax return. If they had already filed their 2017 tax return, either before or after the loss was sustained, they can file an amended return to report the loss.

For losses sustained in 2017 that will be deducted in 2016, taxpayers must attach a statement to their tax return that has the name and date of the disaster and the exact location of the property. For 2018 losses that will be deducted in 2017, the explanation can be done on Form 4684, Section D (https://www.irs.gov/pub/irs-pdf/f4684.pdf).

This election to report the loss in the year prior to when it was sustained can later be revoked by the taxpayer. This would be appropriate if it turns out the loss will provide a greater tax benefit in the later year than in the earlier year. The revocation is done by filing an amended return for that prior year, using either an attachment or Section D of Form 4684. This revocation must be done within 90 days after the due date for making the initial election AND on or before the filing date of the return that now includes the loss.

- **Example 5a** – After electing to report the 2018 loss on their 2017 tax return, the taxpayer decides to revoke the election and claim the loss on their 2018 tax return. They must file an amended 2017 tax return revoking this election by January 13, 2019 and before they file an original or amended 2018 return claiming the loss.

The IRS will often provide additional relief for taxpayers affected by disasters by postponing the deadline for certain activities. This includes the filing of income, excise and employments tax returns, as well as the payment of those taxes, along with making contributions to a Traditional or Roth IRA. These deadlines may be extended for up to one year, and apply to individuals and businesses in the disaster area, those whose tax records are located in the disaster area, certain relief workers and others. Interest and penalties are typically abated in these cases as well.

Other accommodations have been made in prior cases, such as loosening the rules on the deductibility of losses, allowing for penalty-free withdrawals from retirement accounts, and offering unique safe harbor methods for calculating a loss. These may involve Congressional action or rulings from the Department of Treasury and are specific to particular disasters.