ST12-11 Screening for Potential Casualty Loss Deduction

Federal income tax deductions for casualty losses remain out-of-scope for AARP Foundation/TaxAide counselors for TY 2012. This worksheet, which is based on **Publication 547**, **Publication 584 Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)** and **Form 4684,** may, however, be used to help taxpayers determine if they have potentially deductible casualty losses that should be discussed with a tax professional. These publications and forms are included in the IRS **Disaster Losses Kit for Individuals** (www.irs.gov).

IRS **Form 1040** provides for a **limited** deduction for casualty losses. <u>The deduction is not a substitute for insurance coverage</u>. Casualty losses are calculated using IRS **Form 4684** which is attached to **Schedule A, Itemized Deductions.** This means that a taxpayer must itemize deductions to claim a casualty loss. Normally, casualty losses must be reported in the year they occurred on an original or amended tax return. There is an exception to this rule for taxpayers in Presidentially declared disaster areas:

- ➢ The IRS will provide tax relief to victims of Hurricane Sandy in the following NJ counties: Atlantic, Bergen, Burlington, Camden, Cape May, Cumberland, Essex, Gloucester, Hudson, Hunterdon, Mercer, Middlesex, Monmouth, Morris, Ocean, Passaic, Salem, Somerset, Sussex, Union and Warren. This relief includes giving affected taxpayers the option of claiming disaster-related casualty losses on their federal income tax return for either 2011 or 2012. Claiming the loss on an amended 2011 return will get the taxpayer an earlier refund, but waiting to claim the loss on a 2012 return could result in a greater tax saving, depending on other income factors.

It may be appropriate for a taxpayer without adequate data to document a casualty loss to file a 2012 tax return without the casualty loss and amend that tax return with the required information within three years.

<u>Definitions</u>

- In **Publication 547 *Casualties, Disasters, and Thefts*** the IRS defines a casualty as “the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected or unusual.” The IRS also explains in **Publication 547** that
    - A sudden event is one that is swift, not gradual or progressive.
    - An unexpected event is one that is ordinarily unanticipated and unintended.
    - An unusual event is one that is not a day-to-day occurrence and that is not typical of the activity in which the [taxpayer] is engaged.

    ➢ NOTE: Examples of <u>deductible losses</u> include those caused by earthquakes, floods, and storms including hurricanes and tornadoes. Examples of <u>non-deductible losses</u> include damage by a family pet, progressive deterioration, and a car accident caused by the taxpayer’s own negligence.

- The IRS considers events closely related in origin to be a single “casualty event.” A single casualty event may be damage from two or more closely related causes such as wind and flood damage caused by the same storm. A single casualty event may also damage two or more pieces of property, e.g., a hailstorm damages your home and your car in your driveway.

ST12-11 Screening for Potential Casualty Loss Deduction

- A casualty loss requires a documented estimate of Fair Market Value (FMV) of the damaged/loss item before and after the casualty. In **Publication 547** the IRS defines FMV as "the price for which you could sell your property to a willing buyer when neither of you has to sell or buy and both of you know all the relevant facts." The taxpayer, not the IRS, has the burden of proving FMV!
  - FMV is not replacement cost
  - FMV of real property is generally determined by appraisals.
  - Buying guides such as NADA, Edmunds or the Kelly Blue Book may be used to establish the FMV of a car.
  - FMV of furniture, household goods and clothing can be estimated from lists available through organizations like Goodwill.
  - If certain conditions are met, a decrease in FMV may be estimated by the cost of repairs or clean-up.[1]
  - Damage to items that are attached to real property, e.g., fences, shrubs, kitchen cabinets, furnace, water heater, wall-to-wall carpeting, must be considered in the context of the pre- and post-casualty decrease in the FMV of the entire real property.

SCREENING PROCESS

A. <u>Obtain the following information from the taxpayer</u>

1. What kind of property was lost/damaged? When? How?
2. Taxpayer's Adjusted Gross Income (AGI) or estimated AGI (based on a prior year return and anticipated income changes) for the year in which the loss occurred
3. Does the taxpayer normally take the standard deduction or itemize deductions?
4. An estimate of FMV of the property **<u>before</u>** and **<u>after</u>** the loss/damage
5. An estimate of the cost basis or adjusted cost basis of the lost/damaged property.
6. Reimbursement, e.g. FEMA or private insurance payments, for lost/damaged property. The loss must be reduced by the amount of any reimbursement. The loss must also be reduced by salvage value. For calculating a casualty loss, reimbursements must include <u>expected</u> reimbursements as well as any reimbursements that the taxpayer has already received.

- NOTE: If a taxpayer's lost/damaged property is covered by insurance, the taxpayer must file a claim for reimbursement within the time period specified in the taxpayer's insurance policy. If the taxpayer intentionally fails to file a claim for reimbursement or if the taxpayer's claim is rejected because it was filed late, the loss cannot be deducted as a casualty.

[1] An IRS Q & A document at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/FAQs-for-Disaster-Victims-Casualty-Loss-(Valuations-and-Sections-165-(i)) discusses the use of clean-up and repairs to estimate FMV after a casualty. An excerpt of that document follows:

For residential property, damaged and destroyed trees and other landscaping may adversely affect the fair market value of the entire property by reducing the curb or overall appeal of the property. One method of determining the decrease in fair market value is to compare an appraisal of the entire residential property, including trees and other landscaping, before the damage caused by the casualty to an appraisal of the entire residential property after the damage caused by the casualty, including damage to trees and other landscaping. Valuation of the damage to a tree by an arborist does not determine the decrease in fair market value of the entire property. .Alternatively, the cost of cleaning up and restoring the residential property, including trees and other landscaping, to its condition before the casualty may be used as evidence of the decrease in fair market value, if the clean-up, repairs, and restoration are actually done, are not excessive, are necessary to bring the property back to its condition before the casualty, take care of the damage only, and do not cause the property to be worth more than before the casualty. For example, if these requirements are satisfied, the cost of removing destroyed or damaged trees (minus any salvage received), pruning and other measures taken to preserve damaged trees, and replanting necessary to restore the property to its approximate value before the casualty may be acceptable as evidence of the decrease in fair market value caused by the casualty. You may not include in your cost of cleaning up and restoring your property the cost of purchasing any capital asset, such as a compact loader or tractor, or the value of the time you spend cleaning up your own property.

B. For each casualty event, calculate the casualty loss for each item of lost/damaged property using the table below from Publication 584

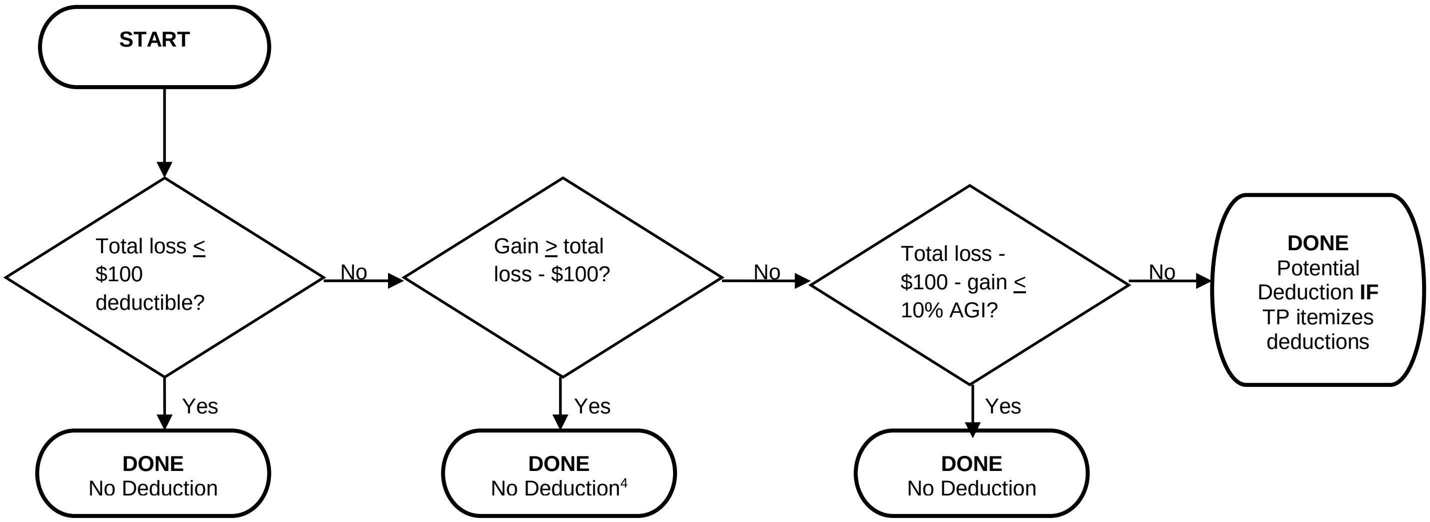
- NOTE: A taxpayer will not recover for appreciation in real or personal property value because a casualty loss is limited by the cost basis/adjusted cost basis of the lost/damaged property. An uninsured Jackson Pollack painting purchased for $25 at a yard sale 20 years ago with a pre-casualty FMV of $1 million and a post-casualty FMV of $0 represents a casualty loss of just $25 (see Column (8))!

(1) Item	(2) Cost or other basis	(3) Insurance or other reimbursement	(4) [2] Gain from casualty	(5) FMV before casualty	(6) FMV after casualty	(7) Column (5) minus Column (6)	(8) Smaller of Column (2) or Column (7)	(9) **CASUALTY LOSS** [3] (Column (8) minus Column (3))
Example								
Chair	*$350.00*	*$200.00*	*0*	*$275.00*	*0*	*$275.00*	*$275.00*	*$75.00*
Clock	*$90.00*	*0*	*0*	*$60.00*	*0*	*$60.00*	*$60.00*	*$60.00*
			TOTAL					**TOTAL**
			0					$135.00

[2] If column (3) is greater than column (2), enter the difference here and skip columns (5) through (9) for that item. A casualty gain could occur if a taxpayer is insured for replacement value of the lost/damaged item.
[3] If zero or less, enter -0-.

ST12-11 Screening for Potential Casualty Loss Deduction

C. <u>Use the following flowchart to determine a taxpayer's potential casualty loss deduction for each casualty event</u>



[4] Taxpayer may have taxable capital gain income on the casualty gain and should be referred to an IRS Taxpayer Assistance Center (TAC), e.g., in Parsippany, or to a tax professional.

Counselors should refer a taxpayer with a potential casualty loss deduction, i.e., the total casualty loss MINUS the $100 deductible MINUS any gain from reimbursement MINUS 10% of the taxpayer's AGI, who itemizes deductions (or would itemize deductions with a casualty loss deduction) to an IRS Taxpayer Assistance Center (TAC), e.g., Route 10 East in Parsippany, or to a tax professional. The TAC or tax professional can prepare either an amended return or, if the taxpayer prefers, an original return to claim a casualty loss.

Taxpayers can deduct tax preparation fees and appraisal fees to figure a casualty loss that are more than 2% of AGI as **Miscellaneous Itemized Deductions** on **Schedule A.**

- NOTE: A taxpayer whose itemized deductions with a potential casualty loss exceed his/her AGI may have a net operating loss (NOL). Such a taxpayer should be referred to a TAC or tax professional. A taxpayer <u>does not</u> have to be in business to have a NOL from a casualty.

D. Examples

The following examples, which are based on the Anthony Webster and Ben Baylor problems, may help a taxpayer understand the effect of a casualty loss deduction on tax owed or a refund:

- Anthony Webster filed a 2011 tax return as Head of Household that shows the following:

  AGI = $41,924
  Itemized Deductions = $11,078
  Taxable Income = $27,146
  Refund = $1345
  Tax Bracket = 15%

  Since Webster had only ordinary income, he calculated his tax using the 2011 Tax Tables. If Webster had a $1000 casualty loss deduction (calculated as in **Step C** above), his 2011 AGI would remain $41,924; his Itemized Deductions would increase to $12,078; his Taxable Income would decrease to $26,146; and his refund would increase by $150 to $1495 while his tax bracket would remain 15%.

- Ben Baylor filed a 2011 tax return as Married Filing Jointly that shows the following:

  AGI = $52,303 (including $737 in capital gain distributions)
  Itemized Deductions = $22,138
  Taxable Income = $19,065
  Refund = $609
  Tax Bracket = 15%

  Since Baylor's AGI included capital distributions which are taxed at a lower rate than ordinary income, he calculated his tax using the 2011 **Schedule D Tax Worksheet**. If Baylor had a $1000 casualty loss deduction (calculated as in **Step C** above), his 2011 AGI would remain $52,303; his Itemized Deductions would increase to $23,138; his Taxable Income would decrease to $18,065; and his refund would increase by $123 to $732 while his tax bracket would remain 15%.