Disaster Losses and Related Tax Rules

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The dollar value of property losses due to fires, floods, tornadoes, earthquakes, lightning, freezes, etc. can be and often are substantial. Federal income tax regulations often provide relief by allowing deductions for losses of business-use property. The passage of the Tax Cuts and Jobs Act of 2017 resulted in significant modifications to the deductibility of losses involving personal-use property. In order to deduct a loss for personal-use property, the area in which the loss occurred must be declared a federal disaster area. These new rules are in effect for losses that occur beginning January 1, 2018 and ending December 31, 2025. This fact sheet describes losses to property, the process used to determine if there is a deductible loss, how insurance proceeds and cost share benefits are treated, and how to reconstruct records to document a loss. Examples are used to help explain the rules that apply to property on the farm, including buildings, machinery, livestock, feed and supplies as well as the home and its contents and personal vehicles.

A casualty is defined as the damage, destruction or loss of property resulting from an identifiable event that is sudden, unexpected or unusual. Therefore, the casualty event must not be gradual or progressive deterioration, an event that is anticipated or intended to occur or a day-to-day occurrence from an activity in which the taxpayer is engaged. A deductible loss can occur from a vehicle or equipment accident, earthquake, a fire that was not willfully set by the taxpayer, flood, freeze, lightning, hurricane, tornado, terrorist attack, vandalism, volcanic eruption or government-ordered demolition or relocation.

To determine the extent of a loss, the owner of the property will need to examine the property's condition immediately before and after the event to determine the extent of the loss and whether the amount of the losses may be deductible against taxable income. If the damaged property was insured, there may be the possibility of a taxable gain if the insurance reimbursement is greater than the amount of the deductible loss. This article addresses casualties and the information needed to determine whether or not a taxpayer will have a deductible loss or a taxable gain depending upon the type of property damaged or destroyed and if it was or was not insured.

Farm and Business-Use Property

A farm operator can deduct casualty losses that occur in the business of farming. For a loss to be deductible, a taxpayer must show proof that a casualty occurred. A record must be kept containing a description of the casualty (fire, tornado, etc.) when it occurred and proof that the loss was a direct result of the event. In addition, the taxpayer must have ownership of or be liable for the damage to the property. If the property was insured, information needs to be provided for the possibility for reimbursement for all or part of the loss. The following information describes and discusses the damage or destruction of various types of property; both farm business-use and personal-use property. The loss of business-use property is presented first, followed by loss of personal-use property.

Example 1. Machinery and Equipment: Your combine is completely destroyed. The combine was purchased four years ago for $180,000 and you took a total of $80,766 of depreciation. The fair market value immediately before the fire was $110,000 and zero immediately afterward. The remaining income tax basis in the combine at the time of the fire was $99,234 ($180,000 less $80,766) and the machine was not insured. The deductible loss in the year the machine burned is the lessor of the adjusted basis or the decrease in the fair market value. The remaining tax basis of the combine was $99,234 and the decline in the fair market value was $110,000. Therefore the deductible loss is $99,234.

If the combine had been insured and the insurance reimbursement was greater than the loss, there can be a taxable gain. Assume the amount of the insurance reimbursement for the combine was $100,000. The taxable gain to be reported is $766 ($100,000 insurance reimbursement less the $99,234 loss). You can avoid reporting the gain by purchasing a replacement combine. If you spend $100,000 on the new machine, then none of the insurance reimbursement is taxable and the $99,234 depreciable basis of the old combine ($100,000) becomes the depreciable basis of the replacement combine ($100,000). In this case, none of the reimbursement is taxable in the year the casualty loss occurred.

Example 2. Multipurpose Farm Building: A tornado takes the roof off the shed used to store machinery, equipment, vehicles and farm supplies. After inspecting the building, it is determined that only the roof has to be repaired. The cost of repairing the roof to its condition immediately before the tornado is $24,500. Therefore the deductible loss is limited to the cost of the repairs ($24,500).

If the shed is insured and you received an insurance reimbursement of $20,000 for the roof repair, your deductible loss would be $4,500 ($24,500 less the $20,000 of insurance reimbursement). Had the reimbursement been $26,000 then there would be a taxable gain of $1,500 ($26,000 of insurance reimbursement less $24,500 repair cost).

Example 3. Fences: An accidental fire burns your pasture and all the fences are destroyed. The fences were completely depreciated and therefore had a zero tax basis. You decide to replace the perimeter fences; you will not have a deductible loss since the tax basis of the fences is zero. The total costs of the fences you replace are depreciable subject to current depreciation rules. The loss of future income from grazing the pasture is not allowed as a deduction. Should you qualify for

cost sharing to replace the fencing, the amount of the cost sharing is not taxable, but it will reduce the depreciable basis in the new fence. There is no tax deduction, but you do not have to include the cost share payment in income.

Example 4. Breeding, Dairy or Draft Livestock: The tax treatment of a casualty loss of breeding, dairy or draft animals is different for raised versus purchased animals. When these animals are raised, all the costs of raising them are deducted as operating expenses on Schedule F: *Profit or Loss from Farming*, and therefore they will have a zero tax basis. Purchased breeding, dairy or draft animals are depreciable and the loss will be limited to the remaining undepreciated purchase cost. This example explains the loss calculations for both raised and purchased breeding animals. Lightning kills 20 head of raised cows and a purchased bull. The costs of raising the cows were deducted; therefore, there is no deductible casualty loss. The undepreciated value of the bull was $1,100; therefore, the deductible loss is the $1,100 remaining depreciable basis.

Example 5. Livestock Purchased for Resale: The tax treatment of livestock purchased for resale depends upon whether you report income and expenses using the cash method of accounting or the accrual method of accounting. Cash basis accounting requires that income is reported on the tax return in the year received and expenses are deducted in the year they are paid. However, there is a unique situation concerning the deduction of the purchase cost of the animal(s). The amount paid for the animal is not deducted until the animal is sold. At that time, the cost of the animal reduces the income from the sale. Therefore the total purchase cost of the animal is amount of the casualty loss that is deducted in the year the loss occurs. For example, in October you paid $600 for a yearling steer to be put on winter pasture and in the following spring lighting kills it. The $600 purchase cost is the casualty loss that is allowed in the year the animal was killed. The costs of growing the steer (feed, vet expenses, etc.) are deducted in the year they are paid.

If accrual accounting is used, the purchased steer would be included in the inventory of animals purchased for resale and removed from inventory in the year that it was sold. Using the information from the previous example, in October you paid $600 for a yearling steer to be put on winter pasture and at the end of the year you put in your tax records the cost of the steer in the end inventory. The following spring, lighting kills it. The animal is simply removed from the closing inventory for the year of the loss and you do not get to take a separate deduction since the adjustment is done in the ending inventory. In both the cash and accrual method of accounting, the future income from the animal is not allowed as a deductible loss even though their value typically increases as they grow.

Example 6. Raised Livestock for Sale: The tax treatment of livestock raised for sale is similar to that for breeding, dairy and draft livestock if you are a cash basis taxpayer. Since the cost of raising an animal is deductible on Schedule F, there is no cost basis for the animal and there is no deductible loss. All the costs of raising the animal are deducted. Like Example 5, the future income from these animals is not allowed as a deductible loss even though their value typically increases as they grow.

Example 7. Raised Crops, Plants and Produce for Sale: The loss of raised crops for sale is similar to the loss of livestock raised for sale. Since the cost of raising the crop is deductible on Schedule F, there is no cost basis for the crop and there is no deductible loss. All the costs for tillage, seed, fertilizer, pesticides, etc. are deducted when paid, so again, there is not a deductible casualty loss.

Example 8. Stored Feed and Grain: The loss of feed and other supplies on hand will not create a casualty loss, since the purchase cost of these items or the cost of raising the feed or grain is a deductible business expense when paid. Thus, stored hay that was raised to be fed, then destroyed, will also not create a casualty loss, since all the costs of raising and getting it into storage are deductible farm business expenses.

Example 9. Tools and Supplies: The loss of shop tools and other farm supplies will not create a casualty loss, since the purchase cost of these items is a deductible business expense when paid. Therefore, their tax basis is zero so the loss will not result in an additional deduction due to the casualty.

Personal-Use Property

The Tax Cuts and Jobs Act of 2017 made significant changes to the allowable deduction of personal casualty losses. Under current law the area where the casualty occurred must be receive a Federal Disaster Declaration in order for personal casualty losses to be deductible. This discussion assumes that a Federal Disaster Declaration applies.

The following examples discuss loss of, or damage to personal-use property and how the loss is calculated. Personal-use property includes items used by you and your family for non-business purposes. Examples of personal-use property include your home, furniture, appliances, electronics, clothing, jewelry, automobiles and other property not used in a trade or business.

To determine the amount of the casualty loss for personal-use property, the following steps are used. Step one, determine the adjusted tax basis in the property immediately before the casualty. The adjusted tax basis equals the price paid for the item plus the cost of any improvements made to the property and less any damage to the property. Step two, determine the decrease in the fair market value of the property immediately after the casualty occurred. This is the difference between the fair market value immediately before and immediately after the casualty. In many cases, an appraisal will be needed to document this for tax purposes. Finally, take the smaller of the amounts from either step one or step two and reduce it by any insurance or other reimbursement received or expected to receive in the future. The amount of the loss is then reported as an itemized deduction and subject to various limits (these limits are beyond the scope of this article). It is important to work with a tax advisor to ensure correct information is included, computed and reported correctly on the income tax return.

Example 10. Loss of Home: Your home is completely destroyed. You paid $200,000 to have the home built and later added a screened-in room for $7,500. Before the casualty, the adjusted basis in the home is $207,500 ($200,000 plus $7,500). A recent appraisal was completed on the home and the fair market value was determined to be $250,000 before the casualty and, since it was completely destroyed, the fair market value after the casualty was zero. It was insured for $185,000. The amount of the casualty loss allowed is $22,500 (the lesser of the adjusted basis ($207,500) or the decrease in the fair market value ($250,000) less the insurance reimbursement ($185,000)).

Example 11. Loss of Automobile(s): The family car was damaged when a tree fell on it. You paid $35,000 for it new, so that is the adjusted basis before the casualty, because no depreciation is allowed for personal vehicles. The fair market value before the casualty as estimated by a car dealer was $12,000 and $1,000 (salvage value the dealer was willing to pay for the car) after the casualty. The decline in the fair market

value was $11,000 ($12,000 less $1,000). You received an insurance reimbursement of $12,000, which was used to repair the car to a useable condition. The cost of doing the repairs was $9,000. Since this was a personal-use asset, there is no taxable gain even though the insurance reimbursement was greater than the cost of repairing the car.

Example 12. Loss of Home Contents: The process of determining the amount of a casualty for items in the home and other personal-use items requires that the purchase price be compared to the decline in the fair market value of the items before and after the casualty adjusted for any insurance reimbursement received or expected to be received. The purchase price is compared to the decrease in the fair market value. The smaller amount is then adjusted by any insurance reimbursements to determine the amount of the casualty loss. It will be necessary to create a room-by-room inventory list of items to ensure nothing is missed. The discussion of reconstructing records later in this article contains suggested methods of determining cost figures for personal-use property.

When a single event ,such as a fire or tornado, involves more than one item of property, separate calculations must be made to determine the loss or possible gain for each business-use item and personal-use item. Once this is completed, then the amounts are combined to determine the overall loss or gain for the business-use property and the personal-use property.

In addition, it is important to keep track of insurance and other reimbursements including disaster relief payments, since these items will impact the amount of the loss allowed. If the area is determined to qualify as a Federal Disaster Area, some disaster payments will not be taxable. In addition, if a Federal Disaster Declaration is made, some casualty gains can be deferred if the taxpayer elects to replace the property and does so within the prescribed period of time. The replacement property must be similar to the property lost or destroyed to postpone reporting the gain on a tax return. It is also possible to postpone reporting gain if the reimbursement is used to restore, repair or replace the property. To postpone reporting all of the gain, the total amount of the reimbursement must be spent.

To correctly report casualty losses, it is important to have and maintain good records. It is also important to list all property that was damaged or destroyed including its cost or other tax basis, the amount of insurance or other reimbursements and the fair market value immediately before and after the casualty occurred. This information is needed for both business-use and personal-use property. It is also important to work closely with an income tax advisor to make sure you take advantage of all the beneficial tax provisions that apply to casualty losses and the postponement of gain that can occur.

Record Reconstruction Tips

The reconstruction of records is not an impossible task, but will require time and effort. Much of the following discussion comes directly from IRS Publication 2194, *Disaster Resource Guide*. It contains the IRS-prescribed methods used to reconstruct records. Supplemental information has also been added to assist in locating agricultural-based information as well. Instructions for obtaining a copy, as well as other publications can be found at the end of this article.

Reconstructing records after a disaster will likely be essential for tax purposes, getting federal assistance or insurance reimbursement. Historical records needed to prove the loss may have been damaged or destroyed in a casualty. The following tips are designed to help reconstruct your records to prove loss of personal-use or business property.

Personal Residence/Real Property

- Be sure to take photographs as quickly as possible after the casualty to establish the extent of the damage.
- Contact the Title Company, Escrow Company or bank that handled the purchase of the property to obtain copies of escrow papers and other documents. Your real estate broker may also be able to help.
- Use the current property tax statement for land versus building ratios, if available. If they are not available, get copies of recent statements from the county assessor's office.
- Check with appraisal companies to locate a library of old multiple listing books. These can be used for comparable sales information to establish a basis or fair market value using property sales from the local area.
- Check with your mortgage company for copies of any appraisals or other information they may have about cost or fair market value for the property.
- Tax records may be important to have. If these were destroyed, contact your income tax preparer and request a copy of your income tax return.
- When improvements have been made to the property, contact the contractor(s) to see if records are available. If possible, get statements from them verifying their work and cost.
- If a home improvement loan was obtained, obtain paperwork from the institution issuing the loan. The amount of the loan may help establish the cost of the improvements.
- For inherited property, check court records for probate values. If a trust or estate existed, contact the attorney who handled the estate or trust.
- When no other property records are available, check the county assessor's office for old records about the property. Look for assessed value(s) and ask for the percentage of assessment to value at the time of purchase. This is a rough guess, but a guess is better than no records at all.

Vehicles, Machinery and Equipment

- Various sources exist that provide values for vehicles, machinery and equipment. For vehicles, Kelly's Blue Book, NADA and Edmunds are available online and at most libraries. They are good sources for the current fair market value of most vehicles. Farm machinery and equipment values can be found on various websites including Fastline, TractorHouse and Machinery Pete to name a few.
- Contact the car and machinery dealer and ask for a copy of the original sale contract. If not available, give the dealer all the facts and details and ask for a comparable price figure.
- Another option is to use newspaper ads for the period in which the vehicle was purchased to determine cost basis. Use ads for the period when it was destroyed for fair market value. Be sure to keep copies of the ads for your records.
- If you are still making payments, check with your lien holder. The note should contain useful information.

Personal-use Property

- The number and types of personal-use property may make it difficult to reconstruct records. One of the best

methods is to draw pictures of each room of the home. Draw a floor plan showing where each piece of furniture was placed. Then show pictures of the room looking toward any shelves or tables. These do not have to be professionally drawn, just functional. Take time to draw shelves with memorabilia on them. Do the same with kitchens and bedrooms. Reconstruct what was there, especially furniture that would have held items in the drawers, dressers and shelves. Be sure to include garages, attics and basements with a list of items contained in each.

- Get old catalogs. These catalogs are a great way to establish cost basis and fair market value. Check the prices on similar items in local thrift stores to establish fair market value. Walk through the stores and look at comparable items, especially items such as kitchen gadgets. Look for odds and ends you may have had but forgotten because of infrequent use.
- Use your local "advertiser" as a source for fair market value. Keep copies of the issues handy and copy pages used for specific items to put with your tax records file on the disaster.
- Check local newspaper "want" ads for similar items. Again, keep a copy of any you use for comparison with the tax file.
- If you bought items using a credit card, contact your credit card company.
- Check with your local library for back issues of newspapers. Most libraries keep old issues on microfilm. The sale sections of these back issues may help establish original costs on items such as appliances.
- Go to a used bookstore with a tape measure and the diagram of the destroyed property. Measure several rows of used books and count the number of books per shelf. Add up the prices of those books and determine an average cost per shelf. Count the number of shelves in your home and multiply by the average cost per shelf. This will help determine the value of books before the loss.

Business Records

- To reconstruct supply inventories, get copies of invoices from suppliers. Whenever possible, the invoices should date back at least one calendar year.
- For income items, get copies of bank statements. The deposits should closely reflect what the sales were for any given time period.
- Obtain copies of last year's federal, state and local tax returns including sales tax reports, payroll tax returns and business licenses (from city or county). These will reflect gross sales for a given time period.
- For furniture and fixtures, it will be helpful to sketch an outline of the inside and outside of the business location. Then start to fill in the details of the sketches, such as where were various equipment and other stored items located.
- If you purchased an existing business, go back to the broker for a copy of the purchase agreement. This should detail what was acquired.
- If the building was constructed for you, contact the contractor for building plans or the county/city planning commissions for copies of any plans.

For individual assistance as well as additional information, contact the IRS Disaster Assistance Hotline at 1-866-562--5227. IRS personnel may be able to provide face-to-face assistance covering disaster-related issues at your local IRS office or Taxpayer Assistance Center. To find a Taxpayer Assistance Center in your area, go to: http://www.irs.gov/localcontacts/index.html.

The Internal Revenue Service (IRS) has a variety of publications available to assist property owners who experience disasters. The following publications will be quite useful and can be accessed by going to www.irs.gov and clicking on "Forms and Publications." Then click on "Publication number" under "Download forms and publications by:" Type the publication number in the find box to search for the publication. Publications may be viewed online or downloaded by double clicking on the publication as it appears in the list.

IRS Publication 2194: Disaster Resource Guide for Individuals and Businesses. This publication includes a discussion of disaster resources and assistance available and the process for reconstructing your tax records.

IRS Publication 547: Casualties, Disasters, and Thefts. This publication explains the tax treatment of casualties, thefts and losses. The publication discusses the following topics:

- Definitions of a casualty, theft and loss on deposits.
- How to figure the amount of the gain or loss.
- How to treat insurance and other reimbursements received.
- The deduction limits.
- When and how to report a casualty or theft.
- The special rules for disaster area losses.

IRS Publication 584: Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property). The workbook is designed to help you create a list of personal-use property that was damaged or destroyed. It contains a variety of schedules with lists of items to help you document various household items on a room-by-room basis as well as other personal-use assets. It will be useful to figure the loss to the main home, its contents and motor vehicles.

IRS Publication 584-B: Business Casualty, Disaster and Theft Loss Workbook. This workbook is designed to help you create a list of business-use property that was damaged or destroyed. It contains a variety of schedules with lists of items to help you document various business-use items. It will be useful to figure the loss on business-use and income-producing property.

IRS Publication 225: Farmer's Tax Guide. The "Casualties, Thefts and Condemnations" chapter provides extensive detail concerning damage or destruction to farm property. The examples and discussion focus on casualty loss calculations and tax treatment for various types of farm property and the specific rules that apply.

Due to the complex nature of the casualty loss rules, it is important to work closely with your tax advisor. A trained tax professional can assist by making sure losses are properly documented and to take advantage of all the potential income tax benefits to reduce the adverse economic impact of the casualty. In addition, special rules apply to federally declared disaster area losses and your tax professional can help explain these rules and help take advantage of them.

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