■ Calamity Claims

Help clients plan ahead to mitigate exposures--before the roof caves in.

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By Michael Hayes

Despite careful plans and the best intentions, accidents happen. At some point almost everyone will suffer a sudden, une x pected loss caused by a natural event such as an earthquake, fire, flood, hurricane or tornado, or a manmade event such as a car accident, theft, va n dalism or bank that goes belly-up. But a physical disaster doesn't have to be a tax disaster.

A client who loses personal property (not a business asset) due to theft or casualty may deduct the loss, but only to the e x tent it exceeds 10 percent of his or her adjusted gross income. The deductible loss is subject to a $100 per occurrence limitation. Casualty and theft losses are reported as an itemized dedu c tion on Form 4684 and Form 1040 Schedule A. Alas, individuals who don't meet the 10 percent thres h old suffer an economic loss without the balm of tax relief.

To be eligible for a deduction, clients have to prove that the loss event occurred and document both the adjusted cost basis (the original price paid for the item lost, plus any improvements) and the fair ma r ket value of the item. Clients must show:

• Evidence of the damaging event when the loss was sustained. For a theft loss, a police report is r e quired.

• Their income tax basis in the property. For real property, that's determined by comparing apprai s als before the damage and after the casualty and insurance adjuster's reports. For personal property, fair market value is more difficult to ascertain. Jewelry appraisals, r e placement cost, and even eBay sales of comparable items can indicate fair market value.

• The amount of salvage value or insurance reimbursement.

• Whether the property was used in a trade or business.

Note that property and casualty insurance premiums for clients' homes and their contents are not d e ductible for income tax purposes, but insurance premiums paid by a business to insure business assets are.

The deductible loss amount represents the decline in fair market value of the property caused by the casualty or theft—less any i n surance reimbursements. The decline in fair market value is determined by subtracting the market value of the property after the cas u alty from the market value before the casualty. The loss is limited to the adjusted basis or cost of the property.

Clients whose theft or casualty losses are covered by insurance face other frustrations. Insurance r e imbursements reduce the deductible, and clients who expect to be reimbursed for the loss must su b tract the expected reimbursement when calculating the loss—even if they do not receive payment u n til a later year. However, there is some good news: Reimbursement for losses is not taxable if the e n tire amount is used to acquire replacement property. But if the reimbursement exceeds the taxpayer's income tax basis and is not used to acquire a replacement, it is treated as if the taxpayer had sold the asset in the marketplace—i.e., a taxable event. "After Hurricane Katrina, we had clients who lost ev e rything but ended up with gains because the insurance they received exceeded the basis of their da m aged or destroyed property," says Cindy Sloan, CPA, of Alexander, Van Loon, Sloan, Levens and Favre , PLLC in Gulfport, Miss.

The IRS has certain rules on how to treat gains resulting from a casualty. After a natural disaster o c curs, individuals in the affected area should monitor the IRS Web site for notices related to possible tax relief with regard to the event, Sloan says.

Insured clients often have to go to extremes to provide evidence of loss to obtain reimbursement, says Martha Devine, CPA, MT, of Bradley, Allen & Associates in Lakewood, Colo. "When the roof of one family's home collapsed from a heavy, wet snow that melted as soon as it fell into the house," says Devine, "the insurance company wanted the owners to prove that the water damage in their home was from the same snow that had caused the roof collapse," she recalls.

Placing a value on certain losses and their consequent tax treatment can be a challenge, says John R. Lieberman, CPA/PFS, of New York. A client who owned an apartment had a painting valued for insurance purposes at $750,000 with a cost basis of $250,000. A pipe burst and damaged the painting. The expert hired by the insurance company under the terms of the policy recommended restoring the painting, which was subsequently done. The owner of the painting then obtained the services of another accredited appraiser who determined that, after repair, the painting was worth only $500,000. The insurance company paid the $200,000 “loss.” Was there a taxable gain on the insurance proceeds, a reduction in basis for the proceeds or some combination of both? “In this case, no taxable event occurred,” Lieberman says.

For details on losses incurred from accidental destruction or theft see Internal Revenue Code (IRC) Section 165 (“Losses”).

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