



Excerpt from eBook

The IRS and Defrauded Investors - Theft Tax Loss

Casualty Loss (IRC Sec 165)(c)(3)

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Gary S. Wolfe has over 34 years of experience, specializing in IRS Tax Audits and International Tax Matters including: International Tax Planning/Tax Compliance, and International Asset Protection.

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles. Gary has received 14 international tax awards from five different Global expert societies in LONDON/UK including being voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries with the following award: Global 100 (2016) (KMH Media Group) - CA/US International Tax Planning Law Firm of the Year.

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Chapter 7 – Casualty Loss (IRC Sec 165)(c)(3)

Theft losses may be deductible either under IRC §165(c)(2) or §165(c)(3).

Casualty Losses (Current Law)

Code Section 165(c)(3) permits a deduction for losses arising from "fire, storm, shipwreck, or other casualty, or from theft." (Casualty losses are also deductible for purposes of the alternative minimum tax (AMT). Code Section 56(b)(1)(A) provides that miscellaneous itemized deductions are not allowed for AMT purposes, but Code Section 67(b)(3) provides that the deductions for casualty and theft losses are not miscellaneous itemized deductions. In addition, a personal casualty or theft loss is deductible only if the taxpayer files a timely claim for any insurance covering the loss. Code Section 165(h)(4)(E).)

While losses attributable to fire, storm, and shipwreck are casualty losses, theft losses are not. (Treas. Reg. Sec. 1.165-7(a)(6).)

The definition of the remaining term, "other casualty" has been the subject of decades of litigation. The IRS, analogizing to fire, storm, and shipwreck, has taken the position that a casualty is "the complete or partial destruction or loss of the taxpayer's property resulting from an identifiable event that is sudden, unexpected and unusual in nature." (Rev. Rul. 72-592, 1972-2 C.B. 101. See also *Martin Marietta Corp. v. United States*, 83-2 U.S.T.C. para. 9607 (Cl. Ct. 1983); *Maher v. Commissioner*, 76 T.C. 593 (1981), *aff'd*, 680 F.2d 91 (11th Cir. 1982); *Popa v. Commissioner*, 73 T.C. 130 (1979); *White v. Commissioner*, 48 T.C. 430 (1967), *acq.*, 1969-1 C.B. 21; *Toten v. Commissioner*, T.C. Memo. 1984-603; *Kielts v. Commissioner*, T.C. Memo. 1981-329; Rev. Rul. 87-59, 1987-2 C.B. 59.)

Limitations on deductibility of amount of casualty loss

An individual taxpayer's non-business casualty or theft loss is deductible only to the extent the loss exceeds \$100 (\$500 in 2009), and only to the extent the losses for the year exceed 10 percent of adjusted gross income (AGI). Code Section 165(h).

\$500 (2009) FLOOR: A non-business casualty or theft loss of an individual is deductible only to the extent it exceeds \$500 (2009). Code Section 165(h)(1). The floor does not apply to business property. Each casualty is subject to the floor. If there is more than one casualty causing loss to the same property, the amount of each loss must be reduced by the amount of the floor. On the other hand, if a single casualty damages several items of the taxpayer's property, the floor applies only once. Similarly, if a single casualty causes losses in more than one year, the floor applies only once. Whether damage to property is the result of a single casualty or more than one casualty is a facts and circumstances determination. However, events that are closely related in origin generally give rise to a single casualty. For example, wind and flood damage from a hurricane would be the result of a single casualty. Reg. Section 1.165-7(b)(4)(ii).

Each joint owner of property is subject separately to the floor. Reg. Section 1.165-7(b)(4)(iii). A husband and wife filing a joint return are considered a single taxpayer to whom a single floor applies, but the floor applies separately to married taxpayers who file separate returns. Reg. Section 1.165-7(b)(4)(iii). The floor applies only to the personal use portion of property used for both business and personal use purposes. Reg. Section 1.165-7(b)(4)(iv).

The 10 Percent of Adjusted Gross Income (AGI) Floor

If personal casualty losses for any taxable year exceed personal casualty gains for such year, the excess is deductible only to the extent that it exceeds 10 percent of the taxpayer's AGI for the taxable year. This limitation applies only after the loss from each casualty is reduced by the \$500 (2009) floor. (Code Section 165(h)(2)(A)(ii); Code Section 165(h)(3).) AGI is computed by deducting personal casualty losses to the extent of personal casualty gains. Code Section 165(h)(5)(A).

A personal casualty gain is the recognized gain from any involuntary conversion of non-business property arising from fire, storm, shipwreck, other casualty, or from theft. Code Section 165(h)(4)(A). A personal casualty loss is any loss of non-business property arising from the same types of events. Code Section 165(h)(4)(B).

If the personal casualty gains for any taxable year exceed the personal casualty losses for such taxable year, all gains and losses are treated as capital gains and losses. Code Section 165(h)(2)(B). In this event, the losses are not subject to the 10 percent AGI floor. (Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 987.)

Method of Valuation

The regulations provide two methods for determining the decline in fair market value of property damaged in a casualty (for both business and personal use property), the appraisal method and the cost of repairs method. Reg. Section 1.165-7(a)(2).

Appraisal

The first method that can be used to measure the amount of damage to property caused by a casualty is to obtain a competent appraisal of the fair market value of the property immediately before and immediately after the casualty. Reg. Section 1.165-7(a)(2)(i). The appraisal should consider the effect of a general market decline affecting the undamaged, as well as the damaged property, in order to isolate the actual loss resulting from the casualty. Reg. Section 1.165-7(a)(2)(i). The appraiser's knowledge of sales of comparable property, conditions in the area, familiarity with the taxpayer's property before and after the casualty, and the method he

uses in ascertaining the amount of loss are all important elements of the appraisal. *Maduza v. Commissioner*, T.C. Memo. 1961-249.

The purchase price of the property is not relevant in determining value, unless the property was purchased shortly before the casualty. Similarly, the sales price of property sold shortly after a casualty may be the best evidence of value after the casualty. *Woods v. Commissioner*, T.C. Memo. 1960-72. A court may also make its own estimate of value based on the taxpayer's testimony. (*Kenerly v. Commissioner*, T.C. Memo. 1975-139; *Scharf v. Commissioner*, T.C. Memo. 1973-272, *aff'd* without opinion, 535 F.2d 1250 (4th Cir. 1976).)

Cost of repairs

The second method used to measure the amount of damage to property caused by a casualty is the cost of repairing the property. Reg. Section 1.165-7(a)(2)(ii). This method can only be used when the property is actually repaired. The taxpayer must show that the repairs were necessary to restore the property to its condition immediately before the casualty and that the amount spent for the repairs is not excessive. The cost of repairs is taken into account only to the extent that the property is restored but not improved; the repairs should not increase the property's value compared to what it was immediately before the casualty. Reg. Section 1.165-7(a)(2)(ii).

The cost of repairs is not a limit on the amount of the loss; it is a basis for a computation of the amount of loss. The amount of the loss can be greater than the cost of repairs if the property is not restored to its value before the casualty. *Brush v. Commissioner*, T.C. Memo. 1962-124.

If repairs restore the property to its original condition, no additional loss is allowed. For example, in *Jenard v. Commissioner*, T.C. Memo. 1961-70, the taxpayer argued the very occurrence of a fire decreased the fair market value of his building in an amount in excess of the repair cost due to the fear of a prospective buyer that there may have been latent structural weaknesses caused by the fire which were not repaired. The Tax Court, however, refused to take into account the "groundless fears" of prospective buyers.

The cost of replacement has also been used as evidence of the amount of the loss. (Rev. Rul. 66-303, 1966-2 C.B. 55. See also *Clapp v. Commissioner*, 321 F.2d 12 (9th Cir. 1963), *acq.*, 1964-1 C.B. 4 (replacement cost used as evidence of fair market value prior to casualty); but see *Hernandez v. Commissioner*, 72 T.C. 1234 (1979) (replacement cost of an air conditioner rejected as evidence of amount of loss because taxpayer did not show that the cost of the replacement unit did not exceed the value of the unit destroyed).)

The actual amount of the loss may be greater than the cost of replacement property, such as when mature trees or plants are replaced with younger trees. *Zardo v. Commissioner*, T.C. Memo. 1982-94. The cost to remove debris and otherwise clean up a damaged property can also be used as evidence of the amount of the loss. (*Waldrip v. Commissioner*, 81-2 U.S.T.C.

9653 (N.D. Ga. 1981); *Stuart v. Commissioner*, T.C. Memo. 1961-186; Rev. Rul. 71-161, 1971-1 C.B. 76.)

Setoffs

A casualty loss (like any loss) is deductible only to the extent it is not compensated for by insurance or otherwise. Code Section 165(a). If the amount of reimbursements exceed the taxpayer's adjusted basis in the property, the taxpayer realizes a gain unless the gain can be excluded from income as the sale of a home or can be deferred as an involuntary conversion. (Code Section 1033 provides special treatment for gains from an involuntary conversion.)

If, in the year of the casualty, the taxpayer has a claim for reimbursement of the loss, and there is a reasonable prospect that she will be reimbursed for part or all of the loss, the taxpayer must subtract the expected reimbursement to compute the loss. Reg. Section 1.165-1(c)(4) and Reg. Section 1.165-1(d)(2)(ii). If the reimbursement in the later year turns out to be less than expected, the additional loss is claimed in that year. Reg. Section 1.165-1(d)(2)(ii). If the reimbursement exceeds the amount deducted, the taxpayer does not go back to the deduction year to recompute the loss. Instead, to the extent required under the tax benefit rule, the taxpayer includes it in income in the year it is received. Reg. Section 1.165-1(d)(2)(iii). The home sale exclusion and the involuntary conversion deferral do not apply to amounts subject to the tax benefit rule, but may apply to other portions of the reimbursed amount.

Insurance expenses that do not compensate for the casualty do not reduce the loss and are income. Accordingly, insurance payments for normal family living expenses, due to the loss of use of the family's income, are income. But payments for additional living expenses, such as for additional transportation expenses or for restaurant meals, need not be included in income. Code Section 123; Reg. Section 1.123-1.

An individual must show that a grant, award, gift, or loan with respect to a casualty was not a reimbursement to avoid a reduction in the amount of the loss. In addition to insurance, compensation can include condemnation awards, cancellations of federal relief loans, reimbursement under the Federal Disaster Relief Act, cash gifts to rehabilitate property, payments from an urban renewal agency and certain payments to businesses affected by the World Trade Center attacks made by the Empire State Development Corporation. (Rev. Rul. 71-160, 1971-1 C.B. 75; Rev. Rul. 71-161, 1971-1 C.B. 76; Rev. Rul. 76-144, 1976-1 C.B. 17; Notice 2003-18, 2003-1 C.B. 699. Grant payments made by the Empire State Development Corporation under the World Trade Center (WTC) Business Recovery Grant Program are reimbursements for casualty losses. Grant payments made under the WTC Small Firm Attraction and Retention Grant Program and the WTC Job Creation and Retention Program are not reimbursements for casualty losses.)

Year of the Casualty Loss Deduction

A casualty loss (like any loss) generally must be claimed in the year sustained. Reg. Section 1.165-7(a)(1). Usually, this is the year in which the casualty occurs. However, the loss may be deductible in a later year if the loss is not determinable until a later year. For example, in *United States v. Barret*, 202 F.2d 804 (5th Cir. 1953), the taxpayer's trees were damaged by a severe Florida freeze and the taxpayer attempted to salvage them during the next two years. When it became evident he could not, he claimed a casualty loss. The Fifth Circuit allowed the claim in the later year.

A casualty loss that is subject to a claim for insurance or other reimbursement for which there is a reasonable prospect of recovery is not allowed in the year of the casualty. These losses may only be deducted in the year in which the reasonable prospect of recovery no longer exists or in which compensation is received for less than the amount of the loss. Reg. Section 1.165-1(d)(2)(i). A taxpayer who properly deducts a loss in one year and receives reimbursement in a later year must include the reimbursement in his gross income, as provided in Code Section 111. (Reg. Section 1.165-1(d)(2)(iii). Under the tax benefit rule of Code Section 111, a recovery is includible in income to the extent the prior loss deduction reduced taxable income.)

If an estate suffers a casualty loss of property during settlement, the loss may be allowed as a deduction in computing the taxable income of the estate. Reg. Section 1.165-7(c). The deduction is only allowed if the loss was not allowed as a Code Section 2054 loss during administration in computing the taxable estate of the decedent and if a statement is filed in accordance with Reg. Section 1.642(g)-1.

There are two central facts about this election. First, the amount of the potential deduction for a personal casualty loss is greater under the estate tax than it is under the income tax, since there are no limitations. Second, if the deduction offsets an otherwise fully taxable portion of the estate, it will usually be worth more (on a dollar-for-dollar basis) as an estate deduction than it would be as an income tax deduction, since the applicable estate tax rate will generally be higher than the income tax rate.

The deduction can be split between the estate tax return and the income tax return. If the estate tax deduction has not been finally allowed and the appropriate statement is filed, claiming a deduction in computing the estate's income tax return is not barred on the estate tax return. Reg. Section 1.642(g)-2. Delay filing the statement until it is clear that an income tax deduction is preferable. Once filed, the statement precludes the right to claim an estate tax deduction for the loss.

Casualty and Theft Losses of Passive Activity Property

In general, a taxpayer is allowed to deduct passive activity deductions only to the extent of her passive activity gross income for the year. (Code Section 469(a); Reg. Section 1.469-2T(b)(1).) A

deduction is a passive activity deduction if it arises in connection with the conduct of a passive activity. Reg. Section 1.469-2T(d)(1). The regulations, however, exclude casualty and theft losses (as defined in Code Section 165(c)(3)) as deductions from characterization as a passive activity deduction. (Reg. Section 1.469-2(d)(2)(xi).) However, the exemption is inapplicable if losses that are similar in cause and severity occur regularly in the conduct of the activity. Reg. Section 1.469-2(d)(2)(xi).

Passive activity rules will not limit losses arising from a natural disaster, such as a hurricane, but may operate to disallow the shoplifting losses of a retail store or the accident losses of a car rental business. (The casualty exception applies to all taxpayers subject to the passive activity rules who sustain a loss during a tax year that begins after 1989. However, a taxpayer sustaining such losses during a pre-1990 tax year may elect to treat such losses as a non-passive deduction on a return or amended return for such year. Notice 90-21, 1990-1 C.B. 332. Although the regulations do not indicate how this election is to be made, taxpayers would be wise to indicate that they are making such election by attaching a statement to their return or amended return. Taxpayers filing amended returns to take advantage of the casualty loss exemption must also recompute and reallocate their disallowed passive activity loss and credit on amended returns for all other affected years for which returns have been filed. Notice 90-21, 1990-1 C.B. 332. The amount and allocation of the disallowed loss and credit for 1989 and future years must reflect any change in the taxpayer's carryovers. See Reg. Section 1.469-1T for details on allocating the PAL loss and credit.)

Reimbursements of casualty losses from passive activities by insurance or otherwise, are also excluded from the definition of passive activity income. Reg. Section 1.469-2(c)(7)(vi). This exclusion applies only to casualty and theft loss reimbursements that are included in gross income under Reg. Section 1.165-1(d)(2)(iii) (relating to reimbursements of losses that the taxpayer deducted in a prior taxable year), and only if the deduction of the loss was not a passive activity deduction. Reg. Section 1.469-2(c)(7)(vi). It does not apply to any other current or prior year deductions, whether from the activity in which the lost or damaged property was used or from any other activity. This exclusion for casualty and theft reimbursements is provided because such reimbursements are included in gross income only to the extent necessary to offset the tax benefits of any deduction that the taxpayer claimed with respect to the loss. Applying this principle to the passive activity computation, the reimbursement amount included in gross income should not be treated as passive activity gross income if the deduction for the loss was excluded from passive activity deductions.

Under Code Section 469(g), losses from an activity are allowed without limitation if the taxpayer disposes of his entire interest in the activity to an unrelated person in a fully taxable transaction. This rule is inapplicable, however, unless all of the assets used or created in the activity, including land, are disposed of. Thus, a casualty or theft loss involving property used in an activity does not constitute a complete disposition of the taxpayer's interest in the activity unless the casualty or theft loss results in the loss or theft of all property used or created in the activity. Notice 90-21, 1990-1 C.B. 332.

This exclusion from the passive activity rules does not change the treatment of a casualty or theft loss for purposes other than Code Section 469. Notice 90-21, 1990-1 C.B. 332. For example, if a casualty totally destroys property used in a trade or business or held for the production of income and the property's fair market value immediately before the casualty is less than its adjusted basis, the amount of the loss taken into account under Code Section 165 is the property's adjusted basis. Reg. Section 1.165-7(b)(1)(ii). However, the loss must be determined by reference to a single, identifiable property damaged or destroyed. Reg. Section 1.165-7(b)(2)(i).

A casualty or theft loss incurred in a passive activity is not a personal casualty loss and, thus, is not subject to the limitation and other rules applicable to personal casualty losses. (Code Section 165(c)(3); Code Section 165(h).) Such a loss may be treated as a Code Section 1231 loss. However, the Code Section 1231 rules are inapplicable to involuntary conversions of property from fire, storm, shipwreck, or other casualty, or from theft, if the recognized losses from such conversions exceed the recognized gains. Code Section 1231(a)(4)(C).

Taxpayers who sustain losses attributable to a disaster occurring in an area later determined to warrant assistance from the Federal government may elect to deduct the loss for the tax year immediately preceding the tax year of the disaster. (See Code Section 165(i).) Under Notice 90-21, 1990-1 C.B. 332, this throwback election may apply to casualty losses excluded from passive activity deductions.

