

Excerpt from eBook

The IRS and Defrauded Investors - Theft Tax Loss

Casualty/Theft Loss: Deductible Loss
Insurance Recoveries & Other Compensations
The \$100 and 10 Percent Floors
The Tax Benefit Rule

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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 8 – Casualty/Theft Loss: Deductible Loss

To determine the amount of the casualty loss deduction, it is necessary to:

1. Measure the taxpayer's loss;
2. Take account of any insurance recovery, other compensation, or salvage value; and
3. Apply the non-deductible floors.

Measuring Taxpayer's Loss:

The basis for determining the amount of any loss (including casualty losses) is the adjusted basis used in determining the taxpayer's loss on a sale or other disposition of the property (IRC § 165(b)). In the case of a personal residence, automobile, or other item held exclusively for personal use, the adjusted basis is ordinarily cost, with adjustments for improvements, prior casualty deductions, and some other receipts, expenses and tax allowances. If there is a difference between the asset's basis for computing gain and its basis for computing loss (e.g., under § 1015(a), relating to property acquired by gift), the latter must be used, even if the property is held solely for personal use so that any loss on sale would be nondeductible. (Reg. § 1.165-7(b)(1)(ii). See, *Pickering v. CIR*, 37 TCM (CCH) 1765 (1978), *aff'd*, 79-2 USTC ¶ 9616 (2nd Cir. 1979), *cert. denied*, 444 US 1008 (1980) [failure of proof on issue of basis sometimes overlooked to permit allowance of small casualty loss if court can infer that deduction does not exceed basis].)

For example, if an uninsured painting costing \$1,000 but worth \$5,000 is totally destroyed by fire, the loss is \$1,000. Since the unrealized appreciation has not been taken into income, it does not figure into the computation of the deduction. Indeed, if the taxpayer recovered \$5,000 from an insurance company or tort-feasor, there would be a gain of \$4,000.

If the painting was held solely for personal pleasure and was worth only \$750 at the time of the fire, the casualty loss is only \$750. The full-adjusted basis of \$1,000 is not allowed in this case because the pre-fire decline in value of \$250 is not attributable to the casualty. Under *Helvering v. Owens*, decided by the Supreme Court in 1939, the loss from casualty is the lesser of the property's adjusted basis and its value immediately before the casualty (*Helvering v. Owens*, 305 US 468 (1939); see, Reg. § 1-165-7 (b)(1)(ii)).

The *Owens* principle does not apply to property used in the taxpayer's trade or business or held for the production of income. When such property is destroyed by casualty, the casualty closes out a loss equal to the full amount of the property's adjusted basis, all of which is sustained in a business or profit-oriented activity (Reg. § 1.165-7(b)(1) (last sentence)). If property is converted from personal to business or income-producing uses, the lower of its value or adjusted basis at the time of conversion is used in computing a casualty loss, with adjustments for post-conversion events; see, Reg. § 1-165-7(a)(5)). In this instance, the casualty is merely

the event that marks recognition of the loss, and the deduction is not limited to the loss caused by the casualty.

In computing the casualty loss when several integrally related assets (e.g., land and improvements) are involved, the regulations distinguish property held for personal use from property used for business or income-producing purposes. In the latter situation, the loss is computed by reference to each “single, identifiable property” that is damaged or destroyed. (Cox v. US, 371 F.Supp. 1257, 1261 (ND Cal. 1973) [loss of “unexpected and unrealized appreciation collateral to [taxpayer’s] original investment” not deductible], vacated and remanded, 537 F.2d 1066 (9th Cir. 1976). The appellate court relied in part on Regulation § 1.165-7(b)(3), Example 2 (ornamental shrubs), although there the adjusted basis of the damaged property exceeded its value after the casualty. Reg. § 1-165-7 (b)(2)(i); see, Weyerhaeuser Co. v. US, 92 F.3d 1148 (Fed. Cir. 1996) [volcanic eruption of Mt. St. Helens caused damage to taxpayer’s timber holdings, including timber stands, logging road systems, and railroad; held, each of seven road systems, entire railroad, and each “subdivision of [the] taxpayer’s forest holdings [aggregated for purposes of] tracking the adjusted basis in the timber” was single, identifiable property]; Westvaco Corp. v. US, 639 F.2d 700 (Ct. Cl. 1980) [taxpayer’s timber damaged by storms and fires; held, all standing timber in district directly affected by each casualty was single, identifiable property]; Carloate Indus., Inc. v. US, 354 F.2d 814 (5th Cir. 1966) [citrus grove land and trees not treated as single unit]; Keefer v. CIR, 63 TC 596 (1975) [office building and land separate units]; see also, Rosenthal v. CIR, 416 F.2d 491 (2nd Cir. 1969) [allocation of basis of timber tract to trees damaged in ice storm].)

According to the regulations, in determining the amount of a casualty loss, a property’s fair market value immediately before and after the casualty shall “generally be ascertained by competent appraisal.” (Reg. § 1.165-7(a)(2)(i).)

Supplemental instructions issued by the IRS stress the importance of the appraiser’s knowledge of the conditions in the area and familiarity with the taxpayer’s property, the value of photographs, and industry “bluebooks” for automobiles. (IRS Pub. No. 547, “Casualties, Disasters, and Thefts (Business and Non-business)” 4 (1998); see also, IRS Pub. No. 561, “Determining the Value of Donated Property” 4-6 (1996) [listing several sources of information on valuing particular items, including books, art objects and stamps]; Bowers v. CIR, 42 TCM (CCH) 1659 (1981) [computation of loss attributable to destruction by tornado of ornamental trees around taxpayer’s home; analysis of relevant factors].)

The cost of repairs is “acceptable evidence” of the loss in value if the repairs are necessary to restore the property to its pre-casualty condition, are not excessive in amount, and are confined to the casualty damage, and if the property’s value after the repairs does not exceed its pre-casualty value. (Reg. §1.165-7(a)(2)(ii).)

The latter condition is easily satisfied in some circumstances (e.g., the replacement of a broken window), but some repairs almost inevitably add value to the property. (See, Bailey v. CIR, 47

TCM (CCH) 321 (1983) [loss from sudden subsidence of soil did not include cost of new retaining walls, which greatly reduced precasualty subsidence]; Root v. CIR, 42 TCM (CCH) 241 (1981) [full cost of repairs not deductible because they put properties in better condition than before casualty].)

The loss may exceed repair costs if repairs cannot restore the property to its pre-casualty value. (See, Finkbohner v. US, 788 F.2d 723 (11th Cir. 1986) [flood caused minimal physical damage to taxpayer's property but substantially diminished fair market value because extensive damage to neighboring property made prospective buyers wary of neighborhood; held, loss is full decline in fair market value, including portion resulting from buyer resistance, and is not limited to cost of repairs]; Conner v. US, 439 F.2d 974 (5th Cir. 1971) [decline in market value fully deductible, even though in excess of repair costs]; Thornton v. CIR, 47 TC 1, 6 (1966) ["in some cases fair market value of damaged property will decline to a far greater extent than can be measured by the yardstick of the cost of repair; once damaged, some property cannot regain its former fair market value no matter how carefully, painstakingly, or expensively repaired"].)

Section 165(k) sometimes allows a casualty loss deduction to a taxpayer ordered to relocate a residence as a result of a presidentially declared disaster. The measure of this loss is the difference between the residence's value before the disaster and its value after the disaster but before the relocation or, if less, the taxpayer's adjusted basis. (Staff of Joint Comm. on Taxation, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1166 (Comm. Print 1984).)

Appraiser's fees and other expenses incurred to establish a deductible loss are not part of the casualty loss itself, but they may be deducted under § 212(3) (expenses of establishing a tax liability) if the taxpayer itemizes deductions.

Chapter 9 – Insurance Recoveries & Other Compensations

Amounts paid by *tort-feasors* are not casualty losses as to them, but they may be deducted under § 162 or § 212 if incurred in a trade or business or a profit-seeking activity. See, *Dosher v. US*, 730 F.2d 375, 377 (5th Cir. 1984) (no deduction for payment to owner of home that taxpayer negligently drove into; taxpayer's money is lost by casualty only if "the actual currency or coinage is physically damaged or destroyed"); *Tarsey v. CIR*, 56 TC 553 (1971).

Section 165(a) permits losses to be deducted only if "not compensated for by insurance or otherwise." Expenses incurred in obtaining reimbursement for a casualty loss are part of the loss or an offset against the recovery. (See, *Spectre v. CIR*, 25 TCM (CCH) 519 (1966) [loss fully covered by insurance, but taxpayer's legal fees deductible]; *Jeffrey v. CIR*, 12 TCM (CCH) 534 (1953).)

If compensation for the loss or the property's salvage value is collected in the year of the casualty, these offsets are taken into account at that time in computing the uncompensated loss, if any. Conversely, if there is no reasonable prospect of a recovery, the entire loss is taken into account when sustained, and any unexpected subsequent recovery is taken into income when received, subject to the tax benefit doctrine. (See, Reg. §§ 1.165-1(d)(2)(ii), 1.165-1(d)(2)(iii); *Montgomery v. CIR*, 65 TC 511 (1975) [insurance recovery taxed when received, in view of earlier deduction with tax benefit].)

In the intermediate situation, where the taxpayer has "a claim for reimbursement with respect to which there is a reasonable prospect of recovery," but this claim is not settled during the year of the casualty, "no portion of the loss" that may be reimbursed by this claim is deductible "until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. (Reg. § 1.165-1(d)(2)(i); but see, *Hensler, Inc. v. CIR*, 73 TC 168 (1979) (acq. in result) [business expense deduction allowed for repairs to business property damaged by casualty, despite possibility of insurance recovery].)

According to the Tax Court, in the case of *Ramsay Scarlett & Co. v. CIR*, 651 TC 795, 811-812 (974), *aff'd*, 521 F.2d 786 (4th Cir. 1975):

A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor.... The standard for making this determination is an objective one, under which this Court must determine what was a "reasonable expectation" as of the close of the taxable year for which the deduction is claimed.... The standard is to be applied by foresight, and hence, we do not look at facts whose existence and production for use in later proceedings was not reasonably foreseeable as of the close of the particular year. Nor does the fact of a future settlement or favorable judicial action on the claim control our determination, if we find that as of the close of the particular year, no reasonable prospect of recovery existed.

(See, *Jeppsen v. CIR*, 128 F.3d 1410 (10th Cir. 1997) [taxpayer had reasonable prospect of recovering funds stolen by stock broker]; *Dawn v. CIR*, 675 F.2d 1077 (9th Cir. 1982) [later suit evidenced reasonable prospect of recovery]; *Scofield's Est. v. CIR*, 266 F.2d 154 (6th Cir. 1959) [loss from trustee's diversions, discovered in 1935, deductible in 1948 on conclusion of litigation by successor trustee]; *Harwick v. CIR*, 184 F.2d 835 (5th Cir. 1950) [insurance for shipwreck]; *Johnson v. CIR*, 41 TCM (CCH) 849 (1981) [deduction in year of fire, not when lawsuit was finally settled, since prospect for recovery was very uncertain]; *Grace v. CIR*, 34 TCM (CCH) 992 (1977) [deduction for loss of interest in credit union denied for 1971 to taxpayer filing claim in 1974 to participate in judicial distribution of debtor's assets].)

In a common situation – a reasonable prospect of reimbursement, falling short of certainty – the taxpayer can deduct the loss currently only if and to the extent it exceeds the potential recovery. For example, a deduction may be taken for the amount by which the loss exceeds the taxpayer's insurance policy limit if the insurance is the only possible source of reimbursement. The balance of the loss must be held in abeyance pending resolution of the uncertainty, to be deducted if it exceeds the amount collected or if the claim is abandoned. In the latter case, the taxpayer must show that the claim has in fact been abandoned (e.g., by the execution of a release) or that the abandonment did not serve an extraneous purpose. (Reg. § 1.165-1(d)(2)(i) ["objective evidence" of abandonment]).

The treatment of taxpayers, who refrain from pressing valid claims against their insurers, presumably to guard against cancellation of coverage or increased premiums, has a long history. Although the courts first denied the deduction, later decisions allowed a covered loss to be deducted if the taxpayer unequivocally waived the insurance claim.

(See, *Hills v. CIR*, 691 F.2d 997 (11th Cir. 1982) [after repeated burglaries, taxpayers did not file insurance claim, fearing non-renewal of policy; loss held not compensated for by insurance]; *Miller v. CIR*, 733 F.2d 399 (6th Cir. 1984) [same]; *Grigsby v. CIR*, 47 TCM (CCH) 620 (1982) [same].)

Congress intervened in 1986, denying the § 163(c)(3) deduction for any loss covered by insurance unless "the individual files a timely insurance claim with respect to such loss." (IRC § 165(h)(4)(E) [applicable to losses sustained in taxable years after 1986].)

Amounts received because of a casualty are not necessarily compensation for damage to or destruction of the taxpayer's property. For example, insurance proceeds compensating for loss of the use and occupancy of business property or for additional living expenses are not ordinarily considered compensation for property and, thus, do not reduce the taxpayer's casualty loss.

(Section 123 excludes insurance proceeds received for certain living expenses from gross income. Before § 123 was enacted in 1969, these amounts usually were gross income and did not reduce the casualty loss deduction. *Millsap v. Cir*, 387 F.2d 420 (8th Cir. 1968); Rev. Rul. 59-

360, 1959-2 CB 75, declared obsolete by Rev. Rul. 72-619, 1972-2 CB 650. But see, *Conner v. US*, 439 F.2d 974 (5th Cir. 1971) [insurance compensating for temporary living quarters not gross income but reduces casualty loss]. See also, *Oppenheim's, Inc. v. Kavanagh*, 90 F.Supp. 107 (ED Mich. 1950) [business interruption insurance included in gross income as compensation for loss of profits].)

Similarly, benefits paid to victims of disasters may or may not be allocable to damaged property. (See, *Spak v. CIR*, 76 TC 464 (1981) [public agency's payment equal to value of house destroyed in flood is compensation for loss, but relocation payment is not]; Rev. Rul. 71-161, 1971-1 CB 76 [federal disaster relief benefits reduce casualty loss]; *Shanahan v. CIR*, 63 TC 21 (1974) [same]; Rev. Rul. 76-144, 1976-1 CB 17 [disaster relief in excess of casualty loss is nontaxable general welfare receipt]; Rev. Rul. 75-28, 1975-1 CB 68 [disaster relief received after casualty deduction taken in earlier year]. See also, Rev. Rul. 73-408, 1973-2 CB 15 [agricultural benefits included in gross income to extent in excess of farmer's basis in damaged crops].)

Chapter 10 – The \$100 and 10 Percent Floors

Section 165(h) imposed two floors on the casualty loss deduction of § 165(c)(3). Section 165(h)(1) disallowed the first \$100 of the loss from each casualty or theft (increased in 2009 to \$500). Under § 165(h)(2), the deduction for losses in excess of \$100 per casualty or theft was limited to the amount by which the aggregate of these losses for the year (reduced by gains on insurance and other recoveries on account of casualties) exceeds 10 percent of the taxpayer's adjusted gross income.

The 10 percent rule only applies in taxable years after 1983. The \$100 floor was enacted in 1964. Until 1982, the statutory language applied the \$100 floor to all "property not connected with a trade or business," but the regulations also exempted property held for the production of income. Reg. §§ 1.165-1(c)(3), 1.165-7(b)(4)(i)(b). See, S. Rep. No. 830, 88th Cong., 2nd Sess., reprinted in 1964-1 CB (pt. 2) 505, 562 [\$100 floor limits personal losses "as distinct from those associated with a trade or business or transactions entered into for profit"]. After amendment in 1982, § 165 (c)(3) applies only to "property not connected with a trade or business or a transaction entered into for profit," and the floors only apply to losses "described in § 165(c)(3)." IRC §§ 165(h)(1), 165(h)(3)(B).)

Under the \$100 rule, if one item of property is damaged in two or more separate casualties in a single taxable year, the floor is applied independently to each casualty. If two or more assets are damaged in the same casualty, however, the rule only strips \$100 from the entire loss. (Reg. § 1.165-7(b)(4)(ii) [whether damage is from single casualty or from two or more separate casualties is question of fact; events closely related in origin, such as winds and flood caused by hurricane, are one casualty].)

When jointly owned property is damaged or destroyed, each owner's loss is subject to the \$100 floor unless the owners are husband and wife, in which event there is only one \$100 disallowance if they file a joint return (IRC § 165(h)(4)(B); Reg. § 1.165-7(b)(4)(iii)).

If property serving both personal and business purposes is damaged by casualty, the floor applies only to the part of the loss allocable to the personal element. For example, if an automobile used one half for business and one half for pleasure suffers an otherwise deductible loss of \$150, the \$75 business loss is fully deductible, but the \$75 personal loss is eliminated by the \$100 floor (Reg. § 1.165-7(b)(4)(iv)).

The 10 percent floor applies to the personal casualty gains and losses of every individual. The limitation also applies to estates and trusts, even though these entities do not usually use the concept of adjusted gross. An estate's or trust's adjusted gross income is specially computed for this purpose in the same manner as it is computed for individuals, except that administration expenses (if not taken as an estate tax deduction) are allowed in computing adjusted gross income. (IRC §§ 165(h)(4)(C), 165(h)(4)(D).)

A “personal casualty loss” is an excess over \$100 of an uncompensated loss resulting from casualty property that is “not connected with a trade or business or a transaction entered into for profit.” (IRC § 165(h) (3)(B). In applying these rules, a husband and wife filing a joint return are treated as one individual. IRC § 165(h)(4)(B).)

A personal casualty gain is realized, for example, if an insurance recovery exceeds the basis of property lost by casualty. Personal casualty gains and losses for the taxable year are aggregated.

If there is net loss:

1. The gains are included in gross income as ordinary income;
2. Losses are deductible to the extent of these gains; and
3. Losses in excess of gains are deductible only to the extent they exceed 10 percent of adjusted gross income.

(IRC § 165(h)(2)(A).) In this case, the gains and an amount of loss equal to the gains are included in determining adjusted gross income, with the consequence that personal casualty gains and losses neither increase nor decrease adjusted gross income. IRC § 165(h)(4)(A). An excess of losses over gains (to the extent deductible under the 10 percent rule) is an itemized deduction.

If there is net gain, each gain and loss is reported as capital gain or loss (IRC § 165(h)(2)(B)). In this situation, the gains and losses are included in computing adjusted gross income. (IRC § 62(a)(3).)

Chapter 11 – The Tax Benefit Rule

Generally, the full amount of any recovery of a previously deducted or credited amount must be included in gross income. However, under the tax benefit rule, a previously deducted or credited amount is not included in gross income to the extent the deduction or credit did not reduce the amount of tax imposed in the prior year. Code Section 111. In other words, taxpayers must include a recovery in income in the year the recovery is received, but only up to the amount by which the deduction or credit the taxpayer took for the recovered amount reduced the taxpayer's tax for the earlier year.

The total of all taxable recoveries are generally reported as other income on Form 1040. Form 1040A or Form 1040EZ may not be used. However, refunds of state and local income taxes must be reported separately on their own line on Form 1040.

A taxpayer who receives a state or local income tax refund of \$10 or more will receive a payee statement during January of the following year on Form 1099-G, Certain Government Payments, reporting the refund. Code Section 6050E.

Taxpayers who recover an item from the same tax year are not required to include the recovery in income except to the extent it exceeds the amount of the item. For example, a taxpayer who receives a property tax rebate in the same year the taxes were paid is not required to include the rebate in gross income except to the extent that the rebate exceeds the real property tax paid by the taxpayer. The amount of the rebate, however, reduces the taxpayer's real property tax deduction. CCM 200721017.

Common recoveries include refunds, reimbursements, and rebates of itemized deductions, and may also include some non-itemized deductions (such as previously deducted bad debts) as well as items for which the taxpayer previously claimed a tax credit. See Reg. Section 1.111-1(a)(2). The reimbursement of a previously deducted casualty or theft loss may be a recovery of an itemized deduction. Reg. Section 1.165-1(d)(2)(iii).

Refunds of federal income taxes are never included in income because they are never allowed as a deduction from income.

Not all refunds are treated as recoveries. For example, where a taxpayer claims a deduction under Code Section 164 for his real property taxes, and in the next year the taxpayer receives a state income tax credit against those real property taxes, the credit is not a taxable recovery of the real property taxes. Instead, the taxpayer's state income tax, which is also deductible under Code Section 164, is reduced. However, if the state income tax credit is refundable, the amount by which the credit exceeds the taxpayer's state income tax is includable in income as a recovery of real property taxes. CCA 200842002.

A recovery does not include the gain resulting from the receipt of an item which exceeds the deduction or credit previously allowed for such item. For example, if a \$100 bond originally purchased for \$40 and later deducted as worthless is collected on to the extent of \$50, the \$10

gain is not a recovery and cannot be excluded from income under the tax benefit rule. Reg. Section 1.111-1(a)(2). Similarly, if a recovery of state taxes paid exceeds the amount of tax actually paid, then the excess is not a recovery and is includable in gross income. CCM 200504027. Also, in the case of a recovery of a previously deducted charitable contribution, if the property returned by the qualified charitable organization has appreciated in value, the amount subject to the tax benefit rule is limited to the value of the property when it was originally contributed. (Rev. Rul. 76-150, 1976-1 C.B. 38; *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967)).

The addition of a carryover that has not expired by the year of recovery is treated as a tax benefit. *Rosenburg v. Commissioner*, 96 T.C. 451 (1991). Because the taxpayer received a tax benefit from the additional carryover, the carryover is treated for purposes of the tax benefit rule as decreasing the taxpayer's tax in the year the carryover was generated. Therefore, the recovery of the item that generated the carryover must be included in gross income in the year of recovery even though the carryover has not yet reduced any tax. Code Section 111(c). Similarly, if a bad debt arising from worthless securities or from certain non-business bad debts is treated as a loss from the sale of a capital asset, the recovery of the bad debt is subject to the tax benefit rule regardless of whether the bad debt generated capital losses or ordinary losses, or whether the loss was used as a deduction in the year the loss arose or was instead treated as a capital loss carryover. Reg. Section 1.111-1(a)(4). If the bad debt generated a capital loss, then the recovery amount is treated as capital gain. Likewise, the recovery of an ordinary loss would be treated as ordinary gain. (*Deely v. Commissioner*, 73 T.C. 1081 (1980); *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).)

The recovery of an itemized deduction is eligible for the tax benefit rule only if the taxpayer elected to itemize her deductions for the taxable year in which the deduction could be claimed, rather than taking the standard deduction. See Rev. Rul. 70-86, 1970-1 C.B. 23. Further, the recovery of an item that was previously claimed as an itemized deduction is includable in income under the tax benefit rule in an amount equal to the lesser of (1) the amount of the recovery or (2) the amount by which the itemized deductions exceeded the standard deduction. Rev. Rul. 92-91, 1992-2 C.B. 49.

A computation statement should be attached to the return to show why the income reported due to the tax refund is less than the amount shown on Form 1099-G, Certain Government Payments. IRS Publication 525, Taxable and Nontaxable Income.

