INSURANCE RECOVERIES, OTHER COMPENSATION, AND SALVAGE VALUE

Prepared by:
Gary S. Wolfe
THE WOLFE LAW GROUP

LORMAN®

May 2017

THE WOLFE LAW GROUP

The Wolfe Law Group is an international array of legal and tax experts providing collaborative services for Global High Net Worth Investors on a per client basis.

Gary S. Wolfe, A Professional Law Corporation has over 35 years of experience providing clients with expertise for IRS Civil and Criminal Tax Audits, International Tax Planning, and International Asset Protection.

Awards
Since 2015 Gary have been the recipient of 29 separate international tax awards from 10 different global expert societies in London/UK including:

International Tax Planning Law Firm of the Year Award (2017) – International Advisory Experts.

International Tax Advisor of the Year (2017) - Global Business Magazine/Prof. Sector Network.

Click here for complete list.

Books
To date Gary has written 18 e-books (available on Amazon) regarding the IRS, International Tax Planning and Asset Protection. Click here for complete list.

Articles
To date Gary has published or been interviewed in 100+ separate articles published by 15 different US and International magazines. Click here for complete list.

Video
In December 2016 Gary was interviewed by California CEO Magazine and RCBNNews.org on the subject of Criminal Tax Evasion and IRS Tax Audits: Civil and Criminal Issues. This 4 part series, which has been published by Lorman Education, can be viewed below:

Criminal Tax Evasion - Part 1
Criminal Tax Evasion – Part 2
Criminal Tax Evasion – Part 3
Criminal Tax Evasion – Part 4

Contact:
Gary S. Wolfe, Esq.
Tel: 323-782-9139
Email: gsw@gswlaw.com
Website: gswlaw.com

<u>Insurance Recoveries, Other Compensation, and Salvage Value</u>:

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 certainly 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. [*Emphasis added.*]

(*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].)

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. 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).)