



# **IRS AND CASUALTY LOSSES**

## **ANCILLARY PROBLEMS AND THE TAX BENEFIT RULE**

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[Criminal Tax Evasion - Part 1](#)

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## **ANCILLARY PROBLEMS:**

### **Year of Deduction:**

Section 165(a) allows a deduction for “any loss sustained during the taxable year.” This ordinarily means that the loss is to be deducted in the year of the casualty itself, but there are several qualifications and exceptions to this general principle:

1. **Delayed Damage:** In unusual circumstances, a taxpayer may be unable to determine promptly whether a storm or other casualty has damaged property or, if so, the extent of the loss. In such a case, the loss is not “sustained” until the effects of the casualty can be observed and evaluated.

(*US v. Barret*, 202 F.2d 804, 806 (5<sup>th</sup> Cir. 1953) [freeze in winter of 1943-1944; damage “latent and uncertain” until 1946, when remedial efforts abandoned and trees removed; held, although “injury” occurred in 1943-1944, “loss” was not sustained until it became “ascertainable” in 1946]; *Oregon Mesabi Corp. v. CIR*, 39 BTA1033 (1939) (acq.), appeal dismissed, 109 F.2d 1014 (9<sup>th</sup> Cir.1940) [fire killed trees in 1933; timber rendered worthless when attacked by insects and fungi in 1934 and 1935; held, losses sustained in 1934 and 1935 as well as in 1933].)

2. **Reimbursement Claims:** The taxpayer has a reasonable prospect of recovering the loss from an insurer or tortfeasor, the deduction must be postponed until the claim is resolved, settled, or abandoned.

3. **Disaster Losses:** To speed up economic recovery from widespread disasters, § 165(i) permits taxpayers, at their election, to deduct casualty losses in the taxable year immediately preceding the year of a disaster if it is officially declared eligible for federal assistance under the Disaster Relief and Emergency Assistance Act.

(See, *Reg.* § 1.165-11. For lists of disasters qualifying under § 165(i) during various years, see, *Rev. Rul.* 99-13, 1999-10 IRB 4 (1998); *Rev. Rul.* 96-13, 1996-1 CB 18 (1995); *Rev. Rul.* 95-17, 1995-1 CB 10 (1994); *Rev. Rul.* 94-14, 1994-1 CB 72 (1993); *Rev. Rul.* 92-111, 1992-2 CB 58 (1992); *Rev. Rul.* 91-69, 1991-2 CB 38 (1991); *Rev. Rul.* 91-10, 1991-1 CB 48 (1990). See, *Matheson v. CIR*, 74 TC 836 (1980) (acq. in result) [invalidating 90-day time limit imposed by *Reg.* § 1.165-11(e) for revoking election].

Section 165(i) applied to both personal casualty losses and to losses to property used in a trade or business or acquired in a transaction entered into for profit, which are governed by § 165(a), rather than § 165(c)(3). See, *Reg.* § 1.165-11(a).

Section 165(i) also applies to condemnation and relocation losses deductible as casualty losses under § 165(k).)

## X. **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.

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