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Hurricane Harvey

Federal Tax Considerations

Associated With Disasters



SPECIAL REPORT



Hurricane Harvey, which came ashore on August 25 as the most powerful hurricane to hit Texas in more than 50 years, and the continued devastation of flooding in its aftermath killed dozens and caused billions of dollars in property damage. According to early estimates from the Texas governor's office, the property damage may be as much as \$180 billion — more costly than hurricanes Katrina or Sandy, which devastated New Orleans in 2005 and New York in 2012. More than 1 million people have been displaced and some 200,000 homes damaged in a path of destruction stretching for more than 300 miles. Individuals and businesses in other states were impacted too, whether by direct damage, damage to property owned in Texas or generous efforts of their citizens to help in the disaster response.

Impacted individuals and businesses will need assistance in dealing with the tax and other financial consequences associated with the damage caused by Harvey. This article addresses federal tax considerations that practitioners must be familiar with to effectively respond to their clients' needs — both immediate response needs and return preparation and planning needs before year end and during the 2018 filing season.

A Client Summary handout covering the tax and financial implications of Hurricane Harvey [is available here](#).





Tax Relief Pronouncements for Hurricane Harvey Victims

Taxpayers affected by a federally declared disaster are eligible for special tax relief provisions. Hurricane Harvey was declared a major disaster on 8/25/17 for the incident period beginning 8/23/17 (FEMA release DR-4332; IRS release TX-2017-09). The following Texas counties have been designated as in the federally declared disaster area as of 9/20/17:

Aransas, Austin, Bastrop, Bee, Bexar, Brazoria, Bureson, Calhoun, Chambers, Colorado, Dallas, DeWitt, Fayette, Fort Bend, Galveston, Goliad, Gonzales, Grimes, Hardin, Harris, Jackson, Jasper, Jefferson, Karnes, Kleberg, Lavaca, Lee, Liberty, Madison, Matagorda, Montgomery, Newton, Nueces, Orange, Polk, Refugio, Sabine, San Jacinto, San Patricio, Tarrant, Travis, Tyler, Victoria, Walker, Waller, Washington, Wharton.

For updates on Texas counties qualifying as in the federally declared disaster area, [click here](#).

Harvey-Specific Relief Provisions

The IRS has issued several releases detailing relief provisions for Harvey victims. These releases are covered below. See “Hurricane Harvey Pronouncements” on our [Disaster Relief Resources webpage](#) for coverage of future releases.

- Harvey victims residing in Texas counties that have been declared as in the federal disaster area (47 counties as of 9/20/17) are eligible for an automatic extension of tax filing and payment deadlines that occur starting on 8/23/17. Affected individuals and businesses have until 1/31/18 to file returns and pay any taxes that are originally due during the relief period. This includes quarterly estimated tax payments, extended 2016 income tax returns and quarterly payroll and excise tax returns. The IRS noted that tax payments related to 2016 individual tax returns were originally due on 4/18/17 and therefore are not eligible for this relief. The relief is automatically available to any taxpayer with an IRS address of record located in the disaster area. Therefore, the taxpayer does not need to contact the IRS to get this relief (News Release IR-2017-135). For more information, [click here](#). See also Bulk Requests from Practitioners for Disaster Relief later in this article for identifying clients outside the disaster area.
- 401(k) plans and similar employer-sponsored retirement plans can make loans and hardship distributions to Harvey victims and members of their families. Plans that do not currently provide for loans and hardship distributions will be allowed to make them before they are formally amended to provide for such features; however, any required amendments must be made no later than the end of the first plan year beginning after 12/31/17. To qualify for this relief, hardship withdrawals must be made no later than 1/31/18. (Ann. 2017-11; News Release IR-2017-138). For more information, [click here](#).
- In response to shortages of undyed diesel fuel caused by Harvey, the IRS will not impose a penalty when dyed diesel fuel is sold for use or used on the highway. The waiver area covers the entire state of Texas beginning 8/25/17 and extending through 9/15/17 (News Releases IR-2017-139 and IR-2017-142).



Observation: Ordinarily, dyed diesel fuel is not taxed because it is sold for uses exempt from excise tax, such as to farmers for farming purposes, for home heating use and to local governments for buses.

- In the wake of Harvey, many employers are considering leave-based donation programs. Under these programs, employees may elect to forgo vacation, sick or personal leave in exchange for employer contributions to charitable organizations. The IRS has announced that cash payments made by an employer under a leave-based donation program will not constitute employee wages if they are paid before 1/1/19 to Section 170(c) organizations for the relief of Harvey victims. In addition, the IRS will not assert that the opportunity to participate in a leave-based donation program results in constructive receipt of gross income or employee wages. Leave-sharing donations don't need to be included in Box 1, 3 or 5 of Form W-2, and employers should deduct the payments as ordinary and necessary business expenses under IRC Sec. 162 rather than charitable contributions that are deductible under IRC Sec. 170 (Notice 2017-48; News Release IR-2017-143). For more information, [click here](#).

- The IRS has provided temporary relief to allow owners and operators of low-income housing projects located anywhere in the U.S. and its possessions to provide temporary emergency housing to individuals who are displaced by a major disaster from their principal residences, regardless of income. The relief authorizes owners and operators, in conjunction with agencies and issuers, to disregard the income limits, transience rules and certain other restrictions that normally apply to low-income housing units when providing temporary emergency housing to displaced individuals. As a result, owners and operators can offer temporary emergency housing to displaced individuals who lived in a county or other local jurisdiction designated for individual assistance by the Federal Emergency Management Agency (FEMA). Currently, this includes parts of Texas, Florida, Georgia, Puerto Rico and the U.S. Virgin Islands, though FEMA may add other locations in the future. Individuals affected by some other recent major disasters, including those affecting parts of Michigan, West Virginia and other localities, may also qualify for emergency housing relief. Upon approval, emergency housing can be provided for up to a year after the close of the month in which the major disaster was declared by the President. Although owners and operators of low-income housing projects are allowed to offer temporary housing to qualified disaster victims, they are not required to do so. For those who do, special rules apply, as detailed in Rev. Procs. 2014-49 and 2014-50 (News Release IR-2017-165).

In an online release that is not a relief provision (FS-2017-11, dated September 2017), the IRS provides helpful information on steps to take after a disaster so taxpayers can reconstruct their records and prove loss of personal-use and business property.

And in a warning that is not a relief provision, the IRS cautions taxpayers to be wary of fake charity scams emerging due to Harvey and encourages taxpayers to seek out recognized charitable groups for their donations (News Release IR-2017-137).



Legislative Tax Relief for Hurricane Harvey Victims

Congress has passed and the President has signed into law the “Disaster Tax Relief and Airport and Airway Extension Act of 2017” (the Act). The Act includes temporary tax relief for Hurricane Harvey victims, as summarized below.

Hurricane Harvey Disaster Area and Disaster Zone

Most of the Act’s relief provisions apply with regard to the “Hurricane Harvey Disaster Area” (the area for which a major disaster was declared by the President before 9/21/17). This “Area” includes the Texas counties listed at Tax Relief Pronouncements for Hurricane Harvey Victims earlier in this article. However, some provisions apply only to a narrower “Hurricane Harvey Disaster Zone” (the portion of the Hurricane Harvey disaster area that qualifies for individual or individual and public assistance). Counties within this “Zone” can be identified by accessing the map included in FEMA release DR-4332. Provisions that apply only to the Harvey Disaster Zone are noted below.

Personal Casualty Loss Relief

The Act provides more favorable rules for disaster-related personal casualty losses in the Hurricane Harvey Disaster area.

1. The net disaster loss does not have to exceed 10% of adjusted gross income (AGI) to qualify for deduction.
2. Taxpayers do not have to itemize to claim a deduction. The taxpayer’s standard deduction is increased by the net disaster loss.
3. The portion of the standard deduction attributable to the net disaster loss is allowed for alternative minimum tax (AMT) purposes.

In addition, the Act increases the \$100 limitation per casualty to \$500.

For Hurricane Harvey purposes, a net disaster loss is the excess of:

- Qualified disaster-related personal casualty losses arising in the Hurricane Harvey Disaster Area on or after 8/23/17 and which are attributable to Harvey over
- Personal casualty gains as defined in IRC Sec. 165(h)(3)(A)

Qualified disaster-related personal casualty losses are those described in IRC Sec. 165(c)(3) (i.e., losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft).

For further discussion of personal and other casualty losses, see Treatment of Casualty Losses Attributable to Hurricane Harvey later in this article.

IRA and Retirement Plan Relief

The Act allows tax-favored withdrawals from retirement plans, by, among other things, providing an exception to the 10% early retirement plan withdrawal penalty for qualified hurricane relief distributions, providing favorable repayment terms, and allowing taxpayers the option of spreading out income inclusion resulting from such withdrawals over a 3-year period.

For Hurricane Harvey purposes, a qualified hurricane distribution is any distribution from an eligible retirement plan, as defined in IRC Sec. 402(c)(8)(B), made on or after 8/23/17 and before 1/1/19, to an individual whose principal place of abode on 8/23/17 was located in the Hurricane Harvey Disaster Area and who sustained an economic loss by reason of Hurricane Harvey.

Caution: The aggregate amount that can be treated by an individual as qualified hurricane distributions for any tax year cannot exceed \$100,000 reduced by the aggregate amount treated as such in all prior tax years.

The Act also permits the re-contribution of certain retirement plan withdrawals for home purchases or construction, which were received after 2/28/17 and before 9/21/17, where the home purchase or construction was cancelled on account of Hurricane Harvey.

In addition, the Act provides flexibility for loans from retirement plans for qualified hurricane relief, by increasing the maximum amount that a participant or beneficiary can borrow from a qualified employer plan from \$50,000 to \$100,000, removing the “one half of present value” limitation, and delaying certain repayment dates.

Charitable Donation Relief

The Act, for qualifying charitable contributions associated with qualified hurricane relief:

1. Temporarily suspends the majority of the limitations on charitable contributions in IRC Sec. 170(b) [i.e., “percentage of AGI limitations for individuals; 10% of taxable income limitation for corporations];
2. Specifies that such contributions will not be taken into account for applying IRC Sec. 170(b) and (d) to other contributions;
3. Eases the rules governing the treatment of excess contributions; and
4. Provides an exception from the overall limitation on itemized deductions for certain qualified contributions.

For Hurricane Harvey purposes, qualified contributions must be paid from 8/23/17 through 12/31/17, in cash, to an organization described in IRC Sec. 170(b)(1)(A), for relief efforts in the Hurricane Harvey Disaster Area.

Employee Retention Tax Credit for Employers

The Act provides an employee retention credit for eligible employers affected by Hurricane Harvey (employers that conducted an active trade or business on 8/23/17 in the Hurricane Harvey Disaster Zone, and the active trade or business is inoperable on any day after 8/23/17 and before 1/1/18 as a result of damage sustained by Harvey). The credit equals 40% of up to \$6,000 of qualified wages paid to each eligible employee (an employee whose principal place of employment on 8/23/17 with such employer was in the Hurricane Harvey Disaster Zone) of such employer for the tax year.

Earned Income Credit (EIC) and Child Tax Credit (CTC) Relief

The Act provides that, in the case of a qualified individual, if the earned income of the taxpayer for the tax year that includes 8/23/17 is less than the taxpayer's earned income for the preceding tax year, then the taxpayer may, for purposes of the EIC and CTC, substitute the earned income for the preceding tax year for the earned income for the tax year that includes 8/23/17. If the election is made, it applies for both the EIC and CTC.

For Hurricane Harvey purposes, a qualified individual is one whose principal place of abode on 8/23/17 was located either in the Hurricane Harvey Disaster Zone, or in the Hurricane Harvey Disaster Area (but outside the Zone) and the individual was displaced from his principal place of abode by reason of Hurricane Harvey. In the case of joint filers, the election may apply if either spouse is a qualified individual.



Tax Relief Provisions for Victims of a Federally Declared Disaster

There are a number of special tax relief provisions available to victims of a federally declared disaster. Many provide favorable tax treatment of payments received to help people who were negatively impacted by the disaster. Hurricane Harvey was declared a major disaster (a type of federal disaster) entitling victims in the disaster area to special tax relief. Following are some special tax relief provisions that apply to victims in the Harvey federal disaster area beginning on 8/23/17.

Qualified Disaster Relief Payments

Qualified disaster relief payments (QDRPs) are not included in the recipient's gross income and are not treated as earnings for self-employment tax purposes or as wages or compensation for employment tax purposes (IRC Sec. 139). QDRPs are amounts paid by the government, a charity or an employer to assist individuals who have been impacted by Hurricane Harvey. QDRPs include:

1. Amounts to reimburse or pay personal, living or funeral expenses incurred as a result of Hurricane Harvey
2. Amounts to reimburse or pay for repair or rehabilitation of a personal residence (including a rented residence) or its contents for damage attributable to Hurricane Harvey
3. Payments by a common carrier due to death or personal physical injuries resulting from Hurricane Harvey
4. Amounts paid by a federal, state or local government, or an agency or instrumentality of those governments, in connection with Hurricane Harvey in order to promote the general welfare

Qualified Disaster Mitigation Payments

Qualified disaster mitigation payments are not included in gross income and do not increase the basis of the property for which the payments are made [IRC Sec. 139(g)(1) and (3)]. These are payments made pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act to or for the benefit of the owner of any property for hazard mitigation (for example, flood control) with respect to such property.

Qualified disaster mitigation payments are made under the following programs:

1. Flood Mitigation Assistance Program (FMA)
2. Pre-Disaster Mitigation Program (PDM)
3. Hazard Mitigation Grant Program (HMGP)

Example: Alex received \$53,000 as a qualified disaster mitigation payment to elevate her home in an area that frequently floods. Alex spends the entire \$53,000 on elevation improvements. The \$53,000 payment is excluded from income, so Alex is unable to increase the basis in her home by the amount of any repairs up to that amount. Any expenditure in excess of the \$53,000 would increase basis.



Observation: Qualified disaster mitigation payments are most commonly paid in the period immediately following damage to property as a result of a natural disaster. These payments are used to mitigate (reduce the severity of) potential damage from future natural disasters. So while not a benefit to help Harvey victims immediately recover, they may be received as part of an ongoing effort to lessen the impact of future hurricanes, flooding, etc.

FEMA “Individuals and Households Program” Payments

Under the Individuals and Households Program (IHP), FEMA provides grant payments to individuals for critical expenses and losses not covered by insurance or other reimbursements that are incurred as a result of a federally declared disaster. FEMA makes the following types of payments under the program:

- **Temporary housing assistance** to rent a different place to live or a government provided housing unit when rental properties are not available
- **Repair assistance** for homeowners to repair damage from the disaster to their primary residence that is not covered by insurance with the goal of making the damaged home safe, sanitary and functional
- **Replacement assistance** for homeowners to replace their primary residence destroyed in the disaster that is not covered by insurance
- **Other needs assistance** for necessary expenses and serious needs caused by the disaster, such as medical, dental, funeral, personal property, transportation, moving and storage

Generally, FEMA IHP payments are excluded from gross income to the extent that the expenses compensated for by the IHP payments are not compensated for by insurance or other reimbursement (ITA 200114044 and 200114045; IRS website — FAQs for Disaster Victims — Mitigation Payments).

Note: The recipient of a FEMA IHP repair or replacement assistance payment must reduce the amount of any casualty loss attributable to the damaged or destroyed residence by the amount of the payment and must reduce the tax basis in the residence by the amount of the payment, as well as by the amount of the allowable casualty loss deduction attributable to the damaged or destroyed residence. If the recipient repairs a damaged residence, the cost of repairs ordinarily is capitalized and added to the recipient's tax basis in the damaged residence.

Bulk Requests From Practitioners for Disaster Relief

According to information on the IRS website, where the IRS has postponed the time to file returns and make payments in response to a federally declared disaster as it has for Harvey, practitioners located in the covered disaster area who maintain records necessary to meet a filing or payment deadline for taxpayers located outside the disaster area may contact the IRS to identify such clients.



Observation: Although the IRS website does not clearly specify the benefits to which identified clients may be entitled, IRS News Release TX-2017-09 states that taxpayers considered to be affected taxpayers eligible for the postponement of time to file returns, pay taxes and perform other time-sensitive acts include individuals who live and businesses whose principal place of business is located in the covered disaster area. The News Release goes on to say that taxpayers not in the covered disaster area, but whose records necessary to meet a deadline are in the covered disaster area, are also entitled to relief. In addition, all relief workers affiliated with a recognized government or philanthropic organization assisting in the relief activities in the covered disaster area and any individual visiting the covered disaster area who was killed or injured as a result of the disaster are entitled to relief. Thus, identified clients who are located outside the disaster area will receive consideration by the IRS for the delayed filing and payment benefits afforded taxpayers located in the disaster area. For Harvey victims located outside the disaster area, this may include any of the benefits provided by the various IRS releases discussed above at Harvey-Specific Relief Provisions (perhaps most significantly the automatic extension of tax filing and payment deadlines until 1/31/18).

To identify clients, either call the IRS at 866.562.5227 or use the following procedure when there are 10 or more clients:

1. Prepare a CD with the following information in an Excel spreadsheet:
 - a. In column A, list the clients' TINs. List SSNs and EINs separately or place dashes in the correct places to indicate whether SSN or EIN.
 - b. In column B, list the first four letters of each client's last name and/or the first four letters of each business name, using upper case lettering. Do not use any periods, commas, separators or any additional wording such as "the," etc. Use the first four letters of the taxpayer's last name for trusts and estates.

Caution: Do not include TINs of clients who live within the declared disaster area.

2. Include a cover letter with the CD requesting relief from penalties and/or interest. The letter should also contain the practitioner's name and address and a statement that identifies which disaster affected his or her clients. A copy of the IRS news release may be helpful, but is not required.
3. Mail the CD and cover letter to:

**Internal Revenue Service
Special Services Section
1 Independent Drive, Suite 500
Stop 6000
Jacksonville, FL 32202**

Note: Be sure to include the "Stop 6000" to ensure timely processing.





Treatment of Casualty Losses Attributable to Hurricane Harvey

A loss resulting from a casualty or theft of property is deductible as a casualty loss. A casualty is the damage, destruction or loss of property resulting from sudden, unexpected or unusual identifiable events, such as car accidents, storms and floods.

Personal-Use Property

A loss to personal-use property sustained as a result of Hurricane Harvey is considered a casualty loss [IRC Sec. 165(c)(3)]. The amount of the casualty loss is determined by taking the lesser of (1) the adjusted basis in the property before the casualty or (2) the decrease in fair market value (FMV) of the property as a result of the casualty and reducing this amount by any insurance or other reimbursement received or expected [Reg. 1.165-7(b)].

Example: John's boat was damaged by Hurricane Harvey. He purchased the boat in 2008 for \$32,000. Prior to the hurricane, the FMV of the boat was \$24,000. Damages were \$8,000 and he received \$7,500 in insurance to cover the repairs. The first step to calculate the casualty loss is to determine the lesser of the decrease in the boat's FMV (\$8,000 based on the cost of the repairs) and John's basis in the boat (\$32,000). This amount (\$8,000) is reduced by the insurance received (\$7,500), so John's casualty loss is \$500.



Observation: If a loss is fully covered by insurance, the taxpayer is not allowed a casualty loss deduction. If the reimbursement is more than the taxpayer's adjusted basis in the property, the taxpayer has a gain. This is true even if the decrease in the FMV of the property is smaller than the adjusted basis. See Gains From Insurance Reimbursement later in this article for the treatment of such gains.

Original basis. The method for determining a property's original basis varies depending on how the property was acquired.

- Purchase — Original basis equals cost.
- Inheritance — Original basis equals the value at the date of the decedent's death. *Exception:* Property inherited from decedents who died in 2010 has a modified carryover basis if the estate's executor elected not to be subject to estate tax (IRC Sec. 1022). The heir's basis should be shown on the Form 8939 (Sch. A) provided by the executor.
- Gift — Original basis equals the donor's basis (if FMV greater than donor's basis) plus any gift tax paid.
- Nontaxable exchange — Original basis equals the basis of the property transferred.

Adjustments to basis. During the period of property ownership, various events may take place that change its basis. Some events, such as additions or permanent improvements to the property, increase basis. Others, such as earlier casualty losses and depreciation deductions, decrease basis. Add the increases to the basis and subtract the decreases from basis to determine the taxpayer's adjusted basis.

Decrease in FMV. The FMV of property can generally be determined by the price for which the property could be sold between a willing buyer and a willing seller when neither party has to sell or buy and both parties know all the relevant facts [Reg. 20.2031-1(b); Somermeyer, 18 AFTR 2d 5114 (DC MN 1966)].

The decrease in FMV used to figure the amount of a casualty loss is the difference between the property's FMV immediately before and immediately after the casualty. All items of property, including structures, exterior improvements such as landscaping, vehicles, boats, furniture and fixtures and household goods should be accounted for. The decrease in FMV of all (1) soft goods, many of which may be worthless and disposed of after the casualty, and (2) hard goods that may be worthless or damaged but salvageable should be included in determining the amount of the loss.

Note: It may be difficult to determine the decrease in the FMV of a taxpayer's property "immediately after" a casualty due to lack of access to the property (for example, the need to remove water from flooded properties). Under such circumstances, the decrease in FMV would take into account additional damage sustained to the property as a result of delays due to legal and physical restrictions to taxpayers' access to their property and the need to remove standing water from the property.

Items to consider in determining the decrease in FMV include:

- Appraisals
- Actual costs of cleaning up or making repairs as evidence of FMV
- Actual costs of restoring landscaping to its original condition as evidence of FMV
- Amounts in books issued by various automobile organizations (for example, Kelley Blue Book) for determining the FMV of a car

Items not considered in determining the decrease in FMV include:

- Costs of protecting property against a casualty
- Expenses related to a casualty that are generally not deductible as casualty losses but may be deductible under other provisions of the Code — see Disaster Related Expenses later in this article
- Cost of replacing stolen or destroyed property
- Sentimental value

One method of determining the decrease in FMV is an appraisal. An appraisal must reflect only the physical damage to the property and not a general decline in the property's FMV [Reg. 1.165-7(a)(2)(i)].

Taxpayers may also use the cost to repair or clean up the property (cost-of-repairs method) to determine the decrease in FMV caused by the casualty if the clean-up, repairs and restoration are [Reg. 1.165-7(a)(2)(ii)]:

- Actually done
- Not excessive
- Necessary to bring the property back to its condition before the casualty
- Undertaken to take care of the damage only and do not cause the property to be worth more than before the casualty

Residential real property. In determining the amount of a casualty loss from damage to personal-use residential property, all improvements, including trees and other landscaping, are considered part of the entire residential property and are not valued separately or assigned a separate basis, even if purchased separately [Reg. 1.165-7(b)(2)(ii)]. In calculating the amount of the loss, damaged and destroyed trees and other landscaping may adversely affect the FMV of the entire property by reducing the curb or overall appeal of the property.

One way to determine the decrease in FMV is to compare an appraisal of the entire property, including trees and other landscaping, from before the damage caused by the casualty to an appraisal of the entire property after the damage caused by the casualty, including damage to trees and other landscaping. Valuation of the damage to a tree by an arborist does not determine the decrease in FMV of the entire property (Rev. Rul. 68-29).

Alternatively, the cost of cleaning up and restoring the residential property, including trees and other landscaping, to its condition before the casualty may be used as evidence of the decrease in FMV (assuming the tests described under Decrease in FMV above are met).

For example, the cost of removing destroyed or damaged trees (minus any salvage received), pruning and other measures taken to preserve damaged trees and replanting necessary to restore the property to its approximate value before the casualty may be acceptable as evidence of the decrease in FMV caused by the casualty. Taxpayers may not include the cost of purchasing any capital asset, such as a compact loader or tractor, or the value of the time they spend cleaning up their own property in the cost of cleaning up and restoring their property.

Determining the deductible loss. After the amount of the casualty loss is determined, the next step is determining how much of the loss can be deducted. Under the general rule for personal casualties, the loss (after deducting insurance proceeds or other reimbursements) from each separate casualty must first be reduced by \$100 [IRC Sec. 165(h)(1)]. After applying the \$100 per casualty reduction, the taxpayer's net personal casualty losses for the year are only deductible to the extent they exceed 10% of the taxpayer's adjusted gross income (AGI) [IRC Sec. 165(h)(2)]. However, the "Disaster Tax Relief and Airport and Airway Extension Act of 2017" (the Act) provides more favorable rules for personal casualty losses in the Hurricane Harvey Disaster Area.

1. The net disaster loss does not have to exceed 10% of adjusted gross income (AGI) to qualify for deduction.
2. Taxpayers do not have to itemize to claim a deduction. The taxpayer's standard deduction is increased by the net disaster loss.
3. The portion of the standard deduction attributable to the net disaster loss is allowed for alternative minimum tax (AMT) purposes.

In addition, the Act increases the \$100 limitation per casualty to \$500.

For Hurricane Harvey purposes, a net disaster loss is the excess of:

- Qualified disaster-related personal casualty losses arising in the Hurricane Harvey Disaster Area on or after 8/23/17 and which are attributable to Harvey over
- Personal casualty gains as defined in IRC Sec. 165(h)(3)(A).

Qualified disaster-related personal casualty losses are those described in IRC Sec. 165(c)(3) (i.e., losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft).

Example: In 2014, Sam bought a personal-use SUV for \$30,000. In 2017, the SUV was damaged in the Hurricane Harvey Disaster Area. Immediately before Hurricane Harvey the SUV's FMV was \$19,000. Immediately after the hurricane, the FMV was \$5,000. Sam filed an insurance claim and received \$10,000 from the insurance company. The amount of the casualty loss deduction in 2017 is \$3,500, calculated as follows:

FMV of property immediately before casualty	\$ 19,000
Less: FMV of property immediately after casualty	(5,000)
Value of property actually destroyed	\$ 14,000
Lesser of amount of property actually destroyed (\$14,000) or adjusted basis of property (\$30,000)	\$ 14,000
Less: Insurance received	(10,000)
Subtotal	\$ 4,000
Less: \$500 threshold	(500)
Deduction allowable	\$ 3,500

Deductible losses exceed income. If casualty or theft losses along with other deductions cause a taxpayer's deductions to exceed his income for that year, the taxpayer may have a net operating loss (NOL). Deductible personal casualty losses are fully allowed in determining a taxpayer's NOL. Thus, the limitation on certain other non-business deductions in calculating an individual's NOL does not apply to personal casualty loss deductions [IRC Sec. 172(d)(4)(C)].

Business or Income-Producing Property

A loss to property used in a business or held for the production of income (for example, rental real estate) sustained as a result of Hurricane Harvey is deductible [IRC Sec. 165(a) and (c)]. Three important differences exist between casualty losses for these types of property and those for personal-use property:

1. No percentage of AGI or per casualty threshold applies to limit the amount deductible for casualty losses of business or production-of-income property. *Exception:* See Employee Business-Use Property below.
2. For real property, a business casualty loss or involuntary conversion gain is calculated separately for each identifiable piece of property [Reg. 1.165-7(b)(2)]. For example, if a casualty damages or destroys an office building and its landscaping, the properties are taken into account separately to determine the casualty loss or conversion gain attributable to each.
3. If business property is totally destroyed in a casualty and the FMV of the property is less than its adjusted basis immediately before the casualty, the loss is calculated solely by considering the adjusted basis and the insurance proceeds. The decrease in FMV is not considered [Reg. 1.165-7(b)(1)(ii)].

Instead, the loss is computed as follows:

Adjusted basis in the property
– Any salvage value
– Any insurance or other reimbursement received or expected to be received
<hr style="width: 80%; margin-left: 0;"/>
= Amount of casualty loss

Inventory. There are two ways to deduct a casualty loss of inventory, including items held for sale to customers:

1. Deduct the loss through the increase in the cost of goods sold (COGS) by properly reporting opening and closing inventories. Do not claim this loss again as a casualty loss. If the loss is claimed through the increase in the COGS, include any insurance or other reimbursement received for the loss in gross income.
2. Deduct the loss separately. If deducted separately, eliminate the affected inventory items from the COGS by making a downward adjustment to opening inventory or purchases. Reduce the loss by the reimbursement received. Do not include the reimbursement in gross income. If reimbursement is not received by the end of the year, a loss cannot be claimed to the extent there is a reasonable prospect of recovery.

Mixed-Use Property

If property is used partly for business (or production of income) and partly for personal purposes, basis must be allocated between the two components. A loss is then computed for each component based on either the business/production of income or personal casualty loss rules. The \$500 per casualty threshold for Hurricane Harvey qualified disaster-related personal casualty losses is only applied to the personal portion of the loss.

Example: Jack, a self-employed contractor, drives a pickup truck that cost \$16,250. He uses it 60% for business and 40% for personal purposes. His adjusted basis in the pickup truck is \$3,000 for the business-use portion (\$9,750 cost less \$6,750 of accumulated depreciation) and \$6,500 for the personal-use portion.

In 2017, Jack's truck was damaged in the Hurricane Harvey Disaster Area by Hurricane Harvey. His insurance company reimbursed him for the cost to repair the truck, subject to his \$1,000 deductible. It cost Jack \$4,000 to have his pickup repaired. Because the pickup was used partly for business and partly for personal purposes, a separate casualty loss is calculated for each. The business loss after reimbursement is \$600 [lesser of (1) \$3,000 adjusted basis or (2) \$2,400 (\$4,000 X 60%) decrease in FMV, minus \$1,800 (\$3,000 X 60%) insurance reimbursement]. The personal loss after reimbursement is \$400 [lesser of (1) \$6,500 adjusted basis or (2) \$1,600 (\$4,000 X 40%) decrease in FMV, minus \$1,200 (\$3,000 X 40%) insurance reimbursement]. The \$500 per casualty threshold is then applied to the \$400 personal loss, resulting in no deductible personal loss.

Employee Business-Use Property

Losses to property used in performing services as an employee are added to other job expenses and miscellaneous itemized deductions on Schedule A (Form 1040) and are reduced by 2% of the taxpayer's AGI.

Electing to Deduct Losses in the Prior Year

A casualty loss attributable to a federally declared disaster — such as Hurricane Harvey — can be claimed in the year the disaster occurred or in the year preceding the loss on a timely filed or amended return [IRC Sec. 165(i)]. This may increase the tax savings from the loss and accelerate receipt of cash by creating a refund on the prior year's return. If multiple properties are damaged by a federally declared disaster, all losses from that disaster must be reported together either in the year of the disaster or in the prior year [Temp. Reg. 1.165-11T(c)].

Practice Tip: Determining the most beneficial year to claim the loss requires a careful evaluation of the tax picture for both years, including filing status, amount of income and other deductions and the applicable tax rates. For example, claiming the loss in the higher income year may not be the most advantageous approach.

Making the election. To claim the disaster loss in the year preceding the loss, an election statement must be attached to the original or amended tax return for that year (Rev. Proc. 2016-53). The statement must indicate that the taxpayer is making a Section 165(i) election and include (1) the name or a description of the disaster and the date or dates of the disaster which gave rise to the loss and (2) the address, including the city, town, county, parish, state and zip code, where the damaged or destroyed property was located at the time of the disaster. For an election made on an original return, this information must be provided on line 1 or 19 (as applicable) of Form 4684. If the election is made on an amended return, this information can be provided by any reasonable means, including writing the information at the top of Form 4684 and in the Explanation of Changes in Form 1040X (for individuals).

An election to claim the casualty loss in the preceding year must be made on or before the date that is six months after the original due date of the taxpayer's return for the disaster year (determined without regard to extensions).

Example: In 2017, Felix incurred a casualty loss related to Hurricane Harvey, a federally declared disaster. He has until October 15, 2018, to amend his 2016 return and make the election to claim the loss on the preceding year return.

Note: In Ltr. Rul. 201542002, the IRS granted the taxpayers a 45-day extension from the date of the ruling to make a Section 165(i) election to claim a disaster loss in a prior year when their tax preparer for the year of the loss was not aware of the election and thus failed to advise them of its availability.

Revoking the election. An election may be revoked on or before the date that is 90 days after the due date for making the election [Temp. Reg. 1.165-11T(g)].

Documenting Proof of Loss

To deduct a casualty loss, the taxpayer must be able to show that there was a casualty and be able to support the amount of the deduction.

Casualty — must be able to show:

- Type of casualty
- When the casualty occurred
- That the loss was a direct result of the casualty
- That the taxpayer was the owner of the property (or was contractually liable for damage to leased property)
- Whether a claim for reimbursement (for example, insurance) exists for which there is a reasonable expectation of recovery

Documentation. It is important to have records and other documentation to prove a loss deduction. This documentation should be retained in case the IRS questions the deduction, but it does not need to be attached to the tax return. If actual records do not exist, the loss deduction can be supported by photographs of the property, appraisals, etc. If records have been destroyed or lost, the taxpayer may need to recreate them. Information about reconstructing records is available at irs.gov. Search for “record reconstruction.”



Observation: Newspaper stories and pictures of the disaster should be saved and kept with the taxpayer’s copy of the return. These items will make it easier to prove a casualty loss from a local disaster to an IRS agent who has no firsthand knowledge of the disaster. This is, of course, not a concern for major federally declared disasters such as Harvey.

Note: The IRS has indicated that it recognizes the extraordinary damage that can be caused by disasters and urges taxpayers and tax professionals to act in good faith in making reasonable estimations based on all information available. When records documenting valuation are not available or it is not feasible to obtain documentation sufficient to recreate records, the IRS will consider documentation requirements satisfied by the best reasonably available information presented in good faith. The IRS will generally consider each situation on a case-by-case basis. (Search for “FAQs for Disaster Victims” at irs.gov.)

IRS release. In online release FS-2017-11, dated September 2017, the IRS provides helpful information on steps to take after a disaster so taxpayers can reconstruct their records and prove loss of personal-use and business property.



Tax Treatment of Insurance Reimbursements

Insurance Claims

If damaged or stolen personal-use property is covered by insurance, an insurance claim must be filed in order to deduct the portion of the loss that would be covered by the insurance. An insurance claim does not need to be filed to deduct the part of the loss not covered by insurance (for example, a deductible) [IRC Sec. 165(h)(4)(E)]. A claim does not have to be filed to deduct a business-use property loss.

The casualty loss deduction amount must be reduced by actual and expected insurance reimbursements. If an insurance reimbursement is expected but has not been received when the return is filed, the taxpayer must consider the expected reimbursement in determining the amount of loss.

In the event that the actual reimbursement is less than what was expected, claim a loss in the year it is determined further reimbursement cannot reasonably be expected (i.e., the settlement year) — do not amend the original return. The additional loss is treated as if it occurred in the year of settlement and is included with any other casualty losses for that year.

In the event that the actual reimbursement is more than expected, include the additional amount in income in the year it is received to the extent a tax benefit was obtained from the prior-year deduction. For individuals, the income is reported as other income on Form 1040, line 21.

Gains From Insurance Reimbursement

Gain results to the extent the insurance payments received on the damaged or destroyed property exceed its adjusted basis (usually its cost, increased for improvements and decreased for depreciation or amortization). Note that the amount realized from the conversion would also include any debt of which the property owner is relieved (such as a mortgage that is wholly or partially forgiven).

If insurance proceeds are used to repair the damaged or destroyed property or purchase qualified replacement property within two years (four years for a principal residence or any of its contents destroyed in a federally declared disaster area — such as the Hurricane Harvey disaster area), the taxpayer can elect to defer the gain as an involuntary conversion [IRC Sec. 1033(a)(2)(A) and (h)(1)(B)]. Gain would be recognized only if the cost to repair the damaged property or the cost of replacement property were less than the amount realized (typically the insurance proceeds).

Property qualifies as replacement property if it's "similar or related in service or use" to the property that was destroyed [IRC Sec. 1033(a)]. *Exception:* If property held for productive use in a trade or business or for investment located in a disaster area is compulsorily or involuntarily converted as a result of a federally declared disaster, tangible property of a type held for productive use in a trade or business is treated as property similar or related in service or use to the property so converted [IRC Sec. 1033(h)(2)].

Example: Ted received \$50,000 from his insurance company for the destruction of a piece of real estate with an adjusted basis of \$20,000. He purchased a qualified replacement piece of property by using \$10,000 cash and assuming a \$40,000 mortgage on the replacement property. The replacement property's cost is at least equal to the proceeds; therefore, Ted does not have to recognize any gain on the transaction even though he did not use all of the insurance proceeds to purchase the replacement property.

Practice Tip: As a practical matter, gain is usually limited to appreciating assets like the residence, real estate and collectibles. Many personal assets (e.g., cars, boats, etc.) decline in value and the initial cost basis would exceed the amount of the reimbursement.

Special Rules for Personal Residence and Contents

If a principal residence, or any of its contents, is partially or completely destroyed as a result of a federally declared disaster like Hurricane Harvey [IRC Sec. 1033(h)(1)(A)] :

1. No gain is recognized on the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such residence. This rule applies regardless of the taxpayer's basis in the unscheduled personal property or how the insurance proceeds are used (Rev. Rul. 95-22).
2. Any insurance proceeds for the residence or its separately scheduled contents are treated as a common pool of funds. The taxpayer can elect to recognize gain only to the extent that the funds exceed the cost of repairing or replacing the residence and its contents. Any type of replacement contents (whether separately scheduled or unscheduled) qualify for this purpose. Insurance proceeds for separately scheduled property (for example, jewelry and art) do not have to be used to purchase the same type of property (Rev. Rul. 95-22).

Gain Exclusion on Principal Residence

The gain exclusion rules that apply to the sale of a principal residence also apply to the destruction of a principal residence [IRC Sec. 121(d)(5)(A)]. Thus, if the destroyed property was the taxpayer's principal residence for at least two years out of the previous five, involuntary conversion gains of up to \$250,000 (\$500,000 MFJ) can be excluded from gross income.

Gain exclusion applies only to a complete destruction of the residence. Factors indicating that a complete destruction has occurred include (CCA 200734021):

1. Whether the damage to the home is so extensive that it is not advantageous to use any remaining structure (or portion thereof) to restore the property
2. The cost of repairs substantially exceeds the home's FMV before the damage

If the casualty gain on a home exceeds the amount of the exclusion, the excess amount can be deferred under the involuntary conversion rules. In other words, for Section 1033 involuntary conversion purposes, the amount realized from the conversion is reduced by the gain excluded under IRC Sec. 121 [IRC Sec. 121(d)(5)(B)].

Example: Ken, a single taxpayer, owns a principal residence with no mortgage. Ken's home is completely destroyed by a hurricane in a federally declared disaster area and he is paid \$425,000 by his insurance company — \$350,000 for the home, \$35,000 for unscheduled personal property, \$30,000 for jewelry and \$10,000 for a stamp collection. The jewelry and stamp collection were kept in Ken's home and were scheduled property on his insurance policy. No gain is recognized on the \$35,000 Ken received for the unscheduled personal property. Ken's basis in the home and scheduled property was \$100,000, so the casualty gain is \$290,000 (\$425,000 insurance proceeds – \$35,000 personal property on which gain is not recognized – \$100,000 basis). The first \$250,000 of this gain is excluded from gross income under the rules that apply to sales or exchanges of principal residences. The remaining \$40,000 of gain is deferred under the involuntary conversion rules as long as Ken spends at least \$140,000 (\$390,000 insurance proceeds attributable to the home and scheduled property less \$250,000 excluded gain) of the insurance payment on a replacement home, any type of replacement contents (whether scheduled or unscheduled) or both.

Determining the Basis of Replacement Property

The basis of the replacement property in a Section 1033 involuntary conversion is reduced by the deferred gain. Thus, the gain is not avoided (it is “built in” to the replacement property).

Example: Dawn and Mark’s personal residence was damaged by a hurricane in 2017 causing a casualty loss (reduction in the FMV of their home) of \$22,000. They received an insurance reimbursement of \$7,000 during 2017 and had no reasonable prospect of recovering any other amounts for damage to the home. Their pre-casualty adjusted basis in the property was \$215,000. In 2018, Dawn and Mark repair the property at a cost of \$25,000 and receive a state grant of \$18,000 to reimburse them for the portion of the cost of repairs not covered by the insurance reimbursement.

Tax consequences:

2017: Casualty loss deduction = \$15,000 (\$22,000 – \$7,000)

2018: Income due to recovery of benefit of \$15,000 casualty loss deduction from receipt of state grant = \$15,000

Basis in the property:

Pre-casualty basis	\$ 215,000
2017 casualty loss deduction	(15,000)
2017 insurance reimbursement	(7,000)
Basis at the end of 2017	\$ 193,000
2018 amount of state grant in excess of amount of recovery of tax benefit income (\$18,000 – \$15,000)	(3,000)
2018 repairs	25,000
Basis at the end of 2018	\$ 215,000



Observation: The nonrecognition provisions of IRC Secs. 121 and 1033 previously discussed apply only when a taxpayer receives reimbursement/compensation (for example, insurance proceeds, grants, etc.) in excess of the taxpayer’s tax basis in the property, which is not the case for Dawn and Mark in the preceding example.

Insurance Payments for Living Expenses

Insurance reimbursements for living expenses due to a casualty to a taxpayer’s principal residence are not included in the casualty loss computation. Report any insurance reimbursements that exceed the temporary increase in the taxpayer’s living expenses as taxable income on Form 1040 (IRC Sec. 123).

Exception: If the casualty occurs in a federally declared disaster area, none of the insurance payments are taxable. See Qualified Disaster Relief Payments earlier in this article.

Other Disaster-Related Rules and Resources

Disaster Related Expenses

Expenses related to a casualty or theft are generally not deductible as casualty losses. However, they may be deductible under other provisions of the Code. The tax treatment of some frequently encountered casualty-related expenses is as follows:

- Cost of temporary housing is not deductible, as insurance proceeds to cover temporary housing costs are generally not included in a taxpayer's income.
- Cost associated with personal injuries related to a casualty is deductible as a medical expense on Schedule A.
- Rental car costs are generally not deductible, but if the damaged property is business property, this may be deductible as a business expense.
- Cost of appraisals and photographs to substantiate loss are miscellaneous itemized deductions subject to 2% of AGI limitation, but, if the damaged property is business property, this may be deductible as a business expense.
- Purchasing a replacement property is generally not deductible, but purchasing a replacement property may allow the taxpayer to defer casualty gain under the involuntary conversion rules. If the replacement property is business property, this may be deductible as a business expense or capitalized and recovered through depreciation.
- Cost of protecting property against current casualty (for example, cost of boarding up windows in preparation for hurricane) is generally not deductible, but if the damaged property is business property, this may be deductible as a business expense.
- Costs of protecting property against future casualties (for example, cost of building a levee to stop flooding) are generally not deductible, but capitalize if this is a permanent improvement to the property. If the damaged property is business property, this may be deductible as a business expense or capitalized and recovered through depreciation. Qualified disaster mitigation payments are not included in income and do not increase the property's basis.
- Costs of repairing property are generally not deductible but provide evidence of decrease in FMV due to casualty. If the damaged property is business property, this may be deductible as a business expense or capitalized and recovered through depreciation.
- Costs of clean-up after casualty are generally not deductible but provide evidence of decrease in FMV due to casualty. If the damaged property is business property, this may be deductible as a business expense or capitalized and recovered through depreciation.
- Travel costs, meals and lodging due to employer relocation (in excess of employer reimbursements) are deductible as employee business expenses subject to 2% of AGI limitation if assignment is temporary (less than one year) but are not deductible if assignment is indefinite (expected to last for more than one year).
- Travel expenses to and from work if taxpayer is displaced from home by a disaster (in excess of employer reimbursements) are deductible as employee business expenses subject to 2% of AGI limitation if taxpayer's relocation is temporary (taxpayer realistically expects to return to his home within one year) but not deductible if tax home has changed (will not return to original home within one year).

IRS materials that may be helpful or required include:

- Form 4684 (Casualties and Thefts)
- IRS Pub. 547 (Casualties, Disasters and Thefts)
- IRS Pub. 584 [Casualty, Disaster and Theft Loss Workbook (Personal-Use Property)]
- IRS Pub. 584-B (Business Casualty, Disaster and Theft Loss Workbook)
- IRS Pub. 2194 (Disaster Resource Guide for Individuals and Businesses)
- IRS Pub. 3067 (IRS Disaster Assistance — Federally Declared Disaster Area)

Useful websites include:

- Federal Emergency Management Agency: fema.gov
- Access to Disaster Help and Resources: disasterassistance.gov
- IRS: irs.gov (for example, search for “Disaster Assistance”)



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