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Hurricanes Harvey and Irma: Casualty Loss Deductions

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by James Atkinson, Washington National Tax*

The recent devastation resulting from Hurricanes Harvey and Irma underscores the importance of understanding how and when companies experiencing casualty losses can claim federal income tax deductions for those losses. The following discussion presents a brief overview of the basic principles of the Internal Revenue Code's casualty loss provisions.

The casualty loss provisions apply somewhat differently to property used in a trade or business or held for investment as compared with property used for personal purposes. This article focuses on business or investment property that has been damaged in a casualty such as Hurricane Harvey or Irma. Other resources discuss the rules applicable to personal losses.¹

Big Picture

If tangible property has been damaged or destroyed, the taxpayer first determines whether the damage resulted from a "casualty," generally meaning an event that is sudden and unexpected, such as a fire, storm, or shipwreck. If so, the taxpayer determines, either by using a "competent appraisal" or by reference to the repair costs, the difference in the damaged property's fair market value before and after the casualty. Any salvage value remaining in the property reduces the loss by affecting the post-casualty fair market value (but is not treated as insurance or other compensation). The taxpayer

* James Atkinson is a principal in the Income Tax and Accounting group of Washington National Tax ("WNT") and a former IRS Associate Chief Counsel (Income Tax and Accounting). James thanks Holly Belanger and Lynn Afeman for their contributions to this article.

¹ See John McCoy, 527-4th T.M., *Loss Deductions* (2014).

compares the change in fair market value with the damaged property's adjusted tax basis, and the lower amount is the permissible loss for purposes of section 165.²

The taxpayer next subtracts from the loss amount any insurance proceeds or similar compensation to arrive at the casualty loss deduction allowable under section 165. If the insurance proceeds exceed the amount of the loss, the taxpayer recognizes "casualty gain" equal to that excess. The taxpayer potentially may defer recognizing that casualty gain by applying the involuntary conversion provisions of section 1033.

If the taxpayer either receives no insurance proceeds, or receives proceeds in an amount less than the loss, the taxpayer recognizes the casualty loss deduction and reduces the damaged property's tax basis by that amount. At that point, the casualty event is a closed and completed transaction, and any additional transactions involving the damaged property are addressed separately.

If the taxpayer subsequently sells the damaged property for its salvage value, the taxpayer recognizes gain to the extent that the sale proceeds exceed the property's remaining tax basis. Recovering the damaged property's salvage value through a subsequent sale is a separate closed and completed transaction. That sale does not affect the amount of the casualty loss determined under section 165 because the proceeds from the subsequent sale of the damaged property for its salvage value are not "insurance or other compensation" for purposes of the casualty loss provisions.

If the sale of the damaged property was necessitated by the casualty event and was not a product of the company's choice (e.g., storm-damaged timber must be sold immediately), gain resulting from that subsequent sale might be eligible for deferral under the involuntary conversion provisions of section 1033. The specific requirements of that provision would be applied separately from the standards used in determining whether a casualty occurred and the amount of the resulting casualty loss, if any.³

These basic principles are developed more fully below.

Casualties

Section 165(a) permits a current deduction for unreimbursed losses, including casualty losses such as those from fire, storm, or shipwreck.⁴ For this purpose, the courts and the IRS define a "casualty" as the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual in nature.⁵

² Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

³ *Weyerhaeuser Co. v. United States*, 32 Fed. Cl. 80 (Fed. Cl. 1994), *aff'd in part rev'd in part*, 92 F.3d 1148 (Fed. Cir. 1996); Rev. Rul. 80-175, 1980-2 C.B. 230.

⁴ Section 1.165-7(a)(1).

⁵ *See, e.g., Weyerhaeuser, supra* note 3; Rev. Rul. 87-59, 1987-2 C.B. 59.

Property damage directly resulting from hurricanes such as Harvey and Irma, as well as floods, tornadoes, storms, and fires clearly fall within the ambit of a “casualty” for this purpose. In contrast, damage caused by progressive deterioration or disease generally are not “casualties” for purposes of section 165.⁶ Taxpayers and the IRS frequently disagree as to whether various fact patterns outside those specifically identified in the Code and regulations are sufficiently sudden or unexpected to constitute casualties for this purpose.

An important subset of casualties for purposes of section 165 are those arising from a federally declared disaster. For this purpose, a federally declared disaster is one subsequently determined by the President of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.⁷ A “federally declared disaster area” means the area determined to warrant such assistance.⁸

Areas eligible for qualifying disaster assistance will be identified as such by the IRS, based on determinations by the Federal Emergency Management Agency (“FEMA”) that an area has been determined to qualify for “individual assistance” (rather than for “public assistance”).⁹ Losses incurred in a disaster area qualify for favorable procedural opportunities, as discussed below.

Amount Deductible

For any casualty loss, the amount of the loss equals the lesser of

- ◆ The property’s fair market value immediately before the casualty reduced by the property’s fair market value immediately after the casualty, or
- ◆ The property’s adjusted tax basis for purposes of computing loss.¹⁰

If business or investment property is totally destroyed by the casualty, and if the property’s pre-casualty fair market value is less than its adjusted tax basis, the entire tax basis may be deducted as a casualty loss.¹¹ When the property is damaged but not destroyed, the measure of the deduction is the change in fair market value resulting directly from the physical damage, capped by the property’s adjusted basis at the time of the casualty. In either event, if the property has no remaining tax basis (i.e., it is fully depreciated), no casualty loss is available.

⁶ *Maher v. Commissioner*, 76 T.C. 593 (1981), *aff’d*, 680 F.2d 91 (11th Cir. 1982).

⁷ Section 165(i)(5)(A); section 1.165-11T(b)(1).

⁸ Section 165(i)(5)(B); section 1.165-11T(b)(2).

⁹ *See, e.g.*, IR-2017-135, “IRS Gives Tax Relief to Victims of Hurricane Harvey; Parts of Texas Now Eligible; Extension Filers Have Until Jan. 31 to File” (Aug. 28, 2017); IR-2017-150, “IRS Gives Tax Relief to Victims of Hurricane Irma; Like Harvey, Extension Filers Have Until Jan. 31 to File; Additional Relief Planned (September 12, 2017). *See* www.irs.gov.

¹⁰ Section 1.165-7(b).

¹¹ Section 1.165-7(b).

Computing the casualty loss by reference to the change in the property's fair market value generally requires a "competent appraisal."¹² Although the regulations do not define that term, the IRS has identified as relevant factors the appraiser's:

- ◆ Familiarity with the property before and after the casualty or theft
- ◆ Knowledge of sales of comparable property in the area
- ◆ Knowledge of conditions in the area of the casualty
- ◆ Method of appraisal¹³

A casualty loss is allowable only to the extent the diminution in fair market value reflects the physical damage caused by the disaster itself. Other factors, such as "buyer resistance" or an anticipated decline in future profits must be factored out of this determination.¹⁴

In lieu of obtaining a competent appraisal to measure the change in fair market value, the taxpayer instead may measure the change by reference to the costs it incurs to repair the disaster-related damage. This alternative is available, however, only if the repairs are actually made; the repairs are necessary to bring the property back to its condition before the casualty; the amount spent for repairs is not excessive; the repairs take care of the damage only; and the value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.¹⁵

Regardless of whether fair market value or basis is used to determine the deduction, the casualty loss must be reduced by insurance proceeds or similar compensation that the taxpayer receives on account of the casualty (including amounts that as of the end of the disaster year the taxpayer can reasonably expect to receive).¹⁶ Insurance proceeds in excess of the damaged property's remaining tax basis may be includible in gross income, subject to potential deferral under the involuntary conversion provisions of section 1033.¹⁷

¹² Section 1.165-7(a)(2).

¹³ IRS Publication 547, *Casualties, Disasters, and Thefts* (2017).

¹⁴ Section 1.165-7(a)(2)(i). *See, e.g.*, *Westvaco Corp. v. United States*, 639 F.2d 700, 707 (Ct. Cl. 1980) (no casualty loss deduction for paper losses or anticipated future profits, or losses of property for which taxpayer has no basis); *Estate of Rinaldi*, 38 Fed. Cl. 341, 353 (1997) (casualty loss can only represent the change in fair market value attributable to actual damage or destruction), *aff'd without opinion*, 178 F.3d 1308 (Fed. Cir. 1998).

¹⁵ Section 1.165-7(a)(2)(ii).

¹⁶ Section 1.165-1(d)(2)(i). *See Shanahan v. Commissioner*, 63 T.C. 21 (1974) (general term "or otherwise" must be construed consistently with term "insurance"); Rev. Rul. 87-117, 1987-2 C.B. 61 (higher rates awarded to regulated utility upon abandonment of partially-completed nuclear plant did not reduce loss deduction because was not in the nature of insurance).

¹⁷ *See also Weyerhaeuser Co. v. United States*, 92 F.3d 1148, 1151 (Fed. Cir. 1996) (salvage value is not the same as insurance proceeds, and can be deferred pursuant to section 1033 without diminishing the current casualty deduction); Rev. Rul. 80-175, 1980-2 C.B. 230.

As an aside, companies should keep in mind the interrelationship between the casualty loss rules and the ability to deduct as repairs the costs incurred to restore the damage. Under the so-called “repair regulations” under section 263(a), the IRS requires the taxpayer to capitalize any restoration costs up to the amount of the basis adjustment required in connection with the casualty (whether due to claiming a casualty loss deduction under section 165, or due to the receipt of insurance proceeds).¹⁸ Restoration costs in excess of the basis adjustment are tested under the general standards of section 263(a) to determine whether those costs may be deducted currently as repairs or instead must be capitalized as improvements to the property.¹⁹

Single, Identifiable Property

Regardless of whether the casualty loss is computed based on the diminution in fair market value, or instead based on the adjusted tax basis, the threshold task is identifying the property whose fair market value or tax basis must be determined. For this purpose, section 165 looks to the “single, identifiable property” or “SIP.”²⁰ Although the SIP seems analytically similar to the “unit of property” used for other purposes (such as the repair regulations),²¹ the section 165 regulations do not provide a working definition of this term. Instead, the regulations posit by way of example that, if a commercial building and its surrounding landscaping are damaged in a storm, the building and the landscaping constitute separate SIPs. The taxpayer must separately compute the casualty loss deduction for each, based upon the separate fair market values and tax bases of the two individual properties.

Requiring separate casualty loss computations for each individual property precludes “borrowing basis” from undamaged property in order to support a larger casualty loss deduction for a damaged or destroyed property. This becomes relevant if the damaged or destroyed property’s adjusted tax basis is lower than the diminution in its fair market value, such as where the damaged property has been substantially depreciated. For this reason, taxpayers and the IRS frequently disagree on the specific property that has been damaged and the amounts that should be used in computing fair market value and basis for purposes of section 165.²²

Much of the case law and administrative guidance exploring this concept has done so in the context of timber,²³ or of damaged utility properties, such as electric²⁴ or telephone lines.²⁵ In general, courts tend

¹⁸ Section 1.263(a)-3(k)(7), Exs 3 – 5.

¹⁹ Section 1.263(a)-3(k)(4).

²⁰ Section 1.165-7(b)(2).

²¹ Section 1.263(a)-3(e) provides that the definitions of “unit of property” set forth in that section apply only for purposes of section 263(a) and the regulations thereunder.

²² *Carloate Indus., Inc. v. United States*, 354 F.2d 814 (5th Cir. 1966) (although agreeing with IRS that land and a citrus grove are separate SIPs, the court disagreed with IRS that fair market value of land was not affected by need to remove dead citrus trees).

²³ *Weyerhaeuser*, *supra* note 3; *Westvaco Corp.*, *supra* note 14.

²⁴ TAM 200902011.

²⁵ TAM 201014052.

to take a “common sense” or “practical” approach in attempting to identify “the property” that has been damaged by the hurricane, flood, or other disaster.²⁶

In a technical advice memorandum analyzing this concept in the context of telecommunication assets, the IRS National Office identified several relevant factors in identifying the SIP, none of which is determinative:

- ◆ Whether the nature and scope of the unit chosen is reasonable and practical
- ◆ Whether it reflects all the physical damage caused by the casualty
- ◆ Whether it is consistent with the taxpayer’s other tax accounting practices (for example, depreciation and depletion)
- ◆ Whether it is a unit whose utility derives from its functioning as a whole (for example, an automobile or a logging road)
- ◆ Whether it is accounted for and identifiable as a unit for non-tax purposes (for example, for regulatory purposes)
- ◆ Whether it is separately treated for operational and management purposes
- ◆ Whether it is a “commercially segmentable” unit likely to be bought or sold as such
- ◆ Whether it is consistent with industry practice

In summarizing its view of the SIP concept, the IRS National Office stated, “In applying these factors, we should take into account the purpose of the ‘single, identifiable property’ rule, which is to arrive at a logical, reasonable, and practical unit for valuation and accounting purposes, while preventing the borrowing of basis from unharmed property, without segregating the damaged property into artificially small subunits.”²⁷ While identifying the relevant SIP will depend heavily on the surrounding facts, this synopsis provides a sound guidepost for making this critical determination.

Inventory

Taxpayers have two options in accounting for casualties to inventory held for sale to customers. First, the loss can be recovered through the normal operation of the taxpayer’s inventory accounting method. By properly reporting the opening and closing inventories for the year, the taxpayer would recover the lost inventory through its cost of goods sold. Under this approach, the loss could not also be claimed as a casualty loss under section 165. Any insurance or other reimbursement would be included in gross income.

²⁶ See, e.g., *Rinaldi*, *supra* note 14.

²⁷ *Id.*

Alternatively, the loss may be computed separately. Under this approach, the taxpayer eliminates the affected inventory items from cost of goods sold by making a downward adjustment to opening inventory or purchases. As with other casualty losses, the deduction must be reduced by insurance proceeds or other reimbursements, but that amount would not be included in gross income (except to the extent it exceeds tax basis).²⁸

Character

In general, depreciable property and land used in a trade or business and held for more than one year are considered “section 1231 property,” and the character of gain or loss derived from the taxable sale or exchange, or from the involuntary conversion, of such property is determined under section 1231. In broad terms, section 1231(a) permits a taxpayer to net its “section 1231 gains and losses” for the year, claiming a net section 1231 loss as an ordinary deduction and a net section 1231 gain as long-term capital gain (subject to special rules, such as for non-recaptured net section 1231 losses).

Section 1231 provides special netting rules for involuntary conversions such as casualty losses, however. The normal netting rules do not apply to any net losses arising from involuntary conversions arising from a fire, storm, shipwreck or other casualty of any property used in a trade or business, or any capital asset that is held for more than one year in connection with a trade or business or transaction entered into for profit.²⁹

In other words, if the taxpayer recognizes a net loss with respect to involuntary conversions during the year (disregarding non-casualty section 1231 transactions), the loss is recovered as an ordinary deduction. If the taxpayer recognizes a net gain with respect to involuntary conversions during the year (such as if the taxpayer receives net insurance proceeds in excess of the SIP’s remaining tax basis and is unable to defer the gain through section 1033), those net gains are included with the taxpayer’s non-casualty section 1231 gains and losses for the year, and subjected to the normal netting rules of that provision.

In applying this provision, the taxpayer must take into consideration not only recognized casualty losses, but also any recognized “casualty gains” (such as sales necessitated by the casualty event to preserve salvage value) that are not deferred under section 1033.³⁰ Casualty gains whose recognition the taxpayer is able to defer under section 1033 would not offset the year’s casualty losses for purposes of section 1231.

²⁸ IRS Publication 547, *supra* note 13.

²⁹ Section 1231(a)(4)(C); section 1.1231-1(e)(3).

³⁰ See, e.g., *Weyerhaeuser*, *supra* note 3.

Accelerated Casualty Loss Claims

The taxpayer must claim the casualty loss in the year in which the loss is sustained.³¹ Although this generally will be the year in which the disaster occurs (the “disaster year”), certain conditions may defer recognition of the loss, such as an unresolved dispute with the taxpayer’s insurance carrier.³²

If the property is damaged within a federally declared disaster area, however, the taxpayer may instead elect to treat the disaster as having occurred in the immediately prior tax year (the “preceding year”).³³ Procedurally, the taxpayer makes this choice by reflecting the casualty loss either on its federal income tax return for the disaster year, or alternatively, on the original or an amended return for the preceding year.

If making the “section 165(i) election” to accelerate the casualty loss deduction, the taxpayer must attach to its original or amended return for the preceding year an election statement indicating that the taxpayer is making a section 165(i) election. The statement must include (1) the name or a description of the disaster and date(s) 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.

If the election is made on an original federal tax return, the information in the prior paragraph must be included on Line 19 of Form 4684 (Casualties and Thefts). If the original return is filed electronically, the taxpayer may attach a statement as a PDF document if there is insufficient space on Line 19 of the Form 4684 to provide the required information. For an election made on an amended federal return, the taxpayer may provide the required information by any reasonable means. For this purpose, reasonable means include (but are not limited to) writing the name or a description of the disaster, the state in which the damaged or destroyed property was located at the time of the disaster, and “Section 165(i) Election” on the top of the Form 4684 and providing the rest of the required information in the Explanation of Changes in Form 1120X (Amended U.S. Corporation Income Tax Return), or other appropriate form, or directly on the Form 4684, attaching a statement if there is insufficient room on the form.³⁴

The section 165(i) election must be made on or before the date that is six months after the original due date for the taxpayer’s federal tax return for the disaster year (determined without regard to any extension of time to file). The taxpayer need not request an extension of time to file the federal tax return for the disaster year in order to benefit from this due date.

The section 165(i) election can be revoked within 90 days of the due date for making the election. Revenue Procedure 2016-53 sets forth the procedures required to revoke a previously made section 165(i) election.

³¹ Section 1.165-7(a)(1).

³² Estate of Boyle, T.C. Memo 2001-235 (casualty loss not sustained until dispute with insurance carrier resolved).

³³ Section 165(i); section 1.165-11T.

³⁴ Rev. Proc. 2016-53, 2016-2 C.B. 530.

The taxpayer must act consistently in claiming the casualty loss in either the disaster year or the preceding year, and must amend any return on which it previously claimed a deduction (as a loss, as cost of goods sold, or otherwise) for the same loss on or before filing a return claiming that same loss for a different tax year.³⁵

While making the section 165(i) election is an attractive means of potentially accelerating the receipt of much needed cash in a crisis period, the taxpayer also should consider the collateral consequences of shifting what may be a substantial loss deduction to the preceding year. For example, the reduction in taxable income may materially reduce or even eliminate the taxpayer's domestic production activities deduction under section 199, since that benefit is limited to the taxpayer's taxable income for the year.

Next Steps

As this discussion shows, mechanically computing the casualty loss deduction is relatively straightforward. The critical elements are almost entirely factual. Care must be taken first in identifying the appropriate SIP and second in obtaining a highly qualified appraisal of the selected SIP (unless the taxpayer prefers to measure the loss by reference to the costs of repairing the property). While sympathies run high in the immediate aftermath of events such as Hurricanes Harvey and Irma, more objective reviews by the IRS several months or years removed place a premium on the need to work closely with those having the greatest knowledge of the company's facts and with industry experiences in performing and contemporaneously documenting these two critical tasks.

In conjunction with computing and documenting the casualty loss, the taxpayer should maintain the following records:

- ◆ Nature and date of casualty
- ◆ Proof that the loss directly resulted from the casualty
- ◆ Proof that the taxpayer owned the property or otherwise bore the risk of loss
- ◆ Adjusted basis of the property at the time of the casualty
- ◆ Fair market value before and after the casualty
- ◆ Amounts of insurance or other compensation received or reasonably expected to be recovered

If after taking these steps it appears the taxpayer has a "casualty gain" (due to actual or reasonably expected insurance reimbursements), attention must quickly shift to the potential application of section 1033 in order to potentially defer recognizing that gain. The section 1033 rules are highly technical, and care must be taken to comply with the precise procedural requirements—including specific replacement requirements and deadlines—in order to avoid compounding the physical losses arising from Harvey and Irma by having an additional tax bill layered on top.

³⁵ Section 1.165-11T(d).



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