

Post Office Box 6063
4112 McKnight Road
Texarkana, Texas 75505-6003
903.223.5653 (Telephone)
903.223.5658 (Facsimile)

How the tax law helps victims of Hurricane Katrina and other Presidentially declared disasters

The many victims of Hurricane Katrina are now preoccupied with sheer survival, or salvaging what they can from damaged or destroyed homes and businesses. When the extent of their losses becomes clear, victims will want to know what tax help they're entitled to. This article explains the key relief provisions available to those who suffered losses in Presidentially declared disaster areas struck by Hurricane Katrina, as well as in other Presidentially declared disaster areas (referred to as disaster losses below).

Postponement of time-sensitive acts. Under Code Sec. 7508A , IRS may permit taxpayers affected by a disaster loss to postpone for a fixed period of time the filing of returns, the submission of tax payments, and the performance of other time sensitive acts. The postponement applies to "affected taxpayers," which includes (1) individuals whose principal residences are located in a disaster area, (2) business entities or sole proprietors whose principal place of business is located in a disaster area, and (3) taxpayers who aren't included in (1) or (2) but whose records necessary to meet the deadline for performing an act are located in a disaster area. (Reg. § 301.7508A-1(d)(1)) The complete list of possible postponements is carried in Rev Proc 2005-27, 2005-20 IRB 1050.

Exclusion for qualified disaster relief payments. Under Code Sec. 139 , individuals may exclude a qualified disaster relief payment. Such a payment also isn't earnings for self-employment tax purposes or wages for employment tax purposes.

A qualified disaster relief payment includes an amount (to the extent not compensated by insurance or otherwise) paid to or for the benefit of an individual:

- (1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster (which includes a Presidentially declared disaster),
- (2) to reimburse or pay reasonable and necessary expenses incurred to repair or rehabilitate a personal residence (including a rented residence) or repair or replace its contents to the extent that the need for the work results from a qualified disaster, and
- (3) if the amount is paid by a federal, state, or local government, or an agency or

instrumentality of those governments, in connection with a qualified disaster in order to promote the general welfare (but not if payments are made to businesses or for income replacement or unemployment compensation).

IRS has ruled that the Code Sec. 139 exclusion applies to grants made by employers for unreimbursed medical, temporary housing and transportation expenses of employees who are affected by a flood that is a Presidentially declared disaster. (Rev Rul 2003-12, 2003-1 CB 283)

Other excludable payments. IRS also has ruled that individuals who are victims of a flood that is a Presidentially declared disaster may exclude: (1) state grants for unreimbursed medical, temporary housing and transportation expenses; and (2) charitable grants. ((Rev Rul 2003-12, 2003-1 CB 283)

Election to deduct disaster losses in preceding year. A taxpayer who suffers a disaster loss can take the deduction in the tax year in which the disaster occurs, or can elect to deduct the loss in the immediately preceding tax year. (Code Sec. 165(i)(1)) Deductions for individuals, estates or trusts that incur a disaster loss with respect to nonbusiness property are subject to the casualty loss deduction limits. Generally, each personal casualty is reduced by \$100; and all personal casualty, disaster and theft losses for the year are deductible only to extent they cumulatively exceed 10% of adjusted gross income (AGI) regardless of whether the taxpayer deducts the loss in the tax year the disaster actually occurs or elects to deduct the loss in the preceding year. (Reg. § 1.165-11(c))

Observation: Claiming the disaster loss for the year before the loss occurred saves taxes immediately, without having to wait until the end of the year in which the loss was sustained. In some cases, the deduction may result in a net operating loss, which will bring a refund by a carryback to an earlier year. On the other hand, deducting the loss in the year the loss actually occurred may result in bigger tax savings if the taxpayer is in a higher bracket that year.

Observation: Because of the 10% AGI floor for deductibility, taxpayers weighing the value of an early disaster loss deduction must also consider the relative amounts of AGI they have or expect to have for the two tax years.

Illustration 1: Jack lives in a county that is hit by severe flooding damage in 2005 and is designated a Presidentially declared disaster. The flooding caused \$40,000 of uninsured damage to his home. Jack estimates that his AGI for 2005 will be \$100,000; for 2004, it was \$80,000. He had no personal casualty gains in either year.

If Jack claims the loss on his 2005 return, the loss would first be reduced by the \$100-per-occurrence floor to \$39,900 and then reduced by 10% of his 2005 AGI (\$10,000) to \$29,900. If he files an amended return for 2004 and claims the loss in that year, the loss

would be reduced by the \$100 threshold to \$39,900 and then reduced by 10% of his 2004 AGI (\$8,000) to \$31,900, or \$2,000 more than the loss he could deduct in 2005.

If Jack also sustained casualty losses in 2004, deducting the current loss in that year could magnify his deduction. For example, if he sustained a casualty loss of \$8,000 in 2004 (exactly equal to 10% of his AGI for that year), then he could deduct \$39,900 of his disaster loss by filing an amended return for 2004.

If the election to claim the loss in the previous year is made for an inventory loss, opening inventory must be reduced for the year in which the loss actually occurred so as not to result in a double deduction. (Rev Rul 77-94, 1977-1 CB 265)

Making the election. The election to deduct a disaster loss in the year before the year in which the loss occurs is made by filing a return, amended return, or refund claim. The election must be made by the later of (1) the due date (without extensions) for filing the taxpayer's income tax return for the tax year in which the disaster actually occurred, or (2) the due date (with extensions) for the return for the preceding year. The return or claim should specify the date or dates of the disaster that caused the loss, and the city, town, county and state where the property was located at the time of the disaster. Taxpayers have 90 days in which to change their minds after making an election to deduct a disaster loss for the year before the year in which the loss occurs. The election becomes irrevocable after 90 days following the date the election was made. (Reg. § 1.165-11(e))

Recommendation: An individual taxpayer who doesn't need an immediate tax refund may find it preferable to wait until near the Apr. 17, 2006 filing deadline before deciding. Then he can make an informed judgment as to which tax year produces the greater tax saving from the deduction and choose that year to claim the loss.

Disaster loss presumption where home is demolished. A taxpayer whose residence is located in a Presidentially declared disaster area may deduct any loss attributable to the disaster as a casualty loss if (Code Sec. 165(k)):

- (1) he is ordered by the state or local government in which the residence is located to demolish or relocate the residence,
- (2) the order is made no later than the 120th day after the date of the President's determination that the area warrants Federal disaster assistance, and
- (3) the residence was rendered unsafe for use as a residence because of the disaster.

Observation: Code Sec. 165(k) creates a conclusive presumption that certain losses attributable to a federally declared disaster are casualty losses for purposes of Code Sec. 165 and qualify for tax relief as disaster losses. The taxpayer doesn't have to prove that the disaster loss qualifies as a casualty loss.

Observation: Losses under this rule are still subject to the \$100 and 10%-of-AGI limitations.

Homes damaged in Presidentially declared disaster. Under the Code Sec. 1033 involuntary conversion rules, gain from an involuntary conversion is deferred if the proceeds of the converted property are timely reinvested in eligible replacement property (generally, property similar or related in service or use to the converted property). Under Code Sec. 1033(h), a taxpayer whose principal residence or contents is compulsorily or involuntarily converted due to a Presidentially declared disaster is entitled to three extra tax breaks:

- (1) Gain realized from the receipt of insurance proceeds for unscheduled personal property (property in the home but not scheduled property for insurance purposes) is not recognized.
- (2) Insurance proceeds for the conversion of the principal residence and any of its contents other than unscheduled personal property are treated as a common fund for purposes of the involuntary conversion rules.
- (3) The taxpayer gets a longer period of time in which to replace a principal residence under the Code Sec. 1033 involuntary conversion rules. In general, the replacement period ends four years (instead of the usual two years) after the close of the first tax year in which any part of the conversion gain is realized.

Observation: Under Code Sec. 121(d)(5)(A), the involuntary conversion of a principal residence is treated as a sale for purposes of the up-to-\$250,000/\$500,000 Code Sec. 121 home-sale exclusion. However, any excess of the gain on the involuntary conversion over the available exclusion may be deferred under the involuntarily conversion rules. Under Code Sec. 121(d)(5)(B), the amount realized for purposes of the involuntary conversion rules of Code Sec. 1033 is the amount realized less the excluded gain.

Illustration 2: When his principal residence was involuntarily converted, a single taxpayer received \$350,000 for the property. He realized \$300,000 of gain on the conversion, \$250,000 of which is excluded under Code Sec. 121. The taxpayer can avoid a current tax on the remaining \$50,000 of realized gain if he timely purchases a replacement residence costing at least \$100,000 (\$350,000 amount realized less \$250,000 excluded gain). Moreover, under Code Sec. 1033(b)(2), the taxpayer's basis in his new home would be reduced by only the \$50,000 of gain that's not taxed due to the involuntary conversion rules—there's no reduction on account of the excluded gain on the old residence. Thus, if the taxpayer timely purchased a replacement residence for \$350,000, his basis in it would be \$300,000.

Qualification for reduced homesale exclusion. Under Code Sec. 121(c), a reduced homesale exclusion may apply to a taxpayer who fails to qualify for the full homesale exclusion because he doesn't meet the Code Sec. 121 two-out-of-five-year ownership and

use rule, or previously sold another home within the two-year period ending on the sale date of the current home in a transaction to which the exclusion applied. Under Code Sec. 121(c)(2)(B) , the failure to meet either rule must result from the home being sold (or exchanged) due to (1) a change of place of employment, (2) health, or (3) to the extent provided by regs, other unforeseen circumstances. Under Reg. § 1.121-3(e)(2), unforeseen circumstances include the involuntary conversion of a residence, and a natural or man made disaster (or act of war or terrorism) resulting in a casualty to a principal residence. These events are treated as unforeseen circumstances whether or not the home is located in a Presidentially declared disaster area.

Replacement for destroyed business/investment property. If property held for productive use in a trade or business or for investment is compulsorily or involuntarily converted as a result of a Presidentially declared disaster, and the taxpayer winds up with a gain, then 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 converted. (Code Sec. 1033(h)(2))

Illustration 3: X Corp receives \$20,000 in insurance proceeds for a production machine (in which it has a basis of \$10,000) destroyed in a Presidentially declared disaster. X Corp replaces the machine with a \$20,000 delivery truck and does so on a timely basis (generally, within two years after the close of the first tax year in which any part of the gain on the involuntary conversion is realized). X Corp's \$10,000 of gain due to the involuntary conversion is not recognized currently. Under the regular involuntary conversion replacement rules, X Corp would have had to replace with a production machine similar in service or use to the destroyed machine.

Observation: To be eligible for the treatment allowed by the above rules, the replaced property (i.e., the property that was converted as a result of a Presidentially declared disaster) may be either property held for productive use in a trade or business or property held for investment. However, the replacement property must be tangible property held for productive use in a trade or business. It may not be intangible property, and it may not be property held for investment.

Deferral of state disaster relief grant to business. A state may have a program to reimburse uncompensated business losses for disaster-related damage to real and personal property. IRS has held that such a grant is not excludable if made to aid in the economic recovery of an area, and conditioned on qualifying businesses continuing operations for a minimum of 5 years in or near the area affected by the disaster. However, IRS said a business may elect under Code Sec. 1033 to defer the gain realized from receipt of the grant to the extent that an amount equal to the grant proceeds is used to timely purchase property similar or related in service or use to the destroyed or damaged property. (Rev Rul 2005-46, 2005-30 IRB 120)

If you have any questions about the above information and how it affects you personal tax situation, please give me a call.

Cordially

John K. Ross IV

To ensure compliance with requirements imposed by the IRS, we inform you that, unless specifically indicated otherwise, any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any tax-related matter addressed herein.