

# SPECIAL EDITION

**FEBRUARY 2007**

## **GUIDANCE FOR THOSE AFFECTED BY TORNADOES**



**Celebrating our 20th Anniversary**

**COHEN, SMITH & COMPANY, P.A.  
CERTIFIED PUBLIC ACCOUNTANTS  
133 EAST INDIANA AVENUE  
DELAND, FLORIDA 32724-4329  
(386) 738-3300  
[www.cohensmithcpas.com](http://www.cohensmithcpas.com)**

Interested in knowing more about our firm? Then take a minute to browse our website at [www.cohensmithcpas.com](http://www.cohensmithcpas.com) – read about us - our services - and the people behind the name.

### **Casualty Losses**

**Note: IRS has notified taxpayers in disaster counties that February 2007 casualty losses may be claimed on 2006 returns in order to expedite any potential tax savings. Taxpayers may also elect to claim February 2007 tornado-related casualty losses in 2007, rather than 2006.**

**Q: A taxpayer’s residence, which is located in the tornado disaster area, is damaged by the tornado. Prior to the tornado the taxpayer’s cost basis in the property was \$200,000. The taxpayer receives insurance proceeds of \$10,000 for the damage (not for living expenses), but only spends \$7,500 for repairs necessary to restore the residence to its condition before the tornado. The taxpayer receives no other form of compensation for the damage. Does the taxpayer have a casualty loss deduction? Is the difference of \$2,500 between the insurance recovery and the repair cost taxable? What is the adjusted basis of the residence after the repairs?**

- A. The taxpayer does not have a casualty loss deduction, because the loss is fully covered by insurance. To compute a tornado casualty loss deduction, a person must:
  - Determine the adjusted cost basis in the property before the casualty.
  - Determine the decrease in fair market value of the property as a result of the casualty (generally by appraisal or using the cost-of-repairs method).
  - From the smaller of these two amounts, subtract insurance and any other form of compensation received or expected to be received.

In this case, using the cost-of-repairs method to measure the decrease in value caused by the tornado, the taxpayer sustained a casualty loss of \$7,500 – the lesser of the \$100,000 basis in the residence and the \$7,500 cost of repairs. However, since the \$10,000 in insurance exceeds the casualty loss, the taxpayer may not claim a casualty loss deduction on the taxpayer’s federal income tax return.

The mere fact that the insurance proceeds exceeded the cost of repairs does not in and of itself result in taxable income to the taxpayer. Any gain from a casualty is determined by the amount of insurance proceeds and any other form of compensation received or expected to be received in excess of the amount of the taxpayer’s adjusted basis in the damaged property prior to the casualty. In this example, the taxpayer would not recognize any gain because the amount of the insurance proceeds is less than the taxpayer’s pre-tornado basis in the residence.

To determine the new basis in the residence, the taxpayer adjusts the pre-tornado basis by taking into account adjustments that decrease basis and adjustments that increase basis. Casualty loss deductions and compensation for the damage (for example, insurance proceeds) both decrease basis. See Publication 551, Basis of Assets, page 5. Note, however, that in this case the taxpayer does not have any allowable casualty loss deduction, so the casualty loss does not affect the taxpayer’s basis. The \$10,000 insurance payment reduces the taxpayer’s basis in the residence. The \$7,500 spent on repairs to restore the residence to its condition before the tornado increases the taxpayer’s basis in the residence. Thus, in this situation, the taxpayer’s new basis of the residence is the taxpayer’s pre-tornado basis reduced by the \$2,500 difference between the insurance proceeds received and the cost to repair the damage, and is computed as follows:

Basis before casualty	\$ 100,000
Less casualty loss deduction	0
Less insurance received	( 10,000)
Plus repairs	<u>7,500</u>
Basis after casualty	\$ 97,500

**Q: How does a taxpayer determine the amount of a casualty loss deduction for business or income-producing property (such as rental property) damaged or destroyed by a tornado?**

- A. If the business or income-producing property was damaged but not totally destroyed, the casualty loss deduction is lesser of the adjusted cost basis or the decrease in fair market value, minus any form of compensation (such as insurance reimbursement).

If business or income-producing property was totally destroyed by the tornado, the amount of the adjusted basis is treated as the amount of the casualty loss, regardless of the pre-tornado fair market value. The casualty loss deduction is the adjusted basis of the property before the tornado, minus any salvage value, and minus any form of compensation (such as insurance reimbursement).

**Q: How does a taxpayer determine a casualty loss from damaged trees and other landscaping on personal-use residential property when that loss is attributable to tornadoes?**

- A. In determining the amount of a casualty loss from damage to personal-use residential property, 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.

To compute your casualty loss:

- Determine your adjusted basis in the entire residential property before the casualty. Your basis is generally the cost of the property, adjusted for improvements and certain other events. For more information on determining your adjusted basis, see Publication 530, Tax information for First-Time Homeowners; Publication 551, Basis of Assets; Publication 4492, Information for Taxpayers Affected by Tornadoes, and, Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).
- Determine the decrease in fair market value of the entire residential property as a result of the casualty.
- From the smaller of these two amounts, subtract insurance and any other form of compensation received or expected to be received.

For residential property, damaged and destroyed trees and other landscaping may adversely affect the fair market value of the entire property by reducing the curb or overall appeal of the property.

One method of determining the decrease in fair market value is to compare an appraisal of the entire residential property, including trees and other landscaping, before the damage caused by the casualty to an appraisal of the entire residential 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 fair market value of the entire property.

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 fair market value, if the clean-up, repairs, and restoration are actually done, are not excessive, are necessary to bring the property back to its condition before the casualty, take care of the damage only, and do not cause the property to be worth more than before the casualty. For example, if these requirements are satisfied, 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 fair market value caused by the casualty. You may not include in your cost of cleaning up and restoring your property the cost of purchasing any capital asset, such as compact loader or tractor, or the value of the time you spend cleaning up your own property.

The following examples illustrate the points discussed above:

**Example 1:** A taxpayer lost a large tree in her backyard due to a tornado, but sustained no other property damage. An arborist valued the damage to the tree at \$3,000. The taxpayer spent \$600 to remove the tree from the yard and grind the stump. Insurance paid \$500 for debris removal.

The value of the damage to the tree determined by the arborist does not qualify as a measure of the casualty loss because it does not reflect the decrease in the fair market value of the residential property as a whole, including the residence, land, and improvements. The taxpayer may obtain an appraisal of the entire property to determine any decrease in value resulting from the loss of tree.

Alternatively, the taxpayer may use costs incurred to clean-up and to remove the tree as a measure of the decrease in the fair market value of the property provided the costs are not excessive, are necessary to bring the property back to its condition before the casualty, take care of the damage only, and do not cause the property to be worth more than before the casualty. The taxpayer would subtract from the loss any insurance reimbursement for tree removal and clean-up expenses. Under this alternative, the taxpayer has a casualty loss of \$100.

**Example 2:** A taxpayer had a large tree that fell during a tornado and crushed a carport. Among many trees on the property, it was the only tree that was damaged. The loss of this tree does not affect the fair market value of the entire property. Homeowners' insurance reimbursed the taxpayer all costs for repairing the carport and removing the tree.

Insurance paid for all repair costs to bring the property back to its pre-casualty condition and value. Therefore, the taxpayer has no casualty loss.

**Q: How can the cost of repairs be used to calculate a casualty loss?**

A: Under the law, a personal casualty loss is determined by taking the **smaller** of:

- The cost or other basis of the property (reduced by any insurance reimbursement), or
- The decline in fair market value of the property as measured immediately before and after the casualty (reduced by any insurance reimbursement).

The cost of repairs may, in certain cases, be used to measure the decline in fair market value, but it cannot be used by itself to determine the amount of the loss. When the cost of repairs is determined to be a fair measure of the decline in fair market value, then all you have to do is take the fair market value before the casualty and reduce it by the cost of repairs to arrive at the fair market value after the casualty.

**Q: A number of concerns have been raised by taxpayers and tax professionals about casualty loss valuations. What are the general guidelines to follow regarding casualty loss valuations?**

- A. While we cannot address every question received about property valuation issues, the IRS wants to express to the public that we sincerely recognize the extraordinary damage caused by the recent Tornadoes. IRS executives traveled to the area, viewed damaged areas, and met personally with local groups to gain a first first-hand understanding of the challenges that exist.

We urge taxpayers and tax professionals to act in good faith and make reasonable estimates on based on all information available. The IRS is committed to considering each situation on a case by case basis. We have extensive experience with disaster situations and will be reasonable in determinations.

As for lost records, when records are not available or it is not reasonably feasible to obtain documentation sufficient to re-create records otherwise required, the IRS will consider documentation requirements satisfied by the best reasonably available information presented in good faith.

**Q: Based on the enormous amount of damages sustained in the tornado, how will the IRS handle “mold issued” over the next several years as a result of insufficient repairs or whatever the cause. Will there be a special reporting on the loss related to mold?**

- A. Whether individuals may claim damage to their personal-use property from mold as part of their tornado casualty loss depends on the facts and circumstances of each situation. A key factor to consider is whether the mold damage occurred as a direct result of the tornados or from some other intervening cause since there must be a causal connection between the casualty event and the loss claimed by the taxpayer. For example, individuals would not be entitled to deduct as part of their tornado casualty loss mold damage that occurred as a result of insufficient repairs. The individuals’ casualty loss deduction would be limited to the property damaged caused by the tornado. In addition, if a large amount of time lapsed between the date of the tornado and the formation of the mold, this raises the question of whether the mold damage was caused by the tornado or some other factor.

The formation of mold may qualify as a separate casualty. A casualty is an event that is identifiable, damaging to property, and sudden, unexpected, and unusual in nature. An event is sudden if it is swift and precipitous, and not gradual or due to progressive deterioration of property through a steadily operating cause. An event is unexpected if it is unanticipated and it occurs without the intent of the one who suffers the loss. An event is unusual if it is extraordinary and nonrecurring, one that does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damage occurred and one that does not commonly occur in the ordinary course of day-to-day living of the taxpayer. If, under a particular set of facts, the formation of mold is a sudden, unexpected, unusual and identifiable event that caused damage to the individuals’ property, then it would qualify as a casualty and the individual may be entitled to deduct the loss for the resulting property damage as a casualty loss, if the individual satisfies the other requirements for the deduction.

**Q: What address should be used on a taxpayer's return considering the number of times they may move and may not remain at the current address for a long period of time?**

- A. Taxpayers should use their current address when filing. If the taxpayer moves after filing the return, they should update their address with the IRS by calling the IRS Disaster Assistance Hotline at 1-866-562-5227, or by filing Form 8822, Change of Address. The IRS also recommends taxpayers notify the post office serving the address.