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CASUALTIES PRODUCE LOSSES, RIGHT?

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As in all things related to the tax laws, whether or not a casualty produces a deductible loss (or gain), depends! I am sure it would not surprise any of our readers if we told you that you could have a gain from a casualty. A casualty must first meet several tests to determine that it is a "casualty" for which a loss may be taken. Since I want to talk about the calculations, we will skip those definitions.

It matters whether you own the property or lease it. In a lease situation, the calculation is simple: the amount of your cost to repair or replace less any reimbursement is the loss. If you own the property it depends on whether it is business use property or personal use property. The business use property calculation is: Adjusted Basis minus Salvage Value minus Reimbursement. If it is personal use property the calculation is: (the lesser of Adjusted Basis or Decrease in Fair Market Value) minus Reimbursement (due or received). Adjusted Basis is a term of art, with different meanings for business use property and personal use property. It is pretty much what you have on your books less depreciation for business use property, but for personal use property it is original cost or transferor basis if gift property, plus improvements, less any earlier losses or "depreciation" (but that is not the same as what applies in business use property and is not defined for personal use property). But remember the lesser of Adjusted Basis or Decrease in Fair Market Value is the important top number, before reimbursements. IRS gives an example of a chair destroyed in a fire. Before the fire the value was \$500 to replace, but it could not have been sold for more than \$100 just before the fire. The cost of the chair 4 years before was \$300. IRS says your loss is \$100. IRS Publication 547 (2006), p 4. Since your Adjusted Basis was \$300 and that is larger than the Decrease in Fair Market Value (\$100 FMV before fire less \$0 FMV after the fire = \$100 Decrease), the loss is \$100. If you got replacement value reimbursement at 80% of the cost to replace ($\$500 * 80\% = \400), then you have a \$300 gain on that loss property ($\$100 \text{ loss less } \$400 = (\$300)$). To complicate things further, costs to determine values are not additions to basis, but may be deducted as "Other Itemized Expenses" – subject to 2% of AGI limitations. If this loss is caused in a federally declared disaster area, these calculations may favor the taxpayer significantly.

Thus, it will be important in the event of a casualty loss for you to be able to determine values before and after the loss, and your original basis. The calculations will have to take into account many things which you may not recognize immediately as being applicable to your loss, and things such as living expense reimbursements may create taxable income (except in a federally declared disaster area) to the extent that they exceed your normal living expenses.
