Deducting Casualty Losses

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On July 22, 2010, the Milwaukee area was pounded with over 7 inches of rain in a two hour period. The flash flooding that accompanied the storm destroyed an estimated $28 million dollars worth of personal and business property. Nothing was spared -- furniture, appliances, flooring, cars, heirlooms, equipment, inventory, and entire buildings. Some people lost everything they had. If you were affected by the flood, what does that mean for your tax situation?

Damage from flooding is considered a casualty loss by the IRS. The good news is that your loss may be at least partially deductible. The bad news is that there may limits to how much you can deduct.

Business Casualty Losses

Business property that is completely destroyed results in a deductible loss. You can figure the loss by subtracting any salvage value received and any insurance reimbursement received from the adjusted basis of the property (generally cost minus depreciation already taken).

For example, a store owner had a piece of equipment fully destroyed in the flood. It cost him $100,000 and he had already claimed $40,000 in depreciation. He sold it to a scrap dealer for $500 and received no insurance reimbursement. His loss is $59,500 (100,000 – 40,000 – 500 – 0).

Any business property that was damaged, but not completely destroyed, also may result in a loss. However, that loss is determined by taking the lesser of the adjusted basis (cost minus depreciation) or the decrease in the fair market value (FMV). You still must subtract any insurance reimbursement received.

What you paid to replace the property is generally not considered in the loss calculation. However, the cost of clean-up or repairs may contribute to the measure of the decrease in FMV. It is difficult to determine the inherent value of structures like roofs, walls, and fences because there is no market for used products. The value can be determined by measuring the cost to restore it to its previous condition. For example, a building worth $300,000 had a roof partially collapse. In order to restore the building to its value of $300,000, repairs of $10,000 were necessary. The decrease in FMV (and casualty loss) must have been $10,000. Repairs must be necessary to repair the damage and restore the property to its previous condition without increasing the value of the property.

The loss of inventory can either be deducted as a separate loss as described above, or it can be deducted through the cost of goods sold (COGS) by properly reporting beginning and ending inventory. The net result should be the same either way.

Personal Casualty Losses

The calculation of personal casualty loss is based on the lesser of the adjusted basis (generally the cost) or the reduction in fair market value. Fair market value (FMV) is generally the price for which you could sell your property to a willing buyer. The FMV of something totally destroyed is $0. You must reduce your loss by any insurance reimbursement received. Like business losses, the cost of replacement does not generally factor into the determination of loss unless the repairs are needed to restore the FMV.

For example, you bought a new chair a few years ago for $300. If you had sold it before the flood, you estimate that you could have received $100 for the used chair. It cost you $500 to replace the chair. Your loss is $100, since the FMV before the flood was $100 and it was $0 after the flood (and the FMV of $100 is less than the $300 original cost). The replacement cost of $500 does not factor in.

Limits to Taking Losses

Personal losses are subject to limits. The limits are applied to each flood, fire, or theft separately. After you have figured your personal loss, you must figure out how much you can actually deduct on your tax return. You must first reduce each loss by $100. This limit is applied separately to each separate event. Then reduce your loss by 10% of your adjusted gross income (AGI) as reported on your tax return.

For example, consider a couple whose AGI on their 2010 tax return is $100,000. If the flood destroyed $20,000 of their property, they must reduce the flood loss by $100 and then by $10,000 (10% of 100,000). Their net deductible flood loss is $9,900. If their property is again damaged by a snow storm later in the year, the limits are applied separately to that damage.

Because the flood in Milwaukee was a federally declared disaster, the federal government may suspend or change the casualty loss reductions. For example, the federal declaration may suspend the $100 rule or the 10% rule. A federal disaster declaration may also create separate rules related to the total loss of your home during the flooding. However, none of those rules have been relaxed yet for Wisconsin flood victims yet. Federal declarations sometimes extend deadlines as well. In September, the IRS had extended some July and August due dates into September for flood victims. Furthermore, the IRS announced that flood victims have the option of claiming the 2010 casualty losses on either their 2010 or 2009 return. In other words, you could claim the loss now on a 2009 return (even if it means amending the return) and don't have to wait until filing in 2011 to receive any refund due. Additional changes that benefit flood victims may yet be announced. Be sure to know the special rules related to any federal disaster area declaration that may be applied to the July flooding in the Milwaukee area.

What is Not Deductible

- The cost of protection. You cannot deduct the cost of insurance or expenses to protect your property from damage (sandbags, pumps, etc…)
- The replacement cost of property. The cost of replacing damaged property is not part of the casualty loss.
- Sentimental value. You cannot increase the value of family heirlooms or keepsakes based on their personal meaning. Their value is still based on the fair market value.
- Decline in market value of your property. A decrease in the value of your property because it appears to be in an area susceptible to floods is not considered.
- Cost of appraisals or photographs to establish the condition and value of property. Though photos may be helpful, the cost is not deductible.

What Can You Do?

Calculating your loss now may help when it comes time to prepare your tax return next spring. It is important that you keep records to justify your deduction of loss.

- Keep any before and after-flood pictures as evidence of the damage.
- Gather receipts and any proof of the cost of what may have been destroyed.
- Keep receipts that demonstrate the cost of restoring the value of your property.

For more information about how the IRS treats casualty losses, review Publication 547 while gathering your tax information. Contact us if you need help determining your personal or business losses.