Casualty Losses for Property Damaged by Hurricane Sandy
Maximizing Tax Benefits
Casualty Losses for Property Damaged by Hurricane Sandy

Maximizing Tax Benefits within the Rebuilding Process

By Robert S. Barnett and Elizabeth Forspan

Many homeowners have unreimbursed losses in the wake of Hurricane Sandy. Maximizing the available tax benefits will be extremely important in enabling cleanup and recovery efforts. This article reviews the IRS rules regarding casualty loss deductions.

Casualty Loss Basics

A loss from a casualty arises as a result of a sudden, unexpected, or unusual cause, including those that arise from fire, storm, shipwreck, or theft (Internal Revenue Code [IRC] section 165[c]). Storm damage will include the loss to shoreline structures from battering by waves and winds or the flooding of buildings due to the storm.

May individuals deduct a casualty loss? Damage to nonbusiness property caused by a hurricane or flood is deductible according to a special set of rules (Treasury Regulations section 1.165-7[a][1]). The loss is generally deductible in the year in which it is sustained. Individuals may claim an itemized deduction if they suffer a casualty loss to personal property, but only with respect to the portion of the loss for which the individual will not be compensated by insurance (as discussed in greater detail later), and only to the extent that the losses exceed 10% of adjusted gross income (AGI) plus $100 per casualty (IRC section 165[h]). The casualty loss is deducted on Form 4684...
and is reported as an itemized deduction on Schedule A of Form 1040.

Note that under Treasury Regulations section 1.165-7(a)(3), an automobile, whether used for personal or business purposes, may be the subject of a casualty loss. In addition, if a loss includes both real and personal property, each loss must be calculated separately for each type of property. A single $100 reduction is applied to the total loss. Similarly, the 10% of AGI rule applies to the entire casualty loss deduction.

In determining the amount of the deduction, taxpayers must determine whether there is a reasonable prospect of recovery.

May a casualty loss deduction be claimed for damage to insured property? Individuals may claim a deduction for damage to insured property, but only if a timely insurance claim has been filed (IRC section 165(b)(5)(E)). If a claim is not filed, any portion of the loss that is covered by insurance will not be deductible (IRC section 165(b)(5)(E)). Any loss actually sustained during the taxable year and not compensated by insurance or another form of compensation is allowed as a deduction (Treasury Regulations section 1.165-1(a)).

An individual may not deduct the portion of the loss with respect to which there is a reasonable prospect of recovery. Thus, in determining the amount of the deduction, taxpayers must determine whether there is a reasonable prospect of recovery (discussed in greater detail below).

Amounts received as compensation to replace damaged property will reduce the amount of the loss that can be deducted. Excludable gifts will not reduce the deduction, even if they are used to repair the damaged property. In Revenue Ruling 84-329, an individual suffered extensive hurricane damage and used cash gifts given by relatives and neighbors to repair his home. The IRS allowed him to claim the full amount of the casualty loss without taking into consideration the money received as gifts.

How should a taxpayer treat payments from an employer to replace and repair damaged property? The IRS’s Information Release 2012-84 discusses qualified employer payments in the wake of Hurricane Sandy.

Under IRC section 139(a), gross income will not include amounts received by an individual as a qualified disaster relief payment. A qualified disaster relief payment includes amounts paid to or for the benefit of an individual to pay for 1) reasonable and necessary personal, family, living, or funeral expenses (not otherwise compensated by insurance) incurred as a result of a qualified disaster and 2) expenses (not compensated by insurance) for the repair or rehabilitation of a personal residence, or repair or replacement of its contents, to the extent the work is needed because of a qualified disaster (IRC section 139(b)). A qualified disaster includes a federally declared disaster and a disaster that results from an event that the IRS determines to be catastrophic in nature (IRC section 139(c)). The IRS has determined that Hurricane Sandy is a catastrophic event for these purposes (IR 2012-84). Thus, employer payments for qualified disaster relief are not includible in a taxpayer’s gross income.

Valuation and Measurement Issues Treasury Regulations section 1.165-7 provides a road map for valuing the amount of the loss that is deductible. Under the regulations, the fair market value (FMV) of the property immediately prior and immediately after the casualty should be ascertained by a competent appraisal, which must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to property” (Treasury Regulations section 1.165-7(a)(2)(i)). The regulations require the loss to result from, and reflect property damage from, the storm.

Cost of repairs. Under the Treasury Regulations, the cost of repairs to damaged property is acceptable as evidence of the value of the loss. The taxpayer must show that—

- the repairs were necessary to restore the property to the same condition it was in immediately prior to the casualty
- the amount spent on the repairs was not excessive
- the repairs were not for anything other than the damage; and
- the value of the property after the repairs did not exceed the value of the property immediately prior to the casualty (Treasury Regulations section 1.165-7(a)(2)(ii)).

How much can an individual deduct for a loss to personal property? As mentioned above, individuals cannot deduct the first $100 of the casualty loss. In addition, an individual may only deduct casualty losses to the extent the total amount of the individual’s losses during the taxable year exceeds 10% of AGI. Another limitation is the taxpayer’s basis, the computation of which is described in greater detail in the following example.

Example. Arnie’s home suffered a flood as a result of Hurricane Sandy. His loss, after insurance and other reimbursements, was $10,000. Arnie has an AGI of $50,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Post-Insurance Loss</td>
<td>$10,000</td>
</tr>
<tr>
<td>Less $100</td>
<td>-$100</td>
</tr>
<tr>
<td>New Loss</td>
<td>$9,900</td>
</tr>
<tr>
<td>Less 10% of AGI</td>
<td>-$5,000</td>
</tr>
<tr>
<td>Casualty Loss Deduction</td>
<td>$4,900</td>
</tr>
</tbody>
</table>

Note that in the wake of hurricanes Katrina, Rita, and Wilma, Congress acted to eliminate the 10% of AGI limitation described above, as well as the $100 threshold. There is a good chance that
Congress will act to extend similar leeway to victims of Hurricane Sandy. Tax professionals should stay abreast of upcoming legislation.

How can one measure the amount of the actual loss? The amount of the casualty loss is equal to the lesser of the following:

- The difference between the FMV of the property immediately prior to the casualty and its FMV immediately after; and
- The adjusted basis of the property immediately before the casualty (Treasury Regulations section 1.165-7(b)).

Example. Maria’s home was destroyed by Hurricane Sandy. The house cost her $30,000, and the FMV of the house immediately preceding the storm was $50,000. The FMV immediately after the storm was $20,000. Maria also collected $20,000 from her insurance company. Maria’s AGI is $50,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV before Storm</td>
<td>$30,000</td>
</tr>
<tr>
<td>FMV after Storm</td>
<td>$20,000</td>
</tr>
<tr>
<td>Decrease in FMV</td>
<td>$10,000</td>
</tr>
<tr>
<td>Minus Insurance*</td>
<td>$20,000</td>
</tr>
<tr>
<td>Loss after Insurance</td>
<td>$10,000</td>
</tr>
<tr>
<td>Minus $100</td>
<td>$9,000</td>
</tr>
<tr>
<td>Minus 10% AGI</td>
<td>$5,000</td>
</tr>
<tr>
<td>Deduction</td>
<td>$4,900</td>
</tr>
</tbody>
</table>

*Assumes no reasonable prospect of recovery for the remainder of the economic loss.

Note that, in this example, the $30,000 decrease in FMV does not exceed Maria’s basis in the property (cost plus improvements and capital expenditures).

Will a casualty loss affect basis in property? Yes. The basis of damaged property will be decreased by 1) the amount of insurance or other reimbursement received or available to be received or recoverable in the year the casualty loss was sustained, and 2) the amount of loss that is deductible (Revenue Ruling 71-161). It is important to note, however, that amounts spent on restoration of the damaged property will be added back to the basis. The following example is based on Revenue Ruling 71-161.

Example. As a result of the hurricane, Jimmy sustained property damage to his home, which is deductible as a casualty loss. The basis in the property immediately prior to the hurricane was $50,000, with a FMV of $50,000. Immediately after the hurricane, the FMV of the property was $40,000. Jimmy paid $2,000 for debris removal and $8,000 for repairs to the property, both of which restored the property to its condition prior to the hurricane. Jimmy received $1,400 from insurance reimbursement in the year of the hurricane for the debris removal, but did not receive the additional $600 until the subsequent year. Jimmy’s basis in the property is reduced by the amount of the allowable deduction. His basis must also be reduced by the amount of insurance or other compensation he received or is recoverable in the year of the loss.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis before loss</td>
<td>$50,000</td>
</tr>
<tr>
<td>Minus allowable deduction</td>
<td>$8,000</td>
</tr>
<tr>
<td>Minus insurance reimbursement</td>
<td>$1,400</td>
</tr>
<tr>
<td>Adjusted basis after casualty</td>
<td>$40,000</td>
</tr>
<tr>
<td>Plus debris removal expenses</td>
<td>$2,000</td>
</tr>
<tr>
<td>Plus expenses for repairs</td>
<td>$8,000</td>
</tr>
<tr>
<td>Adjusted basis after restoration</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

*Assumes no reasonable prospect of recovery in the year of the casualty loss for the $600 received in the next year.

Note that Jimmy will have income on receipt of the $600 in year 2 (year of receipt); he already claimed a deduction in the casualty loss for federal income tax purposes is deductible only in the year in which the casualty occurs (Treasury Regulations section 1.165-10(d)(1)).

Under Treasury Regulations section 1.165-1(d)(1), “a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year.” The regulations go on to state that if a casualty results in the loss, and in the year of the loss there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained—until it can be ascertained with reasonable certainty whether the reimbursement will be received (Treasury Regulations section 1.165-10(d)(1)).

This presents a dilemma for tax preparers, because no claim for deduction is allowed for that part of the loss for which a reimbursement is expected, until it is known.

For losses that occur in a presidentially declared federal disaster area, taxpayers may choose whether to deduct their losses in the taxable year in which the disaster occurred or claim the deduction for the prior year.

Timing issues: During which year may the loss be deducted? A casualty loss is generally deducted in the taxable year in which the loss is sustained, as described below. Hurricane Sandy was declared a federal disaster in much of the New York and New Jersey area, and taxpayers will have the choice of either deducting the loss in 2012 or the prior tax year. Other than in the case of federally declared disaster areas, whether the reimbursement will be received. Under the Treasury Regulations, whether a reasonable prospect of recovery exists with respect to the loss is a facts-and-circumstances determination. Both the tax code and regulations are silent as to the delineation of the particular facts and circumstances that will be considered in determining any reasonable prospect of recovery. Case law indicates that facts such as a taxpayer’s decision to litigate the matter should be considered (Scofield’s Estate v. Comm’r, 3 AFTR 2d 1054). Settlement of a claim or an abandonment of a claim will also indicate whether a reasonable prospect of recovery exists.

It is important to note that if an individual deducts a loss in one year and
receives a reimbursement for that same loss in a subsequent year, the reimbursement should be included in gross income for the taxable year in which it was received (Treasury Regulations section 1.165-
1(d)(1)(iii)).

Note that, as described in greater detail below, if a taxpayer’s casualty loss exceeds gross income for the year, the amount in excess of gross income may be treated as a net operating loss and carried back to prior tax years and over to other years.

Are there special rules for federal disaster areas? Yes. In general, casualty losses are deductible in the year in which the casualty occurs (with available carry-backs and carryforwards). But for losses that occur in a presidentially declared federal disaster area, taxpayers may choose whether to deduct their losses in the taxable year in which the disaster occurred or claim the deduction for the prior year.

This election is made either by filing an amended return or a refund claim. An election statement must be prepared and attached to the return. The statement must include relevant information about the casualty, including the time, place, and nature of the disaster. For Hurricane Sandy victims, this choice must be made by April 15, 2013.

The decision largely depends upon the taxpayer’s relevant income for the respective years. An individual who chooses to deduct the loss in the prior taxable year may be entitled to an immediate refund. If an election is made to take the deduction in the prior year, the casualty will be treated as having occurred in the taxable year for which the deduction is claimed (IRC section 165(j)(2)). Because much of the area affected by Hurricane Sandy was officially declared a federal disaster area, those affected must determine if it is beneficial to file an amended return and claim a refund for the prior year.

How can one protect against the tax statute of limitations? Preserving the tax statute of limitations is important, because in many instances the year of deductibility, as well as the amount of the casualty sustained and insurance recovery, may not be determinable. (Under IRC section 6511, a claim for credit or refund of overpayment of any tax of which the taxpayer is required to file a return must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later; if no return was filed, a claim or refund must be filed within two years from the time the tax was paid.)

There might be a reasonable prospect of recovery with respect to the entire loss, in which case the tax preparer may determine that there is no allowable current deduction and, as a result, may not claim the loss in the year of the casualty. The insurance company might ultimately dispute the amount of damage or may refuse to pay certain amounts altogether; in such a case, a loss will be available when the factors become determinable. Unfortunately, the IRS might not agree with the taxpayer, where a protective claim should be filed with respect to these years.

A protective claim should notify the IRS of all the relevant issues. It is important to note that a protective claim will be valid even if it does not state a particular dollar amount or demand an immediate refund. The protective claim will put the IRS on notice and prevent the IRS from later claiming that the statute of limitations for the relevant tax year has passed. The claim will be sufficient if it identifies the contingencies affecting the claim, if it is sufficiently clear and definite to alert the IRS as to the essential nature of the claim, and if it identifies a specific year or years for er’s determinations and calculations. It is incumbent upon a tax preparer to ensure that the relevant tax years are kept open, even though there are several factors that may not become known until many years later.

In order to keep the statute open, tax preparers should file a protective claim with the IRS for all years in which they reasonably believe there could be an allowable deduction. (A protective refund claim should be filed in situations where the usual refund claim period is still open and the tax preparer learns of events likely to cause an overpayment, even though the exact amount of the overpayment is not yet determinable [330 F2d 635].) In cases where a taxpayer is expecting insurance recovery, a tax advisor should file a protective claim if the full casualty loss was not claimed in one year. If all payments and deductions are not resolved for such year, then a protective claim should also be filed for succeeding tax years. (See the discussion on net operating losses [NOL], which a claim for refund is sought. In essence, a protective claim is a present claim contingent on a future event and notice that, upon the occurrence of the contingency, the claim will be asserted. (See Chief Counsel Advice [CCA] 201136021.) Tax professionals might consider the following as applicable disclosure for cases involving Hurricane Sandy claims:

This 1040X is filed as a protective claim relating to a casualty loss suffered as a result of Hurricane Sandy on October 30, 2012. The taxpayer has not reported a casualty loss for 2012 due to the expectation of a reasonable prospect of insurance recovery. This protective claim is necessary should the year of deductibility be determined to be 2012. Losses are expected to be approximately $50,000.

Is there an opportunity to carry back an NOL? Yes, there may be an opportunity for an additional refund. Individuals can claim an NOL for losses that exceed the amount that can be utilized in the year

Preserving the tax statute of limitations is important, because in many instances the year of deductibility, as well as the amount of the casualty sustained and insurance recovery, may not be determinable.
the loss was sustained and reported. For those who suffered severe damage, the casualty loss may exceed their income and, therefore, they would not be able to maximize their casualty loss deduction for the year in which the loss occurred. The IRS allows such individuals to treat the loss as an NOL and carry it back to prior years. If income was insufficient in the prior years, a carryforward is available. Of course, there are requirements regarding when the NOL claim can be filed. The authors recommend that tax advisors file the NOL claim immediately on a Form 1045; this will allow affected taxpayers to receive a prompt refund, while scheduling the statute of limitations. Form 1045 is used by an individual to apply for a quick refund resulting from, among other things, a carryback of an NOL. The IRS will process the application within 90 days from the later of (1) the date the taxpayer files the complete application, or (2) the last day of the month that includes the due date (including extensions) for filing that tax year’s return. (As described below, the claim may also be filed on a Form 1040X; however, a Form 1045 will generally elicit a more timely response from the IRS.) When filing a Form 1045, the first two pages of the taxpayer’s Form 1040 for the year of the loss should be attached, as well as any other applicable schedules required by the filing instructions. Taxpayers must attach a computation of the NOL using Schedule A (Form 1045) and a computation of any NOL carryover using Schedule B (Form 1045). When filing a Form 1040X amended return for an NOL, taxpayers should enter “carryback claim” at the top of page 1 of the Form 1040X.

Under Treasury Regulations section 1.172-1(c), taxpayers who are claiming an NOL deduction for any taxable year must file, along with their return for such year, a concise statement setting forth the amount of the NOL deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the NOL deduction.

In general, a taxpayer may carry back an NOL for two years and then forward for up to 20 years. But a special rule for casualty and theft losses exists, with respect to these losses, the carryback period is three years. The NOL must first be carried back to the earliest of the three years prior to the NOL year, then to the next year, and then to the year immediately preceding the NOL year. The NOL may only be carried forward to the extent it is not utilized in the prior years. Congress had enacted a special five-year carryback for those who suffered damage as a result of Hurricane Katrina. Tax professionals should keep alert for any new legislation that might extend the carryback period for victims of Hurricane Sandy.

As mentioned above, an individual may claim an NOL on either Form 1045 (Application for Tentative Refund) or Form 1040X (Amended U.S. Individual Income Tax Return). If Form 1045 should be filed no later than one year after the NOL year. If the claim is filed more than one year after the close of the NOL year, it must be filed on Form 1040X within the relevant statute of limitations for the loss year. A separate 1040X must be used for each carryback year to which the NOL will be applied.

Other Issues
Special conversion rules. Generally, under IRC section 1033(a)(1), if property is destroyed as a result of a storm (in whole or in part), no gain will be recognized if the destroyed property is converted into similar property within two years. If the property is converted into money or a dissimilar property, however, the gain generally will be recognized. Similarity is measured by use or service of the destroyed property.

IRC section 1033(h) includes the following special rules for property damaged in a federally declared disaster:

1. First, there is a four-year replacement period for the destroyed property (i.e., four years after the close of the tax year during which the gain is first realized as a result of the conversion).

2. Second, taxpayers need not be concerned with the specific classification of personal items. For example, when property such as a sofa is destroyed in a non-federally declared disaster, the taxpayer generally must replace the sofa with another sofa. Under the special IRC section 1033(h) rule, the funds are not specifically required to be used to replace the exact item of damaged property; rather, the proceeds for the damaged property are treated as a “common pool of funds” and the taxpayer will not be required to prove whether the insurance proceeds received for a specific item were reinvested in similar or related property.

Third, IRC section 1033(b)(1)(A)(i) provides a rule for property that is not specifically scheduled in a taxpayer’s insurance policy. Under this rule, no gain is recognized upon receipt of insurance proceeds for destroyed personal property that was part of the contents of the taxpayer’s residence and not specifically listed on a schedule in the insurance policy. This rule provides additional help to taxpayers affected by Hurricane Sandy.

Note that for purposes of these special rules, a principal residence has the same meaning as under IRC section 121; however, there is no requirement of ownership (i.e., renters who fall under this special rule will be protected).

IRC section 1033(h) also provides for trade or business and investment property located in a disaster area that has been destroyed. Any tangible property used for a productive use in a trade or business is treated as similar/related property and would satisfy IRC section 1033 for conversion purposes.

The IRS requires taxpayers to disclose when they acquire the replacement property. The statute of limitation for assessment of gain upon the conversion of the property is three years from the date the IRS is notified of the replacement of the converted property (or of an intention not to replace).

Retirement plan loans. News release IR 2012-93 clarifies that qualified employer retirement plans can make loans and hardship distributions to those affected by Hurricane Sandy, as well as their family members (i.e., retirement plans meeting the requirements of IRC sections 401(a), 403(b); these include 401(k) plans, 403(b) plans, and deferred compensation plans). A person outside the disaster area may assist a son, daughter, parent, grandparent, or other dependent who lives or works in the disaster area. Hardship distributions are permitted for food and shelter. Qualifying distributions must occur between October 25, 2012, and February 1, 2013. Plans must be timely amended to allow these distributions or loans.

Business Considerations
A casualty loss incurred in a trade or business or in a transaction entered into for profit is computed and determined, as
described above, by reference to the fair market value before and after the casualty; however, in a business context, each identifiable property is viewed separately. The Treasury Regulations give an example of a building with ornamental trees, which requires that the computations and basis limitations be computed separately for the trees and the building. This would also require separate computations for automobiles destroyed.

In comparison, if the property were a personal residence not used in business or for profit, the calculation of the trees and Schedule C, Forms 4684 and 8829 are used to claim the deduction.

Expense considerations under IRC section 162. A casualty loss to a trade or business may be allowable either as a casualty loss or as an ordinary and necessary business expense under IRC section 162. Businesses have the choice; however, they are barred from “double-dipping” and claiming the same deduction twice. In *R.R. Henler Inc. v. Comm’r* (73 TC 168), a construction company repaired and replaced equipment damaged in a heavy rainstorm. The company was permitted to deduct the machinery and equipment, and that the repairs did not prolong the life of the equipment or increase its value or make it adaptable to a different use. When deciding whether to deduct a loss as a business loss under IRC section 162, it is imperative to determine whether the expenditures are capital in nature.

CCA 199903030 discussed whether expenses relating to the restoration of business property damaged by severe flooding in the Red River Valley in April 1997 should be treated as a casualty loss, as repairs deductible as an ordinary and necessary business expense under IRC section 162, or as a capital expenditure under IRC section 263. As described above, IRC section 165(a) allows for a casualty loss deduction; however, no casualty loss is permitted where there is a reasonable prospect of recovery or the basis was insufficient. CCA 199903030 is consistent with *R.R. Henler* in discussing the factors to be considered. Under IRC section 263(a)(1), no deduction is allowed for any “amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.” Capital expenditures include amounts paid or incurred that add to the value or substantially prolong the useful life of the property. Facts and circumstances determine whether capitalization is required: “If the expenditure returns the taxpayer’s property to the state it was in before the situation prompting the expenditure arose, and does not make the relevant property more valuable, more useful, or longer-lived, then it is usually deemed a deductible repair” (CCA 199903030); however, if the expenditure “materially enhances the value, use, life expectancy, strength or capacity of the property as compared with its status prior to the condition necessitating the expenditure, then this expenditure is capital in nature” (CCA 199903030). If it is determined that the expenditures are not capital in nature, but rather would fall under IRC section 162, the taxpayer has a choice of deducting the loss according to the casualty loss requirements or as an ordinary and necessary business expense.

In 2006 and 2008, the IRS issued two sets of proposed regulations that would have required the capitalization of repair costs, instead of allowing taxpayers to claim an IRC section 162 deduction. The
theory was that a casualty was an extraordinary event. Under those proposed regulations, capitalization was required under the basis rules of IRC section 165, and repair costs would have received similar treatment. The IRS, however, recognized the concerns expressed criticizing this harsh treatment in the comments to the proposed rules and softened its stance. The temporary regulations allow taxpayers “to forgo claiming a Section 165 loss in order to qualify for a Section 162 deduction” (Treasury Decision 9564, Dec. 23, 2011. IRC section 162, Explanation of Provisions). Taxpayers must carefully review the temporary regulations before electing IRC section 162 treatment in order to ascertain whether the new regulations would allow a deduction for the repairs. The temporary regulations do not allow taxpayers to claim both a casualty loss deduction and a section 162 deduction. A detailed discussion of the temporary regulations is beyond the scope of this article.

It is also interesting to note that filing an insurance claim may not be required in claiming an IRC section 162 deduction for the cost of repairs. In Wezler Towing Co. v. U.S. (48 AFTR 2d 81-5274), the corporate taxpayer, a barge operator, did not file an insurance claim out of fear that the insurance policy would be cancelled. The court allowed a deduction as a business expense for the cost of repairing the property.

Loss to inventory. In general, the IRC section 163 rules on casualty losses do not apply to casualty losses to taxpayers’ inventories: rather, the Treasury Regulations refer to the general provisions relating to inventories under IRC section 471 and the associated regulations (Treasury Regulations section 1.165-7(a)(4)). But the taxpayer may instead choose to claim the casualty loss separately. Care must be taken not to duplicate deductions and to properly reflect any insurance recovery. Casualty losses to inventory may be automatically reflected in the cost of goods sold by property reporting opening and closing inventories. If included in the cost of goods sold, the losses are not separately deducted as a casualty loss. This is necessary to avoid duplication of the loss (IRS Publication 538).

An example will help illustrate an important difference between claiming a deduction as a casualty loss or as part of the cost of goods sold. If a taxpayer has a casualty loss to inventory that is reflected in a lower ending inventory, the cost of goods sold will include the lost inventory value. One potential consideration is that the reasonable prospect of recovery of a later insurance recovery will not bar the larger of goods sold deduction (but will reduce the casualty loss deduction). Claiming the larger of costs of goods sold deduction will help a taxpayer receive a quicker tax refund. However, the later insurance recovery will be reflected as taxable income.

Many businesses affected by recent inventory losses due to Hurricane Sandy are experiencing reduced business activity, lowering profit expectations. Therefore, the tax paid on the insurance recovery may be more than offset by the business deduction of the cost of goods sold in the earlier year. If a taxpayer elects to claim the deduction as a casualty loss, the reasonable prospect of recovery rule might bar some or all of the claim.

Start the Conversation
In light of the above, it is important for all individuals and businesses that suffered devastating losses because of Hurricane Sandy to begin the process of determining the value of their losses and discussing the potential for tax savings with their tax advisors. The New York and New Jersey area was hit especially hard and many counties were declared federal disaster areas, opening up the potential to claim an immediate refund. Tax advisors must also remember that pending federal legislation may affect some of the factors discussed in this article.

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As more information becomes available, please visit http://www.cbmslaw.com for updates on information in this article.

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RESOURCES:

- IRS Disaster Assistance Hotline: (866) 562-5227
- IRS Tax Relief in Disaster Situations: http://www.irs.gov/uac/Tax-Relief-in-Disaster-Situations
- IRS Disaster Relief Resource Center for Tax Professionals: http://www.irs.gov/Tax-Professionals/Disaster-Relief-Resource-Center-for-Tax-Professionals
- Disaster Assistance Portal: http://www.disasterassistance.gov/
- American Red Cross Disaster Services: http://www.redcross.org/prepares/disaster
- Hurricane Sandy Helpline for New York State Residents: (888) 769-7243

FEBRUARY 2013 / THE CPA JOURNAL