Anthony P. Curatola, Editor

Tax Issues for Individual Victims of Natural Disasters

BY MICHAEL E. BITTER, CPA; RICHARD W. COPELAND; AND PAUL E. DASCHER

Hurricanes Katrina and Rita proved disastrous for individuals, businesses, and communities. Similarly, other disastrous events occur across the country that may be equally devastating to individuals or businesses and that often result in multiple losses. Among those are financial-related losses such as lost records, lost data, and lost, damaged, stolen, or destroyed assets. While disasters often trigger immediate rescue and relief responses, they also may trigger tax-related issues for the victims. Individuals and businesses impacted in unexpected and unique ways by disasters can benefit from the tax compliance expertise of accountants. Here we explore the related federal tax issues for individuals in Presidentially declared disaster areas and suggest some strategies for recovery, compliance, and assistance. In a future article, we will address these issues from a business perspective.

Tax Compliance Relief and Loss of Records

Various forms of federal tax compliance relief are available for individual taxpayers whose "main home" is located in a Presidentially declared disaster area. For example, after Hurricanes Katrina and Rita, the deadlines for taxpayers to file returns or make estimated tax deposits/payments that would otherwise have been due on or after August 24 (Florida Katrina victims), August 29 (other Katrina victims), or September 23 (Rita victims), 2005, were extended to February 28, 2006, without interest or penalties. Further, the IRS is waiving fees and expediting requests for copies of filed returns for taxpayers who need them to seek benefits or who want to file an amended return to claim a disaster-related loss (IR 2005-110, September 27, 2005).

In order to file a return or properly estimate a tax payment, it may be necessary to overcome the loss of records and data. See Table 1 for possible sources of information to mitigate the situation.

Disaster-Related Losses

Disaster-related losses may be an important tax consideration for many disaster victims. Both casualty and theft losses related to disasters may be itemized and deducted. A casualty loss is defined as damage, destruction, or loss of property (real or personal) resulting from a qualified identifiable event, such as a hurricane, flood, or earthquake. A theft loss can result from events like burglary, larceny, or robbery, among others. Losses, whether by casualty or theft, are calculated in the same manner: the lesser of the adjusted basis of the property prior to the casualty or theft OR the decrease in the fair market value of the property as a result of the casualty or theft. From this amount, any actual or expected insurance payment or other nonexcluded reimbursements must be subtracted. It's important to have a thorough understanding of the taxpayer's expectations for reimbursement before proceeding.

Certain related costs aren't deductible as part of the casualty or theft loss, including costs for clean-

Table 1: Replacing Lost Financial Records

MISSING ITEMS	POSSIBLE SOURCE	ACTIONS
Previously filed federal tax returns	Paid preparer or regional IRS Service Center	Contact paid preparer, if possible, or file Form 4506 with regional IRS Service Center.
Missing support for previous returns	Original source of the information	Wait to determine if the return is challenged or audited before seeking information replacement. Document potential sources of information while memory may be clearer.
Current statements, receipts, and other data	Original source of the information	Reviewing previous returns, bank statements, brokerage account statements, or a check register (if available) may help identify potential deductions or income that should be reported.

up, repair of damaged property, property insurance, protecting property against casualty or theft (e.g., sand bags, boarding windows, etc.), and replacing property (see IRS Publication 547, p. 4). Some of these costs may be reflected in the decrease in fair market value, calculated as part of the determination of a casualty loss. Further, the cost of temporary housing, renting a car, or replacing lost or stolen property isn't deductible. The cost of documenting the casualty or theft loss (such as appraisal fees or the cost of photographs documenting damage), however, may be deducted as a miscellaneous expense on Schedule A of Form 1040 by taxpayers who itemize.

Victims suffering casualty losses should complete Section A (personal use property) of IRS Form 4684, Casualties and Thefts, and carry the deductible loss to Schedule A of Form 1040. In determining the deductible loss from a casualty or theft, the taxpayer must reduce the actual loss by $100 per event (not individual piece of property) and then by 10% of adjusted gross income. Section 402 of The Katrina Emergency Tax Relief Act of 2005 provides an exception to the 10% and $100 adjustments in the case of losses attributable to Katrina (see IR 2005-119, October 11, 2005). Special rules for Presidentially declared disasters permit victims the option of deducting the loss in the current tax year or in the year immediately preceding the current tax year. Taxpayers who have already filed their return for the preceding tax year may deduct the loss by amending the return using Form 1040X. In a Katrina loss, it's important to write "Hurricane Katrina" in red ink at the top of Form 1040X (IR 2005-119). Advice concerning which alternative better suits the needs of the taxpayer is essential. Depending on income level, the timing of the deduction will influence the deductible amount. Alternatively, amending the previous year's return may lead to a more rapid refund.

For example, let's assume an individual taxpayer owns a "main home" located in a Presidentially declared disaster area, and the home suffered significant damage in an August 2005 disaster. The home had an adjusted basis of $100,000. The fair market value of the home immediately before and after the disaster was appraised at $250,000 and $125,000, respectively. The casualty loss in this case is $100,000 since the basis of the property ($100,000) is less than the decline in the fair market value of the property resulting from the casualty ($125,000). The $100,000 loss would further be reduced by $100 and 10% of the taxpayer's adjusted gross income in arriving at the allowable casualty loss deduction unless the loss was due to Katrina. In that case, the entire $100,000 would be deductible. The taxpayer could deduct this loss on her 2005 federal income tax return or, assuming she had already filed her 2004 return, she could file an amended 2004 return claiming the loss in that year. She should consider both the tax savings that would result from the two options as well as the urgency with which she needs her refund (presumably, a refund resulting from an amended 2004 return would come more quickly than a refund resulting from filing the 2005 return).

Gains on Casualties and Thefts

Gains on casualties and thefts result when the reimbursement received by the taxpayer (from insurance or other sources) exceeds the adjusted basis of the property. Fortunately, disaster victims may postpone this gain by purchasing replacement property (similar or related in service or use to the original property) with a cost that equals or exceeds the amount of the reimbursement within four years (for example, a replacement related to a 2005 disaster must be purchased by 2010). The basis in the replacement property will be the same as in the old property, thus deferring the gain until the property is sold. Naturally, the alternatives to the tax consequences of replacement decisions also must be evaluated.

Taxability of Disaster Assistance

A final consideration includes questions often raised by taxpayers about disaster assistance received by individuals. In general, "qualified disaster relief payments" (defined as reasonable and necessary personal, family, living, or funeral expenses or reasonable and necessary expenses incurred to repair or rehabilitate a personal residence and replace its contents) aren't taxable—regardless of source (e.g., government programs, charitable organizations, or employers)—unless the expenses are also reimbursed by insurance or other sources. Examples of such nontaxable "payments" include food and temporary housing, transportation, medical and dental care, clothing, and household goods or cash allowances to pay for such items.

Taxpayer Resources

The Internal Revenue Service provides several helpful resources, including a telephone disaster hotline, (866) 562-5227; a Disaster Losses Kit for Individuals, Publication 2194; and the IRS website, www.irs.gov. Information about disaster-related casualty and/or theft losses also can be found in Publications 547 and 584. Since IR-2005-110 (Tax Relief Granted for Hurricane Rita) was updated six times in its first week, current information is vital. ■

Michael E. Bitter, Ph.D., CPA, is associate professor of accounting at Stetson University, DeLand, Fla. You can contact him at mbitter@stetson.edu.

Richard W. Copeland, LL.M., is associate professor of business law and tax at Stetson University, DeLand, Fla. You can contact him at rcopelan@stetson.edu.

Paul E. Dascher, Ph.D., is the Rinker Distinguished Professor of Accounting at Stetson University, DeLand, Fla. You can contact him at pdascher@stetson.edu.