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Natural Disasters and Tax Issues for Business Victims

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While national attention was properly focused on efforts to recover from Hurricanes Katrina and Rita, these disasters weren't unique in affecting communities and businesses across the country. In 2004 alone, catastrophes in 25 states and four U.S. territories resulted in federal disaster declarations from the President. Such a declaration facilitates various forms of assistance to individuals, businesses, and communities recovering from the disaster. Disasters and the resultant declarations also affect individuals and businesses from a tax perspective, likely impacting tax compliance and tax liability.

Disasters often result in multiple losses for businesses, including lost records, lost data, and lost, damaged, stolen, or destroyed assets. In many cases, business interruptions result from physical damage to the business and/or damages suffered by employees, customers, and the community that impede the business's ability to operate.

Lost records and data may be recoverable and are important for insurance and tax compliance purposes. Similarly, losses from damaged or destroyed assets or business interruption may be offset by insurance or governmental assistance that will have tax implications. Businesses themselves, both inside and outside the disaster area, may be supporters of recovery efforts resulting in expenses not generally associated with their operations. This column provides some strategies for accounting advisors to consider when dealing with these situations.

Tax Compliance Relief and Loss of Records

Various forms of federal tax compliance relief are available for firms whose principal place of business or whose business records are located in a Presidentially declared disaster area. For example, after Hurricane Rita, the deadline for business taxpayers (including sole proprietorships, corporations, S-corporations, and partnerships) to file returns, make estimated tax deposits or payments, or file employment or excise tax returns that would have been due on or after September 23, 2005, was extended to February 28, 2006, without interest or penalties. This relief extends to taxpayers not located in the disaster area but whose records, books, or tax professionals are in the disaster area. The extension, however, does *not* apply to other informational returns normally prepared by businesses (such as those in the W-2, 1098, 1099, or 5498 series or Forms 1042-S or 8027) or to employment or excise tax deposits. Further, the IRS will waive fees and expedite requests for copies of filed returns for businesses that need them to seek benefits or loans or that want to file an amended return claiming a disaster-related loss (IR 2005-110, 9/27/2005).

Disaster-Related Losses: Casualty and Theft

Disaster-related theft, damage, or destruction of business or income-producing property may result in significant tax issues for business disaster victims. Generally, such casualty and theft losses are tax deductible as a business expense. If more than one item of property is involved, losses must be computed for each item separately. A casualty loss is defined as damage, destruction, or loss of property resulting from a qualified identifiable event, such as a hurricane, flood, or earthquake. A theft loss can result from burglary or robbery (including looting). Losses resulting from the complete destruction of business or income-producing property are calculated as the adjusted basis of the property less any salvage value and any actual or expected insurance or other reimbursement.

For property that isn't destroyed completely, the loss is calculated as the lesser of the adjusted basis of the property prior to the casualty or the decrease in the fair market value (FMV) of the property resulting from the casualty or theft. From this amount, any actual or expected insurance or other reimbursement must be subtracted. For example, assume that Company A owned an uninsured storage facility costing $150,000 and having a current adjusted basis of $80,000 (due to depreciation) that was damaged. The FMV of the property immediately before and after the disaster was appraised at $200,000 and $150,000, respectively. The casualty loss in this case is $50,000 since the decline in the FMV of the property resulting from the casualty ($50,000) is less than the adjusted basis of the property ($80,000).

There are certain costs that aren't deductible as part of the casualty or theft loss, including costs for cleanup, repair of damaged property, property insurance, protecting property against casualty or theft, replacing property, and other incidentals. These costs, however, are deductible as a business expense.

Businesses suffering casualty and theft losses should be advised to complete section B (Business and Income Producing Property) of IRS Form 4684, *Casualties and Thefts.* Special rules for Presidentially declared disasters permit disaster 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. A review by the accounting advisor can determine which treatment is best.

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. Disaster victims, however, may postpone this gain by purchasing *any* tangible replacement property for use in any business with a cost that equals or exceeds the amount of the reimbursement within two years of the tax year in which any part of the gain is realized. For example, if the disaster event occurred in September 2005 and the payment resulting in the gain was received by the business in 2006, the replacement of property must occur by 2008.

Taxability of Employee/Employer Disaster Assistance

A special provision announced in response to Hurricanes Katrina and Rita permits employees to donate vacation, sick, or personal leave so that employers can make cash donations to qualified tax-exempt organizations that assist hurricane victims. Employers will be permitted to deduct the cash contribution as a business expense under IRC §162 if it is paid before January 1, 2007 (I.R. 2005-97, 9/8/2005). Although the value of the donation isn't deductible by the employee as a charitable contribution, it also isn't reportable as income. An employee not only avoids paying income and payroll taxes, but he or she also avoids the increase of adjusted gross income, which could potentially reduce itemized deductions. Better yet, for employee taxpayers who don't itemize, this is a way to make, in essence, a "pre-tax" charitable contribution.

Another factor for accounting advisors to consider is the taxability of payments made by a business to its employees to help the employees defray certain costs they incurred as a result of a qualified disaster. While the payments are deductible by the business, they may also be excludable from gross income by employees. If the payments meet the standards established in Rev. Rul. 131, 1953-2 C.B. 112 (that is, the payments are "gratuitous," "measured solely by need," "not related to services rendered," and "designed to place employees in about the same economic position as they were before" the disaster) *and* meet the IRC §139 requirement that the payments received by an individual reimburse or pay personal, family, living, or funeral expenses; costs to repair a personal residence; or costs to repair or replace the contents of the residence, the payments are excluded from employee's gross income. Further, Rev. Rul. 2003-12 (1/21/2003) states that payments to employees under an employer program to pay or reimburse medical, temporary housing, or transportation expenses incurred as a result of a qualified disaster are excluded from gross income. Accounting advisors are cautioned to review these sources when determining the taxability of such employer payments. ■

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