**Storm Damage: Casualty Losses and/or Involuntary Conversions**

**Income Tax Considerations**

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An involuntary conversion is an event that is not initiated by the taxpayer. The involuntary conversion can be the result of weather (e.g., hurricane or drought), condemnation or threat thereof, or a casualty event such as a cotton picker catching fire and burning.

A casualty loss is the result of an identifiable event that is sudden, unexpected or unusual which cause damage, destruction or loss of property owned by the taxpayer.

The Tax Cuts and Jobs Act (P.L. 115-97) (TCJA) modified rules for claiming personal casualty losses. The rules for business casualty losses remain the same as under prior law. The discussion below briefly outlines the process and options taxpayers have in dealing with a either a business loss or a personal loss.

**Business Casualty Losses**

When business assets are damaged or lost due to a casualty event (Hurricane Florence), the loss deduction is the lesser of the asset’s adjusted tax basis (generally cost less depreciation deductions taken) or the fair market value (FMV) decrease that results from the casualty event minus any insurance compensation received or other reimbursements.

The casualty loss does not include costs of clean up, repairing or replacing the destroyed property, or other related costs to recover from the casualty event. However, these costs, in total, can be used as a proxy for estimating the decrease in FMV.

For income tax reporting of a business casualty loss, taxpayers will use IRS Form 4684, Section B—Business and Income-Producing Property. If there is insurance payment to cover the loss, there may well be a gain to report. Net losses or gains are transferred from IRS Form 4684 to IRS Form 4797, Dispositions of Business Assets.

**Example:** Building Destroyed by Flood

Bob Producer owned a farm building that was destroyed by Hurricane Florence on September 14, 2018. He paid $200,000 for the building on April 10, 2015 and used straight-line depreciation. The building was valued at $235,000 and had adjusted tax basis of $170,000 before the hurricane. Bob received $150,000 from his insurance company in settlement. Because the building was destroyed, the FMV is not considered.

 Bob has a $20,000 loss ($150,000 - $170,000) to report. Bob uses IRS Form 4648, Section B to calculate the loss, then he reports the loss on Line 14, of IRS Schedule 1, Form 1040. The loss is a deduction against ordinary income.

Bob, in the example above, can choose to report the loss either in the year of the event (2018) or he may amend his 2017 income tax return and claim the loss for a refund which may help his cash flow. This is especially a good management decision if his income tax bracket was higher in 2017 than anticipated for the 2018 tax year. The election is made by filing the election statement with the amended 2017 income tax return.

**Business Casualty Gains**

Business casualty gains result when insurance proceeds exceed the adjusted basis of the damaged or lost property. The adjusted tax basis is always used to calculate gains. FMV is disregarded.

Internal Revenue Code (IRC) § 1033, the involuntary conversion rules, allow that realized gains may be deferred if the insurance proceeds are reinvested in replacement property that is similar in use to the destroyed property. The replacement period allowed is typically two years after the year the gain is realized; December 31, 2020 for losses due to Hurricane Florence for example.

If Bob, from the previous example, had received $235,000 for the destroyed building as a replacement cost insurance payment, he would have a realized gain of $65,000 ($235,000 - $170,000). If he chose to not replace the building Bob is required to report and pay any tax on the gain. However, he has until December 31, 2020 to replace the building. The rules additionally do not require he use the insurance money specifically to pay for the new building. Bob could borrow funds to build if he used the insurance money to cover other expenses in the intervening time frame.

**Deferring Business Casualty Gains**

Farmers wishing to defer any resulting taxable gain attach an election statement to the current year return, e.g., 2018’s for Hurricane Florence, to provide the calculation of gain being deferred. Subsequently, upon replacement, the farmer attaches a second statement informing IRS that the replacement property was obtained and any adjustments to tax basis, such as additional cash boot paid for the tax year in which the property is replaced.

**Personal Casualty Gains under Tax Cuts and Jobs Act**

Under the TCJA, personal casualty losses generally are no longer eligible as a deduction from income. However, if the taxpayer lives and/or suffers a casualty loss in a federally declared disaster area the taxpayer can claim a personal casualty loss deduction. The taxpayer must make some adjustments to the deduction. This is different for business casualty losses as no adjustments are made in the business case.

If the taxpayer/farmer suffers a personal casualty loss and is in a federally declared disaster area, the loss is reported using rules for personal casualty losses.

Generally, a casualty loss deduction is limited to the lesser of the property’s adjusted tax basis or the decrease in its FMV that results from the casualty. For personal use property losses, that amount is further reduced by the following:

1. The loss from each casualty event is reduced by $100.

2. The sum of all personal casualty losses (after the $100 reductions) incurred during the tax year is reduced by 10% of the taxpayer’s adjusted gross income (AGI).

The taxpayer reports the resulting loss on IRS Form 4684, Section A—Personal Use Property and Schedule A (Form 1040), Itemized Deductions. If the taxpayer’s total itemized deductions are less than the allowable standard deduction, there is no tax benefit from the casualty loss.

**Example: Personal Casualty Loss in a Federally Declared Disaster Area**

Maria, who is single, suffered an unreimbursed personal casualty loss during Hurricane Florence in September 2018. Maria’s loss was $20,000 in total and was in a federally declared disaster area. Maria’s AGI was $40,000.

Maria’s allowable casualty loss is $15,900 ($20,000 - $100 - $4,000). She reports the loss as an itemized deduction on Schedule A along with other allowable itemized deductions.

Note, for 2018, the individual standard deduction is $12,000, therefore, it is to Maria’s benefit to itemize.

For taxpayers affected by Hurricanes Harvey, Irma and Maria during 2017 the Disaster Tax Relief and Airport and Airway Extension Act of 2017 (DTRA), Pub. L. No. 115- 63 provided additional relief. As of this writing (September 15, 2018) any additional relief for those affected by Hurricane Florence has not been legislated as it is too early for such to occur. Such legislation may be forthcoming, taxpayers and their advisers should follow developments as they are released.

**Note: Taxpayers are encouraged to seek professional tax advice to understand current and any forthcoming rules to deal with business and personal casualty losses.**

**IRS Resources**

IRS Publication 976 (2018) Disaster Relief (Published in February 2018, updates needed)

<https://www.irs.gov/publications/p976>

IRS Publication 547 (2017) Casualties, Disasters and Thefts (not updated for TCJA)

<https://www.irs.gov/pub/irs-pdf/p547.pdf>