PERSPECTIVE

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Superstorm Sandy and Other Losses You Cannot Deduct

By Robert W. Wood

Tax lawyers and accountants like to plan efficiently and to save clients money. But the tax treatment of casualty losses involves damage control. The loss has occurred and you must deal with it. The only question is how much it costs, and that's where taxes come into play.

If you can deduct a loss, the government picks up part of its cost. Usually, though, casualty loss deductions sound better than they actually are. First, let's look at some definitions.

Surprisingly, the tax code and Treasury Regulations don't define the term "casualty loss." The courts have addressed it on a case-by-case basis. To satisfy the current test, the event causing a loss must be identifiable, damage property, and be sudden, unexpected or unusual in nature.

Clearly, Sandy fits these qualifications, but many of the typical cases are about such things as termites, dry rot, and more. Progressive deterioration is damage that steadily occurs over a long period of time. Damage caused by termite infestation and dry rot are classic examples of non-deductible progressive deterioration losses.

To be tax-deductible, the damage must be caused by a *sudden* event (such as a sudden natural disaster or a sudden infestation). Much of the discussion focuses on just how unexpected the loss truly is and measuring its scope. Measuring a decline in value can be especially tough.

Sometimes, the question is whether the loss is a casualty at all. In *Chamales v. Commissioner*, T.C. Memo 2000-33 (Feb. 3, 2000), a couple bought a $2.85 million home adjacent to the home where O.J. Simpson allegedly murdered Nicole Brown Simpson and Ronald Goldman. Mr. and Mrs. Chamales claimed a casualty loss on their tax return because the media, sightseers, and refuse reduced the value of their property.

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The Tax Court denied the deduction, finding that it was not a fire, storm or shipwreck. In fact, the court said that any damage was a mere temporary decline in market value. You can't claim a loss on your taxes for that.

But since Sandy and similar events clearly qualify as casualties, how do you measure and claim your loss? First, your loss is reduced by any insurance payment you receive, so you can only claim amounts not reimbursed by insurance. Second, your tax deduction cannot exceed your adjusted basis or the fair market value of the property, whichever is less.

There is also a percentage threshold that ties your tax deduction to your income for the year in which you claim the loss. Only an amount *exceeding* 10 percent of your adjusted gross income plus $100 is deductible. That means you can lose up to 10 percent of your annual income by casualty and receive no deduction. Only amounts exceeding that 10 percent figure (plus $100) qualify.

In many cases, you may have a loss but not qualify for any tax deduction. Suppose a tree blows down and causes $15,000 of damage to your house. It might be covered by insurance or it may not exceed the 10 percent of income plus $100 threshold. Either way, you are out of luck.

Still, exactly what constitutes a loss can be debated. In *Finkbohner v. United States*, 788 F.2d 723 (11th Cir. 1986), the court upheld a casualty loss as the result of a flood. The home had been damaged by floodwaters, so clearly qualified as a casualty loss. However, *measuring* the size of the loss was something else.

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Most of the claimed loss was not from actual damage to the house, but rather from permanent damage to the marketability of the property. The worry was over floodplains leading to a permanent buyer resistance in the area, which the court agreed was a real consequence and could be measured. This case is still viewed as an important one today.

When the federal government declares an area to be a disaster area, usually in the wake of a major storm, there is additional tax help. Sometimes it involves timing. Tax returns are annual and each year starts on its own.

However, after a disaster area designation, taxpayers can even deduct losses in the tax year *before* the event occurred by filing an amended tax return. Often, filing an amended tax return and claiming the loss will make the individual eligible for an immediate tax refund. Tax refund dollars can be useful money that might be used to live on or to commence making repairs.

However, since casualty losses are only for itemizers that must be considered too. A filer who didn't itemize deductions the previous year may want to amend the return. If the total of the casualty loss and any other itemized deductions will amount to more than the standard deduction they originally took, amending may be to their advantage. Disaster-related tax relief also generally includes extended return filing deadlines and various forms of penalty relief.

Casualty loss deductions usually are not worth as much as people think. Insurance recoveries and how they are taxed, however, are another matter. If you are getting insurance money, especially from business or investment property, get some sound tax advice.

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