RENO GAZETTE-JOURNAL

Realty tax tips-part 4: 2004 was big year for casualty loss tax deductions

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1/23/2005 04:00 am

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Unfortunately, 2004 was a big year for uninsured casualty losses. Hurricanes, firestorms, floods and other "sudden, unusual or unexpected" events caused millions of dollars of uninsured losses.

But the good news is Uncle Sam wants to help pay for part of your loss. He does so in the form of income tax savings from the casualty loss tax deduction.

Even if you didn't suffer a major loss, you still might be entitled to a tax-deductible deduction. The casualty loss deduction is a tax break you hope you never have to use, but you're glad it's available when needed.

WHAT IS A CASUALTY LOSS? Uncle Sam defines a tax-deductible casualty loss as an uninsured "sudden, unusual or unexpected" loss event. Examples include fire, flood, earthquake, hurricane, tornado, mudslide, theft, accident, water damage, riot, embezzlement, vandalism, snow, rain, and ice damage.

To qualify for this tax deduction, the loss wasn't paid by your insurance. If you received full insurance payment for your loss, you don't have a casualty loss tax deduction. However, if insurance paid only part of your loss, you probably qualify for a partial casualty loss deduction.

When the president declares a disaster area, such as a major flood, fire, earthquake or hurricane, affected taxpayers who suffer casualty losses can then claim their uninsured deductions either in the tax year the loss occurred, or in the previous tax year by amending their prior year tax returns. The taxpayer then either receives a prior year tax refund, or a current year tax savings.

SLOW LOSSES ARE NOT DEDUCTIBLE CASUALTY LOSSES. If your loss occurred slowly, over several months or years, it probably is not a deductible casualty loss.

Examples of non-deductible, too-slow events include termite damage, carpet beetle infestation, dry rot damage, rust, dry well, corrosion, growing plant loss, moth damage, Dutch Elm disease, erosion, drought, and mold.

To illustrate, my home's sewer line recently became clogged with roots that entered the clay sewer pipe. I paid the plumber about $300 to clear the blockage. However, if I instead decided to pay the $4,500 estimated cost to replace the pipe, it is not a deductible casualty loss because it occurred gradually over many years. I know because every four or five years when the drains slow I pay the plumber to clear my sewer line. I figure that's less costly than replacing the sewer pipe.

NOT ALL OF YOUR CASUALTY LOSS IS DEDUCTIBLE. Presuming your personal casualty loss meets the "sudden, unusual or unexpected" test, and it was not fully paid by insurance, the next issue is determining how much of your casualty loss is deductible.

The reason is only personal casualty losses that exceed 10 percent of the taxpayer's annual adjusted gross income (line 37 of your 2004 federal tax return), minus a $100 non-deductible "floor" per event, are deductible.

To illustrate, suppose a home garage fire cost $15,000 to repair. Your homeowner's insurance paid only $5,000 because you were underinsured. The result is you had a $10,000 out-of-pocket loss. Suppose your adjusted gross income is $60,000. Subtracting 10 percent or $6,000, minus the $100 floor per event, means your $10,000 loss results in a $3,900 deductible casualty loss.

Instead, suppose your adjusted gross income is $25,000. Then $10,000 minus $2,500 minus $100 results in a $7,400 casualty loss deduction. To calculate your exact casualty loss deduction, use IRS Form 4684 and attach it to your federal income tax return.

EXPECT AN I.R.S. CASUALTY LOSS AUDIT. Because some taxpayers overstate their casualty loss deductions, the IRS has learned auditing casualty loss claimants is very profitable taxwise.

If you have adequate proof of loss, you have nothing to fear. Your repair cost bills and receipts are excellent evidence to support your casualty loss deduction. But repair estimates alone are usually not enough.

Police reports, photos of the lost or damaged property, and appraisals of before and after values are superb proof of loss.

However, the deductible loss is limited to the taxpayer's adjusted cost basis for the damaged or destroyed property. Market value at the time of loss is irrelevant.

For example, suppose you paid $200,000 for your uninsured vacation cottage. It was worth at least $450,000 when it burned to the ground in 2004. Because your casualty loss is limited to your $200,000 adjusted cost basis, minus 10 percent of your 2004 adjusted gross income, minus the $100 "floor" for each personal casualty loss event, your casualty loss can't exceed $200,000. The actual repair costs exceeding the basis are irrelevant, as is the market value before the fire.

DON'T FORGET TO INCLUDE INDIRECT EXPENSES. In addition to the actual casualty loss expenses, you can also deduct indirect expenses that were not paid by insurance.

Such costs might include temporary housing, moving expenses and property protection, such as board-up and legal expenses.

However, if the property suffering the loss was business or investment property, the full uninsured casualty loss is deductible regardless of amount as a business expense on your income tax Schedule C or E.

WILL FAILURE TO FILE AN INSURANCE CLAIM CUT YOUR CASUALTY LOSS DEDUCTION? Until the last few years, there was little hesitancy for property owners to file insurance claims under their homeowner and business policies.

However, beginning in 2002 and 2003, some insurance companies refused to renew homeowner and rental or business insurance policies, or they greatly increased annual premiums, after policyholders filed claims.

The result has been many policyholders failed to file insurance claims, fearing non-renewal or greatly increased policy rates. So far, there is no evidence the IRS has denied casualty loss deductions for failure to file insurance policy claims.

However, when an insurance claim is filed, and the payment to the insured exceeds the property's adjusted cost basis, if the funds are not used to replace or rebuild, then the taxpayer incurs taxable income on the excess payment amount.

If the insurance payment is for damaged or stolen personal property, the excess insurance money received exceeding the adjusted cost basis is not taxable, even if the items are not replaced.

Taxpayers in federal disaster areas, such as those affected by the recent Florida and Gulf Coast hurricanes, have up to four years to reinvest their insurance payments in repairs or acquire replacement property to avoid owing capital gains tax on their insurance payments.

SUMMARY. When a "sudden, unusual, or unexpected" casualty loss occurs and it exceeds 10 percent of your adjusted gross income, minus a $100 per event "floor," Uncle Sam wants to help out in the form of an income tax deduction. For full details, please consult your tax adviser.

Next week: Big tax benefits of investing in real estate. (1,141 WORDS).