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AVOIDING PITFALLS IN THE PROCESS OF RECOVERY

IF YOU DON'T CONSIDER THESE, YOUR CLIENTS WILL BE AT RISK

Not having adequate experience in *Disaster Recovery Income Tax issues* may expose you and your clients to unintended, costly errors. Awareness of the following Pitfalls and Alerts will reduce your stress during Tax Season.

GENERAL

1. Not recognizing that the disaster will likely be reported over **multiple** tax years could result in costly errors

MAJOR DISASTER DECLARATION

2. In order to take advantage of the Internal Revenue Code's special disaster income tax relief provisions, make sure that a **MAJOR FEDERAL DISASTER DECLARATION** has been issued: **FEMA.gov/Disasters**

PRIMARY "PRINCIPAL" RESIDENCE – REALIZED GAIN – FEDERAL DISASTER AREA

3. Confirm that the property is the "**principal**" residence; see Reg. §1.121-1(b)(2)

4. Internal Revenue Code follows Coverage Categories in Homeowners Insurance Policy

5. Only Structure (Coverage A and B), Scheduled Property, and Contents (Coverage C) are considered for IRC special disaster income tax relief – also endorsements for debris removal, code upgrades, landscaping, and other similar real property endorsements

6. Vehicles, trailers, boats, etc., do not qualify for these special benefits, but are covered under basic rules

7. **Contents** (Primary Residence): Determine the total amount of insurance proceeds received for Contents; do **not** include proceeds for **Scheduled Property** in this total

8. **For Gains Only, Structure** (Primary Residence) and **Scheduled Property** are considered a "Single Item of Property" for determination of **cost basis** and **proceeds**

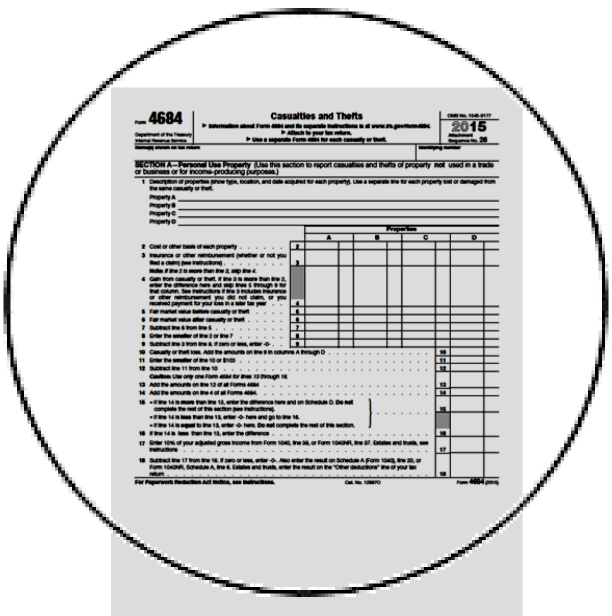
9. **"Qualified Replacement Property"** Proceeds for **Structure & Scheduled Property** may be invested in:
   a. **Personal Use** Real Estate
   b. **Scheduled** Property
   c. **Contents** (independent of proceeds received for Contents)

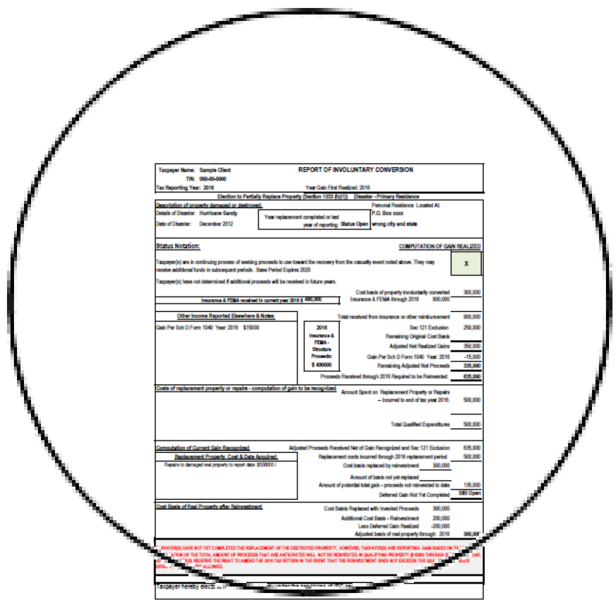
GATHER FACTS

FORM 4684 - CASUALTIES AND THEFTS

§165 Casualty Losses and Gains

§1033 Involuntary Conversion Deferred Gains





10. Be aware of the type of loss when using Form 4684
    a. Personal Losses are reported on page 1
    b. Commercial or Investment Property Losses on page 2

11. Determine if there is a "tax-deductible loss" or a "realized gain" Determine the possibility of future proceeds being received which could change a loss into a gain
    a. Are total "Insurance" Proceeds—received and expected—greater than the cost basis?
    b. If "Insurance" Proceeds are greater, this eliminates the possibility of a loss
    c.

AVOIDING PITFALLS IN THE PROCESS OF RECOVERY

If you don't think about these, your client could be impacted negatively

Case:		A1	A2	A3	A4
Cost Basis	2	176	176	176	126
Insurance	3	30	150	150	150
Gain	4	-	-	-	24
Value before loss	5	130	130	300	
Value after loss	6	0	0	120	
Loss – (Economic) Line 5 less line 6	7	130	130	180	
Loss– smaller of line 2 or line 7	8	130	130	176	
Subtract line 3 from line 8, if zero or less, enter zero -LOSS	9	100	-0-	26	

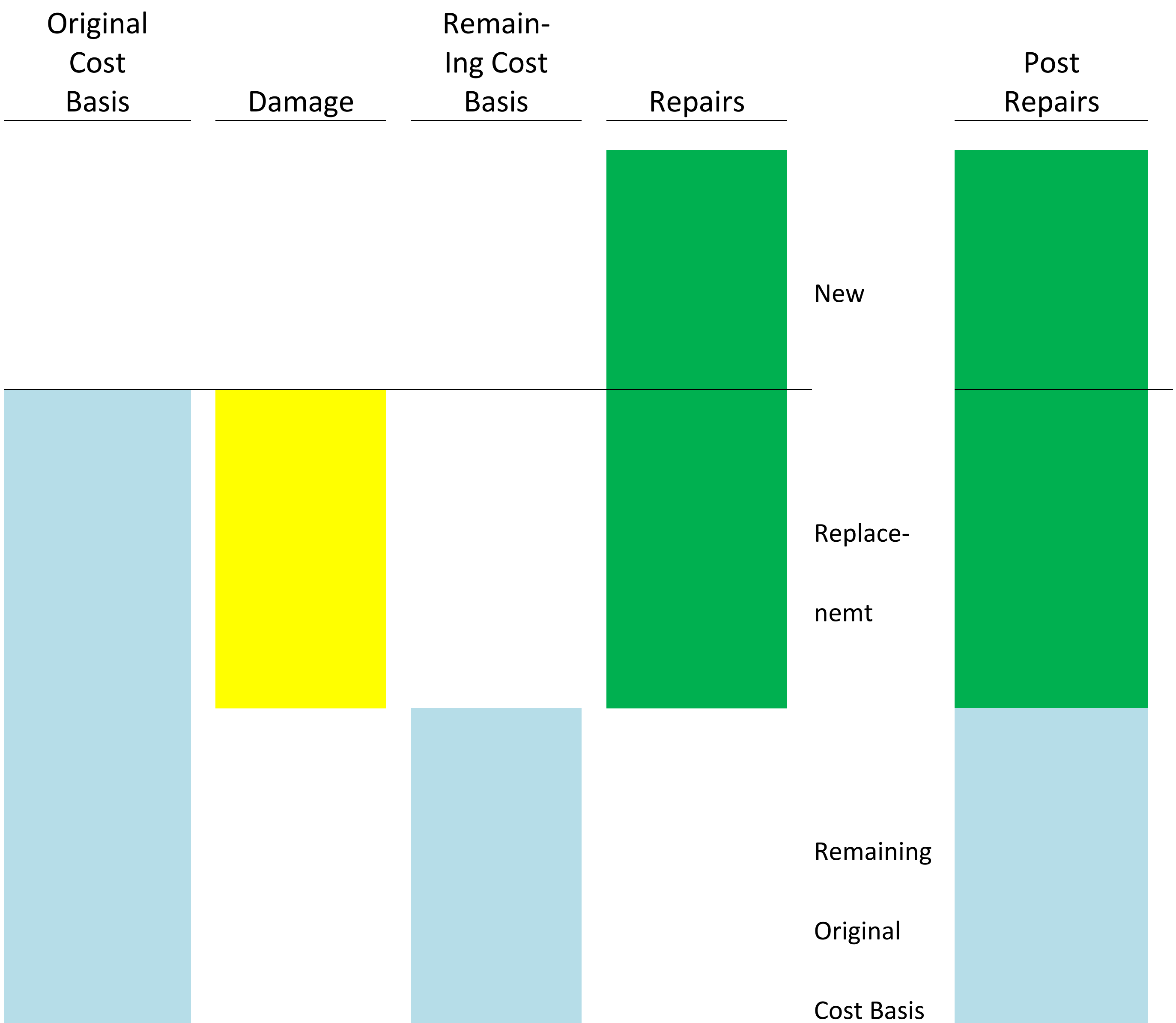
12. **Line 2, Cost or other basis of property**

    Understand the different ways to compute cost basis for each asset

    a. **Real Property**:
        i. Personal Use Property – "**Integral Nature**" (Primary Residence, Second Home, Vacation Home)
        ii. Commercial and Investment Property – "**Single Identifiable Property**"
        iii. Mixed Use – part personal, part commercial / investment
    b. **Other Property** – Personal Property, Furniture, Fixtures, Vehicles, etc.
    c. For business and investment property, accumulated depreciation may generate a realized gain

13. **Line 3, Insurance Proceeds or Other Reimbursement**
    a. **Insurance Proceeds –** Separate the proceeds by Insurance Coverage Categories
        i. Report each category of Insurance Proceeds in separate Columns of Form 4684, proceeds reported on Line 3 must relate to the cost of the related item on Line 2
        ii. Inspect insurance payment documentation for multiple Insurance Coverage Categories on one check
    b. **"Quasi" Proceeds** are funds received to compensate the taxpayer for actual property loss, but are not paid under the terms of a property and casualty insurance policy, these payments may be made by FEMA, non-profit organizations, employers, or even relatives

14. **Other Cash Received that is not reportable on Line 3:**
    a. Funds received for "general health & welfare," and not to compensate the taxpayer for actual property loss, possible sources include Grants from FEMA, non-profits, employers, or even relatives – IRC §139
    b. SBA Loans

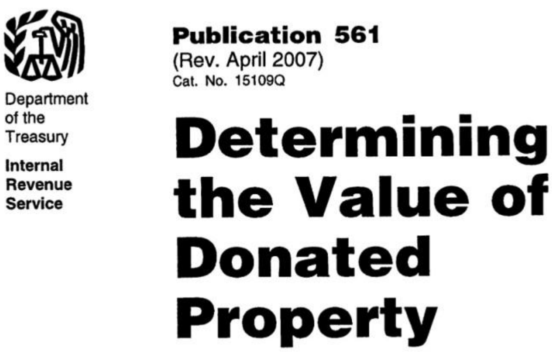


FORM 4684 - DETERMINING A LOSS (OR NO LOSS)

15. **Lines 5 & 6,** Insurance proceeds that are less than the cost basis does not necessarily mean taxpayer has a deductible loss
    a. If proceeds received are less than the cost basis, there **may be** a deductible loss, to determine if there is a deductible loss, the difference between fair market value **before** and **after** the loss must be computed

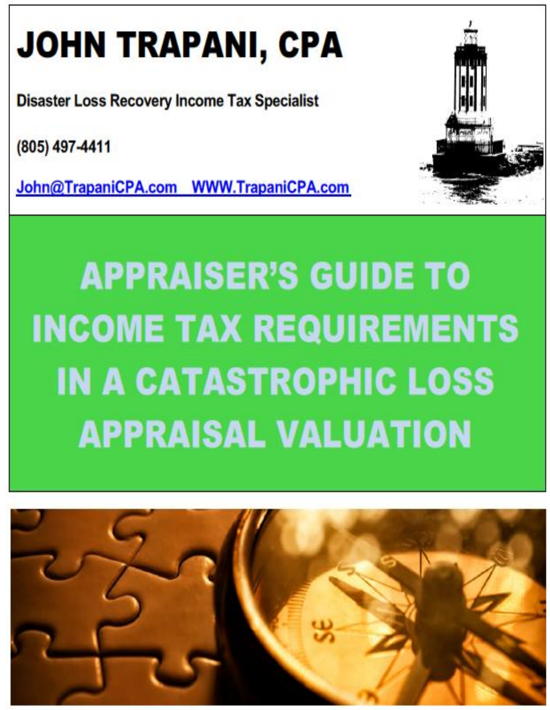
b. What is the meaning of "Immediately Before" and "Immediately After" the (economic) loss?
c. Identify the advantages and disadvantages of the available Valuation Methods:
   i. **Appraisal Method**
   ii. **Safe Harbor Methods** (Rev. Proc. 2018-08 and -09)
   iii. **Cost of Repairs Method**

<u>**Appraisal Valuation Method**</u>


Department of the Treasury
Internal Revenue Service

Publication 561
(Rev. April 2007)
Cat. No. 15109Q

Determining the Value of Donated Property



16. **Appraisal Method**:
   a. Need to engage an Appraiser and secure an Appraisal that meets the definitions in IRS Pub. 561
   b. Appraiser Qualifications per IRS Pub. 561 must be acknowledged in the Appraisal
   c. The IRS has many requirements for disaster appraisals that are not compiled in one publication, these requirements are compiled in the ***Appraiser's Guide to Income Tax Requirements in a Catastrophic Loss Appraisal Valuation***

      The most important topics include:
      i. Required Appraiser Disclosure acknowledging that appraisal will be used in preparation of a tax return
      ii. Identifying Impact of Debris on Damaged Property
      iii. Adjustment for "Temporary" Buyer Resistance (TBR)

17. **What Needs a Professional Appraisal vs. a Taxpayer Estimate:**
   a. Real Property: almost always requires appraisal
   b. Items with a fair market value in excess of $5,000 (Pub. 561): potentially requires appraisal
   c. Items with a fair market value less $5,000: taxpayer estimate okay, though avoid "Thrift Store" values

18. **Valuation of Personal Use Real Property**:
   a. Value the whole property as one amount. Do not separate Land and Improvements – "**Integral Nature**"

19. **Valuation of Business & Investment Real Property**:
    a. At minimum, Land and Improvements are each "**Single Identifiable Properties**"

<u>**Safe Harbor Valuation Methods**</u>

20. **Safe Harbor Rules** – **Rev. Proc. 2018-08 and -09** For computing economic loss (difference: Line 5 and Line 6)
    a. May not be appropriate for California losses
    b. Provides no guidance for computing cost (Line 2)
    c. Does not discuss Cohan Rule.

<u>**Cost of Repairs Valuation Method**</u>

21. **Cost of Repairs Method**
    a. No relief from appraisal of property immediately before loss event
    b. Claim Loss on return for year repairs are completed
    c. <u>Actual cost incurred to repair—not Estimate of cost to repair</u>
    d. Only costs required to return property to pre-loss condition are allowed
    e. Actual cost of Debris removal is part of repair cost
       -What about city being reimbursed directly by taxpayers' insurance company for debris removed?
    f. Costs cannot be "excessive"
    g. **Improvements** and **upgrades** are not includable in cost of repairs
    h. **Additions** are not includable in cost of repairs
    i. Cost of repairs cannot exceed fair market value of property before loss event

22. **Comparison of Appraisal vs. Cost of Repair Methods**: There should be no expectation that these methods will produce similar results

FORM 4684 – OTHER ISSUES

23. <u>**Temporary Buyer Resistance**</u> **(TBR)**: if TBR is not considered in the appraisal, then the appraisal will likely be "shredded" by the IRS on examination

24. <u>**Business & Investment Property**</u> **Exception**: If the Improvements are completely destroyed:
    a. Deduct the net adjusted cost basis of the damaged Improvements

b. The Land is still burdened by the residual debris, therefore the Land still needs to be appraised to consider the impact of the debris on the valuation

25. **Who Can Deduct A Loss?** The taxpayer must have a cost basis and be at risk for a loss.

26. **When to Deduct a Loss?** A loss can be deducted only when it has been "SUSTAINED," defined as a loss that has OCCURRED and is SETTLED. If there remains a "reasonable prospect of recovery," the Loss is not settled and thus cannot be deducted

GAINS - DEFERRAL

27. **Primary Personal Residence**: if §121 exclusion applies, deduct exclusion from proceeds, resulting in reducing gain

DISASTERS: GAINS
INVOLUNTARY CONVERSION
GAIN DEFERRAL

*** §1.121-1(b)(2) Defines Primary Residence**

"Involuntary Conversions"
§1033(h)(1)- Special Rules

28. **§121 Exclusion**:
    a. Exclusion does not apply to "Scheduled Property" portion of single item of property
    b. Taxpayer must demonstrate "**Complete Destruction**" which is not defined in the Internal Revenue Code or Regulations
    c. Under the "Unforeseen Circumstances" provision, taxpayer prorates the exclusion where occupancy does not meet §121, 2-year requirement (proration applies to "exclusion," **not** "gain")

29. **Numerous details must be disclosed for Deferral of Involuntary Conversion Gain**
    a. For insurance proceeds and replacement costs, current year amounts and cumulative amounts must be reported in each applicable year

DEFERRAL DISCLOSURE:
For year or years of event and receipt of proceeds, and for each year thereafter **UNTIL REINVESTMENT** is completed or the replacement period (including extensions) has expired, report by tax year and cumulatively, details related to activities occurring in the tax return year for the taxpayer who owns the property damaged (or the taxpayer is leasing and is contractually liable to the owner for the damage): (Separate disclosure for each property – similar to those that would be listed for losses on Form 4684)

IDENTIFICATION 1-5
1. Event identification – including any federal or state disaster declarations,
2. Date(s) of event
3. Statement: "The destruction of [type of property lost] was a direct result of the casualty"
4. City, county and state in which the covered event occurred
5. IRC Section being applied for deferral including an election to defer gain under the applicable IRC
6. **Cost basis of property converted**, identification of "originating property" - include address for real property
7. **Insurance proceeds received** or expected o be received, by year proceeds are received, Less Gain Excluded and, less any "recognized gain" Equals **Net Proceeds realized**
8. Year(s) and amount of **gain realized** – (the gain may be realized in more than one year) – each realization year must be reported

FOR REPLACEMENT PROPERTIES:
9. **Dates of reinvestment** (year of income tax being reporting)
10. **Identification of replacement property**(ies) or repairs, type of property, location, proceeds invested
11. For **last year**:
a. Statement that **"Replacement / Repairs are completed"** and the year of completion
b. **Total cost of Replacement Property** and **Amount Of Deferred Gain**

QUALIFIED REPLACEMENT PROPERTIES

30. **General Rule:** Qualified Replacement Properties can be "Similar or related in service or use to converted property"
    a. Generally a "Functional" test

31. **Any qualified replacement property can be acquired as early as the date of loss.**

32. **Replacing a Primary Personal Residence:** When a primary personal residence is destroyed in a disaster, replacement property does **not** need to be another primary personal residence.
    a. Replacement real property can be any **"Personal –Use Real Estate"** including a primary personal residence, vacation home, or second home. (It cannot be a rental home or commercial building, which has a different function.)
    b. **Scheduled Property.** Note: Scheduled Property does not include vehicles, boats, trailers, airplanes, etc., which are not covered under a homeowner's insurance policy.

c. **Contents.**

OTHER MATTERS

33. **Option to Sell & Buy**: If taxpayer decides to Sell & Buy, benefits are available if specific conditions are met:
    a. For Gain Deferral, "**Complete Destruction**" must be demonstrated
    b. For Gain Deferral, sale must take place within "**Replacement Period**"
    c. To apply unused §121 Gain Exclusion, sale must take place within two years of the date of loss.
34. **Time period to complete qualified replacements – Deferred Gains only**
    a. The Replacement Period **starts** on the **Date of Loss**
    b. The Replacement Period **ends four years** <u>after the end of the **first** year in which a gain is realized</u> on a Primary Residence **destroyed in a disaster**
    c. The Replacement Period **ends two years** <u>after the end of the **first** year in which a gain is realized</u> on a property **other than** a Primary Residence **destroyed in a disaster**
    d. The IRS may extend the time to replace; the extensions are only granted in one-year increments.

35. **Statute of Limitations for Disaster Gains**:
    For disaster gains, all of the years starting with the year of the loss event and ending with the final replacement year remain open until 3 years after the filing date of the tax return for the final replacement year. For example:
    2010 Year of Loss Event
    2016 Final Tax Year that replacements are reported
    8-25-17 Date of filing 2016 Tax Return

    In this example, the statute remains open for <u>all</u> years from 2010 through 2016 until <u>August 25, 2020</u>.

THINGS CAN GET WORSE

36. "**Deemed Election**": Warning—this is not an opportunity

37. **Death** & **Divorce**:
    a. For a taxpayer who realized a gain but died before completing the replacement, any un-invested gain becomes taxable and reportable in the year the gain originally arose
    b. For taxpayers in a community property state who divorce before completing the replacement, the spouses leave the marriage with the responsibility to each reinvest one-half of the proceeds.

38. **Change in Circumstance**:
    a. After reporting a gain and paying the tax, a taxpayer may revoke the election to pay the tax (i.e., recoup the tax paid) in order to reinvest in qualified replacement property if completed within the replacement period. The IRS does not pay interest on these refunds.

b. After initially reporting a loss, a taxpayer receives unexpected, additional proceeds that triggers §111 Recovery of Prior Losses, and results in current ordinary income recognition of the lower of prior losses or new proceeds received

c. If a taxpayer does not reinvest proceeds by the end of the replacement period, then the gain becomes taxable in the year in which it was **realized.** Because **an election to defer a Gain cannot be revoked**, the gain is reported on an **amended** return after the replacement period has expired; the taxpayer also incurs approximately 4 years’ interest.

d. After completing the investment of proceeds from personal-use real property loss, a taxpayer immediately rents out the property, triggering a taxable gain as the property has been converted from personal-use to rental use, and is therefore not a qualified replacement.

ADDITIONAL LIVING EXPENSE - ALE

39. **Additional Living Expense (ALE)**:
    a. The purchase of **temporary** housing is not “additional living expense”; it is an acquisition of a capital asset that results in ALE proceeds becoming taxable
    b. Unexpended ALE proceeds become taxable in the year the taxpayer no longer incurs actual ALE
    c. If the taxpayers decide to make a purchased **temporary** residence their permanent replacement property—and the temporary home was not declared as replacement property—the gain becomes taxable. See 38c.

IRS AND MISCELLANEOUS MATTERS

40. **IRS Matters** – Miscellaneous
    a. “Five Year Rule” on recapture of ordinary losses
    b. Be careful regarding estimated taxes for remainder of the year of event and the year following event year
    c. IRS examiners are prevented from using information during an audit that was unavailable to the taxpayer at the end of the year under examination.

PROPERTY TAXES

41. A taxpayer may decide to acquire replacement property in a county other than the one in which the loss took place. Under Prop. 50 & 171 (R&TC §69 & 69.3), only the following counties allow the transfer-in of the taxpayer’s pre-event Prop. 13 Tax Base:

Contra Costa	Los Angeles	Modoc	Orange	San Francisco
Santa Clara	Solano	Sonoma	Sutter	Ventura

MAJOR FEDERAL DISASTER DECLARATIONS

42. IRC §7508A: “Permitted Delays” are available to taxpayers in disaster area, clients of tax professionals located in disaster area, and taxpayers outside of disaster area connected to properties inside disaster area

43. **Possible Loss Claims on Prior Year Tax Return**:
    New Rules: Reg. §1.165-11T: New extended filing period allowed
    a. New definition of "**Disaster Year**"
    b. Extended time to file return to claim loss on the "**preceding year**."
    c. New Revocation Rule
    d. Pub. 547 Error: In Table 3, When To Deduct a Casualty or Theft Loss, the word ***occurred*** should be ***sustained***
44. **Order to Demolish**: If there is any chance that the municipality might issue an order to demolish "undamaged" improvements, wait for the 120-day period to expire to process any tax return
    a. Once 120-day period expires, Order to Demolish is a new casualty loss claim
    b. For non-disasters, Order to Demolish generates a new casualty in all cases

BUSINESS & INVESTMENT PROPERTY

45. **"2-Year" Replacement Period not "4-year"**

46. New definition of **Qualified Replacement Property** for **Disasters Only**:
    <u>"Tangible property of a type held for productive use in a trade or business"</u>
    a. **Any** business, not just the original business is allowed
    b. **Business** property allowed for reinvestment of **investment** property proceeds
    c. **Investment** property allowed for reinvestment of **investment** property proceeds. Simply use non-disaster general replacement rule.

47. All decisions and all reporting take place **within the entity** that experienced the event

48. **Inventory:**
    a. Be careful to replace LIFO base before end of taxable year
    b. Loss can be claimed through cost of sales. If reporting loss in a manner other than through cost of sales, adjust beginning inventory.

49. **Passive Activities**
    a. Casualty **Losses** are not passive activities: claim loss on Form 4684, no impact on suspended passive losses
    b. Casualty **Gains** are not passive activities: report as a gain on Form 4797 or defer without any impact on suspended passive losses

50. **Reimbursements for Loss of Income, Loss of Rents, and Extra Expense for Business and Investment Property:**
    a. Always taxable
    b. Grants related to business and investment property are almost always taxable

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If you don't think about these, your client could be impacted negatively

Notes: