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AEE318
1976
(no designated month)

The Farmers' Tax Option as a Consequnce of the Teton Dam

by

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The Internal Revenue Service allows losses resulting from physical damage to property to be itemized and deducted as casualty losses - subject to a number of rules limiting its application. The major IRS rules pertaining to the Teton Dam disaster are reviewed below as a general guide for preparing the farmer to talk to his accountant or attorney.

What Type of Loss is Deductible?

To be deductible the loss must be physical damage and be caused by the flood itself. Depreciation in value because property is near the flood area or because of damage to complementary or related business or property located nearby is not a deductible casualty loss. Such a loss is not deductible because there is no physical damage to the property in question.

Who May Deduct the Casualty Loss?

Only the taxpayer who actually sustained the loss may deduct the loss on his tax return.

Buyer and Seller: For either real or personal property being sold under a contract of sale, the question of who sustains the casualty loss will normally be determined by the provisions of the contract of sale and applicable Idaho law determining which party bears the risk of loss.

Husband and Wife: If a joint return is filed it does not matter which spouse owned the destroyed property and the total loss may be deducted.

A. E. Extension Series No. 318.

When separate returns are filed each spouse may only deduct for the loss to the extent that he or she owned the property destroyed. If the property is commumity property and separate returns are filed, each spouse can claim a separate deduction only to the extent of his or her community interest.

Stockholder-Corporation: A sole stockholder whose corporation becomes worthless because of a casualty loss is not entitled to a casualty loss deduction for the amount of his investment. The casualty loss belongs to the corporation and the stockholder will have only a capital loss on his stock loss.

Landlord-Tenant: Normally a tenant will not be able to deduct a casualty loss because of the rule denying deduction where the taxpayer has no basis in the property. However, a tenant who has made leasehold improvements would be entitled to a deduction for the improvements. Furthermore, if the tenant was obligated under the terms of the lease to repair the property and return it to the landlord in good condition, the Treasury has allowed the tenant to claim a casualty loss to the extent of his obligation under the lease agreement.

What Expenses May be Deducted?

Normally expenses incident to a casualty loss are not deductible. These include such items as the cost of temporary utilities or fuel, moving expenses, or rental of temporary quarters. This Treasury position is based upon the theory that the casualty loss deduction extends only to losses to property and not to personal expenses resulting from a casualty.

However, under certain circumstances clean-up expenses have been allowed as a casualty loss deduction on the theory that clean-up expenses are an acceptable method of determining the cost of replacement of the property

or as a measure of the loss. Thus, deductions have been allowed for the actual cost of clearing away debris.

How Much Can be Deducted?

The amount of the casualty loss incurred in a business or transaction entered into for profit is the lesser of the following:

1. The difference in the fair market value of the property immediately before and immediately after the casualty, or
2. The adjusted basis for determining loss from the sale or other disposition of the property.

This amount, reduced by salvage value, insurance, and any reimbursement is the deductible casualty loss.

The amount of the casualty loss incurred to property held for personal use is the lesser of the following:

1. The difference in the fair market value of the property immediately before and immediately after the causalty, or
2. The adjusted basis for determining loss from the sale or other disposition of the property.

This amount is reduced by a $100 floor and by the amount of any insurance or other reimbursement.

The $100 floor applies to each casualty and therefore each taxpayer having flood disaster losses will have only $100 floor offset. Where property is held for both business and personal use, the $100 floor applies only to the personal part of the loss.

How Can the Value of the Loss be Determined?

The taxpayer must offer proof of the decline in the value of the property by showing the value immediately before the casualty and immediately after

the casualty. This determination is not necessary for business or for-profit property that is totally destroyed, inasmuch as the taxpayer merely deducts the adjusted basis in such situations, regardless of whether the fair market value is less than the adjusted basis. In all other situations, the valuation procedure is of significance.

The most acceptable method of determining the values is the use of competent appraisers. Where substantial losses are involved, the taxpayer should consider obtaining appraisals. However, the courts have accepted the following evidence to determine the values: 1) evidence of the original cost and condition of clothing and personal effects; 2) original cost less depreciation for household furniture and furnishings; 3) the sales price of property after the casualty; 4) costs of repairing, replacing, or cleaning up after the casualty may be used as a measure of the decline in value if actually made.

The Regulation dealing with repairs provides that the cost of repairs is acceptable evidence of the loss of value if the taxpayer shows that: 1) the repairs are necessary to restore the property to its condition immediately before the casualty; 2) the amount spent for repairs is not excessive; 3) the repairs are not greater than the damage actually suffered; 4) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.

What is the Effect of Insurance or Other Compensation Claims on Allowable Casualty Loss Claims?

The amount of the casualty loss is reduced by any insurance or other compensation received which compensates for the property actually destroyed. Costs of presenting or collecting a claim for insurance or compensation reduce

the amount of the recovery and to that extent increase the loss.

Generally, amounts received from a governmental or disaster relief agency specifically to restore property damaged by casualty reduce the loss. Cancellation of an unsecured disaster loan, a flood disaster loan, a small business or farmers home loan, or the receipt of debris removal reimbursement will all reduce the loss. However, cash payments without limitation or directive as to the use of the funds or disaster relief, such as food, medical supplies, food stamps, etc. do not reduce the casualty loss.

If after deducting a casualty loss the taxpayer receives insurance or other compensation for the loss, the taxpayer must include the reimbursement in income for the taxable year received.

When Can the Deduction for a Disaster Loss be Taken?

A taxpayer who incurs a casualty loss resulting from a disaster occurring in an area designated by the President of the United States as a disaster relief area, may elect to deduct the casualty loss either: 1) in the taxable year in which the disaster occurred, or 2) in the taxable year immediately preceding the taxable year in which the disaster occurred. If the election is made for the preceding year, then the casualty loss is treated as "sustained" in that year. The election does not affect the amount deductible or the method of determining the casualty loss.

The advantage of electing the earlier year is that the taxpayer can immediately file for a refund for the year in question and even produce an immediate net loss carryback for other years. The disadvantage is that the earlier year may have been a lower tax bracket year for the taxpayer than the current year. Thus, the taxpayer should check his estimated tax brackets before making the election.

The election is made by filing a return, amended return, or refund claim. An election to deduct the loss on the early year's return must be made on or before the later of (1) the regular due date for the disaster year return without regard to extensions, or (2) the due date for the return for the previous year with permitted extensions taken into account. Taxpayers may change their minds within 90 days after making the election, but after 90 days the election is irrevocable. Taxpayers should clearly mark the returns or amended returns "TETON FLOOD DISASTER" to expedite handling by IRS.

If the casualty loss produces a net operating loss in the year of deduction, the net operating loss may be carried back up to three years and carried forward up to five years, thus producing additional tax refunds.

How Can a Taxable Gain on Government Reimbursements be Avoided?

With strong possibilities of full reimbursement being made by the Federal government for flood losses, flood victims are perhaps more likely to have an involuntary conversion of property than a casualty loss. Ordinarily, the receipt of insurance or other compensation for property involuntarily destroyed results in a taxable gain if the reimbursement exceeds the adjusted basis of the property. However, the taxpayer may eliminate all or a portion of the gain by electing to replace the property in accordance with existing rules and regulations.

1. Existence of Involuntary Conversion

Flood damage to both personal and real property and damage to land or mineral rights qualifies for involuntary conversion benefits. Either business or personal use property qualifies.

2. Time of Replacement

The time of replacement begins with the date of the destruction of the

property and (unless extended) ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized. The time for replacement may be extended by the District Director if the taxpayer can show reasonable cause for his inability to replace the property within the required time period.

3. Replacement with Similar Property

A taxable gain is recognized only where the destroyed property is replaced with property similar or related in service or use. This is commonly known as the "function use" test and requires that while the replacement property need not be a physical duplication of the converted property, it must have the same general characteristics. The taxpayer should be very careful that the replacement property qualifies. He should obtain a private ruling from the IRS before replacement is begun.

How Can Recapture of Investment Credit and Depreciation be Avoided?

If property upon which investment credit has been taken is disposed of or ceases to be eligible before the end of its estimated useful life, the investment credit must be recomputed using the actual useful life. Thus, the involuntary conversion of qualified investment credit properties by the flood disaster will result in recapture of investment credit. However, if insurance or reimbursement funds are reinvested in qualified property, then the replacement property will itself be eligible for the investment credit.

The farmer or businessman who has suffered significant machinery and equipment losses in the Teton Dam Flood must be alert to the recapture problems of the involuntary conversion of his properties. He must make a prompt replacement of these properties before the end of his fiscal year, or he may be required to pay substantial additional taxes by reason of the conversion.

Where Can Additional Information be Obtained?

Additional information relating to the tax implications of the Teton Dam disaster may be obtained from your attorney, certified public accountant or the local Internal Revenue Service office. Internal Revenue Service Publication No. 547, Tax Information on Disasters, Casualty Losses, and Thefts can be obtained from the local IRS office and should provide additional useful information.

The potential cost of making the "wrong" decisions can be quite substantial. Thus, qualified tax advice should be obtained before undertaking any major reinvestment or rebuilding program.