



## The Impact of Natural Disasters on Your Taxes

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Natural disasters occur every year, impacting both individuals and businesses. If you or your business have experienced a disaster-related loss, you might have a tax deduction or an unexpected gain!

### *Deductions for Personal Casualty Losses*

You may be wondering, what exactly is a casualty loss? It's when the fair market value of your property is reduced or eliminated by a hurricane, flood, fire, earthquake, volcanic eruption, theft, vandalism, etc. The Internal Revenue Code contains provisions that allow you to claim an itemized deduction for personal casualty losses not covered by your insurance.

However, many victims of natural disasters won't qualify for the deduction due to two restrictions imposed by the IRS. The first restriction requires that you reduce your loss by \$100. The second restriction requires that you further reduce your loss by 10% of your adjusted gross income for the year. For example, you have a \$15,000 personal casualty loss during the year and your adjusted gross income is \$100,000. Your deduction is \$4,900 (\$15,000 - \$100 - \$10,000). Keep in mind that, in the facts described, you get no tax deduction if your loss is \$10,100 or less. In addition, you get no deduction if you don't itemize your deductions.

What if my loss was caused by a disaster in a federally declared disaster area? A special IRS rule allows you to choose between claiming the deduction on this year's return or last year's return. If you already filed your 2010 tax return, you can file an amended return to claim the loss. If you extended your 2010 tax return, you can claim the loss on your original 2010 return. As a result, this rule provides immediate tax relief as opposed to waiting until 2012 when you file your 2011 income tax return.

### *Deductions for Business Casualty Losses*

If your business incurred a disaster-related loss, you can deduct the full amount of any uninsured loss as a business expense.

### *Casualty Losses Resulting in Taxable Gains*

Did you have a personal or business casualty loss for which you received insurance proceeds? If so, did the insurance proceeds exceed the tax basis of the damaged property? If you answered yes to both questions, you may have a taxable gain called an involuntary conversion gain.

The involuntary conversion gain must be reported on your tax return unless you do the following: 1) restore the property to its original condition or purchase property that is similar or related in service or use to the original property in an amount greater than or equal to the insurance proceeds and 2) make a tax election to defer the gain. If you make the election (the general rule is that you should), then you have a taxable gain only to the extent that the insurance proceeds exceed the amount you spend to restore or replace the property. The expenditures must generally occur within the period beginning on the date the property was damaged or destroyed and ending two years after the close of the tax year in which you had the involuntary conversion gain.

However, no gain is recognized if property held for use in a business is involuntarily converted as a result of being in a federally declared disaster area and is replaced with property to be used in a business. In addition, the gain is deferred even if the replacement property is not similar-use. For example, your restaurant is destroyed by a hurricane in a federally declared disaster area. You decide not to reopen the restaurant and use the insurance proceeds to purchase a hardware store. You would recognize no gain on the transaction because the new property is business property. Additionally, the IRS can, and often does, extend the deadline for replacing damaged or destroyed property in federally declared disaster areas.

If your principal residence is located in a federally declared disaster area and is involuntarily converted, you can elect to recognize gain only to the extent that the funds exceed the cost of replacing your residence and its contents. A four-year replacement period is available for a principal residence or any of its contents located in a federally declared disaster area.

For a state-by-state listing of federally declared disaster areas, visit the Federal Emergency Management Agency website at [www.fema.gov](http://www.fema.gov), or the IRS website at [www.irs.gov](http://www.irs.gov).

*Helpful Hint:* Taxpayers must be able to substantiate claimed casualty losses. Be sure to obtain/retain receipts for purchases of damaged property, appraisal reports, etc. Photographs of property damage can also provide valuable documentation.