CHAPTER 8

DAMAGED, DESTROYED, OR STOLEN PROPERTY

SYNPOSIS (click on section title to go directly there)

Introduction

After their property is damaged, destroyed, or stolen, many taxpayers are surprised to learn that their economic loss is not a tax-deductible loss. This occurs in either of the following circumstances:

- The taxpayer does not have an income tax basis in the property, or
- The taxpayer is reimbursed for the loss (by insurance or other compensation) in an amount that is equal to or greater than the taxpayer's income tax basis in the property.

If a reimbursement exceeds the property's income tax basis, the taxpayer has a gain that must be reported on the income tax return.

The tax rules for these gains and losses are explained thoroughly in the publications listed in the following cross-reference. This chapter explains some of the basic rules and some planning opportunities for taxpayers whose property is damaged, destroyed, or stolen, but it does not provide a detailed explanation of these complex rules.

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Cross-Reference

IRS publications that explain the tax rules for damaged, destroyed, and stolen property are:

- IRS Publication 547, *Casualties , Disasters, and Thefts*
- IRS Publication 584, *Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)*
- IRS Publication 584-B, *Business Casualty, Disaster, and Theft Loss Workbook*
- IRS Publication 225, *Farmer's Tax Guide* (Chapter 11 in the 2010 edition)

IRS Form 4684, Casualties and Thefts, and its instructions are also very helpful in calculating the tax consequences for damaged, destroyed, and stolen property.

General Rules

When property is damaged, destroyed, or stolen, the owner suffers an economic loss unless the loss is fully reimbursed by insurance or other compensation. The damage, destruction, or theft may result in a tax loss or a tax gain, depending on whether the compensation is less than or greater than the property owner's income tax basis in the property.

Example 8.1 Casualty Gain or Loss

Rose Petal's cow was struck by lightning and killed. The cow was worth $700, and Rose's insurance company compensated her for $500 of the loss. Therefore, Rose's economic loss is $200 ($700 – $500). However, Rose had deducted all the costs of raising the cow, so she had a zero income tax basis in it. Consequently, Rose had a $500 ($500 – $0) tax gain.

Casualty and Theft Losses

The Internal Revenue Code gives taxpayers more favorable treatment of casualty and theft losses than of other losses.

Personal-Use Property

If the property's use is for **personal purposes**, one favorable treatment is allowing part of the loss to be included as an itemized deduction on Schedule A (Form 1040), Itemized Deductions. By contrast, losses of personal use property that are **not** due to a casualty or theft are not deductible. Two reductions apply to personal casualty or theft losses—$100 per loss event and a 10% of adjusted gross income (AGI) subtraction from the total of all such losses.

Example 8.2 Loss on Personal-Use Property

Pedro Gonzales' exotic pet bird was killed by a cat. The bird was worth $10,000 and Pedro's insurance company compensated him for $7,000 of the loss. Pedro paid $12,000 when he purchased the bird and therefore realized a $5,000 ($12,000 – $7,000) loss for income tax purposes. Because the bird's death was a casualty (it was sudden and unexpected), the loss may be included as an itemized deduction on Pedro's income tax return after subtracting $100 and 10% of his AGI from the $5,000. If the bird had died from natural causes, Pedro could not deduct any of his loss.

The acceleration of a disaster-area casualty loss deduction that is explained in the next section also applies to disaster losses incurred on personal-use property.

Business-Use Property

If the property's use is for **business purposes** and the loss occurred in a federally declared disaster area, the taxpayer may elect to deduct the loss in the tax year preceding the disaster. By contrast, losses that are **not** due to a federally declared disaster must be deducted in the year the loss occurred unless there is a reasonable likelihood the loss will be reimbursed. If there is a reasonable likelihood that part or all of the loss will be reimbursed, the deduction is deferred (to the extent of the likely reimbursement) until the tax year it becomes reasonably unlikely that it will be reimbursed.

The $100 and 10% of AGI reductions do not apply to business property losses.

Casualty

For federal income tax purposes, a **casualty** is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. For example, damage to shingles caused by a hailstorm is a casualty loss, but gradual damage to shingles by the sun over several years is not a casualty.

Loss of property due to progressive deterioration is not deductible as a casualty loss because the damage results from a steadily operating cause or normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration rather than from a sudden, unexpected, or unusual event:

- Gradual weakening of a building due to normal wind and weather conditions.
- Deterioration and damage to a water heater that has burst. However, rust and water damage to rugs and drapes caused by the bursting of a water heater does qualify as a casualty.
- Most losses of property caused by a drought. To be deductible, a drought-related loss must be incurred in a trade or business or in a transaction entered into for profit.
- Damage or destruction of trees, shrubs, or other plants by fungus, disease, insects, worms, or similar pests. However, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.

Theft

A **theft** is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred, and it must have been done with criminal intent.

Theft losses are calculated in the same manner as casualty losses, but the loss is reported in the year that the taxpayer discovers the theft.

Example 8.3 Theft Loss

Thieves removed irrigation pipe from Lemon Lime's orchard. The fair market value of the missing pipe was $5,000 and Lemon's income tax basis in the missing pipe was $3,000. Lemon did not have any insurance coverage.

Lemon's casualty loss for tax purposes is limited to the $3,000 income tax basis in the asset.

Casualty and Theft Gains

The tax law also treats gains that result from a casualty or theft favorably by treating them as resulting from an involuntary conversion of the property. This allows the taxpayer to avoid recognizing the gain if he or she reinvests the insurance proceeds or other compensation in replacement property. The unrecognized gain is deferred by reducing the taxpayer's basis in the replacement property. Therefore, a subsequent taxable transfer of the property causes the taxpayer to recognize the gain.

Cross-Reference

See the discussion of postponing gain on pages 69-71 of IRS Publication 225, *Farmer's Tax Guide (2010),* for more information on involuntary conversions.

Example 8.4 Deferring Casualty Gain

Rose Petal, from Example 8.1, may elect to defer the $500 gain from her cow that was killed by lightning if she buys a replacement cow that costs $500 or more by the end of the second tax year following the year the cow was killed. The entire insurance payment must be reinvested to postpone all of the gain.

Tax Management of Damaged, Destroyed, or Stolen Property

Although the tax benefits are often less than a taxpayer anticipates, there are tax-planning opportunities when property is damaged, destroyed, or stolen.

Deferring Recognition of Gain

As noted in the previous section, property that is damaged, destroyed, or stolen is eligible for the involuntary conversion rules. An involuntary conversion does not have to result from a casualty. Therefore, the destruction could be due to progressive deterioration. If the taxpayer receives compensation for the damaged or destroyed property that results in a gain, the taxpayer may elect to defer recognition of the gain if he or she reinvests the compensation in similar property by the end of the second tax year after the damage, destruction or theft.

✔ **Observation**

Rules Less Restrictive than Like-kind Exchange Rules

Although the involuntary conversion rules are similar to the like-kind exchange rules, some differences make the involuntary conversion rules more taxpayer-friendly. A broader range of property often qualifies as replacement property in an involuntary conversion than under the like-kind exchange rules. (However, for some involuntary conversions, a narrower range of property qualifies as replacement property than under the like-kind exchange rules.) A second difference is that a taxpayer may take possession of the compensation for the converted property under the involuntary conversion rules before acquiring the replacement property. By contrast, a taxpayer can defer gain under the like-kind exchange rules only if the proceeds from the relinquished property are held by a qualified intermediary until they are used to acquire the replacement property.

Example 8.5 Deferred Gain

Amanda Reckonwith owns farmland by a river that floods regularly. Amanda paid $1,000 per acre for the land in 1975. In 2011, a flood washed out a levee, and 10 acres of her land are now under water. Instead of rebuilding the levee, the government bought the 10 acres from Amanda for $3,000 per acre.

Amanda has realized a $2,000 ($3,000 – $1,000) per acre gain from this involuntary conversion of her land. If she does not replace the land, she must recognize $20,000 ($2,000 × 10 acres) of long-term capital gain in 2011. The federal income tax rate on her long-term capital gain is 15%, and her state income tax marginal rate on her long-term capital gain is 5%. Therefore, Amanda must pay $4,000 ($20,000 × 20%) income tax on the gain if she does not acquire replacement property timely.

If Amanda pays at least $30,000 for replacement land, regardless of total acreage, she can defer recognition of the gain by rolling it into the replacement land. For example, she can defer the gain if she buys 25 acres of land for $50,000 ($2,000 per acre). Her basis in the replacement 25 acres will be her $10,000 ($1,000 × 10 acres) basis in the flooded land, plus the $20,000 excess she paid for the replacement land over the $30,000 she received for the flooded land. Therefore, her basis in the replacement land is $30,000 ($10,000 + $20,000). If she later sells the replacement land for $50,000, she will then recognize the $20,000 gain that was deferred from the 10 acres the government bought from her.

Depreciable Replacement Property

If replacement property is depreciable, it is often more advantageous to **not** defer gain from involuntarily converted property. By not deferring the gain, the taxpayer acquires a higher income tax basis in the replacement property. The depreciation or I.R.C. § 179 deduction for that higher basis reduces not only ordinary income but also self-employment income. By contrast, the gain that is recognized increases only ordinary income or capital gains and does not increase self-employment income.

Cross-Reference

See the discussion of self-employment tax in Chapter 6 of this guide.

Example 8.6 Depreciable Replacement Property

Allen Rentch's tractor caught on fire in 2011 and was damaged beyond repair. The loss was insured, and his insurance company paid him the tractor's $5,000 fair market value. Allen had depreciated his original $12,000 basis of the tractor down to zero, so he realized a $5,000 tax gain from the tractor's loss.

- If Allen does not elect to defer the gain he must report $5,000 of ordinary income (depreciation recapture) on his 2011 income tax return. Allen is in the 15% federal marginal income tax bracket and a 5% state marginal income tax bracket. Therefore, recognizing the gain adds $1,000 ($5,000 × 20%) to his 2011 income tax liability.
- If Allen pays $5,000 for a used replacement tractor and elects to defer the gain on the destroyed tractor, he has no gain to report in 2011 and has a zero basis in the replacement tractor. If he sells the replacement tractor in 2015 for $5,000, he must report $5,000 of ordinary income in 2015. If his marginal tax rates are the same as in 2011, he will pay an additional $1,000 of income tax for 2015 due to the sale of the tractor. Therefore, his tax liability is the same, but he has postponed paying the $1,000 of taxes for 5 years.
- If Allen pays $5,000 for a used replacement tractor and **does not** elect to defer the gain on the destroyed tractor, he must report the $5,000 of gain in 2011. However, if he has not used up his $500,000 I.R.C. § 179 deduction for 2011 on other property, he can elect to deduct the entire $5,000 cost of the replacement tractor in 2011. That deduction offsets his entire $5,000 gain from the destroyed tractor. It also reduces his self-employment income for 2011, which saves him $614 ($5,000 × 92.35% × 13.3%) of self-employment tax. The self-employment tax savings reduces his self-employment tax deduction from ordinary income by $307 ($614 × 50%), which adds $46 ($307 × 20%) to his income taxes. Therefore, the net tax savings is $568 ($614 – $46).

  If Allen has used his I.R.C. § 179 deduction on other property, he can depreciate the $5,000 he paid for the used replacement tractor over 8 tax years (7-year property with a half-year convention). The used tractor does not qualify for additional first-year depreciation because its original use did not begin with Allen. The depreciation deductions will reduce his ordinary income and self-employment income by a total of $5,000 over the 8 years. Therefore, by not electing to defer the gain on his destroyed tractor, Allen has accelerated $1,000 of taxes into 2011 but will save $1,635 of taxes over the 8 years. Using a 6% discount rate, the present value of the $1,635 of tax savings over the 8 years is $1,374. Therefore, the net value of Allen's tax savings over the 8 years is $374 ($1,374 – $1,000) and even without the I.R.C. § 179 deduction, Allen is better off **not** electing to defer the gain from the destroyed tractor.

Planning Pointer

Capital Gain on Converted Property

If the gain on the converted property is capital gain and the replacement property can be depreciated, it is even more advantageous to include the gain in income rather than deferring it. For example, if in Example 8.6, Allen lost five raised cows held for more than a 24 months and realized the same $5,000 gain, the gain would be long-term capital gain, and the federal income tax rate on that gain is zero in 2011. Assuming a 5% state income tax rate on long-term capital gain, Allen would owe only $250 ($5,000 × 5%) of income tax on the realized gain if he did not defer that gain. His $5,000 basis in replacement cows would reduce his income and self-employment taxes by the same $1,635 as in Example 8.6.

Effect on Netting of Gains and Losses

The tax rules allow taxpayers to deduct a net loss from certain property they use in a trade or business from ordinary income but to treat a net gain from that property as a capital gain. For example, if a farmer has a $10,000 gain from selling cull cows and a $12,000 loss from selling machinery in 2011, the net $2,000 loss is deducted from ordinary income. If the loss on the machinery is only $7,000, the $3,000 net gain is taxed as capital gain.

If a taxpayer has a net gain from damaged, destroyed, or stolen property during a tax year, that net gain is included in the netting of gains and losses from property used in a trade or business. However, if a taxpayer has a net loss from damaged, destroyed, or stolen property, that net loss is deducted from ordinary income without netting it with the gains and losses from property used in a trade or business.The effect of these rules is the following. If a taxpayer has a net gain from damaged, destroyed, and stolen property and also has a net gain from assets used in the trade or business, the losses from damaged, destroyed, or stolen property just reduce gain that is taxed as capital gain. By contrast, if a taxpayer has a net loss from damaged, destroyed, or stolen property, that net loss reduces ordinary income.

Electing to defer gain from damaged, destroyed, or stolen property preserves the benefits of deducting a loss from other property in the same tax year.

Example 8.7 Preserving Ordinary Deduction

A tornado completely destroyed Braxton Bovine's barn on August 29, 2011, killing the 20 dairy cows that were in the barn. Figure 8.1 shows information from Braxton's records regarding the barn and the cows.

Figure 8.1 Braxton Bovine's Records

Item	Barn	20 Dairy Cows
Purchase date	May 15, 1990	August 20, 2007
Cost	$35,000	$20,000
Depreciation claimed	– 35,000[1]	– 13,336[2]
Adjusted basis	$0	$6,664
FMV before casualty	$ 35,000	$ 17,000
Insurance payment	$ 30,000	0
Gain or loss	$ 30,000	- $6,664

[1] 150% declining balance for 20-year property

[2] 150% declining balance for 5-year property, half-year convention

If Braxton does not elect to roll the gain from the barn into a replacement barn, the $6,664 loss from the cows reduces the $30,000 gain from the barn, so that Braxton reports only the $23,336 ($30,000 – $6,664) remaining gain as long-term capital gain. His other ordinary income is not reduced by the loss.

If Braxton elects to roll the gain from the barn into a replacement barn, the $6,664 loss from the cows offsets ordinary income in 2011 rather than capital gain on the barn.

Accelerating a Loss Deduction

If a disaster caused your area to be eligible for federal assistance, you can elect to deduct the loss on your original or amended return for the tax year immediately preceding the tax year in which the disaster occurred. There are two potential advantages of making this election:

1. Accelerating the deduction may allow you to realize the tax savings earlier.
2. Accelerating the deduction may offset income in a higher tax bracket.

Example 8.8 Earlier Tax Savings

The roof on Paige Turner's barn collapsed under the weight of ice from a January 2011 ice storm that caused her county to be declared a federal disaster area. Paige files her income tax return on a calendar-year basis. Because she qualifies as a farmer, she avoids the penalty for not making estimated tax payments by filing her return and paying her taxes before March 1 each year. The barn was not insured, and her income tax basis in it was $10,000. Therefore, Paige realized a $10,000 loss that she can deduct on her 2011 income tax return.

Paige can elect to accelerate the deduction by claiming the $10,000 loss on her 2010 tax return. If she is in the same income tax brackets in 2010 and 2011, she will realize the same tax benefit on either income tax return. However, by claiming the deduction on her 2010 income tax return, Paige will realize the tax savings when she files the 2010 income tax return and pays her taxes in February 2011 rather than when she files her 2011income tax return and pays her taxes in February 2012.

In many cases, the disaster that caused the tax loss also reduces income for the tax year. Consequently, taxable income in the year preceding the loss year may be in a higher tax bracket than in the year of the disaster. If that is the case, accelerating the tax deduction results in a larger tax savings from the deduction.

Example 8.9 Greater Tax Savings

The ice storm in Example 8.8 also suffocated most of Paige's alfalfa crop, which reduced her 2011 income substantially. As a result, her taxable income for 2011 is in the 15% federal income tax bracket. In 2010, her taxable income was in the 25% federal income tax bracket.

By electing to deduct the $10,000 loss on her 2010 income tax return, Paige increased the income tax savings from the deduction from $1,500 (15% of $10,000) to $2,500 (25% of $10,000).

Summary

Many taxpayers are surprised to learn that losing property in casualties, thefts, or disasters often does not result in the deductible income tax loss they expected. However, special income tax provisions provide some tax advantages. These provisions may allow taxpayers to postpone reporting taxable gain or to accelerate reporting tax losses. Making optimal use of these special provisions can take some of the economic sting out the unexpected loss of property.