JACKSON HEWITT®
TAX SERVICE

2011 Handling Tax Situations for Casualties, Thefts, & Disasters

Participant's Manual

Prepared by the Learning Group of Jackson Hewitt Tax Service®.
To offer feedback or suggestions, please email taxschool@jtax.com.

Table of Contents

Introduction

As a tax preparer, you may come across taxpayers whose property has been damaged, destroyed, or stolen. For example, their homes may have been burglarized or they may have survived a house fire. They would like to know whether their loss can be deducted on their tax return. This module will help you guide your clients and prepare their tax returns in the event they experience a casualty, theft, or disaster.

Before You Get Started

Prerequisite: The prerequisite for taking this module is the successful completion of all three Basic Income Tax courses or their equivalent.

Continuing Professional Education: Enrolled Agents who successfully complete this module will earn 3 Continuing Professional Education (CPE) credit units. Certified Public Accountants should check with their State Board of Accountancy to determine if they can earn CPE credit units by completing this module. Other professionals should check with their governing boards to determine whether this module qualifies for CPE credit units.

Content Scope:

This module discusses:

- Personal casualty and theft losses
- How to report a casualty or theft loss on the taxpayer's return
- How to treat insurance and other payments/reimbursements the taxpayer receives
- The special rules that apply to presidentially declared disasters

Note: Business casualty and theft losses are not covered in this module.

Knowledge Check Exercises: There are Knowledge Check exercises at the end of each section in this module. These exercises are used to reinforce the concepts covered in the section and are not graded.

Module Review: The Module Review is included before the Module Assessment and includes one performance-based exercise for you to practice completing forms, schedules, and worksheets that are used to support the concepts covered in the module. The Module Review is not graded.

Module Assessment: The Module Assessment is an open-book exam, and it is graded (you must score a minimum of 70%). It includes both questions and tax return exercises that will require completion of forms, schedules, and worksheets.

Objectives

The goal of this module is to enable you to calculate your client's casualty and theft loss deduction using the IRS Form 4684, and report it on the return.

To achieve this goal, you need to be able to:

- Determine whether a loss is a casualty or a theft as defined by the IRS.
- Calculate the amount of casualty and theft losses.
- Determine how payments other than property insurance may affect the amount of deductible loss or taxable gain.
- Report a gain from a casualty or theft event.
- Apply special tax rules to determine losses for victims of federally declared disaster areas.

Lesson I: Casualties, Thefts, and Disasters Overview

In this lesson, we'll explore the concepts of casualties and thefts. It is important to understand this topic because the taxpayer may be entitled to a tax deduction if their property is destroyed, damaged, or stolen due to a casualty or theft.

Casualty Events

Casualty losses can result from a number of different events such as fires, floods, automobile accidents, earthquakes, etc. A casualty event is:

Sudden – not gradual or progressive

Unexpected – not ordinarily anticipated or intended

Unusual – not a day-to-day occurrence or not typical

Here are a few examples of sudden, unexpected, or unusual events.

- Earthquakes
- Floods
- Mine cave-ins
- Shipwrecks
- Sonic booms
- Storms, including hurricanes and tornadoes
- Terrorist attacks
- Vandalism
- Volcanic eruptions

Note: Car accidents and fire can also be considered casualties, but with the following exception:

- A car accident caused by the taxpayer's willful negligence or willful act is not a casualty loss. The same is true if the willful act or willful negligence of someone acting for the taxpayer caused the accident.
- A fire willfully set by the taxpayer, or by someone the taxpayer paid to set it, is not a casualty loss.

Casualty Event Scenarios

Let's look at a couple of scenarios. Review them and determine whether they constitute a casualty event.

Scenario 1: Riley and Ashley are married and have decided to file separately. Prior to their marriage, Ashley owned a speedboat that she used on weekends. After they were married, Ashley kept the boat at a marina near their home. On August 7, a boat that was parked in the slip next to her boat exploded. This caused a fire that damaged Ashley's boat.

Is this a casualty event?

Yes this is a casualty event.

Because this event was sudden, unexpected, and unusual, it qualifies to be considered a casualty event.

Scenario 2: Rina's fine china was broken when the hutch in which she kept it tipped over due to a sonic boom from a jet passing over her home.

Is this a casualty event?

Yes this is a casualty event.

As long as Rina does not live in the normal path of jet air traffic, Rina's loss of the china is eligible for consideration as a casualty loss.

Nondeductible Losses

Be aware of cases where a loss would not be deductible. This happens if the damage is caused by:

- Accidentally breaking articles such as glassware or china under normal conditions.
- Loss of property due to damage by a family pet.
- Loss of property due to progressive deterioration such as steady weakening of a building due to normal wind and weather conditions.

Progressive Deterioration

Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a normal process, rather than from a sudden event. For example:

- The damage to an old water heater that bursts. ***However, the 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 droughts. To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit.
- Termite or moth damage.
- The damage or destruction of trees, shrubs, or other plants by a 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.***

Special procedure for damage from corrosive drywall

- "Corrosive drywall" means drywall that is identified as problem drywall under the two-step identification method published by the **Consumer Product Safety Commission (CPSC**) and the **Department of Housing and Urban Development (HUD)** in their interim guidance dated January 28, 2010, as revised by the CPSC and HUD.
- The revised identification guidance and remediation guidelines are available at www.cpsc.gov/info/drywall/index.html.
- Under a special procedure, the taxpayer can deduct the amounts paid to repair damage to their home and household appliances due to corrosive drywall. Under this procedure, treat the amounts paid for repairs as a casualty loss in the year of payment.
- For example, amounts the taxpayer paid for repairs in 2010 are deductible on their 2010 tax return and amounts they paid for repairs in 2009 are deductible on their 2009 tax return.
- **For more information, see Publication 547, *Casualties, Disasters, and Thefts*.**

Proof of Casualty

A taxpayer must be able to prove that the loss was due to a casualty event. They must also be able to prove the loss amount.

It is important that the taxpayer's records show all of the following:

☑	The type of casualty and when it happened.
☑	Proof that the loss was a direct result of a casualty event. For example, photos or videos of items before and after the casualty.
☑	Proof that the taxpayer was the owner of the property. For example, titles, deeds, purchase receipts, cancelled checks, credit card statements. Or if the taxpayer leased the property, a contract stating that the taxpayer was liable for damages.
☑	Whether a claim has been submitted for which the taxpayer expects to receive reimbursement.

Let's review an example to see what information can be used to prove a casualty event.

Example

On May 17, a terrible wind storm ripped through Kyle's town. It destroyed the shrubs he had planted in his yard just a year ago.

Kyle's records include the following information which can be used to prove the casualty event:

- Kyle has the deed showing he owns the property on which the shrubs are located.
- He has the receipt from the landscaping company that plated the shrubs.
- He has a video showing what the shrubs looked like before the casualty. After the storm was over, he videotaped the damage that was done.
- He kept a newspaper article that documented the occurrence of the storm.
- Kyle filed a claim with his insurance company for the damage.

What if the Property is covered by insurance?

If the taxpayer's property is covered by insurance, it is important to recognize two key facts:

1. The taxpayer should file a timely insurance claim for reimbursement of the loss.
2. Any portion of the loss not covered by insurance is allowed as a deduction.

Let's review an example of a casualty loss as it relates to an insurance deductible.

Example: Steve's car was involved in a collision. Steve is covered under a car insurance policy which has a $500 deductible, which means the insurance does not cover the first $500 of the collision.

The $500 would be a deductible casualty loss even if no insurance claim is filed because the insurance company would never have reimbursed Steve for the deductible.

Theft Event

A theft includes the taking or removing of money or property by means of blackmail, burglary, embezzlement, extortion, kidnaping for ransom, larceny, etc. The following two criteria are important:

1. The taking and removing of money or other property from its rightful owner must be intentional.
2. The taking of property must be illegal under the laws of the state where it occurs and it must be done with criminal intent.

The simple disappearance of money or property is not a theft and cannot be deducted.

When is a Theft Loss Deductible?

A taxpayer may have a deductible loss as a result of theft. Here are some examples of events that are considered as theft events and are deductible:

- A taxpayer relies on his attorney regarding the use of a tax loophole that turns out to be fraudulent.
- A taxpayer bets on horse races that were fixed.
- A taxpayer makes payment to a divorce attorney for what turns out to be a forged divorce decree.

Note: Occasionally, an event that appears to be a theft may not qualify for a deduction. Let's look at some examples.

- The taxpayer's spouse leaves and takes items that the taxpayer may consider to be their personal property (state law will determine whether or not this event can be considered as a deductible theft event).
- A taxpayer borrows personal property from someone and that property is stolen while it is in their possession (this may be a theft event for the owner but not the taxpayer who borrowed it).
- The value of a taxpayer's stock decreases due to misconduct by a corporate executive (in this case, a capital loss would be reported when the stock is sold or becomes worthless).

Proof of Theft

Similar to a casualty loss, to be a deductible theft loss, a taxpayer must be able to prove that the loss was due to a theft event. They also must be able to prove the loss amount.

The taxpayer's records should show all of the following:

☑	When the taxpayer discovered that their property was missing.
☑	Proof that the property was stolen. For example, police reports, photos or videos of the crime scene.
☑	Proof that the taxpayer was the owner of the property.
☑	Whether there is a claim submitted for which the taxpayer expects to receive reimbursement.

Let's review an example to see what information can be used to prove a theft event.

Example

You may recall that Ashley experienced a casualty event when her boat was damaged by fire. Her husband, Riley, had an upsetting experience, too. He was the proud owner of a classic sports car. After Riley and Ashley were married last year, he didn't have room to store the car in their garage, so he rented space at a nearby storage facility.

On March 15, Riley went to the storage facility to bring the car home for use during the nice weather. However, when he arrived at his storage bay, the lock was broken and his classic sports car was missing.

Riley's records include the following information which can be used to prove the theft event:

- The car was registered and titled in Riley's name.
- He has a specific date on which he became aware of the theft.
- He filed a police report and took photos of the damage to the storage bay lock.
- He filed a claim against the storage company owner and his auto insurance company to try to recover his loss.

When to Deduct a Casualty or Theft Loss?

Remember this simple rule to determine when to deduct a casualty or theft loss.

If the taxpayer has a loss…	THEN deduct it…
From a casualty	In the year the loss occurred.
From a theft	In the year the theft event is discovered, without regard to which year the theft event actually happened.

Let's review an example of when to deduct casualty and theft losses.

Brad's town was hit by a bad storm on December 26, 2010. While he was without power for a few days, he stayed with his sister. He checked his most prized possessions to make sure they were OK before he locked up the house and left. The power was restored on December 30, but Brad decided to stay with his sister a little while longer. When he returned to his house on January 3, 2011, he noticed his antique coin collection was missing. He knows that he saw it before he left to go to his sister's house, so he is pretty sure it was stolen during the looting that occurred while the power was out.

Brad should deduct the loss from the damage that occurred as a result of the storm on his 2010 tax return – the year the casualty loss occurred. And he should deduct the loss from the theft of his coin collection on his 2011 return – the year the theft was discovered even though the coins were likely stolen in 2010.

Presidentially Declared Events

Sometimes an event is so catastrophic that the area in which it occurred is declared as a disaster area by special proclamation of the President. This is referred to as a presidentially declared disaster area.

When such devastating natural disasters happen, a team of individuals sometimes including the President is sent to observe the consequences experienced by the event's victims. Disaster area declarations enable victims to be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Note: Many special tax rules become available for victims located within an area declared to be a disaster area by the President. These rules help victims quickly overcome the consequences of the disaster.

These rules will be covered in detail in a Lesson V: Determining Federally Declared Disaster Area Losses.

Knowledge Check One

1. Which of the following events meet the criteria to be considered a casualty event?
    A. Diamond ring stolen during burglary
    B. Prize winning roses damaged by worm infestation
    C. Barn damaged due to fire the taxpayer paid someone to set
    D. Roof damaged due to hurricane-force winds

2. Which of the following events qualify for theft loss consideration? (Select all the apply)
    A. Diamond ring stolen during burglary
    B. A loss from betting on horse races that were fixed
    C. A decrease in stock value due to misconduct by a corporate executive
    D. An expensive camera lost that went missing while on vacation

3. Which of the following can be used to prove a casualty event? (Select all that apply.)
    A. Documentation of when the theft occurred
    B. Proof that the taxpayer owned the property or was contractually required to repair or replace leased property
    C. Whether a claim has been submitted for which the taxpayer expects reimbursement
    D. Proof that the property was stolen

4. For a theft event to be deductible, taxpayers must be able to show which of the following? (Select all that apply.)
    A. When they discovered their property was missing
    B. Proof that their property was stolen
    C. That the thief was arrested
    D. Whether a claim for reimbursement exists for which there is reasonable expectation of recovery

5. Vinnie's antique oriental rug was damaged by his new puppy before it was housebroken. Is the loss deductible as a casualty loss?
    A. Yes
    B. No

6. A car door is accidently slammed on Elizabeth's hand, breaking the setting of her diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is considered a theft event.
    A. True
    B. False

7. Which of the following are deductible as a casualty loss? (Select all that apply.)
    A. The steady weakening of a building due to normal wind and weather conditions
    B. The rust and water damages to rugs and drapes caused by the bursting of a water heater
    C. Termite or moth damage
    D. Destruction of trees by an unusual infestation of beetles

Lesson II: Calculating Casualty and Theft Losses

In this section, we'll look at the steps needed to calculate the amount of casualty or theft loss.

Casualty or theft loss = Smaller of adjusted basis in the property or decrease in FMV of the property – any insurance or other reimbursement received or expected to be received

To this amount, you need to then apply deduction limits.

To perform this calculation, you need to do the following:

1. Determine the taxpayer's cost or other basis in the property prior to the casualty or theft event.

2. Determine the taxpayer's decrease, if any, in FMV of the property caused by the casualty event.
3. From the smaller of the amounts calculated in steps 1 and 2, subtract any insurance or other reimbursement received or expected to be received.
4. Apply the deduction limits.

Step 1: Determine Adjusted Basis

A taxpayer's basis in the property is the amount of investment made in the property, which is usually the cost of the property.

The basis of the property may need to be adjusted up or down depending on the circumstances. When a taxpayer makes improvements to the property during their ownership, their basis is increased to include the additional expense they incurred. Similarly, if the taxpayer takes a loss or deduction for the property on their tax return, such as a prior casualty loss or a depreciation deduction, the property's basis is decreased by the amount of their loss or deduction.

Add the increases to the basis and subtract the decreases from the basis TO get the adjusted basis.

Example: Sally purchased her first home in 2004 for a cost of $350,000, including $50,000 for the land. She spent $30,000 to upgrade her kitchen and another $10,000 for landscaping. The adjusted basis of her property is $390,000, which is the $350,000 cost including land + the $30,000 kitchen upgrade + $10,000 for landscaping.

Step 2: Determine Decrease in FMV (Fair Market Value)

"Fair Market Value is the price for which a taxpayer could sell their property to a willing buyer where neither of them has to sell or buy and both know all the relevant facts." In other words, it is the price the taxpayer's property would fetch if selling it in the market.

The decrease in FMV is the difference between a property's FMV immediately before and immediately after a casualty or theft. ***The FMV of the property immediately after a theft is considered to be zero because the taxpayer no longer has the property***.

Ways to Calculate the Decrease in FMV

Appraisal

To determine the decrease in FMV because of a casualty, the taxpayer generally needs an accurate appraisal. An appraisal should be made by a competent appraiser. The appraiser recognizes the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

Other measures to establish certain decreases in FMV are:

Clean Up and Repairs

The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. However, the cost of repairing damaged property and cleaning up after a casualty can be used as a measure of the decrease in FMV if they meet all the following conditions:

- Repairs are actually made
- Repairs are necessary to bring the property back to its condition before the casualty
- The amount spent for repairs is not excessive
- The repairs only take care of the damage
- The value of the property after the repairs is not greater than the value of the property before the casualty

Landscaping

The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. Measure the loss by the amount spent on the following:

- Removing destroyed or damaged trees and shrubs, minus any salvage the taxpayer receives.
- Pruning and other measures taken to preserve damaged trees and shrubs.
- Replanting necessary to restore the property to its approximate value before the casualty.

Car Value

Books issued by various automobile organizations that list the taxpayer's car may be useful when determining its value. The taxpayer can modify the retail value by factors such as mileage and the condition of the car. These prices are not official, but may be useful in determining value and suggesting relative pricing for comparison with current sales and offerings in the taxpayer's area. If the car is not listed in the books, use other sources to determine its value.

NOTE: A dealer's offer for the car as a trade-in on a new car is not usually a measure of its true value.

Items NOT Considered When Determining FMV

The following items are generally not considered when establishing the decrease in FMV of the taxpayer's property:

The cost of replacing stolen or destroyed property is not part of a casualty or theft loss. **Example**: Joe bought a new chair 4 years ago for $300. In April, a fire destroyed the chair. He estimates that it would cost $500 to replace it. If he had sold the chair before the fire, he estimates that he could have received only $100 for it because it was 4 years old. The chair was not insured. Joe's loss is $100, the FMV of the chair before the fire. It is not $500, the replacement cost.
The cost of protecting property against a casualty or theft is not part of a casualty or theft loss. **Example**: The amount spent on insurance or to board up the house against a storm is not part of the casualty loss. Add the cost of making permanent improvements to the property to protect it against a casualty or theft to the basis in the property.
Incidental expenses due to a casualty or theft such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of casualty or theft loss.
Do not consider sentimental value when determining loss.
A decrease in the value of the taxpayer's property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. The taxpayer

has a loss only for actual casualty damage to their property.
The costs of photographs and appraisals used as evidence of the value and condition of property damaged as a result of a casualty are not a part of the loss.

Step 3: Apply Insurance and Other Payments

A taxpayer who experiences a casualty or theft event may receive payments from many different sources such as insurance companies, friends, government agencies, and relief agencies.

The most common type of reimbursement received is an insurance payment for the damaged or stolen property. To determine the loss amount, subtract any insurance or other reimbursement the taxpayer received or expects to receive from the smaller of the amounts of steps 1 and 2 (i.e., smaller of the adjusted basis or the decrease in the FMV of the property).

Note: If the taxpayer receives an insurance reimbursement or other reimbursement that is more than their adjusted basis in the destroyed or stolen property, they have a gain from the casualty or theft. **We'll look at reporting gain in a later section of this module.**

We'll also discuss other types of reimbursement payments in Lesson III: Reimbursements/Payments and their Effect on Deductible Loss or Taxable Gain.

Example

Remember Ashley and Riley? They each have insurance coverage for damaged and stolen property. Ashley has insurance with a $1,000 deductible on her boat that was damaged by the explosion of a nearby boat. Riley's insurance policy on his sports car stolen from storage has a $500 deductible.

Because they've decided to file separate tax returns this year, they will each be able to consider their deductible amount as part of the unreimbursed loss.

Calculating Casualty and Theft Loss: Scenario

After calculating the taxpayer's casualty or theft loss, you must apply the deduction limits. Before we move on to reviewing the deduction limits, let's apply the concepts (adjusted basis, FMV, and insurance reimbursement) to a real life scenario first.

Scenario

Amanda bought a home a little over a year ago. She paid $150,000, which includes $10,000 for the land and $140,000 for the house. She also spent an additional $2,000 for landscaping. This year a fire damaged her home. The fire also destroyed the trees and shrubbery in her yard. The fire was her only casualty or theft loss this year. Competent appraisers valued the property as a whole at $175,000 before the fire and $50,000 after the fire. Shortly after the fire, the insurance company paid Amanda $95,000 for the loss.

What is Amanda's loss amount after reimbursement?

Solution

1. Adjusted basis of the property (cost of land, building, and landscaping)	$152,000
2. FMV of the property before the fire	$175,000
3. FMV of the property after the fire	$50,000
4. Decrease in FMV of the property (line 2 – line 3)	$125,000
5. Tentative loss (smaller of line 1 and line 4)	$125,000
6. Insurance reimbursement received	$95,000
7. Loss after reimbursement (line 5 – line 6)	**$30,000**

Step 4: Reducing the Loss by Deduction Limits

After determining the taxpayer's casualty or theft loss, you must reduce that loss by two limits:

1. **$100 rule:** Reduce the loss by $100. This reduction applies to each casualty or theft event.
2. **10% rule:** After reducing each loss by $100, reduce the total casualty or theft loss after reimbursement by 10% of the taxpayer's Adjusted Gross Income or AGI.

Let's look at the different scenarios that apply for each of these rules.

		$100 Rule	**10% Rule**
General application		Must reduce each casualty or theft loss by $100 when calculating the deduction.	Must reduce the total casualty or theft loss by 10% of AGI.
Single event		Apply this rule only once, even if many pieces of property are affected.	Apply this rule only once, even if many pieces of property are affected.
Multiple events		Apply to the loss from each event.	Apply to the total of all losses from all the events.
More than one person – *With loss from the same event (other than a married couple filing jointly)*		Apply separately to each person.	Apply separately to each person.
More than one owner – *Other than a married couple filing jointly*		Apply separately to each owner of jointly owned property.	Apply separately to each owner of jointly owned property.
Married couple – *With loss from the single event*	Filing joint return	Apply as if they are one person.	Apply as if they are one person.
	Filing separate return	Apply separately to each spouse.	Apply separately to each spouse.
*** The 10% rule does not apply to a net disaster loss from a disaster declared a federal disaster in tax years beginning after 2007 that occurred before 2010.**			

Deduction Limits: Examples

Example 1 – Single event, multiple properties: A thunderstorm destroyed Ron's pleasure boat. He also lost some boating equipment in the storm. His loss was $10,000 on the boat and $1,200 on the equipment. His insurance company reimbursed him $2,500 for the damage to his boat. He had no insurance coverage on the equipment. His AGI is $54,000. His casualty loss is from a single event and the $100 rule and 10% rule applies once.

	Boat	**Equipment**
Loss	$10,000	$1,200
Subtract insurance reimbursement	$2,500	$0
Loss after reimbursement	$7,500	$1,200

Total loss before limits = $8,700 ($7,500 + $1,200)

Loss after the $100 rule = $8,600 ($8,700 - $100)

Loss after 10% of AGI ($54,000) = 8,600 – 5,400 = $3,200

Example 2 – Single event, multiple properties: *When calculating a loss to real property the taxpayer owns for personal use, all improvements (such as buildings and ornamental trees and the land containing the improvements) are considered one piece of property.*

Raven's house and several trees in her yard were damaged during a hurricane. Her house cost $200,000 including a land value of $25,000. The fair market value before the hurricane was $191,000 for the house and $29,000 for the land, for a total of $220,000. The fair market value after was $89,000 for the house and $23,000 for the land, for a total of $112,000. Also, Raven's big screen TV was destroyed. She paid $4,000 for the TV. The fair market value was $1,800 before the hurricane and zero after.

The insurance reimbursement was $100,000 for everything. Therefore, it needs to be split between the house property and the TV. Divide the amount received according to the fair market value of each at the time of the loss.

Combined Fair Market Value before the hurricane for the house and the TV = $221,800 ($220,000 + $1,800)
The house's percentage of that total = $220,000 ÷ $221,800 = 99.2% approx. or $99,200
Reimbursement for the TV = 0.8% or $800

Her AGI is $54,000.

	House/land	TV
1. Adjusted basis of the property	$200,000	$4,000
2. FMV of the property before the hurricane ($191,000 + $29,000)	$220,000	$1,800
3. FMV of the property after the hurricane ($89,000 + $23,000)	$112,000	$0
4. Decrease in FMV of the property (line 2 – line 3)	$108,000	$1,800
5. Tentative loss (smaller of line 1 and line 4)	$108,000	$1,800
6. Insurance reimbursement received	$99,200	$800
7. Loss after reimbursement (line 5 – line 6)	$8,800	$1,000
8. Total loss after reimbursement (add both columns of line 7)	$9,800	
9. Loss after $100 rule	**$9,700**	
10. Loss after 10% of AGI (54,000) [7,900 – 5,400]	**$3,700**	

Example 3 – More than one event: Isabella's family car was damaged in an accident in January. Her loss after the insurance reimbursement was $75. In February, her car was damaged in another accident. This time her loss after the insurance reimbursement was $90.

In this scenario, there are two separate casualty events. You would apply the $100 rule to each of these events and then apply the 10% rule to the total of both the losses. However, **because neither**

accident resulted in a loss of over $100, Isabella is not entitled to any deduction for these accidents.

Here's another example of the more than one event scenario.

In March, Connie had a car accident that totally destroyed her car. She did not have collision insurance on her car, so she did not receive any insurance reimbursement. Her loss on the car was $1,800.

In November, a fire totally destroyed the furniture, washer, dryer, and other items she had stored in her basement. Her loss on the basement items after reimbursement was $2,100. These losses were smaller than the decreases in FMV.

Her AGI for the year that the accident and fire occurred is $25,000.

Calculate her casualty loss deduction as follows:

- First, apply the $100 rule. Subtract $100 from each loss, which gives us $1,700 for the car and $2,000 for the basement.
- Then, add together the amounts after the $100 rule. $1,700 + $2,000 = $3,700
- Finally, apply the 10% rule. Take the $3,700 and subtract $2,500, which is 10% of Connie's $25,000 AGI. The result, $1,200, is Connie's casualty loss.

Example 4 – More than one person: A fire damages a taxpayer's house and also the personal property of their house guest. The taxpayer must reduce their loss by $100 and 10% of AGI and so should the house guest.

Example 5 – More than one owner: If two sisters live together in a home they own jointly and they have a casualty loss on the home, the $100 rule and the 10% rule applies separately to each sister.

Example 6 – Married taxpayers: When married individuals file a joint return, the taxpayer and the spouse are treated as one individual in applying the $100 rule and the 10% rule. It does not matter whether they own the property jointly or separately.

Note that if the taxpayer and their spouse file separate returns, each of them must reduce their loss by $100 and the 10% of AGI. This is true even if they own the property jointly. However, if one spouse owns the property, only that spouse can calculate a loss deduction on a separate return.

Putting It All Together

Let's revisit Amanda's situation. We calculated her casualty loss to be $30,000. Her AGI for this year is $70,000. **What is her casualty loss deduction after applying the $100 rule and 10% rule?**

Solution:

1. Adjusted basis of the property (cost of land, building, and landscaping)	$152,000
2. FMV of the property (before fire)	$175,000
3. FMV of the property (after fire)	$50,000
4. Decrease in FMV of the property (line 2 – line 3)	$125,000
5. Tentative loss (smaller of line 1 and line 4)	$125,000
6. Insurance reimbursement received	$95,000
7. Loss after reimbursement (line 5 – line 6)	**$30,000**
8. Subtract $100 per event ($100 rule)	$29,900
9. 10% of $70,000 AGI (10% rule)	$7,000
10. Casualty loss deduction (line 8 – line 9)	**$22,900**

IRS Forms and Schedules

To calculate the amount of the loss, use the following IRS forms and schedules:

Form 4684, Casualties and Thefts: Use section A of this form to calculate personal casualty and theft losses. Use a separate form 4684 for each casualty and theft event.

Schedule A, Itemized Deductions: The total allowed loss from Form 4684 is entered on Schedule A. Both Form 4684 and Schedule A are attached to Form 1040.

Schedule D, Capital Gains and Losses: Sometimes casualty and theft losses result in a gain. If there is a gain, report it on both Form 4684 and Schedule D.

Form 4684

Form **4684**

Department of the Treasury
Internal Revenue Service

Casualties and Thefts

▶ See separate instructions.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each casualty or theft.

OMB No. 1545-0177
2010
Attachment Sequence No. 26

Name(s) shown on tax return | Identifying number

SECTION A—Personal Use Property (Use this s… in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date a… amaged from the same casualty or theft.

Property A
Property B
Property C
Property D

For lines 2 through 9, use a separate column to show each item lost or damaged from a single casualty or theft event.
If more than 4 items were lost or damaged, use additional sheets following the format of lines 2 through 9.

					D
2 Cost or other basis of each property					
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	3				
Note: *If line 2 is* ***more*** *than line 3, skip line 4.*					
4 Gain from casualty or theft. If line 3 is **more** than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4				
5 Fair market value **before** casualty or theft	5				
6 Fair market value **after** casualty or theft	6				
7 Subtract line 6 from line 5	7				
8 Enter the **smaller** of line 2 or line 7	8				
9 Subtract line 3 from line 8. If zero or less, enter -0-	9				

10 Casualty or theft loss. Add the amounts on line 9 in columns A through D	10	
11 Enter the **smaller** of line 10 or $100	11	
12 Subtract line 11 from line 10	12	
Caution: *Use only one Form 4684 for lines 13 through 21.*		
13 Add the amounts on line 12 of all Forms 4684	13	
14 Add the amounts on line 4 of all Forms 4684	14	
15 • If line 14 is **more** than line 13, enter the difference here and on Schedule D. **Do not** complete the rest of this section (see instructions). • If line 14 is **less** than line 13, enter -0- here and go to line 16. • If line 14 is **equal** to line 13, enter -0- here. **Do not** complete the rest of this section.	15	
16 If line 14 is **less** than line 13, enter the difference	16	
17 Does the amount on line 12 include a loss from a disaster declared a federal disaster in tax years beginning after 2007 that occurred before 2010? ☐ **Yes.** Enter the amount fron… hedule A (Form 1040), go to line 18. … complete the rest of Sectio… ☐ **No.** Enter -0- and go to line…	17	
18 Subtract line 17 from line 16	18	
19 Enter 10% of your adjusted gross… usts, see instructions	19	
20 Subtract line 19 from line 18. If ze…	20	
21 Add lines 17 and 20. Also enter th… , line 8. Estates and trusts, enter the resu…	21	

Line 12: Shows the loss amount after reimbursement. During the year, if the taxpayer suffered more than one casualty or theft event, you will complete separate Forms 4684 for each of the events.
Line 13: is the sum of the losses on all the Forms 4684.
IMPORTANT: For lines 13 through 21, use only one Form 4684.

For Paperwork Reduction Act Notice … Form **4684** (2010)

Amanda's Form 4684

Form **4684**

Department of the Treasury
Internal Revenue Service

Casualties and Thefts

▶ See separate instructions.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each casualty or theft.

OMB No. 1545-0177
2010
Attachment Sequence No. 26

Name(s) shown on tax return | Identifying number

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property **A** Home destroyed by fire
Property **B**
Property **C**
Property **D**

		A	B	C	D
2 Cost or other basis of each property	2	152,000			
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	3	95,000			
Note: *If line 2 is* **more** *than line 3, skip line 4.*					
4 Gain from casualty or theft. If line 3 is **more** than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4				
5 Fair market value **before** casualty or theft	5	175,000			
6 Fair market value **after** casualty or theft	6	50,000			
7 Subtract line 6 from line 5	7	125,000			
8 Enter the **smaller** of line 2 or line 7	8	125,000			
9 Subtract line 3 from line 8. If zero or less, enter -0-	9	30,000			

10 Casualty or theft loss. Add the amounts on line 9 in columns A through D	10	30,000
11 Enter the **smaller** of line 10 or $100	11	100
12 Subtract line 11 from line 10	12	29,900
Caution: *Use only one Form 4684 for lines 13 through 21.*		
13 Add the amounts on line 12 of all Forms 4684	13	29,900
14 Add the amounts on line 4 of all Forms 4684	14	
15 • If line 14 is **more** than line 13, enter the difference here and on Schedule D. **Do not** complete the rest of this section (see instructions). • If line 14 is **less** than line 13, enter -0- here and go to line 16. • If line 14 is **equal** to line 13, enter -0- here. **Do not** complete the rest of this section.	15	0
16 If line 14 is **less** than line 13, enter the difference	16	29,900
17 Does the amount on line 12 include a loss from a disaster declared a federal disaster in tax years beginning after 2007 that occurred before 2010? ☐ **Yes.** Enter the amount from line 3 of the Worksheet for Line 17, in the instructions. If you are filing Schedule A (Form 1040), go to line 18. Otherwise, enter this amount on Schedule L (Form 1040A or 1040). Do not complete the rest of Section A. Form 1040NR filers, see instructions. ☒ **No.** Enter -0- and go to line 18	17	
18 Subtract line 17 from line 16	18	29,900
19 Enter 10% of your adjusted gross income from Form 1040, line 38, or Form 1040NR, line 36. Estates and trusts, see instructions	19	7,000
20 Subtract line 19 from line 18. If zero or less, enter -0-	20	22,900
21 Add lines 17 and 20. Also enter the result on Schedule A (Form 1040), line 20, or Form 1040NR, Schedule A, line 8. Estates and trusts, enter the result on the "Other deductions" line of your tax return	21	22,900

Net Operating Loss

A taxpayer may have a net operating loss (or NOL), if their loss deduction is more than their income.

NOL = Loss deduction > Income

If the taxpayer has a NOL, it can be used to:

- Lower the taxpayer's tax liability in an earlier year, allowing the taxpayer to get a refund for tax already paid. This is referred to as *Carryback*.
- Lower the taxpayer's tax liability in a later year. This is referred to as *Carryforward*.

How are Carryback and Carryforward Periods Handled?

Generally, the taxpayer must:

- First, carry back the entire amount of the NOL to the 3 tax years before the NOL year for casualty and theft losses, which is an exception to the regular 2-year carryback period for NOLs.
- Then, carry forward any remaining NOL for up to 20 years after the NOL year (*the Carryforward period*).

Note: The taxpayer can also choose not to carry back an NOL and only carry it forward.

Example: Philippe suffered a casualty loss in 2010. In calculating the loss on his return, you realize his loss is greater than his income. Philippe can carry back his loss to 2006 or forego the carryback and deduct his loss starting 2011.

Note that NOLs resulting from qualified disaster losses have an extended 5-year carryback period.

For more information see Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.

Knowledge Check Two

1. If a taxpayer has two separate casualty losses in the same year, they must reduce:

    A. Each loss by $100

    B. Each loss by 10% of AGI

    C. There is no deduction limitation

    D. Both losses by $100 and 10% of AGI

2. A single casualty may damage two or more pieces of property. Would the $100 rule apply to each property separately?

   A. Yes

   B. No

3. A taxpayer and spouse file separate returns. A property that the spouse owns solely is destroyed in a fire. Can the taxpayer as well as the spouse calculate a loss deduction on their separate returns?

   A. Yes

   B. No

4. If a taxpayer has more than one casualty or theft loss during the tax year, you must reduce each loss by any reimbursement and then by $100 as well as by 10% of the taxpayer's AGI.

   A. True

   B. False

5. Several years ago, Robert purchased a lakeside cottage, which cost $144,800 (including $14,500 for the land). In June, a fire destroyed his cottage. The land was not damaged. This was the only casualty or theft loss for the year. The FMV of the property immediately before the fire was $180,000 ($145,000 for the cottage and $35,000 for the land). The FMV immediately after the fire was $35,000 (value of the land). Robert collected $130,000 from the insurance company. His AGI for the year the fire occurred is $80,000. His deduction for the casualty loss is:

   A. $8,000

   B. $6,700

   C. $14,800

   D. $6,500

6. In August, a storm destroyed Anne's pleasure boat, which cost $18,500. This was her only casualty or theft loss for the year. Its FMV immediately before the storm was $17,000. She had no insurance, but was able to salvage the motor of the boat and sell it for $200. Her AGI for the year the casualty occurred is $70,000. Her deduction for the casualty loss is:

   A. $16,800

   B. $7,000

   C. $9,700

   D. $16,700

7. In June, Richard was involved in an auto accident that totally destroyed his personal car and his antique pocket watch. He had bought the car for $30,000. The FMV of the car just before the accident was $17,500. Its FMV just after the accident was $180 (scrap value). The insurance company reimbursed him $16,000. His watch was not insured. He had purchased it for $250. Its FMV just before the accident was $500. His AGI for the year the accident occurred is $97,000. His deduction for the casualty loss is:

   A. $250

   B. $0

   C. $500

   D. $1,000

Lesson III: Reimbursements/Payments

In the previous lesson, you learned about reimbursement received from insurance companies and how that affects the casualty or theft loss calculation. In this lesson, we'll look at other types of payments a taxpayer may receive as a result of a casualty or theft loss:

- Money from employer emergency disaster funds
- Cash gifts from friends and relatives
- Insurance payments for living expenses incurred when the taxpayer loses the use of property

Note: ***Qualified disaster relief payments are covered in Lesson V "Determining Federally Declared Disaster Area Losses."***

Employer's Emergency Disaster Funds

If a taxpayer works for an employer who has established an emergency disaster fund, they may receive benefits that could reduce their reportable loss in the event of a casualty.

How does this impact the casualty loss deduction?

It can have an impact in either of the two ways depending on the situation. For instance:

1. If the payments received from the fund are directed only to the replacement or rehabilitation of the affected property, the funds will reduce the deductible loss to the extent that they were applied to the property.

2. If the use of the funds is not specified, then they do not reduce the deductible loss.

Example:

Hal's home was damaged by a tornado. His insurance reimbursement was $25,000. Hal's employer's emergency disaster fund specifies that payments can only be used to repair, replace, or rehabilitate the damaged property. The fund paid out $5,000, which was all used to repair Hal's damaged property. The $5,000 payment from the employer's emergency fund must be added to the insurance reimbursement. Hals' total reimbursement for Form 4684, Line 3, is $30,000 ($25,000 + $5,000). The allowed loss is still subject to the deduction limits.

Cash Gifts

Victims of casualty or theft events may often receive cash gifts from friends, relatives, and neighbors.

How does this impact the casualty loss deduction?

These gifts have an impact in the following ways:

- They do not reduce the amount of the taxpayer's casualty loss, even if the taxpayer uses this money to repair, replace, or rehabilitate the damaged property.
- Also, cash gifts are not included in income.

Example:

Lucinda's home was damaged by a hurricane. She received cash gifts of $2,500 from her friends without specification about how the gifts must be used. Lucinda used all of the funds to repair her damaged home. These gifts do not reduce her deductible loss for the hurricane, even though she used all of the money to make repairs to her damaged property.

Insurance Payments for Living Expenses

Taxpayer's may receive insurance payments to cover living expenses incurred due to losing the use of a main home because of a casualty, or not being allowed by government authorities to access their main home after a casualty or threat of one.

How does this impact the casualty loss deduction?

These payments have the following impact:

- They do not reduce the taxpayer's casualty deduction because they are not considered a reimbursement.
- However, if the payments exceed the temporary increase in living expenses, the excess is reported as income on Form 1040, Line 21.
- Please note that if the casualty occurs in a presidentially declared disaster area, none of the insurance payments are taxable.

Examples of living expenses

- Rental costs for suitable housing
- Transportation
- Food
- Utilities
- Miscellaneous services

The temporary increase in living expenses due to loss of use of a family's main home is calculated as the difference between what their normal living expenses would have been during the time frame they could not use their home and the amount actually spent during the same time frame.

Remember, the expenses must be both reasonable and necessary.

Temporary increase in living expenses (due to loss of use of main home)

= Amount actually spent - Normal living expenses

As a result of a fire in their apartment, Julio and Elba moved into a motel for a month. Their monthly apartment rent was $650. No apartment rent was charged for the month the apartment was vacated for repairs to be made. The monthly cost of the motel room was $1,200. The couple normally spends $200 per month for food. However, during their motel stay, the monthly expenditure for food was $400. Their renters' insurance policy paid them $1,100 to cover living expenses.

Here's the calculation used to determine how much, if any, of the living expenses payment must be included in Julio's and Elba's income.

Insurance payment received for living expenses…………………………………………………………. $1,100

Actual expenses during motel stay…………………………………………………………$1,600

Motel cost……………………………$1,200

Food…………………………………….+$400

Normal living expenses for the same time period would've been………………...$850

Apartment rent……………………..$650

Food……………………………………. +$200

Temporary increase in living expenses ($1,600 - $850)……………………………………………………. $750

Insurance payment amount includible in income…………………………………………………… $350

Note: The taxable part of the insurance payment for living expenses is included in income for the year the taxpayer regained use of their main home, unless they receive the taxable portion of the payment in a later year. If received in a later year, then the taxpayer reports the income in that year.

Expected Reimbursement vs. Actual Reimbursement

If a casualty or theft loss is calculated using the amount of expected reimbursement, the tax return for the tax year in which the actual reimbursement is received, may need to be adjusted. There are two possible scenarios when adjustments might be made.

Possible Scenarios

Scenario 1: If actual reimbursement is less than expected

Taxpayers may receive less reimbursement than they expected in a year after the casualty or theft event happened. If that's the case, include that difference as a loss with the other losses (if any) on the return for the year in which the taxpayer determines that further reimbursement is not likely.

Example: Last year, Tanya's car (which has a FMV of $2,000) was totally destroyed in an accident. The accident was due to the other driver's negligence. Originally, Tanya had a reasonable expectation that she would be reimbursed in full for her loss. With the expectation of full reimbursement, Tanya did not report this as a casualty event.

The court awarded Tanya with a judgment of $2,000. Later this year, it became apparent to Tanya that she would not be able to recover that court award from the other driver. In this instance, Tanya would then report any deductible loss on this year's tax return.

Scenario 2: If actual reimbursement is more than expected

If, in a later year, a taxpayer receives greater reimbursement than expected, they may need to include the extra amount as income for the year received.

Note: If any part of the original loss deduction did not reduce their tax for the earlier year, do not include that part of the reimbursement in their income. In addition, do not amend the tax return for the year in which the original loss was deducted.

Example: Last year, Wayne's storage barn was destroyed by a severe hailstorm. His loss was $3,000, and he estimated his insurance reimbursement to be $2,500. Wayne did not itemize his deductions last year, so he was unable to claim any casualty loss on his tax return. This year, he received a check from the insurance company for the full $3,000. This reimbursement is not reported as income because Wayne's tax was not reduced last year by the loss sustained.

Knowledge Check Three

1. Mark's family home was extensively damaged by an earthquake. Mark's reimbursement from his insurance company was $100,000. His employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. Mark received $4,000 from the fund and spent the entire amount on repairs to his home. What is Mark's total reimbursement that must be entered on Form 4684?

    A. $4,000

    B. $96,000

    C. $100,000

    D. $104,000

2. Linda's home was damaged by a hurricane. Relatives and neighbors made cash gifts to her. There were no limits or restrictions on how she could use the monies. She used part of the cash gifts to pay her repairs to her home. Does Linda need to reduce her casualty loss by the amount she received from her relatives and neighbors and used to pay for repairs to her home?

    A. Yes

    B. No

3. When the taxpayer loses the use of their main home and receives an insurance payment for living expenses, a portion of the payment may need to be reported as income. Which scenario would require income to be reported?

		Payment received	Actual expenses	Normal expenses
A	**Scenario 1**	$1,100	$3,400	$1,650
B	**Scenario 2**	$300	$1,800	$1,000
C	**Scenario 3**	$1,710	$1,900	$1,650
D	**Scenario 4**	$2,000	$2,500	$300

4. In December 2010, Susan had a collision while driving her personal car. Repairs to the car cost $950. She had $100 deductible collision insurance. Her insurance company agreed to reimburse her for the rest of the damage. Because she expected a reimbursement from the insurance company, she did not have a casualty loss deduction in 2010. Due to the $100 rule, she cannot deduct the $100 she paid as the deductible. When she receives the $850 from the insurance company in 2011, should she report it as income?

    A. Yes

    B. No

Lesson IV: Reporting a Gain from a Casualty or Theft

It is possible to have a gain from a casualty or theft. In this lesson, we'll look at situations that would result in a gain and learn how to determine the gain amount and report it.

When would a taxpayer have a gain from a casualty or theft?
If the taxpayer receives an insurance reimbursement or other reimbursement that is more than their adjusted basis in the damaged, destroyed, or stolen property, they have a gain from the casualty or theft.

NOTE: Always use the adjusted basis of property to calculate a gain, even if the decrease in FMV of the property is smaller than its adjusted basis.

Let's look at an example of the calculations involved.

Scenario:

Keith's sports car was stolen. It cost $14,000 when he purchased it five years ago. Keith has since had a custom paint job and interior restoration in amounts totaling $8,200. The FMV at the time he discovered the theft in March of this year was $32,300. Keith's insurance reimbursement is for full FMV less his $500 deductible. Therefore, he received $31,800 from the insurance company. He also received $1,000 from the storage company owners group, which specified that the money be used toward replacement of the stolen car. Keith's reportable gain is calculated as follows:

1. Cost or other basis of property $22,200

   ($14,000 basis + $8,200 improvements)

2. Total payments received $32,800

   (Insurance $31,800 + storage payment $1,000)

3. Reportable gain $10,600

NOTE: Do not apply the $100 or the 10% rule if a casualty or theft results in gain.

Gains and Losses in the Same Year

If the taxpayer has more than one casualty or theft during the year with a combination of individual gains and losses, whether the taxpayer has taxable income or a deductible loss depends on which is greater – the gains or the losses.

Gains more than losses

If gains are more than losses after applying the $100 rule, subtract losses from gains. The difference is a taxable gain.

Note: The 10% rule does not apply whenever gains are greater than losses.

Example: After reimbursements, Jeff has a theft loss of $600 (after the $100 rule) and a casualty gain of $1,600. His gain is more than his loss by $1,000 ($1,600 - $600), so the $1,000 net gain is reported as income.

Losses more than gains

If losses after applying the $100 rule are more than gains, subtract gains from losses and reduce the result by 10% of AGI. The rest, if any, is a deductible loss.

Example: Jenny's theft loss after reducing it by reimbursements and by $100 is $2,700. Her casualty gain is $700. Her loss is more than her gain, so reduce her $2,000 net loss ($2,700 – $700) by 10% of her AGI to calculate her deductible loss. Suppose her AGI is $60,000. 10% of that is $600, so her theft loss would be $2,000 minus $600, which equals $1,400.

How is a gain reported?

When reporting a gain, two options exist:

I. The gain is reported as income in the year the reimbursement is received.

II. The taxpayer can choose to postpone reporting the gain if certain requirements are met.

Reporting Gain as Income on Schedule D

The amount by which gains exceed losses is treated as a capital gain and must be reported on Schedule D. The period of time the taxpayer owned the property is used to determine whether the gain is considered long-term or short-term.

Long-term: Property held more than one year

Short-term: Property held one year or less

Postpone Reporting a Gain

A taxpayer must ordinarily report the gain on their stolen or destroyed property if they receive money or unlike property as reimbursement. However, if they have a gain on the property, they can choose to postpone reporting the entire gain if they purchase replacement property within a specified replacement period that:

1. Cost at least as much as the reimbursement received and
2. Is similar or related in service or use to the stolen or destroyed property within a specified replacement period

Note: Taxpayers can postpone a gain on a damaged property if they spend the reimbursement to restore the property instead of replacing it. Also, a taxpayer does not have to use funds received as reimbursement to acquire the replacement property. For example, if they spend the money received from the insurance company for other purposes, and borrow money to buy replacement property, they can still postpone reporting the gain.

Replacement Property

1. **To postpone reporting all the gain, the cost of the replacement property must be at least as much as the reimbursement received.**

   If the cost of the replacement property is less than the reimbursement, the taxpayer must include the gain in their income up to the amount of the reimbursement that is more than the cost.

   Example: In 1970, Michelle bought an oceanfront cottage for her personal use at a cost of $18,000. She made no further improvements or additions to it. When a storm destroyed the cottage this January, the cottage was worth $250,000. She received $146,000 from the insurance company in March. Therefore, she had a gain of $128,000 ($146,000 – $18,000). She spent $144,000 to rebuild the cottage. Because this is less than the insurance proceeds received, she must include $2,000 ($146,000 – $144,000) difference in her income.

   Please note that the taxpayer must reduce the cost basis of their replacement property (its cost) by the amount of postponed gain. In this way, tax on the gain is postponed until they dispose of the replacement property.

2. **Replacement property must be similar or related in service or use to the property it replaces.**

   Property acquired as a gift or inheritance does not qualify. A taxpayer must buy replacement property for the specific purpose of replacing their destroyed or stolen property.

   Example: Wendy's home was destroyed by fire, and she invested the insurance proceeds in a grocery store. Her replacement property is not similar or related in service or use to the destroyed property.

Replacement Period

If a taxpayer is choosing to postpone a casualty or theft gain, they must purchase the replacement property within a specified replacement period. The replacement period begins on the date the property was damaged, destroyed, or stolen and ends two years after the close of the first tax year in which any portion of the gain is realized.

Example: While the Rolands were on vacation, a valuable piece of antique furniture that cost $2,200 was stolen from their home. They discovered the theft when they returned home on August 10, 2010. The insurance company investigated the theft and did not settle their claim until January 4, 2011, when they paid the Roland's $3,000.

The replacement period begins august 10, 2010, the date the furniture was stolen. The replacement period ends December 31, 2013, because that is two years after the end of 2011, the year they realized a gain from the reimbursement for the theft; so they have until December 31, 2013, to replace the furniture if they want to postpone the gain.

Three-Year Limit

The period for assessing tax on any gain ends 3 years after the date the taxpayer notifies the director of the Internal Revenue Service for their area of any of the following:

- They replaced the property.
- They do not intend to replace the property.
- They did not replace the property within the replacement period.

Please note that the taxpayer can change their mind about whether to report or to postpone reporting their gain at any time before the end of the replacement period.

When Main Home is Destroyed

If a taxpayer has a gain because their main home was destroyed, they generally can exclude the gain from their income as if they had sold or exchanged their home. They may be able to exclude up to $250,000 of the gain (up to $500,000 if married filing jointly). To exclude a gain, they generally must have owned and lived in the property as their main home for at least 2 years during the 5-year period ending on the date it was destroyed.

Example: Bob is single. A fire destroyed his main home. The insurance company reimbursed him $367,000 for the property, which had an adjusted basis of $62,000. So he had a gain of $305,000 from the casualty. He meets the requirements to exclude the gain on his main home, so he excludes $250,000. He still has a remaining gain of $55,000 ($305,000 - $250,000). ***What should Bob do with the excess gain?***

Bob can postpone reporting the excess gain by buying replacement property that is similar or related in service or use within the replacement period. To postpone reporting all the excess gain the replacement property must cost at least as much as the amount they received because of the destruction minus the excluded gain.

Six months later…Bob bought another home for $170,000. Because his new home cost more than the excess gain he can postpone reporting the remaining gain of $55,000. His basis for the new home is $115,000 ($170,000 cost – $55,000 postponed gain).

How to Postpone Reporting a Gain?

To postpone reporting gain from a casualty or theft, the taxpayer must report their choice to postpone the gain on the tax return for the year they have the gain. Gain is realized in the year insurance proceeds or other reimbursements are received that result in a gain.

Required Statement

Taxpayers must attach a statement to their tax return for the year of the gain. The statement should include:

- The date and details of the casualty or theft
- The insurance or other reimbursement received from the casualty or theft
- How the gain was calculated

Replacement Property Acquired before Return Filed

If a taxpayer acquires replacement property before filing their tax return for the year they have a gain, they should also include the following detailed information on the statement:

- The replacement property
- The postponed gain
- The basis adjustment that reflects the postponed gain
- Any gain on the event being reported as income

Replacement Property Acquired after Return Filed

When a taxpayer intends to acquire replacement property after filing the return for the year in which they have a gain, their statement should inform the IRS that they are choosing to replace the property within the required replacement period. Later, when the taxpayer actually acquires the replacement property, they need to attach another statement for that tax year notifying the IRS of the acquisition.

NOTE: If the taxpayer acquires part of the replacement property in one year and part in another year, they must make a statement for each year. The statement should contain detailed information on the replacement property acquired in that year.

Amended Return

Taxpayers must file an amended return (using **Form 1040X, Amended U.S. Individual Income Tax Return**) for the tax year of the gain if either of the following situations occurs:

- Replacement property is not acquired within the required replacement period, plus extensions. On this amended return, the taxpayer reports the gain and pays any additional tax due.
- Replacement property is acquired within the required replacement period plus extensions, but at a cost that is less than the amount reimbursed for the casualty or theft event. On this amended return, report the portion of the gain that cannot be postponed and pay any additional tax due.

Example: David's property was stolen in 2009. His insurance company reimbursed him $10,000, of which $5,000 was a gain. He reported the $5,000 gain on his return for 2009 (the year he realized the gain) and paid the tax due. In 2010 he bought replacement property. His replacement property cost $9,000. Because he reinvested all but $1,000 of his reimbursement, he can now postpone reporting $4,000 ($5,000 – $1,000) of his gain.

To postpone reporting his gain, he must file an amended return for 2009 using Form 1040X. He should attach an explanation showing that he previously reported the entire gain from the theft but he now wants to report only the part of the gain ($1,000) equal to the part of the reimbursement not spent for replacement property.

Knowledge Check Four

1. A taxpayer would have a gain from a casualty or theft if their insurance reimbursement or other reimbursement is more than their__________.

    A. Decrease in FMV of the property

    B. Adjusted basis in the destroyed or stolen property

    C. AGI

    D. Replacement property cost

2. Nate's theft loss is $900 after reducing it by reimbursements and by $100. His casualty gain is $1,450. You must report the ___________ net gain on ____________.

    A. $550, Schedule A

    B. $550, Schedule B

    C. $550, Schedule D

    D. $1,450, Schedule D

3. The replacement period for property stolen or damaged by a casualty event has which of the following beginning and ending dates? (Select all that apply.)

    A. Begins 30 days after the property was damaged, destroyed, or stolen

    B. Begins on the date the property was damaged, destroyed, or stolen

    C. Ends two years after the close of the first tax year in which any portion of the gain is realized

    D. Ends at the close of the second calendar year after which the event occurred

4. Maria's car was destroyed by a tornado in September 2010. In December 2010, the insurance company paid her $5,000 more than the adjusted basis of her car. By what date must Maria replace her property if she wants to postpone reporting her gain?

    A. September 30, 2011

B. December 31, 2011

C. September 30, 2012

D. December 31, 2012

5. Generally, a gain is reported as income in the year the reimbursement is received. Under what conditions can the taxpayer postpone reporting the gain? (Select all that apply.)

   A. If the reimbursement is spent to restore the property

   B. If the reimbursement is spent to purchase replacement property

   C. If the cost of the replacement property is less than the reimbursement

   D. The taxpayer cannot postpone reporting a casualty or theft gain.

6. Maxine's home was damaged by the aftershock of an earthquake. She had purchased the home for $45,000 in 2009. In 2010, she replaced the roof on home for $6,000. The FMV prior to the event was $85,000. After the earthquake, the home had a FMV of $22,000.

   Maxine's insurance reimbursed her $53,000 for the damage to her home, and she does not expect to receive any additional reimbursement. Maxine's AGI is $48,000. Maxine's employer has an emergency relief fund that specifies funds be used for repair, replacement, or rehabilitation of property. She received $2,500 from the fund, all of which she use for repairing her home. Her relatives gave her $8,000 that they specified for her to use for home repairs. Maxine does not intend to make any more repairs within the next two years, and she does not qualify to exclude any of the gain.

   Complete her Form 4684. What is the amount on Line 15?

   A. $12,400

   B. $12,500

   C. $6,700

   D. $6,600

Lesson V: Determining Federally Declared Disaster Area Losses

A presidentially declared area is an area declared by the President of the United States to be eligible for federal assistance under the Disaster Relief and Emergency Assistance Act.

Special Rules

For 2008 and 2009, the following special rules apply to losses of personal use property due to federally declared disasters:

- The taxpayer's net disaster loss is not subject to the 10% rule.
- The taxpayer can deduct a net disaster loss even if they do not itemize deductions on Schedule A by including the loss in their standard deduction.
- They must complete Form 4684 and use the net disaster loss to calculate the standard deduction.

Starting in 2010, these rules no longer apply. Disaster losses occurring in 2010 are subject to the 10% rule and are deductible only if the taxpayer itemizes.

When Home is Damaged or Destroyed

There are some special considerations for main homes located in federally declared disaster areas. Special rules apply to home owner or renters who receive insurance proceeds for property related to the damage or destruction of their main homes located in federally declared disaster areas. They can postpone reporting a gain if they spend the reimbursement to repair or replace their home. In addition:

- Any gains from insurance proceeds received for property that is not listed separately on the taxpayer's insurance policy, such as furniture or clothing (also referred to as unscheduled property), are not taxable.
- Any other insurance proceeds received for the home or its contents are treated as received for a single item of property. Therefore, any replacement property purchased that is similar or related in service or use to any of the items is considered similar or related in service or use to the entire group of items that have been lumped together. The taxpayer can choose to have a taxable gain only to the extent the insurance proceeds treated as received for that single item exceed the cost of the replacement property.
- If the taxpayer chooses to postpone any gain from the receipt of insurance or other reimbursement for their main home or any of its contents, the replacement period ends four years after the end of the first tax year in which any part of the gain is realized (instead of the normal two-year replacement period).

Example: Ted's main home and its contents were completely destroyed in 2010 by a tornado in a federally declared disaster area. In 2010, he received insurance proceeds of $200,000 for the home and $25,000 for unscheduled personal property. He also received $5,000 for jewelry and $10,000 for a stamp collection, which were included on his insurance policy.

Assuming Ted does not qualify to exclude any of the gain on his home, here's an analysis of Ted's situation:

- The $25,000 received for the unscheduled property is not taxable.
- If Ted reinvests the remaining $215,000 in a replacement home, any of the contents, or both the home and contents, he can elect to postpone the gain on his home, jewelry, and stamp collection.
- If Ted reinvests only $180,000, his gain is $35,000 ($215,000 – $180,000).
- Ted has until the end of 2014 to purchase replacement property if he wants to postpone the gain.
- The basis in the replacement property is the cost minus $35,000, the postponed gain.

When Home is Declared Unsafe

Now, let's take a look at the special rules that apply if the taxpayer's home is made unsafe by a federally declared disaster. If the state or local government orders the taxpayer to tear their home down or move it because it is no longer safe to live in because of the disaster, treat the loss in value as a casualty loss from a disaster.

NOTE: The state or local government must issue the order for them to tear down or move the home within 120 days after the area is declared a disaster area.

When will the taxpayer's home be considered unsafe?

Only if both of the following apply:

- The home is substantially more dangerous after the disaster than it was before the disaster.
- The danger is from a substantially increased risk of future destruction from the disaster.

Calculate the loss in the same way as for casualty losses of personal-use property. When determining the decrease in FMV, use the value of the home before the taxpayer moves it or tears it down as its FMV after the casualty.

The taxpayer does not have a casualty loss if their home is unsafe due to dangerous conditions existing before the disaster (for example, if the home is located in an area known for severe storms). This is true even if the home is condemned.

Example: Due to a severe storm, the President declared the county Dawn lives in a federal disaster area. Although her home has only minor damage from the storm, a month later the county issues a demolition order. This order is based on a finding that Dawn's home is unsafe due to nearby mud slides caused by the storm.

- The loss in her home's value because the mud slides made it unsafe is treated as a casualty loss from a disaster.
- The loss in value is the difference between her home's FMV immediately before the disaster and immediately after the disaster.

When to Deduct a Disaster Loss?

Deducting Loss in the Preceding Year
Normally, casualty losses are deducted in the year they occurred. However, in case of a casualty loss from a federally declared disaster, the taxpayer can choose to deduct that loss on their return for the year the disaster occurred or on their return or amended return for the tax year immediately preceding the tax year in which the disaster happened. If they make this choice, the loss is treated as having occurred in the preceding year. Claiming a qualifying disaster loss on the previous year's return may result in a lower tax for that year, which may produce or increase a refund.

Claiming a Disaster Loss on an Amended Return
If a taxpayer has already filed their return for the preceding year, they can claim a disaster loss against that year's income by filing an amended return (on Form 1040X).

If the taxpayer elects to deduct their loss on the original or amended return for the previous tax year, they must include a statement declaring they are making the election. The statement can be made on the return or filed with the return. The statement should specify the date or dates of the disaster and the city, town, county, and state where the damaged or destroyed property was located when the event occurred.

When to Itemize Disaster Loss Deduction?

If the taxpayer wants to deduct the disaster loss as an itemized deduction and they did not itemize their deductions on their original return, they must first determine whether the casualty loss deduction now makes it advantageous for them to itemize. For federal tax purposes, it is advantageous to itemize if the total of the casualty loss deduction and any other itemized deductions is more than their standard deduction.

If itemizing, attach Schedule A and Form 4684 to the amended return. Fill out Form 1040X to recalculate the tax and their refund. Taxpayers should keep the records that support their loss deduction. They do not have to attach the records to the amended return.

Filing Elections

The election to deduct the loss on the preceding year's original filing or amendment must be made by the later of:

- The due date (without extensions) for filing the return for the year the disaster happened
- The due date (with extensions) for filing the return for the preceding tax year

For example, if the taxpayer is a calendar year taxpayer, they ordinarily have until April 18, 2011, to amend their 2009 tax return to claim a casualty loss that occurred during 2010.

Note: Taxpayers can revoke their election within 90 days after making it by returning to the IRS any refund or credit they received because they made the election. If they revoke their election before they receive the refund or credit, they have 30 days from receiving it to return it for the revocation to be effective.

IRS Postponed Deadlines & Interest Abatement

The IRS may postpone, for up to one year, certain tax deadlines for taxpayers who are affected by a presidentially declared disaster. The area for which the IRS postpones tax deadlines is called a covered disaster area. The tax deadlines the IRS may postpone include the following:

- Filing income tax returns
- Paying income tax due
- Making contributions to a traditional or Roth IRA

The IRS will publicize the postponement by publishing a news release, revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB). The IRS may reduce or eliminate the interest and penalties on underpaid income tax for the length of any postponement of tax deadlines.

Who is Eligible for the Postponement?

If the IRS postpones a tax deadline for taxpayers affected by a presidentially declared disaster area, the following taxpayers are eligible for the postponement:

- Any person whose main home is located in a covered disaster area.
- Any sole proprietor whose principal place of business is located in a covered disaster area.
- Any relief worker affiliated with a recognized government or philanthropic organization who is assisting in a covered disaster area.
- Any person or sole proprietor whose records are needed to meet a postponed deadline (if those records are maintained in a covered disaster area). The main home or principal place of business does not have to be located in the covered disaster area.
- The spouse on a joint return with a taxpayer who is eligible for postponements of tax deadlines.
- Any other person determined by the IRS to be affected by a presidentially declared disaster.

Qualified Disaster Relief Payments

Qualified disaster relief payments that the taxpayer receives for expenses incurred as a result of a federally declared disaster are not taxable income.

Qualified disaster relief payments include payments received (regardless of the source) for the following expenses:

- Reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a federally declared disaster.
- Reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence due to a federally declared disaster. (A personal residence can be a rented residence or one the taxpayer owns.)

- Reasonable and necessary expenses incurred for the repair or replacement of the contents of a personal residence due to a federally declared disaster.

Qualified disaster relief payments do **not** include:

- Payments for expenses otherwise paid for by insurance or other reimbursements, or
- Income replacement payments, such as payments of lost wages, lost business income, or unemployment compensation.

NOL Carryback Provision for Disaster Losses

Net Operating Losses caused by qualified presidentially declared disaster areas can be carried back five tax years preceding the year in which the event occurred. This enables the taxpayer to decrease their prior year tax liabilities and potentially receive an influx of tax refund money to help offset the financial consequences of the event.

NOTE: Refer to the IRS Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts, for additional information.

Knowledge Check Five

1. The IRS may postpone for up to ________ year(s) certain tax deadlines for taxpayers who are affected by a presidentially declared disaster.

    A. One

    B. Two

    C. Three

    D. Four

2. Which of the following are true for casualty losses of personal-use property due to federally-declared disasters that occurred in 2010?

    A. The taxpayer can make an election to deduct losses on the prior year's original or amended tax return.

    B. The $100 rule does not apply for net losses.

    C. The 10% rule does not apply for net losses.

    D. The taxpayer does not have to itemize to deduct net losses.

3. Which of the following apply for main homes located in federally declared disaster areas? (Select all that apply.)

    A. The taxpayer can deduct casualty loss if their home is unsafe due to dangerous conditions existing before the disaster.

    B. Insurance proceeds received for unscheduled personal property that was part of the contents of the home are not taxable.

    C. The replacement period for postponing a gain is four years.

    D. Insurance proceeds received for the home or its contents are treated as received for a single item of property.

Module Review

Before the module assessment, take a moment to practice the concepts covered in the module by completing the following scenario-based exercise.

Jason Cooper (born 02-28-1983, SSN 400-00-9250) and Megan Cooper (born 11-16-1982, SSN 410-00-9250) are married, but choose to file separately. They own a home at 5246 Daley Street, Your City, Your State and ZIP Code. They itemize their deductions and choose to split their real estate taxes and mortgage interest evenly with each claiming 50% of the amount on their Schedule A.

Jason owns a classic car (purchased 06-22-2003, cost $14,000), but it was stolen from Midtown Storage, Inc., 600 Stow Drive, Your City, Your State and ZIP Code. He discovered the car was missing on March 5, 2010, when he tried to bring the car home to use during the nice weather. The police report was filed on that same day. Jason had spent $8,200 on a custom paint job and interior restoration.

When Jason tried to file a claim with his insurance company, he discovered that his policy had lapsed. The FMV of the car was $32,300 when he discovered it was missing. Jason filed a claim in court against the storage facility ownership group, who paid him $10,000 to settle out of court. However, they specified that the money be used towards replacement of the vehicle.

Jason's AGI is $54,500. He had federal withholdings of $5,620 and state tax withholdings of $3,320.

Complete Jason's Form 4684 and carry the result to the appropriate schedule, as needed.

Module Assessment

1. Zane had a rough year:

    - Vandals went through Zane's neighborhood and set several cars on fire, including Zane's 1994 pickup truck.
    - A wind storm ripped through Zane's town, uprooting some of the trees in Zane's front yard.
    - Termites ate through the foundation of Zane's house.
    - Zane survived an earthquake that severely damaged the shed in his back yard.

    A loss resulting from which of the following does not qualify as a deductible casualty loss?

    A. Vandalized truck

    B. Trees uprooted in the wind storm

    C. Termite-damaged house

    D. Earthquake-damaged shed

2. Bobby Jo woke up one morning to discover that her prized pig, Porker, was missing from its pen. Let's look at the evidence:

    - The lock on the pen is still intact.
    - There are no tire tracks or footprints leading to or from the pen other than Bobby Jo's.
    - There is an area of the pen's fence where it appears someone, or something, dug a hole under it from inside the pen.
    - After one week, Bobby Jo has not recovered Porker, nor has she seen any ads or posters saying someone found a stray pig.

    This scenario is a ______________ event.

    A. Nondeductible

    B. Theft

    C. Casualty

    D. Presidentially declared disaster

Partial Problem One

3. Use the information provided below to calculate John Ablee's casualty gain or loss amount.

- John Ablee (01-02-1961, 400-00-9254), single, Sales Manager
- His AGI is $49,325

Casualty - Hurricane Albatross:

- Event date: September 1, 2010.
- Location: 456 Pine Island Way, Your City, YS and Zip Code.
- John's vintage automobile was parked in his detached garage when the storm hit.
- His neighbor's giant oak tree was blown over and smashed through the roof of his garage and onto the car.

	Garage	Vintage Automobile
Date acquired	Built 03-03-2008	Purchased 10-07-2004
Cost/adjusted basis	$20,000	$7,000
FMV before the hurricane	$21,000	$8,000
FMV immediately after the hurricane	$12,000	$1,500
Insurance reimbursement	$2,000	$0
Additional expected insurance reimbursement	$1,000	$0

After calculating the casualty gain or loss amount, answer the five questions that follow.

I. John has experienced a ___________________.

A. Casualty gain

B. Casualty loss

C. Theft gain

D. Theft loss

II. How many Forms 4684 were needed for John?

____

III. What is the amount of John’s hurricane gain or loss before limits? Enter a loss as a negative number.

____

IV. What is the amount of John's hurricane gain or loss after applying all limits? Enter a loss as a negative number.

____

V. On what Schedule is John’s Form 4684 gain or loss reported?

   A. Schedule A

   B. Schedule B

   C. Schedule C

   D. Schedule D

4. Barry lost all of his possessions when a flood destroyed his house. His friend, Dexter, gave Barry $2,000 as a gift to help defray his loss, but Dexter did not specify to Barry how to use the money. How does the $2,000 impact Barry’s ability to claim a casualty loss?

   A. Barry must reduce his casualty loss by the $2,000.

   B. Barry does not have a casualty event if the flood waters rose slowly.

   C. Barry does not have to reduce his casualty loss by the $2,000.

   D. Barry must reduce the money received by the $100 rule and the 10% rule.

5. Which of the following items reduce a deductible casualty loss?

   A. Cash gifts from friends and relatives given without conditions.

   B. Employer's emergency disaster fund payments that are not specified for repair or replacement of damaged property.

   C. Employer's emergency disaster fund payments that are specified for repair or replacement of damaged property.

   D. Insurance payments for living expenses that are less than the temporary increase in living expenses.

Partial Problem Two

6. Use the information provided below to calculate Monica Randall's casualty gain or loss amount.

   - Monica Randall (04-15-1980, 400-00-9255), single, Pilot
   - Her AGI is $45,147

   Casualty - Fire:

   - Event date: August 30, 2010.
   - Location: 4891 27th Road East, Your City, YS and Zip Code.
   - Monica's personal airplane was damaged by a fire at the airport where she kept her plane.
   - She bought the plane on her birthday in 2003 for $58,000.
   - The FMV of the plane before the fire was $54,000.
   - The FMV after the damage was $36,000.
   - Her insurance company settled the claim by paying Monica $30,000.
   - To avoid litigation, the airport paid Monica $30,000 to assist with replacing the plane.

   After calculating the casualty gain or loss amount, answer the four questions that follow.

Monica has experienced a ______________.

A. Casualty loss

B. Casualty gain

C. Theft loss

D. Theft gain

I. What is the amount of Monica's gain or loss before limits? Enter a loss as a negative number.

____

II. What is the amount of Monica's gain or loss after applying all limits? Enter a loss as a negative number.

____

III. On what Schedule is Monica's Form 4684 gain or loss reported?

A. Schedule A

B. Schedule B

C. Schedule C

D. Schedule D

7. In 2010, Cameron had a casualty loss in a federally declared disaster area. Cameron can choose to claim the loss on his tax return for which of the following years?

A. 2010 only

B. 2009 only

C. 2010 or 2009

D. He can carry it back 3 years and forward 20 years

8. Which of the following is not true for tax year 2010 casualties in a federally declared disaster area?

    A. Taxpayers cannot amend their preceding year's tax return to claim a disaster loss that occurred this year.

    B. Gains from insurance proceeds received for unscheduled property are not taxable.

    C. The $100 rule does apply.

    D. The 10% rule does apply.

Module Knowledge Check Answers

Knowledge Check One

1. Which of the following events meet the criteria to be considered a casualty event?

    A. Diamond ring stolen during burglary

    B. Prize winning roses damaged by worm infestation

    C. Barn damaged due to fire the taxpayer paid someone to set

    D. Roof damaged due to hurricane-force winds

Feedback: Roof damage caused by hurricane-force winds is a sudden, unexpected event and is therefore considered a casualty event.

The following are not a casualty event:

- Diamond ring stolen during burglary – This is considered a theft event.
- Prize winning roses damaged by worm infestation – The damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests is a progressive deterioration and not considered a casualty.
- Barn damaged due to fire the taxpayer paid someone to set – A fire willfully set by the taxpayer, or someone they paid to set it, is not considered a casualty event.

2. Which of the following events qualify for theft loss consideration? (Select all the apply)

    A. Diamond ring stolen during burglary

    B. A loss from betting on horse races that were fixed

    C. A decrease in stock value due to misconduct by a corporate executive

    D. An expensive camera lost that went missing while on vacation

Feedback: A burglary is considered a theft event and a taxpayer betting on horse races that were fixed is permitted as a theft event.

The following are not a theft event:

- A decrease in stock value due to misconduct by a corporate executive – In this case, a capital loss would be reported when the stock is sold or becomes worthless.
- An expensive camera lost that went missing while on vacation – The simple disappearance of property is not a theft and cannot be deducted.

3. Which of the following can be used to prove a casualty event? (Select all that apply.)
   A. Documentation of when the theft occurred
   B. Proof that the taxpayer owned the property or was contractually required to repair or replace leased property
   C. Whether a claim has been submitted for which the taxpayer expects reimbursement
   D. Proof that the property was stolen

Feedback: Choices A and D are incorrect because theft considerations do not count as proof for a casualty event.

4. For a theft event to be deductible, taxpayers must be able to show which of the following? (Select all that apply.)
   A. When they discovered their property was missing
   B. **Proof that their property was stolen**
   C. That the thief was arrested
   D. Whether a claim for reimbursement exists for which there is reasonable expectation of recovery

Feedback: Choice C is incorrect. The individual who stole the property does not have to be arrested in order to prove a theft event occurred.

5. Vinnie's antique oriental rug was damaged by his new puppy before it was housebroken. Is the loss deductible as a casualty loss?
   A. Yes
   B. No

Feedback: Because the damage was not unexpected and unusual, the loss is not deductible as a casualty loss.

6. A car door is accidently slammed on Elizabeth's hand, breaking the setting of her diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is considered a theft event.
   A. True
   B. False

Feedback: The simple disappearance of property is not a theft. However, the loss of the diamond qualifies as a casualty because it was sudden, unexpected, and unusual.

7. Which of the following are deductible as a casualty loss? (Select all that apply.)
    A. The steady weakening of a building due to normal wind and weather conditions
    B. The rust and water damages to rugs and drapes caused by the bursting of a water heater
    C. Termite or moth damage
    D. Destruction of trees by an unusual infestation of beetles

Feedback: Choices B and D are deductible as casualty losses as they are sudden, unexpected events. Choice A and C are not deductible as casualty losses as the damage results from progressive deterioration, rather than a sudden event.

Knowledge Check Two

1. If a taxpayer has two separate casualty losses in the same year, they must reduce:
    A. Each loss by $100
    B. Each loss by 10% of AGI
    C. There is no deduction limitation
    D. Both losses by $100 and 10% of AGI

    Feedback: If a taxpayer has two separate casualty losses in the same year, they must reduce each loss by $100. And then apply the 10% rule to the total of all losses from all the events.

2. A single casualty may damage two or more pieces of property. Would the $100 rule apply to each property separately?
    A. Yes
    B. No

    Feedback: You must calculate the loss separately for each item of property damaged or stolen in a single event. Then combine these separate losses to calculate the total loss, and reduce the total loss by $100.

3. A taxpayer and spouse file separate returns. A property that the spouse owns solely is destroyed in a fire. Can the taxpayer as well as the spouse calculate a loss deduction on their separate returns?

    A. Yes

    B. No

    Feedback: If a taxpayer and spouse have a casualty or theft loss and they file separate returns, each of them must reduce their loss by $100. This is true even if they own the property jointly. However, if one spouse owns the property, only that spouse can calculate a loss deduction on a separate return.

4. If a taxpayer has more than one casualty or theft loss during the tax year, you must reduce each loss by any reimbursement and then by $100 as well as by 10% of the taxpayer's AGI.

    A. True

    B. **False**

    Feedback: If a taxpayer has more than one casualty or theft loss during the tax year, you must reduce each loss by any reimbursement and by $100. Then you must reduce the total of all losses by 10% of the taxpayer's AGI.

5. Several years ago, Robert purchased a lakeside cottage, which cost $144,800 (including $14,500 for the land). In June, a fire destroyed his cottage. The land was not damaged. This was the only casualty or theft loss for the year. The FMV of the property immediately before the fire was $180,000 ($145,000 for the cottage and $35,000 for the land). The FMV immediately after the fire was $35,000 (value of the land). Robert collected $130,000 from the insurance company. His AGI for the year the fire occurred is $80,000. His deduction for the casualty loss is:

    A. $8,000

    B. $6,700

    C. $14,800

    D. $6,500

    Feedback: In calculating a loss to real estate the taxpayer owns for personal use, all improvements (such as buildings and ornamental trees and the land containing the improvements) are considered together.

Robert's deduction for the casualty loss is calculated in the following manner:

1.	Adjusted basis of the entire property (cost in this case)	$144,800
2.	FMV of entire property before fire	$180,000
3.	FMV of entire property after fire	$35,000
4.	Decrease in FMV of entire property (line 2 – line 3)	$145,000
5.	Tentative loss (smaller of line 1 or line 4)	$144,800
6.	Insurance reimbursement	$130,000
7.	Loss after reimbursement (line 5 – line 6)	$14,800
8.	$100 rule	$100
9.	Loss after $100 rule (line 7 – line 8)	$14,700
10.	10% of $80,000 AGI (10% rule)	$8,000
11.	**Casualty loss deduction (line 9 – line 10)**	**$ 6,700**

6. In August, a storm destroyed Anne's pleasure boat, which cost $18,500. This was her only casualty or theft loss for the year. Its FMV immediately before the storm was $17,000. She had no insurance, but was able to salvage the motor of the boat and sell it for $200. Her AGI for the year the casualty occurred is $70,000. Her deduction for the casualty loss is:

    A. $16,800

    B. $7,000

    C. $9,700

    D. $16,700

Feedback: The boat is Anne's personal property. If personal property is stolen or is damaged or destroyed by a casualty, you must calculate the loss separately for each item of property. Although the motor was sold separately, it is part of the boat and not a separate item of property. You must calculate casualty loss deduction as follows:

1.	Adjusted basis (cost in this case)	$18,500
2.	FMV before storm	$17,000
3.	FMV after storm	$200
4.	Decrease in FMV (line 2 – line 3)	$16,800
5.	Tentative loss (smaller of line 1 or line 4)	$16,800
6.	Insurance reimbursement	-0-
7.	Loss after reimbursement (line 5 – line 6)	$16,800
8.	$100 rule	$100
9.	Loss after $100 rule (line 7 – line 8)	$16,700
10.	10% of $70,000 AGI (10% rule)	$7,000
11.	**Casualty loss deduction (line 9 – line 10)**	**$ 9,700**

7. In June, Richard was involved in an auto accident that totally destroyed his personal car and his antique pocket watch. He had bought the car for $30,000. The FMV of the car just before the accident was $17,500. Its FMV just after the accident was $180 (scrap value). The insurance company reimbursed him $16,000. His watch was not insured. He had purchased it for $250. Its FMV just before the accident was $500. His AGI for the year the accident occurred is $97,000. His deduction for the casualty loss is:

   A. $250

   B. $0

   C. $500

   D. $1,000

Feedback: If personal property is stolen or is damaged or destroyed by a casualty, you must calculate the loss separately for each item of property. Then combine these separate losses to calculate the total loss. Reduce the total loss by $100 and 10% of the AGI to calculate the loss deduction. The casualty loss deduction is zero, calculated as follows:

		Car	Watch
1.	Adjusted basis (cost in this case)	$30,000	$250
2.	FMV before accident	$17,500	$500
3.	FMV after accident	$180	-0-
4.	Decrease in FMV (line 2 – line 3)	$17,320	$500
5.	Tentative loss (smaller of line 1 or line 4)	$17,320	$250
6.	Insurance reimbursement	$16,000	-0-
7.	Loss after reimbursement (line 5 – line 6)	$1,320	$250
8.	Total loss before limits		$1,570
9.	$100 rule		$100
10.	Loss after $100 rule (line 8 – line 9)		$1,470
11.	10% of $97,000 AGI (10% rule)		$9,700
12.	**Casualty loss deduction (line 10 – line 11)**		**$-0-**

Knowledge Check Three

1. Mark's family home was extensively damaged by an earthquake. Mark's reimbursement from his insurance company was $100,000. His employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. Mark received $4,000 from the fund and spent the entire amount on repairs to his home. What is Mark's total reimbursement that must be entered on Form 4684?

    A. $4,000

    B. $96,000

    C. $100,000

    D. $104,000

   Feedback: In calculating his reimbursements, include Mark's insurance reimbursement and disaster relief fund payment. His reimbursement is $104,000 ($100,000 + $4,000).

2. Linda's home was damaged by a hurricane. Relatives and neighbors made cash gifts to her. There were no limits or restrictions on how she could use the monies. She used part of the cash gifts to pay her repairs to her home. Does Linda need to reduce her casualty loss by the amount she received from her relatives and neighbors and used to pay for repairs to her home?

    A. Yes

    B. No

   Feedback: The money Linda received was an excludable gift, so the amount used to pay for repairs to her home does not reduce her casualty loss on the damaged home.

3. When the taxpayer loses the use of their main home and receives an insurance payment for living expenses, a portion of the payment may need to be reported as income. Which scenario would require income to be reported?

		Payment received	Actual expenses	Normal expenses
A	Scenario 1	$1,100	$3,400	$1,650
B	Scenario 2	$300	$1,800	$1,000
C	**Scenario 3**	**$1,710**	**$1,900**	**$1,650**
D	Scenario 4	$2,000	$2,500	$300

   Feedback: Part of an insurance payment for living expenses needs to be reported as income when it exceeds actual increase in living expenses.

Scenario 3 calculation:

Insurance payment received for living expenses………………………………………$1,710

Total actual living expenses…………………...$1,900

Total normal living expenses……………………$1,650

Temporary increase in living expenses……………………………………………………..-$250

Insurance payment amount includible in income……………………………………$1,460

4. In December 2010, Susan had a collision while driving her personal car. Repairs to the car cost $950. She had $100 deductible collision insurance. Her insurance company agreed to reimburse her for the rest of the damage. Because she expected a reimbursement from the insurance company, she did not have a casualty loss deduction in 2010. Due to the $100 rule, she cannot deduct the $100 she paid as the deductible. When she receives the $850 from the insurance company in 2011, should she report it as income?

   A. Yes

   B. No

   Feedback: If a taxpayer receives exactly the reimbursement they expected to receive, they do not have to include any of the reimbursement in their income and they cannot deduct any additional loss.

Knowledge Check Four

1. A taxpayer would have a gain from a casualty or theft if their insurance reimbursement or other reimbursement is more than their__________.

   A. Decrease in FMV of the property

   B. Adjusted basis in the destroyed or stolen property

   C. AGI

   D. Replacement property cost

   Feedback: If the taxpayer receives an insurance reimbursement or other reimbursement that is more than their adjusted basis in the destroyed or stolen property, they have a gain from the casualty or theft. Even if the decrease in FMV of the property is smaller than its adjusted basis, use the adjusted basis to calculate the gain.

2. Nate's theft loss is $900 after reducing it by reimbursements and by $100. His casualty gain is $1,450. You must report the __________ net gain on ___________.

   A. $550, Schedule A

   B. $550, Schedule B

   C. $550, Schedule D

   D. $1,450, Schedule D

   Feedback: The amount by which gains exceed losses is treated as a capital gain and must be reported on Schedule D.

3. The replacement period for property stolen or damaged by a casualty event has which of the following beginning and ending dates? (Select all that apply.)

   A. Begins 30 days after the property was damaged, destroyed, or stolen

   B. Begins on the date the property was damaged, destroyed, or stolen

   C. Ends two years after the close of the first tax year in which any portion of the gain is realized

   D. Ends at the close of the second calendar year after which the event occurred

   Feedback: The replacement period begins on the date the property was damaged, destroyed, or stolen and ends two years after the close of the first tax year in which any portion of the gain is realized.

4. Maria's car was destroyed by a tornado in September 2010. In December 2010, the insurance company paid her $5,000 more than the adjusted basis of her car. By what date must Maria replace her property if she wants to postpone reporting her gain?

   A. September 30, 2011

   B. December 31, 2011

   C. September 30, 2012

   D. December 31, 2012

   Feedback: Maria first realized a gain from the reimbursement for the casualty in 2010. So she has until December 31, 2012, to replace the property.

5. Generally, a gain is reported as income in the year the reimbursement is received. Under what conditions can the taxpayer postpone reporting the gain? (Select all that apply.)

    A. If the reimbursement is spent to restore the property

    B. If the reimbursement is spent to purchase replacement property

    C. If the cost of the replacement property is less than the reimbursement

    D. The taxpayer cannot postpone reporting a casualty or theft gain.

    Feedback: Taxpayers can postpone reporting a gain if the reimbursement is spent to restore the property or to purchase replacement property.

6. Maxine's home was damaged by the aftershock of an earthquake. She had purchased the home for $45,000 in 2009. In 2010, she replaced the roof on home for $6,000. The FMV prior to the event was $85,000. After the earthquake, the home had a FMV of $22,000.

    Maxine's insurance reimbursed her $53,000 for the damage to her home, and she does not expect to receive any additional reimbursement. Maxine's AGI is $48,000. Maxine's employer has an emergency relief fund that specifies funds be used for repair, replacement, or rehabilitation of property. She received $2,500 from the fund, all of which she use for repairing her home. Her relatives gave her $8,000 that they specified for her to use for home repairs. Maxine does not intend to make any more repairs within the next two years, and she does not qualify to exclude any of the gain.

    Complete her Form 4684. What is the amount on Line 15?

    A. $12,400

    B. $12,500

    C. $6,700

    D. $6,600

    Feedback: Here's her completed Form 4684 (next page).

Form **4684**

Department of the Treasury
Internal Revenue Service

Casualties and Thefts

▶ See separate instructions.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each casualty or theft.

OMB No. 1545-0177
2010
Attachment Sequence No. 26

Name(s) shown on tax return	Identifying number
Maxine Hinde	

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property **A** House, earthquake, 8235 Ingail St. Sarasota FL; 03/28/1994
Property **B**
Property **C**
Property **D**

		Properties A	B	C	D
2 Cost or other basis of each property	2	51,000			
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	3	63,500			
Note: *If line 2 is **more** than line 3, skip line 4.*					
4 Gain from casualty or theft. If line 3 is **more** than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4	12,500			
5 Fair market value **before** casualty or theft	5				
6 Fair market value **after** casualty or theft	6				
7 Subtract line 6 from line 5	7				
8 Enter the **smaller** of line 2 or line 7	8				
9 Subtract line 3 from line 8. If zero or less, enter -0-	9				

10 Casualty or theft loss. Add the amounts on line 9 in columns A through D	10	
11 Enter the **smaller** of line 10 or $100	11	
12 Subtract line 11 from line 10	12	
Caution: *Use only one Form 4684 for lines 13 through 21.*		
13 Add the amounts on line 12 of all Forms 4684	13	
14 Add the amounts on line 4 of all Forms 4684	14	12,500
15 • If line 14 is **more** than line 13, enter the difference here and on Schedule D. **Do not** complete the rest of this section (see instructions). • If line 14 is **less** than line 13, enter -0- here and go to line 16. • If line 14 is **equal** to line 13, enter -0- here. **Do not** complete the rest of this section.	15	12,500
16 If line 14 is **less** than line 13, enter the difference	16	
17 Does the amount on line 12 include a loss from a disaster declared a federal disaster in tax years beginning after 2007 that occurred before 2010? ☐ **Yes.** Enter the amount from line 3 of the Worksheet for Line 17, in the instructions. If you are filing Schedule A (Form 1040), go to line 18. Otherwise, enter this amount on Schedule L (Form 1040A or 1040). Do not complete the rest of Section A. Form 1040NR filers, see instructions. ☐ **No.** Enter -0- and go to line 18	17	
18 Subtract line 17 from line 16	18	
19 Enter 10% of your adjusted gross income from Form 1040, line 38, or Form 1040NR, line 36. Estates and trusts, see instructions	19	
20 Subtract line 19 from line 18. If zero or less, enter -0-	20	
21 Add lines 17 and 20. Also enter the result on Schedule A (Form 1040), line 20, or Form 1040NR, Schedule A, line 8. Estates and trusts, enter the result on the "Other deductions" line of your tax return	21	

For Paperwork Reduction Act Notice, see page 5 of the instructions. Cat. No. 12997O Form **4684** (2010)

Knowledge Check Five

1. The IRS may postpone for up to _______ year(s) certain tax deadlines for taxpayers who are affected by a presidentially declared disaster.

    A. One

    B. Two

    C. Three

    D. Four

    Feedback: The IRS may postpone for up to one year certain tax deadlines for taxpayers who are affected by a presidentially declared disaster.

2. Which of the following are true for casualty losses of personal-use property due to federally-declared disasters that occurred in 2010?

    A. The taxpayer can make an election to deduct losses on the prior year's original or amended tax return.

    B. The $100 rule does not apply for net losses.

    C. The 10% rule does not apply for net losses.

    D. The taxpayer does not have to itemize to deduct net losses.

    Feedback: Losses due to federally declared disasters can be deducted on the prior year's return.

3. Which of the following apply for main homes located in federally declared disaster areas? (Select all that apply.)

    A. The taxpayer can deduct casualty loss if their home is unsafe due to dangerous conditions existing before the disaster.

    B. Insurance proceeds received for unscheduled personal property that was part of the contents of the home are not taxable.

    C. The replacement period for postponing a gain is four years.

    D. Insurance proceeds received for the home or its contents are treated as received for a single item of property.

    Feedback: These three special rules apply for main homes located in federally declared disaster areas.