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TAXATION & WEALTH PLANNING

ALERT

Tax Considerations in the Wake of Hurricane Sandy

The Internal Revenue Code allows taxpayers who suffer casualty losses to deduct the amount of the loss to property in computing taxable income.In particular, Section 165(c)(3) allows a noncorporate taxpayer to claim a casualty loss deduction, subject to applicable limitation, for losses to property arising from fire, storm such as Hurricane Sandy, theft or other casualty even if the property damaged or destroyed is neither used in a trade or business nor held in a transaction entered into for profit. Losses incurred with respect to property used in a trade or business or held in a transaction entered into for profit are deductible under Sections 165(c)(1) or (2), without regard to causation.

Generally, a noncorporate taxpayer's non-trade or business deductions are only taken into account for purposes of determining a net operating loss to the extent of the taxpayer's nonbusiness income. Casualty and theft losses with respect to investment property or personal property are not subject to this limitation. See Section 172(d)(4)(C).

In computing the amount of a casualty loss, the type of property involved is relevant. Where property held in a trade or business or held in a transaction entered into for profit is partially destroyed, the amount of deductible loss is the lesser of the adjusted basis of the property, original cost less depreciation plus improvements (other than normal maintenance) or the decline in fair market value of each item of property including a structure or building due to the casualty. If such property is totally destroyed and if its fair market value immediately before the casualty is less than its adjusted basis for tax purposes, the deductible loss is not limited to the property's fair market value but is instead allowed up to the amount of the property's adjusted basis. The measure of the loss for personal use property, however, is always the lesser of the economic loss (decline in fair market value) or the adjusted basis of the property. There are low threshold dollar amounts which are not allowed in computing the nonbusiness casualty (or theft) loss.

Special rules "kick in" if Hurricane Sandy is recognized as a federal disaster. Under § 165(k), losses resulting from a federal disaster are sometimes allowed as casualty losses even if they would not qualify under the foregoing definition. This rule applies if:

(1) the taxpayer's residence is located in an area determined by the government to warrant federal assistance under the Disaster Relief and Emergency Assistance Act;

(2) the disaster makes the residence unsafe for use as a residence; and

(3) within 120 days after the determination, a state or local government orders the taxpayer to demolish or relocate the residence.

The rule is meant to cover taxpayers whose residences are not physically damaged, and thus would not qualify for the casualty loss deduction under the general rules, but "whose residences [are] condemned because of a threat of further destruction or because their residences [are] otherwise… rendered uninhabitable by the disaster."

To satisfy the requirement that the disaster make the residence unsafe, the residence must be rendered materially more dangerous after the disaster than it was before the disaster, and the danger must be from a materially increased risk of future destruction arising from the disaster. For example, in a storm disaster area, loss from a demolition or relocation order based on a finding that the residence was rendered unsafe by nearby mudslides would be treated as a casualty loss under the provision. By contrast, any decline in the value of a residence resulting from pre-existing dangerous conditions (e.g., by reason of location in an historically storm-prone region) does not constitute a casualty loss, even if the house is condemned.

To qualify, you will have to itemize your deductions on your 2012 tax return. However, you still may not get a large deduction. The catastrophic loss deduction is limited to amounts above 10 percent of adjusted gross income -- the

amount on line 37 of the 1040 form.

This is not a tax credit. It is a deduction, which reduces taxable income, which, in turn, reduces taxes. The deduction is more lucrative for those with no insurance or if insurance refuses to pay. However, those in a federally declared disaster area can amend their 2011 returns to get the deduction more quickly.

It is important to document any claims you make. If your property is destroyed, it is likely many of your records are as well, and you will have to reconstruct records related to your property value.

If you are dealing with a particularly large property claim, you might consider getting an appraisal of your property's pre- and post-disaster value from a qualified professional. If the IRS challenges your loss, you are required to proof the amount of the loss under the applicable tax rules.

Declaration as a Federal Disaster Area

Under § 165(k), all losses sustained by the taxpayer in the disaster, not merely the loss to the residence, are treated as casualty losses and allowed to be deducted as a casualty loss on your tax return.

On Nov. 2, the IRS announced various tax relief measures for individuals and businesses affected by Hurricane Sandy in Connecticut, New Jersey, and New York (e-News for Tax Professionals No. 2012-44). The relief applies to taxpayers in areas in those states declared a disaster area by the Federal Emergency Management Agency (FEMA). The IRS noted other locations may be added in coming days, based on additional damage assessments by FEMA.

Qualified Disaster Treatment of Payments to Victims

Also on Nov. 2, the IRS announced that in addition to declaring Hurricane Sandy a federal disaster it stated that the storm was a "qualified disaster for purpose of Section 139" and that qualified disaster relief payments made to individuals by their employer or any person can be excluded from those individuals' taxable income.

Qualified disaster relief payments are defined by Section 139, in general, as amounts paid: :

(1) to or for the benefit of an individual to reimburse or pay reasonable and necessary personal, family, living or funeral expenses (not otherwise compensated for by insurance or otherwise) incurred as a result of a qualified disaster;

(2) to reimburse or pay reasonable and necessary expenses (not otherwise compensated for by insurance or otherwise) incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation or replacement is attributable to a qualified disaster;

(3) to reimburse a person who provides or sells transportation as a common carrier because of the death or personal physical injuries arising from a qualified disaster; or

(4) by a federal, state or local government, or an agency or instrumentality of those governments, in connection with a qualified disaster in order to promote the general welfare. See Sections 139(b)(1)-(b)4).

However, the items listed in (1) through (4) above will be qualified disaster relief payments only to the extent any expense compensated by them is not also compensated by insurance or otherwise.

The IRS also announced that the designation of Hurricane Sandy as a qualified disaster means that employer-sponsored private foundations may provide disaster relief to employee-victims in areas affected by the hurricane without affecting their tax-exempt status.

Postponement of Various Tax Filing and Payment Deadlines

The IRS also announced on Nov. 2 that it is postponing various tax filing and payment deadlines starting in late October, giving affected taxpayers until Feb. 1, 2013, to file these returns and pay any taxes due. The postponed deadlines include those for fourth quarter individual estimated tax payments, normally due Jan. 15, 2013. Also postponed are the deadlines for payroll and excise tax returns and accompanying payments for the third and fourth quarters, normally due on Oct. 31, 2012, and Jan. 31, 2013, respectively. The postponement also applies to tax-exempt organizations required to file Form 990 series returns with an original or extended deadline falling during this period.

So far, IRS filing and payment relief applies to the following localities:

- New York: Bronx, Kings, Nassau, New York, Queens, Richmond, Rockland, Suffolk and Westchester counties

The IRS announced that it will also abate any interest and late-payment or late-filing penalties that would otherwise apply. It is also waiving failure-to-deposit penalties for federal payroll and excise tax deposits normally due on or after the disaster area start date and before Nov. 26, if the deposits are made by Nov. 26, 2012.

The relief applies automatically to any taxpayer located in the disaster area, and taxpayers do not need to contact the IRS to get the relief.

On Oct. 31, the IRS announced it was granting taxpayers and tax preparers affected by Hurricane Sandy until Nov. 7 to file returns and accompanying payments normally due on Oct.

31 (see "IRS delays Oct. 31 deadlines for taxpayers and preparers affected by Hurricane Sandy").

The IRS also announced it is willing to work with any taxpayer who resides outside the disaster area but whose books, records or tax professional are located in affected areas. Also, all workers assisting the relief activities in the covered disaster areas who are affiliated with a recognized government or philanthropic organization are eligible for relief.

The IRS has told taxpayers who live outside of the affected area and think they may qualify for relief that they must contact the IRS at 866-562-5227.

Additional federal disaster relief information is available at www.disasterassistance.gov.

If you have questions about this Alert, please contact any member of Fox Rothschild's Taxation & Wealth Planning Department.