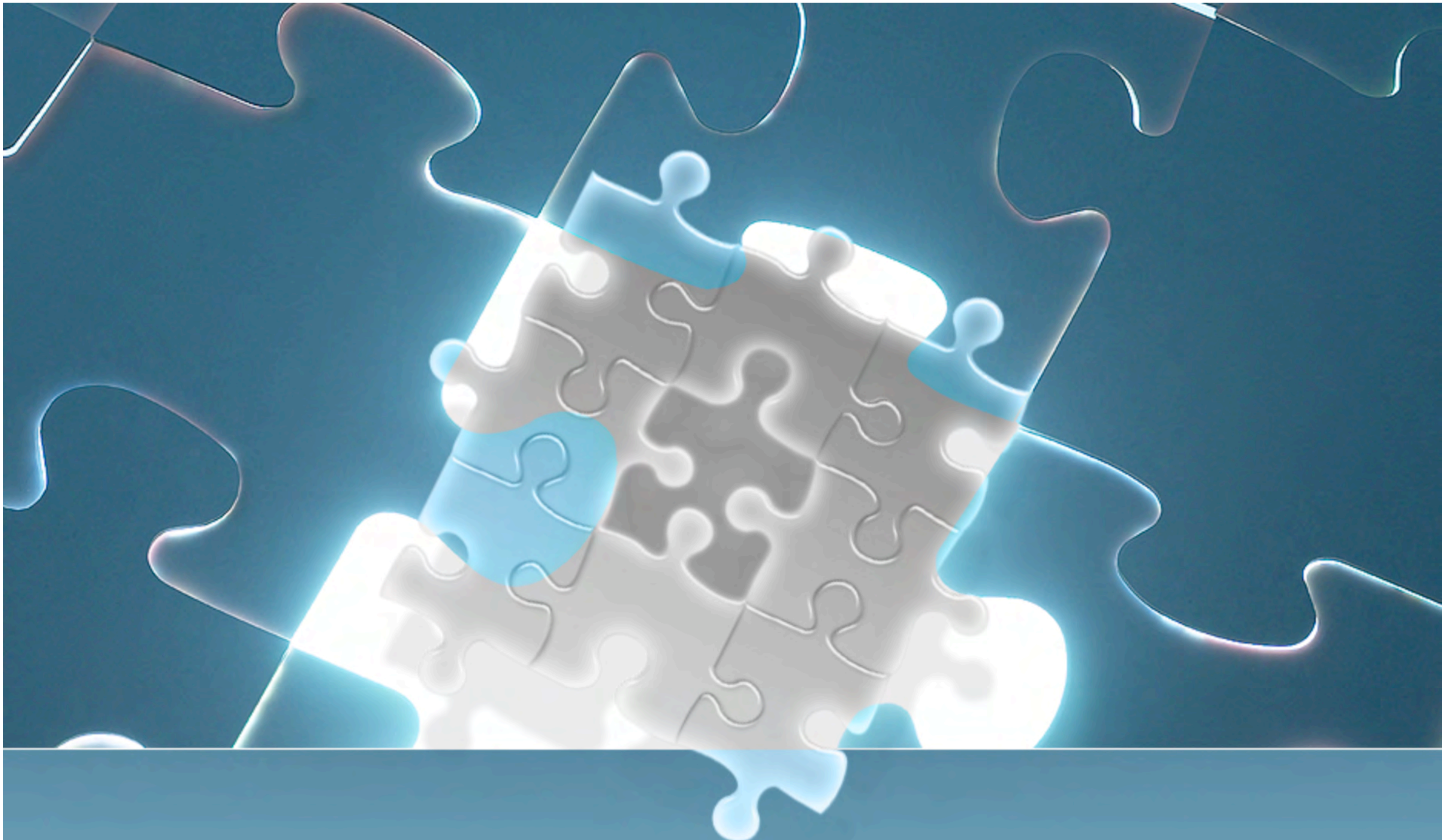

Your Taxes and the October 2007 Wildfires

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The Disclaimer

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Taxpayer and Preparer Penalties

- May 2007 law expanded the tax return preparer penalty and heightened the standards of conduct that must be met by tax return preparers in order to avoid that penalty.
- For undisclosed positions on a tax return, the new law replaced the "realistic possibility standard" with a requirement **<u>that there be a reasonable belief that the tax treatment of the position would "more likely than not" be sustained on its merits.</u>**
- In cases in which the taxpayer discloses the position on the tax return, the the new law states there must be a reasonable basis for the tax treatment of the position taken on the tax return.
- Preparers generally can continue to rely on taxpayer representations in preparing returns and can also generally rely on representations of third parties, unless the preparer has reason to know they are wrong.

Evolution of Disaster Losses and the IRS

- The inadequacy of many disaster-related federal tax regulations became apparent after the 1991 Oakland firestorms. As affected communities began to pick up the pieces, they also fought to reform several areas of the tax code. Much of the work done to help the Oakland fire victims gave those affected by the Southern California fires in October 2003 better guidance on many of the issues they faced in rebuilding.

- The 1991 Oakland firestorm brought about what is known as Internal Revenue Code Section 1033 (H)(1), enacted in August 1993 and effective for all federally declared disasters occurring after August 31, 1991. Prior to this enactment of this code, the Oakland fire victims faced taxation of insurance proceeds received for their personal contents, which was used for rebuilding their homes.

- After Hurricane Katrina, the IRS has evolved to providing the clearest guidance ever to assist disaster victims.

Your Disaster Loss

- Can not possibly cover every scenario.
- Each Family's loss scenario will be different.
- Be wary of feeding frenzy. Everyone out there wants to provide your advice and guidance. You will find every other person you talk to and compare notes will have a different take on how to treat your losses. Each individual circumstance should be analyzed.
- If you have significant losses, unique circumstances, you should seek the advice of a professional to assist you in determining the best course of action.
- For example, the IRS guidelines are cut in stone in publications for you to follow. But if you have a unique circumstance – a professional can research to see if any tax court cases. If you have a reasonable stand that you believe will stand on it own merits – then you should be able to support a valid claim.

Your Emotions Versus the IRS

First and foremost and this may be the most difficult thing you ever go through –

You must to check your emotions at the door to get through this ordeal!

Your personal residence and possessions has much more value to you than the IRS says its does.

You must separate that your personal residence may have appreciated significantly since you bought it VERSUS what you actually paid for it.

You can not consider sentimental value when determining your loss. If a family portrait, keepsake or heirloom is destroyed, you must base your loss on its **Fair Market Value**.

The Basics

Basis in your property =

The original cost you paid in cash, debt, other property or services.

The Basics

Adjusted Basis in your property =

Increase or decrease to original basis.

Most common increase is improvements/remodel of your residence.

Most common decrease is depreciation.

The Basics

Depreciation = Reduction in value of your property as a result or wear and tear, age.

Most assets lose their value over time (in other words – they depreciate.)

The Basics

Fair Market Value (FMV) =

The price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

The Basics

Casualty Loss =

The lesser of

decrease in fair-market value as the result of the fire

or

adjusted basis before the fire.

It is NOT replacement cost!

Less any insurance reimbursements received

The Basics

Decrease in FMV =

Difference between property's value immediately BEFORE and immediately AFTER the fire.

Important to consider immediately after since in event of an audit – two or three years will have pass. Even if no interim improvements, general appreciation in value may mask some of the loss incurred.

The Basics

For example,

You bought a new chair 4 years ago for $300. The October fire destroyed the chair. You estimate that it would cost $500 to replace the chair.

If you had sold the chair before the fire, and you estimate that you could have received only $100 for it because it was 4 years old, your loss is $100 – the FMV of the chair. It is not $500, the replacement cost.

Computing Your Loss

First – Your Residence (include all outbuildings, barns, landscaping, pool, driveways, etc):

You must determine what your "adjusted basis" is in your residence before the fire.

Think **COST** – not what your house value was worth before the fire because of appreciation!

Computing Your Loss

Second – The Contents (Your Personal Possessions)

You must first compute the **Fair Market Value** of your possessions the day before the fire.

Remember: FMV is the price that the item would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

Thus FMV will equal Thrift Store Prices on many items.

Computing Your Loss

Third – Determine what the fair market value is after the fire.

This will equal zero will just about every possession if your home was destroyed.

However, your land wasn't destroyed. Therefore that will still have value attached to it. Anything else that wasn't entirely destroyed has some value left.

Computing Your Loss

The cost of repairs may, in certain cases, be used to measure the decline in FMV, but it cannot be used by itself to determine the amount of your loss.

When the cost of repairs is determined to be fair measure of the decline in fair market value, then all you have to do is take the fair market value before the fire and reduce it by the cost of repairs to arrive at the FMV after the fire.

Computing Your Loss

To use cost of repairs or cleaning up as measure of loss:

- Repairs must be necessary to bring property back to its condition before the fire;
- The amount spent is not excessive;
- The repairs take care of the damage only
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the fire.

Computing Your Loss

One method of determining the decrease in FMV is to get an appraisal.

The appraiser must recognize the effects of any general market decline that many have occurred along with the casualty.

Important valuation by appraiser needs to be well documented.

Appraiser must be “qualified” (recognized in field).

Make sure you get documentation of the Appraiser’s qualifications and his/her competence.

IRS maintains a list of appraisers whose work they have found fault with.

Computing Your Loss

- Insurance Companies will come up with a list of household contents they have valued at replacement cost.   However, the IRS regulations limits household contents to thrift store value.
- While the IRS limits the value to thrift store values, in rare cases the courts have allowed taxpayers to rebut that assumption and prevail.
- Insured disaster victims may have an economic loss if their insurance companies won't settle with them for the replacement cost of their real and personal property. However, you generally will not have a tax loss because the depreciated value of your contents are less than insurance proceeds received (think thrift store value – depending on age and condition of items).

Computing Your Loss

If you have an independent appraisal already completed with list of all your contents

or

The list filed with insurance company supporting your claim – then you have completed the worst part in reconstructing your list of destroyed property

After the Smoke Clears Reconstructing Your Records

When records are not available or its not feasible to obtain documentation sufficient to re-create records otherwise required in filing your tax return – the IRS will consider documentation requirements satisfied by the best reasonably available information presented in good faith.

After the Smoke Clears
Reconstructing Your Records

The IRS's Guidelines on what you must show to deduct a casualty loss:

1. You must be able to support the amount you take as a deduction.
2. Be able to show the type of casualty and when it occurred.
3. That you were the owner of the property, or if you leased from someone else, that you were contractually liable to the owner for damage.
4. Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

After the Smoke Clears Reconstructing Your Records

Uninsured disaster victims can use the Federal Emergency Management Agency (FEMA) appraisal of their loss to document their tax loss, a code section that was enacted after the Northridge earthquakes of 1994 [Sec. 165(i)(4)]. No loss can be taken until reimbursement claims have been settled

After the Smoke Clears
Reconstructing Your Records

- Should be done as soon as possible after the fire. Essential to prove you have a casualty loss for taxes, getting federal assistance or insurance reimbursement.
- First step is to recover whatever tax records you can find. If you have a tax preparer – obtain copies directly from them.
- File Form 4506, Request for Copy of Tax Form, with the IRS to obtain previous four years of federal income tax returns filed.
- Form 4506-T Request for Transcript of Tax Return. Transcripts are quicker to obtain, but harder to read.
- Write "California Wildfires" in red letters across the top of the forms to expedite processing and to waive the normal user fees.
- California Franchise Tax Board (FTB) file Form FTB 3516.

After the Smoke Clears Reconstructing Your Records

- Take photographs as quickly as possible after fire to establish extent of the damage.

- Contact the title company, escrow company or bank that handled the purchase of your residence to obtain copies of escrow papers. Your real estate agent may also be able to help.

- Use your current property tax statement for land vs. building ratios. If not available get from the county's assessor's office.

- Access at https://www.sdctreastax.com/ebpp3/

After the Smoke Clears
Reconstructing Your Records

- Contact lenders or contractors to determine the value of any home improvements you've made.
- Check court records for the probate values of property you may have inherited.
- Contact credit card companies or banks for copies of statements/cancelled checks to reconstruct remodel.
- If re-fi or home equity loan obtained, get paperwork from the bank issuing the loan.   If loan truly used to pay for improvements, may be way to establish the cost.
- Get written accounts from friends and relatives who saw your house before and after any improvements. Get photos of get-togethers.

After the Smoke Clears
Reconstructing Your Records

- No other records – check the county assessors office for old records about your property.   Especially if you have owned for years. Ask for percentage of assessment to value at the time of purchase. This is a rough guess, but better then nothing.
- Remember: reasonable belief that your tax treatment would more likely than not be sustained on its merits.
- And finally, at the end of the day – does it all pass the sniff test?   Remember – the IRS knows what your income was! Can get access to your credit and banking information. Be honest!

Thus – Document! Document!

After the Smoke Clears
Reconstructing Your Records

Calculating decrease in FMV of Landscaping

- The cost of restoring your landscaping to its original condition after the fire may indicate the decrease in FMV. Thus you may be able to measure your loss by what you spend on:
  - Removing destroyed or damaged trees and shrubs
  - Pruning and other measures taken to preserve damaged trees and shrubs.
  - Replanting necessary to restore the property to its approximate value before the fire.

After the Smoke Clears
Reconstructing Your Records

Loss on personal Vehicles

- Kelley's Blue Book, NADA or Edmunds are available online or at local library. Excellent sources for current fair value of most vehicles.
  - www.kbb.com
  - www.edmunds.com
  - www.nada.com
- Call dealer and ask for copy of contract, or comparable price figure.
- Newspaper ads during period destroyed for fair market value.
- Lien holder if you are still making payments.
- Remember to keep copies of any ads you rely on.

After the Smoke Clears
Reconstructing Your Records

- Reconstructing your personal property – the contents of your personal residence
  - The sheer number and types of personal property a person possesses makes it difficult to reconstruct records.
  - One of the best methods to reconstruct is to draw pictures of each room, or just make extensive lists by room. Conduct a mental inventory of each room. It doesn't have to be professionally drawn. Just functional. Take time to consider shelves with memorabilia on them. Do the same with kitchens and bedrooms. Reconstruct what was there, especially furniture that would have held items – drawers, dressers, shelves. Be sure to include garages, attics and basements. Don't forget the pantry!

After the Smoke Clears Reconstructing Your Records

- Get old catalogs. These catalogs are a great way to establish cost basis and fair market value.
- Check prices on similar items at local thrift stores. Walk through stores and look at comparable items, especially items such as kitchen gadgets. Look for odds and ends you may have forgotten because of infrequent use.
- Want ads in newspapers. Local library has back issues of newspapers.
- Ask credit card company for copies of statements.

After the Smoke Clears
Reconstructing Your Records

- If you had a lot of books, go to used bookstore with a tape measure and diagram of the destroyed property. Measure several rows of used books and count the number of books per shelves. Add up the prices of those books and determine an average cost per shelf. Then count the number of shelves you had and multiply by the average cost per shelf.

- Intuit (Turbo Tax) has software called "It's Deductible". Or you can get used copies on Amazon of the workbook. The Blue Book for Donated Items – thus determining fair market value at "thrift store values" depending on condition of items.

Inherited Property or Valuable Antiques, etc.

Need to figure out your Basis in the property.

"Basis" in inherited property defined as FMV of the property at time of person's death.

Valuable antiques, irreplaceable property. Your Basis is what you originally paid for the item.

FMV would be documented through creative means previously discussed or through an independent dealer specializing in the property.

Will I qualify for a tax refund or deduction?

You may be eligible for tax refunds, deductions or other benefits due to lost or damaged possessions or property. Here are a few things to keep in mind:

- In general, losses are deductible if, in one year, they total more than $100 and more than 10 percent of your adjusted gross income.
- You must keep documentation to prove that a loss took place due to a specific disaster, the dollar amount of the loss and who owns or is liable for the property. Some costs of documenting your loss, such as appraisals or photographs, may be tax deductible.
- You cannot deduct losses that are covered by insurance or emergency aid assistance.

Special Rules for Federally Declared Disaster Area

Generally a disaster loss must be taken in same year disaster occurred.

For 2007 fires because in Federally Declared Disaster Area, you can amend your previous year's (2006) tax return to report current losses as if the fire happened in 2006, instead of waiting to report the losses on your current year's return. This gives you a quick refund (generally within 45 days) of taxes you've already paid.)

Treating Loss as if Occurred in 2006

Time limit for making choice –

Later of

- Due date (without extension) for filing 2007 return when the disaster occurred (APRIL 15, 2008)
- Due date (with extension) for filing the return for 2006 return (OCTOBER 15, 2007)

Thus you have until April 15, 2008 to amend your 2006 return.

File Form 1040X by April 15, 2008. Attach statement to 2007 specifying this choice.

California now conforms to federal on claiming disaster loss in prior year. 2003 victims didn't have this option.

Filing 2007 Tax Return

Tax Return Due April 15, 2008

File Form 4868 – Application for Automatic Extension of Time to File U.S. Individual Income Tax Return

Extends return due date automatically to October 15, 2008

California follows federal extension – unless you owe taxes.

Claiming Disaster Loss

Have four years to replace personal property in Federally declared disaster areas.

If need more time, an extension can be requested from the IRS.

Exact Amount of Insurance Reimbursement Unknown

Sometime necessary to file tax return before total insurance settlement known.

Where there is a reasonable prospect that there will be additional reimbursement for loss some time in the future, the expected reimbursement must be taken into consideration in computed your casualty loss.

Make best estimated of reimbursement and file return claiming the loss for year of fire.

Exact Amount of Insurance Reimbursement Unknown

If actual reimbursement ends up being less in a later year – the difference is claimed as a loss in the year the lesser amount received.

If total exceeds what was originally reported, difference reported in year received. Either really is a GAIN and taxable income or treated as an adjustment to the basis of your replacement property.

Insurance Reimbursement for Living Expenses

Keep separately documented. Unreimbursed living expenses not deductible.

You do not reduce your casualty loss for payments for living expenses.

If payments are more then the "temporary increase" in your living expenses, generally you must include excess in your income.

But because Federally Declared Disaster you do NONE of these payments are included in income.

What if you want to take the insurance settlement and walk away?

- You have 4 years to replace your property.

- The Section 121 Exclusion Rules apply if you have a gain. Thus $250,000 if you are single / $500,000 if married can be excluded from your income.