Disaster Tax Relief For Those Affected By The Wildfires
Why are we here?
Recovery & Rebuild

Linkenheimer has been an active part of our Sonoma County community for over 85 years. And like most of you, we have all been profoundly affected by these horrific fires that have swept through our community and continue to affect those that live here. We have lost houses and entire neighborhoods, friends and families have been displaced and like many of you, we are still reeling from the ongoing damage the fires have created.

We want to express our utmost condolences to all of our friends, families and clients who have lost something in this disaster. And we want you to know, we will be working side by side with you all during this difficult time to rebuild our community.
Agenda

- Disaster Tax Relief
  - Extension of time and other timing matters
  - Tax implications for individuals
    - Treatment of reimbursements
    - Casualty loss
    - Gain from involuntary conversion
  - Tax implications for businesses
    - Gain/Loss on involuntary conversion
    - Business interruption insurance
- Questions
Disaster Relief Basics

Applies to individuals and businesses that reside or have necessary records in Butte, Lake, Mendocino, Napa, Sonoma and Yuba Counties

Reimbursements include amounts received from insurance Co., FEMA, Charitable Organizations
Tax Relief – Timing Matters

Additional time

Permits tax returns that have either original or extended due dates occurring on or after 10/8/17 and before 1/31/18 to file by 1/31/2018. Includes:

- 2016 individual income tax returns that were on extension.
  - Since individual income tax payments were due in April, no relief on balances due.
- Quarterly payroll and excise tax returns normally due 10/31/17.
- Tax-exempt organizations on extension to 11/15/17.
- Quarterly estimated tax payments due 1/16/18
Other Timing Matters

- 12 Months to file for property tax reassessment.
  - Should receive a notice from Sonoma Co. by 12/31/17

- Personal casualty loss can be taken on 2016 (amended) or 2017 tax returns.
  - If reimbursements are estimated for casualty loss purposes in 2016/2017 and then actual reimbursements are different, an adjustment will be necessary in later year.
  - Suggest taking in year with lower AGI
Individual Income Tax Matters

- **Non-taxable reimbursements include:**
  - Payments for living expenses, including FEMA payments
  - Payments for personal items (Federally Declared Disaster)

- **Taxable payments include:**
  - Unemployment compensation
  - Reimbursement for items already reimbursed
  - Payments in excess of basis in personal residence (can be deferred in most situations)
What is a casualty loss?

- Damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual
- Not a typical, day to day occurrence, and not progressive
  - Examples of non casualty losses:
    - Termite damage
    - Destruction of personal use trees/shrubs due to drought (business rules may be different)
- Must be permanent – temporary reduction in value does not qualify
Casualty loss – Non-business property

- Tax deduction that generally occurs when damages exceed reimbursements.
  - Deduction reduced by 10% of AGI and $100 per in event.

- Damages equal the lessor of decrease in FMV or cost basis of totally destroyed property.

- Reimbursements include all payments received for damaged property.

- You must file an insurance claim to deduct the loss
Loss substantiation is similar to what is required for insurance companies.

Must be able to show the following:

- Type of loss that occurred (fire, storm, etc.)
- Loss was a direct result of the casualty
- You own the property, or for leased property that you are contractually liable for the damage
- Whether a claim for reimbursement exists for which there is a reasonable expectation for recovery
**Personal Residence Casualty Loss Example**

Home purchased for $400,000 last year. Property tax statements allocate $100,000 to the land value and $300,000 to the building. Total expected insurance reimbursements are $200,000. FEMA repair assistance payment of $50,000 was received. FMV prior to the loss was $475,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of totally destroyed home</td>
<td>$300,000</td>
</tr>
<tr>
<td>Less Insurance reimbursements</td>
<td>($200,000)</td>
</tr>
<tr>
<td>Less FEMA repair assistance payment</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Loss after reimbursements</td>
<td>$50,000</td>
</tr>
<tr>
<td>Less 10% of AGI (assume AGI of $100K)</td>
<td>($10,000)</td>
</tr>
<tr>
<td>Less $100</td>
<td>($100)</td>
</tr>
<tr>
<td>Casualty loss deduction</td>
<td>$39,900</td>
</tr>
</tbody>
</table>

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Basis of property after casualty loss

- Decreased by insurance and/or other reimbursements
- Decreased by casualty loss taken
- Increased by amounts spent to restore property
Home purchased for $400,000 last year. Property tax statements allocate $100,000 to the land value and $300,000 to the building. Total expected insurance reimbursements are $200,000. FEMA repair assistance payment of $50,000 was received. FMV prior to the loss was $475,000. Paid $25,000 for debris removal and $300,000 to rebuild the property.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial purchase price</td>
<td>$400,000</td>
</tr>
<tr>
<td>Less casualty loss deducted</td>
<td>(39,900)</td>
</tr>
<tr>
<td>Less insurance reimbursements</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Less FEMA repair assistance payment</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Plus debris removal expenses</td>
<td>25,000</td>
</tr>
<tr>
<td>Plus construction costs for rebuild</td>
<td>300,000</td>
</tr>
<tr>
<td>Adjusted basis after rebuild</td>
<td>$435,100</td>
</tr>
</tbody>
</table>
Gain on involuntary conversion

- Involuntary conversion occurs when your property is destroyed, stolen, or condemned and you receive money in payment for the property (IRC Section 1033)

- Gain will generally occur if reimbursements exceed basis

- For residences, may be able to exclude gain under sale of personal residence rules (IRC Section 121)
  - Must have been your personal residence 2 out of the last 5 years (pro-rata exclusion amount if less than 2 years)
  - Exclusion of $250K single or $500K married

- Can defer gain if reimbursements are reinvested in rebuilding home or to acquire replacement home within four years if in Federal Disaster area
Gain on involuntary conversion – cont.

- To defer gain, replacement property must cost at least as much as the amount you received as a reimbursement, minus any excluded gain under IRC Section 121.
- When postponing your gain, your ownership period includes the period you owned your destroyed property.
- Four year replacement period can be extended with reasonable cause & IRS’s consent.
- If postponing gain, must attach a statement to your tax return with details.
Involuntary Conversion gain example - Personal Residence

Home purchased for $150,000 and $50,000 was allocated to the land. There were $25,000 of improvements made since the home was purchased. The home was completely destroyed and instead of rebuilding the taxpayer purchased a new home for $275,000.

Insurance proceeds $800,000

Basis of destroyed home (structure only) ($125,000)

Realized gain $675,000

Insurance proceeds $800,000

Less personal residence exclusion (MFJ) ($500,000)

Proceeds realized for involuntary conversion $300,000
Involuntary Conversion gain example - continued

Proceeds realized for involuntary conversion $300,000
Less basis of structure ($125,000)
Realized gain on involuntary conversion $175,000 (A)

Proceeds realized for involuntary conversion $300,000
Less cost of new home ($275,000)
Recognized gain $25,000 (B)
Deferred gain (A-B) $150,000

Cost of new house $275,000
Less deferred gain ($150,000)
Basis of new home $125,000
Business Tax Matters

Gain/Loss on involuntary conversion calculation is similar to the previous examples with the following differences:

- No exclusion on gain available.
- Deduction not limited by 10% of AGI and $100
- Only consider adjusted basis in computing gain or loss not change in FMV
- Loss must be substantiated, similar to individual losses
Deferral of Gain

To defer gain on involuntary conversion (IRC Section 1033):

- Need to reinvest in tangible property used in a trade or business. If it was a rental property destroyed, reinvest with another rental property.
- Trade or business replacement property cannot become investment property – needs to be held for productive use in a trade or business.

Qualifying example:
- Restaurant is destroyed in federally declared disaster and insurance proceeds are used to purchase bowling alley.

Example that does not qualify:
- Restaurant is destroyed in federally declared disaster and insurance proceeds are used to stock in a REIT.

- Have four years to reinvest in replacement property.
- Can request extension of time for reasonable cause if needed.
- If gain is not deferred then, depending on underlying asset, there is potential depreciation recapture, which can change the character of the gain.
Gain example – Business Property

Adjusted basis of restaurant        ($200,000)
Reimbursements                      $300,000
Realized gain                       $100,000
Gain to be potentially deferred     $100,000

Proceeds used to buy bowling alley  $300,000
Less deferred gain                  ($100,000)
Basis of bowling alley              $200,000

*You should also adjust for any remaining salvage value.*
Other Business Losses

- **Inventory:** If you have a loss of inventory, you can deduct one of two ways:
  - Deduct through cost of good sold. If you receive reimbursement, include this in gross income.
  - Deduct separately by making an adjustment to opening inventory or purchases, reduce this loss by the reimbursement.

- **Leased Property**
  - If liable for casualty damage on leased property, your loss is the amount you must pay to repair or replace less any reimbursements expected to be received.
Business Interruption Insurance

- The tax treatment of the proceeds from business interruption insurance depends on what the payments compensate. If the proceeds compensate for lost profits, then they are ordinary income to the recipient.

- However, if the proceeds reimburse for lost use of the property, they may constitute recovery of capital and result in gain to the extent they exceed basis. These gains are on the disposition of a property right and can be deferred under the involuntary conversion rules if the proceeds are reinvested in qualified replacement property (see previous slides).

- If an insurance settlement provides payments for both the loss of the use of property and for the loss of profit, the payments must be allocated between ordinary income and property payments.
Additional items to consider...

Partial business, partial personal use property
- Examples: Business use of home, vacation rental
- Must figure each loss separately for each portion of property
- Still able to use the involuntary conversion rules discussed previously

Net Operating Losses
- Can be generated by business and personal casualty losses
- Able to carry back 3 years due to the federal disaster declaration.
Questions??

- To stay up to date on information as it comes out, sign up for our newsletter at www.linkcpa.com (at the bottom of the page) or follow us on social media.