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Safe Harbor from the Hurricane

Casualty Losses

As taxpayers continue to recover from the summer hurricane disasters that hit our area, many must now face the burden of finding documentation to support their property losses if they wish to deduct that loss on their tax return. In an effort to help these victims of natural disasters, the Internal Revenue Service has issued guidance providing safe harbor methods that individuals can use to aid them in determining the amount of their casualty losses to their homes and personal belongings.

One of the most difficult areas of calculating a casualty loss is determining the loss in value of the property. There are now two statements issued by the IRS describing safe harbor methods to calculate this amount. A Safe Harbor is a provision of a statute that specifies that certain conduct will be deemed not to violate a given rule. In this case, it means that the IRS will not challenge an individual's determination of the decrease in Fair Market Value (FMV) of their residential property if they qualify and use one of the safe harbor methods in these statements. The first statement, Revenue Procedure 2018-08 contains 5 new safe harbor methods available to determine the deductible amount of losses to homes and 2 safe harbor methods for personal belongings. These methods will be available for calculating decreases in FMV of personal residences now and into the future in presidential declared disaster areas. Under the new tax bill, starting in 2018, personal casualty losses can only be deducted if incurred in a Federally-declared disaster. The second statement, Revenue Procedure 2018-09, is a special safe harbor only available to those affected by the 2017 hurricanes after August 22 (this includes Harvey).

First, be reminded that the amount of your tentative casualty loss is the lesser of

1. The difference between the FMV of the property immediately before the casualty and the FMV immediately after the casualty (loss in value).
2. The adjusted basis of the property (what you paid plus cost of any improvements).

So, if your house was worth $400,000 before the hurricane and $200,000 after the hurricane then the difference is $200,000. If you paid $125,000 the house 10 years ago, the adjusted basis is $125,000. So your tentative casualty loss is $125,000.

Next you must reduce the amount of your tentative casualty loss by any insurance reimbursement and also by $500. The remaining loss will then be added to your itemized or standard deduction on your tax return.

Unfortunately, it is usually not so easy to know the value of your property before and after the casualty. According to Form 4684 Instructions – Casualties and Thefts, this FMV can be determined by:

1. A competent appraisal providing the FMV both before and after the casualty.
2. The cost of repairs can be used if:
a) the repairs are necessary to restore the property to its condition immediately before the casualty;
b) the amount spent on such repairs is not excessive;
c) the repairs do not restore more than the damage suffered;
d) the value of the repairs does not exceed the value of the property before the casualty;
e) the repairs were actually done (can't rely on estimates).

The new safe harbor methods offered by the IRS in Revenue Procedure 2018-08 allow the following 5 simplified ways to determine the loss in value of your real estate. These can only be used on non-business losses and cannot be used if you had an office in the home or partial rental property. It can be used on a town home but not on a condominium where the individual does not own the structural components of the building. If you are unable to use these safe harbor methods, the casualty loss can still be calculated and claimed, you simply must use one for the methods detailed above from Form 4684. The New Safe Harbor methods are:

1. Estimated Repair Cost Safe Harbor – You may use the lesser of 2 repair estimates prepared by two separate and independent contractors licensed or registered with the state. These must itemize costs to restore the individual's personal–use residential property to the condition existing immediately prior to the casualty. Any improvements (including a required elevation of the residence) must be excluded from the estimate. To use this method the casualty loss must be $20,000 or less.
2. De Minimis Safe Harbor Method – An individual may estimate the cost of repairs required to restore the personal-use residence to the condition existing immediately prior to the casualty. Again, no cost for improvements can be included. The individual must maintain records detailing the methodology used to estimate the loss. To use this method, the casualty loss must be $5,000 or less.
3. Insurance Safe Harbor Method – You may use the estimated loss determined in reports prepared by your homeowner's or flood insurance company giving the estimated loss sustained as a result of the damage to or destruction of your personal residence.

4. Contractor Safe Harbor Method – You may use the contract price for the repairs specified in a contract prepared by an independent contractor which sets forth the itemized costs to restore the personal-use residence to pre-disaster condition. Improvements must be excluded and the contract must be a binding contract signed by you and the contractor.

5. Disaster Loan Appraisal Safe Harbor Method – An appraisal prepared for the purpose of obtaining a loan of Federal funds or a loan guarantee from the Federal Government setting forth the estimated loss sustained from the casualty can be used to support the decrease in fair market value.

For your personal belongings, the following safe harbor methods can be used:

1. De Minimis Safe Harbor Method – You may make a good faith estimate of the decrease in the fair market value of your personal belongings damaged or destroyed by the hurricane. You must maintain records describing the belongings affected and detailing the method used to estimate the loss. To use this method the loss must be $5,000 or less.

2. Replacement Cost Safe Harbor Method – If this method is chosen, it must be used for all personal belonging affected. This method cannot be used for boats, trailers, antiques, or other items which maintain or increase in value over time. For each item

a. Determine the pre-casualty current cost to replace with an equivalent item then reduce that amount by 10% for each year you owned the item. If you have owned it 9 years or longer, use 10% of the replacement cost.

b. Subtract the FMV of the item after the casualty from this pre-casualty number (if destroyed or stolen the FMV is $0).

c. Determine how much the item cost initially.

d. Use the lesser of b. or c.

For any of these safe harbor methods, in addition to reducing the loss by the amount of any insurance received, you also must reduce the loss calculated by the amount of "no-cost repairs" such as the value of repairs to or rebuilding of the personal residence provided by another party at no cost to the individual (e.g. by volunteers).

The second Revenue Procedure that the IRS implemented is for the 2017 hurricane season only. It is called the Cost Indexes Safe Harbor Method and it is used to determine the decrease in value of a residence due to 2017 hurricane related damage. As with the previous safe harbor methods, this is not available to homes that were used partially for rental, residences taking an office in the home deduction, or condominium units. To use this method, you first determine which category your losses fall under:

1. Total loss of personal residence
2. Near total loss of personal residence
3. Interior flooding over 1 foot of a personal residence
4. Structural damage from wind, rain, or debris to personal residence
5. Roof covering damage from wind, rain, or debris to personal residence

6. Damage to a detached structure (structure had some electrical capabilities but little or no interior finishing - shed, shop, detached garage)
7. Damage to decking attached to personal residence

The procedures provides tables based on square footage, property location, etc. The square footage affected is multiplied by the correct number from the table to arrive at the decrease in value of the property. This is then compared to the basis (cost) of the residence and reduced by insurance received and "no-cost repairs".

The following is an example of this calculation from Revenue Procedure 2018-09:

Example 4. The first floor of any individual's personal residence in Texas was flooded with 3 feet of water during Hurricane Harvey. As a result of the flooding, all of the flooring and drywall on the first floor needs to be replace. The second floor of the personal residence is not damaged. While the personal residence sustained flooding of more than 1 foot, it did not sustain damage that falls within the definition of total loss or near total loss in sections 3.03(1) and (2) of this revenue procedure. Therefore, the personal residence sustained interior flooding over 1 foot as described in section 3.03(3) of this revenue procedure. In addition, the deck attached to the personal residence was completely destroyed by Hurricane Harvey. The personal-use residential real property is located in the 2017 Disaster Area. The personal residence is 2,000 square feet and the personal-use residential real property does not contain any detached structures. The total square footage of the flooded rooms on the first floor is 1,000 square feet. Prior to Hurricane Harvey, the individual purchased the personal-use residential real property for $200,000. Insurance and other reimbursements total $90,000. The individual chooses to use the Cost Indexes Safe Harbor Method.

To calculate the decrease in fair market value of the personal-use residential real property, the individual uses the first column of Table 3 to determine the size of the personal residence based on the total square footage of the personal residence. The individual multiplies the flooded square footage of the personal residence.

1,000 square feet, by $117, the cost index for a Medium Personal Residence in Texas, in Table 3.

1,000 sq. ft. x $117/sq. ft. = $117,000

The deck is 200 square feet. Using Table 7, the individual multiplies the square footage of the damaged area of the deck, 200 square feet, by the cost index of $27 for Texas in Table 7.

200 sq. ft. x $27/sq. ft. = $5,400

To determine the total decrease in fair market value of the personal-use residential real property the individual adds $5,400 to $117,000.

$5,400 + $117,000 = $122,400

The individual compares the basis of the personal-use residential real property, $200,000, to the decrease in fair market value determined by using the Cost Indexes Safe Harbor Method, $122,400. Since the decrease in fair market value of $122,400 is less than the basis of $200,000, the individual's casualty loss is limited to $122,400. After subtracting $90,000, the amount of insurance and other reimbursements, from $122,400, the amount of the individual's casualty loss is $32,400 ($122,400 - $90,000 = $32,400).

Finally, if you are unsure whether part of your casualty loss will be reimbursed, do not deduct that part until the tax year when you become reasonably certain that it won't be reimbursed. If you are later reimbursed for a loss you deducted in an earlier year, the reimbursement will be income in the year received to the extent that the deduction reduced your tax in the earlier year.

After calculating the allowable casualty loss, if you arrive at a number less than $0 then you probably received more in insurance and other reimbursements than the allowable loss for tax purposes. If you received more in insurance and other reimbursements than your cost or other basis in your damaged property, you may have a taxable gain to report on your tax return.

As you can see, this is a very technical area. We want to let you know about your options and what type of documentation you will be needing as the 2017 tax season approaches. Contact us if you need additional help and one of our professionals would be happy to work with you in navigating this tax area which will be affecting so many homeowners in the 2017 Disaster Area.

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