Tax Implications of Disaster-related Personal Casualty Losses

If you suffered a personal casualty loss, you might be entitled to a tax deduction. This article provides a quick summary of the applicable federal income tax rules.

Deductions for Damaged and Destroyed Property

The tax law allows you to claim an itemized deduction for personal casualty losses that are not reimbursed by insurance. Unfortunately, you must first reduce your loss by $100 and then by 10% of your adjusted gross income. If you have any loss remaining after these reductions, you can claim an itemized write-off on Schedule A of Form 1040.

If you have a deductible loss due to a disaster in a federally declared disaster area, a special rule allows you to claim your allowable write-off in the year before the year the loss actually occurred and thereby get a tax refund. For example, Hurricane Sandy victims can choose to deduct their allowable losses in 2011; even though, the damage obviously happened this year. This special deduction timing rule allows you to quickly receive some tax-saving relief instead of having to wait until next year when you file your 2012 return. If you've already filed your 2011 return, you must file an amended return to claim your loss in that year.

You must make the choice to take the write-off in the earlier year by no later than the filing deadline (without extensions) of this year's return. For example, victims of Hurricanes Sandy have until April 15, 2013 to decide.

Beware: You Might Have a Taxable Gain

If you have casualty insurance coverage, you actually might have a taxable involuntary conversion gain instead of a deductible loss. Why? Because when insurance proceeds exceed the tax basis of a damaged or destroyed asset, you have a taxable profit as far as the IRS is concerned. This is the case even when the insurance doesn't compensate you for the full precasualty fair market value of the damaged or destroyed property. These gains are termed involuntary conversion gains.

If you turn out to have an involuntary conversion gain, it must be reported on your tax return unless you: (1) make sufficient expenditures to repair or replace the property and (2) make an election to defer the gain. If you make the election, you'll have a current taxable gain only to the extent insurance proceeds exceed what you spend to repair or replace the affected property.

Conclusions

Disaster victims may receive other types of insurance reimbursements and assistance that can have important tax implications. Please contact us if you want more information about anything covered in this article, or if you have any other questions.