TAX ISSUES FOR DISASTER SURVIVORS

Panelists
James Creech, Law Offices of James Creech, San Francisco, CA
Kristie J. Iatrou, Mondrik & Associates, Austin, TX
Andrew VanSingel, Chicago, IL

Moderator
Mandi L. Matlock,
Texas RioGrande Legal Aid, Inc.
In early August, gusts of wind rolled off the Sahara Desert...
Weeks later, it developed into the worst hurricane to hit the U.S. since Katrina in 2005.
It was a storm only a Gator could appreciate (Beaumont, TX)
Water remained more than a week after Harvey hit in Port Arthur
An explosion at Lone Star Legal Aid’s largest regional office in Houston displaced all of its staff, and knocked out its e-mail server until 9/13.
Released flood water from the Addicks and Barker Reservoirs will keep Buffalo Bayou flooded for weeks.
Thousands of people and animals were rescued during recovery operations. 15,000 animals were rescued after Katrina’s aftermath, and it’s estimated that 80 percent of those pets were never reunited with their owners.
As of September 14, over 735,000 people filed FEMA claims, making it the second largest incident ever (with thousands of new claims filed every day).

Hurricane Katrina resulted in 1,080,732 registrations in Louisiana, and 518,100 in Mississippi.
Nearly 40,000 people were sheltered after Harvey.

As of Wednesday night, 4,900 were still there.
After the immediate needs for food and shelter are met, survivors will be faced with numerous legal issues…

…even tax issues.
Disaster Legal Services

• Touchstone public service project of the YLD, created in response to Hurricane Camille

• Operates pursuant to a MOU between the ABA, LSC, and FEMA, administered by the ABA Young Lawyers Division

• Provides FREE legal assistance “low income” persons affected by a presidentially declared major disaster

• Volunteer attorneys and law students assist with a wide range of legal issues (must not be fee generating)
When is DLS Activated?

• Requires Letter of Intent from FEMA, following a Presidential Disaster Declaration

• Upon receiving the LOI, the DLS team springs into action to issue a press release promoting the toll free hotline

• The team works with LSC grantees, other civil legal services providers, state and local bar associations, local VOAD chapters, and YLD Affiliates
LSLA Attorney Nancy Chavez & YLD Volunteer Akilah Craig at the GRB Convention Center field legal questions from Harvey survivors.
How should the legal community respond?
Camille Ouragan, lives in Houston. She owns a two-story home worth $360,000 and her basis is $280,000. Her landscaping company employs 12 people divided into 4 crews. Each crew has a company-owned truck and equipment. During 2016 she reported $120,000 of Schedule C income. Her 2017 business was roughly the same as 2016. Just prior to Harvey, Camille had received notice that her 2015 return was selected for audit.
Damage To Camille’s Home

Camille’s home received 6 feet of water. The flooding lasted 2 weeks. Her home office was flooded destroying all her records and her computer. She had flood insurance through the National Flood Insurance Program.

A week after the flood waters recede Camille’s neighbor, who is a residential contractor, estimates the damage at $80,000. Camille then starts tearing out the drywall.
IRC Section 165 governs losses

165(c)(3) defines casualty losses as losses from fire, storm, shipwreck, or other casualty, or from theft. The cause of the loss needs to be a sudden, unexpected, or unusual event. The loss must be claimed in the year it is incurred.

165(i) provides special rules for casualty losses in “Federally declared disaster” zones (areas determined by the President to warrant assistance under the Stafford Act). Taxpayers in such disaster zones may elect to claim the loss in the year it was incurred or carry it back to the previous year.
What Do We Know?

Camille has a casualty loss. The flooding was caused by a hurricane. Camille lives in a federally declared disaster zone so 165(i) applies.

What don’t we know that we need to know in order to take a loss? When will we know it?
**SECTION A—Personal Use Property** (Use this section to report casualties and thefts of property not used in a trade or business or for income-producing purposes.)

1. Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.
   - Property A
   - Property B
   - Property C
   - Property D

2. Cost or other basis of each property

3. Insurance or other reimbursement (whether or not you filed a claim) (see instructions).

   **Note:** If line 2 is more than line 3, skip line 4.

4. Gain from casualty or theft. If line 3 is more than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year.

5. Fair market value before casualty or theft

6. Fair market value after casualty or theft

7. Subtract line 6 from line 5

8. Enter the smaller of line 2 or line 7

9. Subtract line 3 from line 8. If zero or less, enter -0-

10. Casualty or theft loss. Add the amounts on line 9 in columns A through D

11. Enter the smaller of line 10 or $100

12. Subtract line 11 from line 10

   **Caution:** Use only one Form 4684 for lines 13 through 18.

13. Add the amounts on line 12 of all Forms 4684

14. Add the amounts on line 4 of all Forms 4684

15. • If line 14 is more than line 13, enter the difference here and on Schedule D. Do not complete the rest of this section (see instructions).
   • If line 14 is less than line 13, enter -0- here and go to line 16.
   • If line 14 is equal to line 13, enter -0- here. Do not complete the rest of this section.

16. If line 14 is less than line 13, enter the difference

17. Enter 10% of your adjusted gross income from Form 1040, line 38, or Form 1040NR, line 37. Estates and trusts, see instructions

18. Subtract line 17 from line 16. If zero or less, enter -0-. Also enter the result on Schedule A (Form 1040), line 20, or Form 1040NR, Schedule A, line 6. Estates and trusts, enter the result on the "Other deductions" line of your tax return

For Paperwork Reduction Act Notice, see instructions.
Basic Formulas For Personal Property Casualty Losses

Lesser Of:

(Fair Market Value Prior - Fair Market Value After) - Insurance Proceeds - $100 - 10% AJI

Or

Adjusted Basis - Insurance Proceeds - $100 - 10%AJI

If the insurance or other proceeds exceed adjusted basis the property the taxpayer can have a casualty gain

Casualty gains are taxable unless the taxpayer finds qualified replacement property within a certain amount of time or are within the Section 121 exclusion
Valuations and timing become problems

Harvey is estimated to have flooded 100,000 homes. How long does it take to get an insurance adjustor? How long does it take to get a contractor? What happens when the price of repairs goes up 300% in the 10 months between the estimate and repair? (actual repairs can be used determine FMV loss)

All of these issues, plus the statute of limitations for filing a 1040X, come into play in determining when a taxpayer has enough certainty to file an amended return
If Camille does not have savings and her insurance won’t pay, filing an amended 2016 return may be her easiest access to cash.

Section 165(i)(3). The amount of the loss taken into account in the preceding taxable year by reason of paragraph (1) shall not exceed the uncompensated amount determined on the basis of the facts existing at the date the taxpayer claims the loss.

Determining the “existing facts” can be a judgement call. Prior to Harvey, the National Flood Insurance Program was $25 billion in debt and was losing $1 billion a year. Should that be taken into account if it takes until the end of 2017 to even get an estimate? Does political dysfunction figure into this calculation?
In January 2018, Camille receives a $75,000 payment from her insurance.

If she had already filed a 2016 Form 1040X she must redo her casualty loss calculations to reflect the payment. She must file a second 1040X with the correct loss. She must also reduce the basis in her house by the amount of insurance received.
Camille’s Hard Luck Home Pt 2

In February 2018, 6 months after gutting the lower level of her home, she hires a contractor who is willing to do the work for the amount her insurance company paid her. She feels lucky to find someone to work for “cheap” until she pays him the 30% materials deposit and he disappears.

Camille also starts feeling chronically sick. She has a permanent headache and cough. One day she notices mold growing in the second floor bathroom. Opening up the drywall reveals a mold infestation.
**Tax Treatment?**

The theft of the deposit is separate from the damage suffered during the storm despite being factually linked. Camille may have a tax year 2018 theft loss under 165(h)(3). The loss may have little current tax value if her business is suffering and does not have income to offset. It is not uncommon for a disaster to cause a string of 165 losses.

Generally mold is not a casualty loss because it is not a sudden occurrence. However, if it was directly caused by Harvey’s flooding then it may be part of her casualty loss. If it was caused by insufficient repairs, or was unrelated to Harvey’s flooding and spread because of the increased moisture then it is not a casualty loss.
When are Disaster Related Payments Included in Income?

• IRC 139 provides a broad definition of excluded disaster relief payments. Can come from any source and includes payments for living expenses. Includes FEMA payments, property owner hazard mitigation payments, and HUD assistance.

• Grants to business are included in income

• Money received from family, friends and NGOs, is governed by standard gift rules

• FEMA (and other emergency) loans that are later canceled may create IRC §108 income

• If the taxpayers do not use excluded disaster payments for recovery purposes the payments may become taxable

• Generally disaster payments are not treated as income for other government aid calculations
Camille’s Business

- Camille’s corporate filing deadlines and payroll tax deadlines are extended.

- Casualty losses for Camille’s trucks and equipment are calculated using a similar formula to the personal property but without the AGI or the $100 limitations.

- She may have a casualty gain from her insurance proceeds due to depreciation. She can avoid this gain by using the proceeds to purchase replacement equipment.

- She cannot claim losses based upon lost future income.

- If she has business interruption insurance it may be subject to self employment taxes. Newberry v. Commissioner, 76 T.C. 441, 444 (1981) held that such payments were not taxable but the IRS declined to acquiesce to that decision.

- If Camille has the resources she can provide qualified disaster relief payments to her employees without it counting as income to her employees. However she cannot take a deduction for the payments.
Camille’s Audit

• Substantiation is going to be a major problem. Deductions are a matter of legislative grace and the burden is on the taxpayer to show they are entitled to claim them.

• The loss of the home office and the business records put Camille at a disadvantage. This forces her to rely on third party records such as bank statements, and credit card receipts.

• The Cohan rule allows for reasonable expenses in most situations. Specific expenses like those found in Section 274 require more detail. Chances are Camille had significant §274 expenses for her trucks and workers. Treasury Reg. §1.274-5T(c)(5) allows for reasonable reconstruction where the records are lost and destroyed due to circumstances beyond taxpayer control.
What Could Camille Have Done Differently To Preserve Records?

• Created a disaster plan for her business that included a backing up her records to a portable hard drive and keeping that hard drive with her emergency/evacuation supplies

• Scan paper documents and keep a digital back up in the cloud

• Use electronic bill pay and email invoices. Work with vendors that send digital invoices. Almost anything digital uses a third party provider that hopefully keeps electronic records.
Other Post Disaster Traps That May Have Tax Consequences

- Identity theft
- Unscrupulous return preparers
- Unqualified contractors
- ACA hardship exemptions
Tax Issues For Harvey Charities

• Tax deductible charitable donations must be in accordance with Section 170(c)

• Harvey is a large enough disaster that groups formed to aid Harvey survivors should qualify as a public charity

• It is likely that a significant portion of the Harvey aid will come in the form of service projects or non cash donations. Charities need to be aware of the substantiation rules for out of pocket expenses and for property
Questions?