SIFTING THROUGH THE RUBBLE
DISASTER GAINS AND LOSSES

Southern California Wildfires

September 2004

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Qualifications

- Anna Maria Galdieri is a CPA in Oakland, California. She developed her expertise in the area of disaster tax law working to bring tax reform to the victims of the Oakland firestorm.
- She worked with local representatives to draft legislation that eventually was enacted as section 1033(h), wrote extensively about the new tax law that brought relief to disaster victims and
    - with the local IRS office to obtain private letter rulings and public revenue rulings that answered questions which she raised with the IRS.
- She was awarded the Saul Braverman award by the CSCPAs for her work with disaster victims.
- She has and continues to advise disaster victims and their representatives on their insurance settlements and
    - works with plaintiffs' attorneys to structure lawsuit settlements to minimize the tax burden to the plaintiffs.
- Past chair of the Disaster Tax subcommittee of the American Institute of Certified Public Accountants where she had responsibility for their Disaster Area Practice Guide.
- Current chair of the Disaster Tax Subcommittee of the California Society of Certified Public Accountants
- Member of CSPAS Statewide Committee on Taxation and Estate Planning
- Chair of the Annual advanced Estate Planning Symposium of the East Bay Chapter of the CSCPAs
- Chair of the Disaster Recovery Workshop sponsored by the CSCPAs in December, 2003
- Speaker on Disaster Tax for the American Institute of Certified Public Accountants and the California Society of CPAs
- Columnist with the Phoenix Journal and the Oakland Montclarion writing extensively during the rebuilding phase on disaster tax-related topic and
    - Has been interviewed and quoted on disaster tax topics since 1991

My thanks to:

- Paul Vandeventer
- And Community Partners for underwriting the cost of this video and
- George Kehrer of CARe

Important Information to give to your tax advisor

- The Southern California Wildfires have been declared a Presidential disaster
- IRS Code Section 1033(h)(1)

  Tax treatment when you lose your personal residence in a Presidentially declared disaster
- IRS Code Section 1033(h)(2)

  The tax treatment when you lose tangible property held for productive use in a trade or business in a Presidentially declared disaster
- Code Section 1033(a)

  The tax treatment when you lose rental property or real property used in a trade or business in a fire
- Code Section 123

  Loss of use proceeds IRS news release provides that uninsured disaster victims may use their public grants to purchase a mobile home – section 139.
- Revenue Ruling 95-22

  Clarification of exemption of insurance proceeds received for unscheduled personal property and common pool of funds.
- Revenue Ruling 96-32

  Sale of lot part of the involuntary conversion, mortgage interest on vacant lot is qualified residential interest expense, no allocation of land and building under Section 1033.
- Revenue Ruling 2003-12

  Certain disaster relief payments aren’t includible in income
- Regulations issued under Section 121 defining unforeseen circumstances.
- ITA 200114046

  Clarification of contents located at a site other than a personal residence

My home was destroyed in the wildfires. What are the tax consequences?

- If you are uninsured, you have a casualty loss.
- If you are underinsured, you may have an economic loss, but not a tax loss.

I got insurance proceeds for my house and contents. Do I have to pay tax on that money?

- If you are covered by a homeowner's insurance policy, the proceeds received for your unscheduled personal property, your household contents, is exempt from tax.
- You are not required to reinvest this money.
- The proceeds you receive for your home and for scheduled personal property, like jewelry and art works, MAY RESULT IN A GAIN, if you receive one more dollar in insurance proceeds than your tax basis in your home and scheduled personal property.

What if my insurance company doesn't give me enough to replace my contents?

- You may have a casualty loss if the sum of the depreciated value of your household contents minus your insurance proceeds is more than zero and
  - Greater than $100 and 10% of our adjusted gross income and you already itemize.

How do I determine my gain or loss on my household contents?

- You don't need to determine whether you have a gain on your contents because the money you get for your contents is exempt from tax.
- To determine whether you have a loss on your contents, you must determine when you purchased each item, how much it cost, and then depreciate it.

Do I have to compute the loss or gain on each of the things that were in my home?

- No, you will add up the sum of the depreciated value of your contents and reduce this by the insurance proceeds you received for your contents
- The balance of your loss is then reduced by $100 and 10% of your adjusted gross income.

How can I take a loss if the insurance proceeds are exempt

- You can take a loss whether or not the proceeds are exempt. If the depreciated value of your items is greater than the amount of insurance you got, have a loss.

Don't I have to lump my insurance money all together to determine whether I have a gain or a loss?

- No, the amount that you receive for contents is compared to the depreciated value of your contents to determine whether you have a casualty loss
- Amounts you receive for your home are compared to your tax basis in your home to determine whether you have an involuntary conversion.

What is an involuntary conversion?

- It is a tax term of art for the destruction of your homes in the wildfires, and the receipt of one more dollar of insurance proceeds than your tax basis in your home.

How do I determine whether I have a gain or loss on my home?

- The gain or loss is determined once you know your tax basis in your home and the amount of your insurance settlement.

How do I determine the tax basis in my home?

- Did you inherit your home?

  Your tax basis is the fair market value of the home at the time of death of the decedent.

- Did you inherit your spouse's community property interest in your home?

  Your tax basis is the fair market value of the home at the time of your spouse's death.

- Did you purchase your home after May 6, 1997?
  Did you make improvements to your home?
  Use your home in your business?

  Your tax basis is your purchase price plus improvements minus depreciation.

- Did you purchase your home before May 7, 1997?
  Make improvements?
  Use it in your business?

  You will need to obtain a copy of your Form 2119, Sale of a Personal Residence to determine your basis in your home

  2119 basis plus improvements minus depreciation equals your tax basis

How do I compute my gain?

- My basis in my home is $30,000
- I received $350,000 to rebuild my home.
- Your gain is $320,000

What makes me eligible to exclude the gain on my home destroyed in the wildfires?

- You must have lost your home in a Presidentially declared disaster and owned and occupied your home for two out of the last five years as your principal residence unless you were in a nursing home.
- If you owned and lived in it less than 2 years, you may be able to exclude part of the gain.

I've taken my exclusion and I still have a gain. What do I have to do to avoid taxes on my insurance settlement?

- You must reinvest the balance in another home and/or contents.
- If you don't reinvest the balance in another home and/or contents, you will e taxed on the remainder of the gain.

Even though you just told me that money I got for my contents is exempt, are you telling me that I can take the money I got for my house and buy contents?

- YES

How do I determine how much I have to reinvest?

• Insurance proceeds	$350,000
• Tax basis	30,000
• Gain	$320,000
• Excluded gain-single	($250,000)
• *Amount to reinvest*	*$70,000*

Are you sure that's all I have to reinvest?

- Yes, since 1997 you can exclude the gain on your personal residence as long as you have occupied and owned it for two out of the last five years.
- Since you only have to reinvest $70,000 of your insurance settlement, and amount over and above that amount increases your tax basis in your new home.

Can I spend my insurance proceeds on my home and contents?

- Yes
- The new law allows you to take the money you got for your home and scheduled personal property and reinvest it in a new home and contents, or just contents!

Are you telling me that I can exclude gain, and take the balance of my money and spend it just on contents?

- Yes
- That's what the law says and the IRS has issued a ruling stating this

How long do I have to reinvest?

- You have 4 years from the end of the year in which you receive one more dollar from your insurance company than your tax basis in your home and scheduled personal property.
- Your basis in your home is $30,000
- You receive $125,000 from your insurance company in 2003.
- You receive an additional $225,000 in 2004.
- Since $125,000 is more than your tax basis in your home, you have 4 years from the end of 2003 to reinvest.
- By December 31, 2007 you must reinvest in another home and/or contents.

What happens if I can't rebuild within the 4 years.

- If you can't rebuild, you can request a year by year extension of time from the IRS.
- You may need to do this if there are delays in rebuilding because of infrastructure problems or because you are still negotiating a settlement with your insurance company.

What if I don't want to buy another home?

- You may not have any tax to pay if you reinvest in household contents
- Insurance proceeds $350,000
- Tax Basis ($30,000)
- Gain $320,000
- Exclusion (single) ($250,000)
- Gain if you don't reinvest $70,000
- Amount to reinvest $100,000

What if I don't reinvest that amount?

- You have a couple of options
- If you don't reinvest that $100,000 you pay tax on $70,000. The long-term capital gains rate is 5-15% depending upon your other income
- You can reinvest some of the money and pay tax on the balance
- You pay tax on the smaller of the gain realized ($70,000)
- Or the amount of your unspent proceeds ($100,000)
- Or for example you could spend $50,000 and pay tax on the balance of the gain of $20,000

What if I don't want to rebuild on my lot?

- You are not required to rebuild on your lot for tax purposes.
- You are required to replace your destroyed residence with another personal residence and/or contents.

What happens if I sell my lot and buy another home elsewhere?

- The sale proceeds are treated as part of the involuntary conversion of the home and are added to the amount of insurance proceeds received to determine the amount that you have realized.

What if I haven't lived in my home two out of the last five years?

- You will still be able to exclude a prorated amount of the gain under the new regulations that came out at the end of 2002 detailing unforeseen circumstances.

Can I take my insurance proceeds that I got for my rental home and reinvest the money in a bed and breakfast?

- A rental home is not the same kind of business as a bed and breakfast.
- This is an area where reform is needed. There are unduly restrictive requirements for disaster victims who lose real property that they use in a trade or business or which they hold for investment.

I operated a drive through coffee stand that was destroyed in the wildfires. Can I take my insurance money and buy a small building somewhere else?

- Unfortunately no. But you could take your insurance money and reinvest in any other tangible personal property that you use in your trade or business. So you could, for example, reinvest in computer equipment and start a coffee consulting business.

It will cost me $500,000 to rebuild. My insurance company is only paying me $350,000. What is my tax loss?

- Assuming your tax basis is $30,000, you have a tax gain of $320,000 ($350,000-$30,000).
- You have no tax loss since your insurance settlement is greater than your tax basis in your home.
- You have an economic, nondeductible loss unless policy reformation is possible.

What are my remedies if I suffer an economic loss/

- Policy reformation which can be achieved by working with your fellow insureds sharing information, and working with organizations like CARe

Can I take a deduction for legal expenses incurred to settle with my insurance company?

- NO. Jasko lost his home in the Oakland firestorm in 1991.
- He spent all of his insurance settlement on replacing his home, and was out of pocket for the legal expenses incurred to settle his claim.
- He argued that he was entitled to deduct these legal fees under Section 212. He lost. Legal expenses are added to basis.

Why can't I take my legal expenses as a casualty loss?

- The Court in Jasko held they related back to the insurance claim, and under the origin of claim doctrine they related to a capital asset, the personal residence. Losses on a personal residence aren't deductible unless they fit into the definition of a casualty.

How is my loss of use insurance proceeds taxed?

- Currently the IRS requires you to compare your living expenses before the disaster to your living expenses after the disaster. Only the incremental increase in these expenses is allowed to be netted against your insurance recovery.

Additional living expense example

Expense	Before	After
Rent	0	$1,500
Food	$400	$1,000
Utilities	$150	$250
Transportation	$140	$250
Total	$690	$3,000
Increase		$2,310

- Most victims who are insured do not have income from the receipt of ALE used to rent an interim home during reconstruction.

Can I use my ALE to purchase a mobile home since there are no rental units available in my area?

- No, use of these proceeds to purchase a mobile home results in taxable income.
- Work with your local representatives to get a favorable ruling from the IRS

How can I get the IRS to issue a favorable ruling so that the money I spent to purchase a mobile home isn't taxed?

- Go to your local representatives and ask them to lobby on your behalf.
- The IRS can issue a revenue ruling that would hold the following:

  Since there is insufficient rental housing available in the area destroyed by the Southern California wildfires, victims of the disaster who use their loss of use funds to purchase a mobile home will not be taxed.

  The IRS's ruling could hold that these amounts are to compensate or reimburse such individuals for living expenses incurred for themselves and members of their household resulting from the loss of use or occupancy of their principal residence.

My rent expense is greater than my insurance settlement. Where do I take my loss?

- You do not have a tax deduction for your personal living expenses that exceed your insurance settlement.
- Consider policy reformation to increase your benefits under your policy.
- If the insurance company gives you a lump sum settlement, the IRS has ruled that whether it is taxable is determined after the taxpayers move back into their principal residences.

I heard that the IRS ruled that we could purchase a mobile home

- The IRS news release said the following: Uninsured disaster victims who received certain government payments in the Southern California wildfires may use those funds to purchase a mobile home. The ruling covered payments received under Section 139 of the Internal Revenue Code.
- This ruling does not cover payments received under an insurance contract. Those payments are covered under Section 123.

I own another rental home that I moved into while my home is being rebuilt. Can I use my loss of use settlement to rebuild my home?

- No, the tax law only allows you to use these proceeds for loss of use expenses: temporary housing, utilities, food, transportation and other miscellaneous services to the extent that these exceed your normal living expenses.

I owned a cabin that was uninsured. I want to sell my lot and move somewhere else. What taxes am I going to have to pay?

- It depends. Your sale of your lot would be considered to be part of the involuntary conversion of your home. That's the tax term of art used to define the destruction of your home by the wildfires.
- Whether you have a casualty loss on the destruction of your home depends upon how much you sell your vacant lot for. In accounting for your loss on your home, you must include the amount of the sale of the lot as part of your recovery.

I was a renter and lost everything in the fire. I had a renter's policy that paid me $25,000. My contents cost me more than that to replace. Where do I take my loss?

- It depends. Does the *depreciated* value of your household contents exceed $25,000
- If it does, you may have a casualty loss if it is greater than $100 and 10% of your adjusted gross income and you already itemize.

Measuring the loss

- Depreciated value is a fact of life. Whether you used your personal property for business or not, the tax law measures your loss by the decline in fair market value before and after the fire.
- When everything is burned up, it's clear that the value is zero after the fire. The value before the fire is more difficult to determine.
- The law says you must use the lower of the decline in fair market value or depreciated basis.
- Your first hurdle is to remember everything you had in your home
- Your second hurdle is to remember when you bought it and for how much
- Your third hurdle is to determine a depreciated value for these "used items"
- Keep a notebook with you at all times and write down anything when you remember it.
- Your tax loss is comparatively small compared to your economic loss. Be prepared for an audit of your return.
- The IRS has a disaster tax booklet available at their website www.irs.gov. It's publication 2194, 2003 Disaster Losses Kit for Individuals.
- Ask friends and neighbors to help you remember what you lost.
- Go through catalogs, walk through the aisles of stores, ask friends to help you recreate your contents.
- Look at old pictures of family gatherings, go through your friends homes and see what's there.

Documenting the loss

- Homeowners don't keep the records that business owners do
- IRS & insurance companies require proof.
- Courts will accept reasonable client oral testimony about contents, require appraisal or other creditable evidence
- One 91 year old firestorm victim kept 40 plus years of her receipts in her safety deposit box!

Local property tax relief

- Check your local assessor's office for available property tax relief.
- In California taxpayers whose property is destroyed in a disaster can transfer their property tax base to a new property.
- Assessor mandated to write down value of property until property is rebuilt.
- Property tax basis can be transferred to another property if you purchase your new property within the same county. You have a three year period in which to do this.
- There is no time limitation if your rebuild your home on your vacant lot.
- You may be able to transfer your tax basis to your replacement home if you purchase one in another county that allows the transfer of your tax basis.
- Counties that allow for property tax base year transfer are Alameda, Kern, Modoc, Orange, San Diego, San Mateo, and Santa Clara.