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Neil E. Harl
Iowa State University

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Deducting Casualty Losses

by Neil E. Harl

Although 2005 was a heavy period for casualty losses, farm and ranch operations can encounter casualty losses in almost any year.¹ This article focuses on casualty losses related to floods, wind and hurricanes and limits on deductibility.²

General

A casualty loss arises from an event due to a sudden, unexpected or unusual cause.³ The loss is deductible as an ordinary loss in the year the loss is sustained, to the extent the loss is not compensated by insurance or otherwise.⁴ For an individual, casualty losses are limited to losses incurred in a trade or business; losses incurred in any transaction entered into for profit, even though not connected with a trade or business; and other losses arising from “fire, storm, shipwreck or other casualty, or from theft.”⁵

Thus, losses to nonbusiness property caused by flood⁶ are deductible but the loss deduction is generally limited to the area flooded and a deduction is not allowed for the loss of anticipated profits or reduction in value for the rest of the property.⁷ In a 2000 case, no deduction was allowed for a loss in market value because the house was in an avalanche zone.⁸ If rainfall causes damage but was not an unexpected event, the damage does not produce a casualty loss.⁹

Although damage from wind can produce a casualty loss,¹⁰ damage from normal operation or from progressive deterioration of property through a steadily operating cause such as wind or weather is generally not considered to be a casualty loss for income tax purposes.¹¹ A casualty loss deduction is not allowed if there is a reasonable prospect of recovering from the loss.¹² Moreover, a casualty loss deduction is only allowed if proved.¹³

Amount of the deduction

The amount of the deduction is the lesser of (1) the difference in fair market value before and after the loss¹⁴ or (2) the amount of the adjusted income tax basis for purposes of determining the loss.¹⁵ However, if business property or income producing property is totally destroyed, the casualty loss is the adjusted basis of the property if fair market value is less than the adjusted basis.¹⁶

Any loss must be reduced by any insurance recovery.¹⁷ For many years, a taxpayer who elected not to collect insurance proceeds in the event of loss because of fear of policy cancellation could deduct the loss (less the $100 deductible amount for non-business losses, where applicable).¹⁸ However, after 1986, a casualty loss deduction is denied to the extent that an individual has insurance coverage on non-business property and elects not to file a claim.¹⁹

¹Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
For property held for nonbusiness use, the first $100 of loss is not deductible. This limitation applies separately to each casualty sustained on nonbusiness property and applies to the entire loss due to the casualty.

Commencing in 1983, nonbusiness losses have been deductible only to the extent total nonbusiness casualty and theft losses exceed 10 percent of adjusted gross income. For purposes of the $100 limit and the 10 percent limitation, a husband and wife filing a joint return are treated as one individual.

Footnotes

2. I.R.C. § 165.
3. See, e.g., Matheson v. Comm’r, 18 B.T.A. 674 (1939), acq., IX-2 C.B. 38, aff’d, 54 F.2d 537 (2d Cir. 1931), which applied this definition in denying a deduction for a loss incurred due to progressive deterioration of a faultily constructed building.
4. I.R.C. §§ 165(b), 1011.
5. I.R.C. § 165(c); Treas. Reg. § 1.165-7(a)(1).
6. Radding v. Comm’r, T.C. Memo. 1988-250 (casualty loss for damage caused by mud slide limited to repair costs in excess of insurance recovery); Maduza v. Comm’r, T.C. Memo. 1961-249 (food damage to trees as well as vegetables).
9. Portman v. United States, 683 F.2d 1280 (9th Cir. 1982).
11. See, e.g., McDaniel v. Comm’r, T.C. Memo. 1980-557 (damage due to settling of foundation of building was from progressive deterioration; no deduction allowed); Pryor v. Comm’r, T.C. Memo. 1983-695 (normal rainfall caused deterioration of sand beneath concrete slab; no deduction allowed for crack in slab); Shaffer v. Comm’r, T.C. Memo. 1983-677 (no deduction from damage to brickwork; deduction allowed, however, for storm damage to concrete driveway); Leonard v. Comm’r, T.C. Summary Op. 2005-114 (deck collapse was not casualty). But see Bailey v. Comm’r, T.C. Memo. 1983-685 (deduction allowed for soil slippage from unidentified causes over six to eight weeks).
12. Mitic v. Comm’r, T.C. Memo. 2000-144 (good chance of insurance recovery); Concord Instruments Corp. v. Comm’r, T.C. Memo. 1994-248 (loss from fire not deductible in year in question; insurer still considering claim at year end). See CCA Ltr. Rul. 9915050, February 19, 1999 (no casualty loss deduction where reasonable prospect of recovering government payments; involved Oklahoma City bombing).
14. Treas. Reg. § 1.165-7(b). See Finkbohner v. United States, 788 F.2d 723 (11th Cir. 1986) (fair market value of residence decreased for permanent buyer resistance after flood damage to house); Baker v. Comm’r, T.C. Memo. 1990-553 (taxpayer unable to prove decline in fair market value); Oliver v. Comm’r, T.C. Memo. 1997-84 (failure to establish by competent appraisal fair market value before and after casualty; claimed loss could not be based on original cost of contents).
17. I.R.C. § 165(a). See Gorman v. Comm’r, T.C. Memo. 1995-268 (excess of insurance recovery over basis was gain).
18. E.g., Hetts v. Comm’r, 76 T.C. 484 (1980), aff’d, 691 F.2d 997 (11th Cir. 1982).