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Planning for Rising Income Taxes by Accelerating Income

Benjamin Franklin once said, "In this world nothing can be said to be certain, except death and taxes." Post-election, it now appears that rising income tax is now going to be a certainty.

Although we do not know whether Congress will extend the Bush-era tax cuts, who will be affected, for how long, and when any changes might go into effect, we do know the planned rate increases that will go into effect short of any action by Congress. The long-term capital gain rate is currently scheduled to increase in 2013 to 20% from 15%. The maximum dividends and ordinary income tax rates are increasing to 39.6%, from 15% and 35%, respectively. The 2% exemption on the employee portion of payroll taxes will also expire at the end of the year for those with wage income. Additionally, The Patient Protection and Affordable Care Act (also known as Obamacare) which adds a 0.9% tax on earned income and a 3.8% surtax on investment income goes into effect on January 1, 2013. So, even if the Bush-era tax cuts are temporarily extended, a capital gain of $100,000 realized in January, 2013 will result in a $3,800 increase in tax. If the rates increase as currently scheduled, an $8,800 increase in tax actually occurs.

In most recent years, it was generally advised to defer income and accelerate deductions while considering adverse forces such as the alternative minimum tax (AMT) and/or phase-outs of certain itemized deductions. Contrary to that axiom, the principal focus of this article is dealing with the real possibility of increasing personal income tax rates and the attempt to answer the question of how one actually accelerates taxable income into a particular year and save future taxes.

One way to accomplish this goal is to exercise stock options or sell appreciated property before year-end, recognize the built-in gain, and step-up the tax basis by repurchasing the property. Unlike assets with losses, selling at a profit to relatives or a related company to recognize gain is not prohibited. The wash sale rules also do not apply. For example, if you anticipate selling an asset with a $2,000,000 gain in January and the capital gains are subject to a total tax rate of 23.8%, you may have been able to sell it in December when the capital gains rate is only 15%, producing a tax savings of $176,000. If you are not certain when you might actually sell the asset in the near term, consider utilizing an installment sale to a related party.

Cash basis taxpayers can accelerate income through advancing collections. The key is not when to send the bill, but whether you can actually receive payment before year-end. Sending the bill earlier is probably just good business practice. However, you may even consider giving small discounts for pre-year-end accelerated payments. Also consider settling any open lawsuits or insurance claims that could generate taxable income.

The ability to defer losses and deductions can normally be just as beneficial in a rising tax-rate environment as accelerating income. Payments can easily be deferred until the following year for items such as real estate taxes, interest expenses, charitable contributions, medical and dental expenses, or even year-end bonus payments to employees. Proper timing adjustments of even one day can make a sizable difference in the tax benefit. You can also make certain elections to max out or defer an investment interest expense. However, you must keep an eye on Congress regarding the possibility of placing hard caps or increasing the phase-outs on certain or all itemized deductions, as discussed during the campaign season, which would potentially impact the proper decision to defer those deductions.

For business owners, consider utilizing basis and at-risk limitations on pass-through entities to defer loss recognition until future years through suitable timing of intercompany loans and capital contributions. If the tax rate on dividends significantly increases, a leveraged capitalization could allow you to borrow money for a quick distribution of cash of corporate earnings and profits just before year-end. Another method to minimize the negative effect of increasing tax rates on dividends is to consider distributing appreciated property instead of cash. If you are selling your business, consider electing out of installment sale treatment when either a note is utilized or earn-outs exist, thus locking in a lower tax rate by accelerating gain recognition.

Largely bantered about over the last couple of years is the new ability for higher income taxpayers to accelerate income and to never pay income taxes again on the appreciating property in their Individual Retirement Account (IRA) by converting it to a Roth IRA. Other Roth IRA advantages include no mandatory distribution requirement and tax-exempt income to heirs on future distributions from inherited IRAs.

In summary, many variables have to be considered when planning for an increasing income tax rate environment. Although effective planning techniques exist, the current federal tax code is extremely complex and likely to change. Further, the interaction of diverse state tax laws along with the hidden traps of the AMT and phase-out of itemized deductions must be taken into account. Since there is an economic cost of accelerating taxes, sufficient modeling and scenario analysis should be a fundamental part of the planning process.

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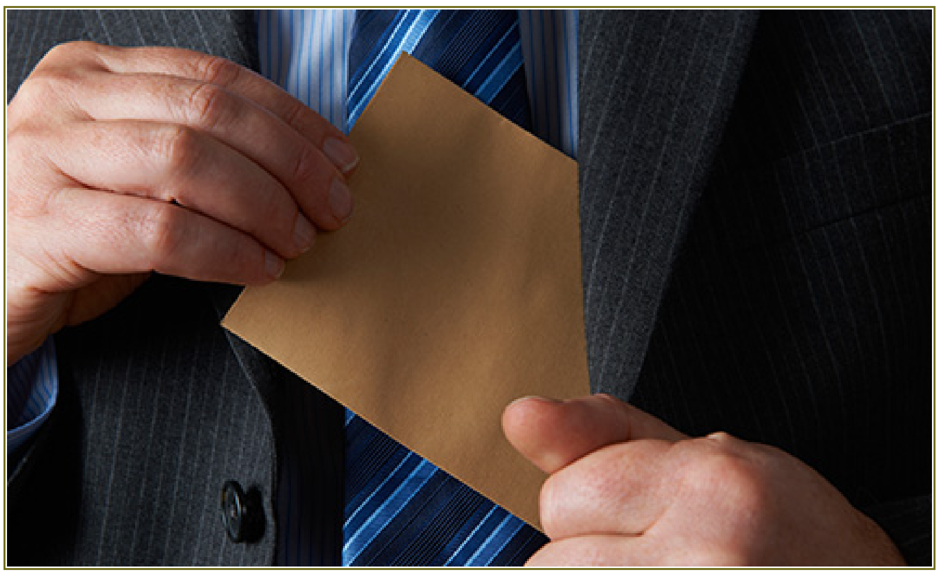
Hidden Tax and Legal Tribulations in Fair Value Measurements for Acquisition Accounting



Asset values determined by generally accepted accounting principles (GAAP) do not establish tax basis, but the document trail left for financial reporting can be a mine field of unintended consequences.

The organizational structures around M&A activity vary widely; acquisitions are often contemplated and executed by a small team of business-development specialists with limited input from the rest of the organization. Even though tax and legal specialists are frequently involved in the due diligence process, after the deal is completed the post-close team is often restricted to a smaller group of operational and financial reporting managers as the acquirer focuses on the difficult task of integration and limits the involvement of the larger organization.

A thorough due diligence process that evaluates the key elements of a transaction may not consider the developments that occur post-close. One of the major post-close tasks is the acquisition valuation work that is generally not undertaken until after the due diligence report is completed. The valuation work, frequently developed without the benefit of the diligence report, is overseen by the financial reporting group, who may be unaware of the tax planning strategy or the concerns of the legal department. The result can be the memorialization into the valuation work of facts and assumptions whose impact is not known by those responsible for reviewing the draft analysis.

As an example, earlier this year the Tax Court determined that a taxpayer, Peco Foods, Inc. and Subsidiaries (Peco), could not perform a cost segregation study (which might have yielded a significant tax benefit in the form of accelerated depreciation) because of certain language found in the purchase agreement. The agreement specified that the determined "allocation will be used for all purposes (including financial accounting and tax purposes)." (See the May 2012 WTAS Newsletter *The Peco Case: Are You Giving Enough Attention to Details in Purchase Price Allocations?* for more information on the Peco case.) If Peco's tax advisors had been involved in thoroughly reviewing the purchase price allocation at the time of acquisition, they might have been able to mitigate this issue and leave open the possibility of a cost segregation study in the future.

Financial reporting valuations often consider non-compete agreements. If there is an Internal Revenue Code Section 280G [1] issue for the sellers, the seller's non-compete valuations could be dramatically different from the financial reporting valuations. Given that non-compete valuations include assumptions related to the impact of a particular individual competing and the probability that he would compete without the agreement in place, it is easy to imagine divergent views between the buyer and the seller on these key inputs.

In international transactions, the appraiser may value customers, trade names, and technologies in various jurisdictions. This "trail" of value and the underlying economic assumptions could be different from the economic analysis developed in transfer pricing studies. In the best case, these discrepancies could prevent tax planning strategies that might otherwise be available; in the worst case, they could present contradictory evidence to that developed in previous transfer pricing work and jeopardize the benefits of existing structures and strategies.

The valuation report could also imply that an asset resides in a particular legal entity when in fact, the proper entity "ownership" is less clear and subject to some interpretation. With foresight, the asset could be strategically assigned, and future planning opportunities could be maintained.

Finally, in certain litigious industries such as medical devices, companies often find themselves the subject of patent infringement suits related to technologies. If not properly developed and presented, opposing counsel may find damaging evidence related to management's views on appropriate royalty rates or other assertions on the market factors affecting value. An improperly worded report could unwittingly cost a company its best legal defense.

The solution is simple. The tax and legal teams that are often active during the diligence process should participate on the front end in valuation planning meetings, and companies should seek valuation experts with experience in navigating through these issues during the valuation process. The initial meetings are the best time to identify tax or legal issues and the prior work done in the jurisdictions or functional areas of the acquired business. Examples include expected profit margins for the distribution activities for certain products or prior royalty rates for the transfer of technology between the country entity that owns the intellectual property and the market where the goods are produced and/or sold. As the Peco case illustrated, a review of the language in the purchase agreement or purchase price allocation can also impact future opportunities to revisit financial reporting valuations for tax purposes. Finally, it may also be appropriate in litigious industries for legal counsel to review and comment on draft reports before they are finalized so as to minimize the risk of potential controversy down the road.

[1] Internal Revenue Code Section 280G provides for penalties on excess parachute payments to executives of target companies in transactions.

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Help! I'm Being Audited: Are My Professional Fees Deductible?

When a taxpayer receives an audit notice from a taxing authority he or she should seek immediate professional assistance. Dealing with an audit is a complex process and a trained professional can assist you in avoiding many common pitfalls.

While hiring a tax professional to assist in your audit defense can be costly, in many cases, the fees paid can be deducted on your tax return. The nature of the deduction can depend upon what tax item(s) are being audited. In general, professional fees that relate to producing or collecting taxable income or receiving tax advice are deductible.

Individual Tax Audits

Audits of individuals can range in scope from a cursory look at a particular item of income or deduction to an intensive review of all items included in a return. This latter type of audit relates primarily to employed individuals and covers income and deduction items such as wages, pensions, mortgage interest, charitable contributions and medical expense deductions. In general, professional expenses associated with defending this type of audit are deductible as a miscellaneous itemized deduction on Schedule A of a tax return. It is important to note that to benefit from this deduction the taxpayer must itemize his or her deductions and the amount of all such deductions must exceed 2% of the taxpayer's adjusted gross income (AGI). Also, this deduction is not allowed to the extent that the taxpayer is subject to the dreaded alternative minimum tax (AMT) regime.

Self-Employed Individual Tax Audits

A self-employed individual who files as a "sole proprietor" will include a Schedule C in his or her tax return. Schedule C income/loss can also arise from activities through a single member limited liability company (LLC). Schedule C audits are very common especially if there is a resultant loss. Professional fees incurred defending an audit of this activity are deductible in full as an ordinary and necessary business expense. This is, of course, a much more favorable tax treatment than an employed person's miscellaneous itemized deduction. A Schedule C deduction does not depend on whether the taxpayer itemizes, nor is it limited in any material way. Additionally, it results in a reduction of AGI which may favorably affect other items on the tax return. The Schedule C deduction is also allowable under the AMT taxing regime and will benefit taxpayers subject to this tax.

Taxpayers often organize their business activities through partnerships or S corporations, which are reported on a taxpayer's Schedule E. These active trade or business income and deduction items can likewise be audited. The treatment of costs for defending these items are nearly identical to that of the Schedule C "sole proprietor." The only difference is that the costs are instead deducted on Schedule E. Additionally, a deduction of this nature on either Schedule C or E will reduce the taxpayer's self-employment income and the associated self-employment tax.

Audits of Passive Activities

Many taxpayers who invest in business activities through partnerships and S corporations, but do not materially participate in the business, will be subject to the passive-activity loss rules. These rules are complex and beyond the scope of this article. However, it is important to note that professional expenses incurred for the audit defense of these activities will also be subject to the passive-activity loss rules. If a loss is limited by these rules, it is merely deferred until the activity terminates or sufficient passive income (from this or other passive activities) is generated to utilize the loss. Similar to the Schedule C business audit, the deduction for professional fees on Schedule E does not depend on whether the taxpayer itemizes. Also, it results in a reduction of AGI and is allowable under the AMT regime.

Audits Covering Several Types of Tax Items

Very often, a single audit will cover several of the above categories. In this case, an allocation of the audit defense costs should be performed and the expenses deducted on the appropriate forms. A proper allocation of the professional expenses is critical to maximizing the deductibility of those fees. For instance, if an audit defense includes items from a Schedule C activity, that time should be documented separately to make sure the fees can be deducted on Schedule C as opposed to a less advantageous tax treatment. Like many other areas of tax, maintaining accurate and complete records is vital.

When is the Expense Deductible?

Individuals are almost always "cash basis" taxpayers. Therefore, professional expenses incurred must be deducted in the year paid. For example, assume that a 2009 tax return was audited during 2011. Let also assume that the professional work to defend the audit took place in 2011, but the bill for the services was not paid by the taxpayer until 2012. The expense would be deductible by the taxpayer on his or her 2012 tax return on the appropriate Schedule, depending on the nature of the item being audited, as discussed previously.

Conclusion

It is advisable to retain a trained tax professional to assist you in an audit. Professional costs you incur associated with the defense of specific items of income or deduction should be properly documented to obtain the most beneficial deduction for those costs. Costs associated with business items will generate the most favorable tax benefit, while those associated with personal and investment income items the least. A deduction for costs associated with defending passive activities is available, but may be limited due to the complex passive activity rules. One should consult a tax professional to determine whether professional expenses incurred relating to a tax audit may be deductible. For more information on audits, please see *I Received an IRS Collection Notice: What are My Options?* and *Help! The IRS is Auditing Me!*

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Post-Election Investment Strategies

The global economy has experienced a number of significant events in 2012 that have influenced the markets.

Recurring headlines have focused on a slowdown in the Chinese economy as well as the ongoing Euro zone crisis. In the United States, our sluggish growth and slowly improving unemployment and housing market are constantly at the forefront of media coverage. More recent discussions have turned to focus on the impact of the recent U.S. election. As we make preparations to close the year and look forward to the next, we encourage investors to carefully review their portfolios and consider the following year-end strategies with their team of trusted advisors.

2012 Election Results

In the months leading up to the election, the U.S. endured grueling campaigns with over $6 billion spent by the candidates and affiliated parties. Once the votes were counted, however, the spending and campaign efforts yielded little change in Washington. President Obama has been re-elected and Congress will see no changes in leadership since the Democrats and Republicans maintained control of the Senate and House, respectively. With the election uncertainty behind us, attention has once again turned to the looming “fiscal cliff.” Without compromise in Washington, huge tax hikes and spending cuts are due to take effect at the end of the year. With a divided government and a continuation of gridlock, the markets are likely to remain volatile and the U.S. economy may feel profound effects.

The first and most pronounced issue is the potential sunset of the Bush-era tax cuts that are set to expire at the end of the year. Under current law, qualified dividends and long-term capital gains are taxed at a maximum rate of 15%. President Obama has expressed a desire to keep these preferential tax rates in place for any married couples with income less than $250,000 annually and for any singles with income less than $200,000 annually. Those with income over these thresholds can expect to see the long-term capital gains tax rate increase to 20% and the dividend tax rate increase to 39.6% next year. There is still a great deal of speculation that there is room for these income levels to be higher (or lower), but what does seem to be evident is that “high-income” earners will likely be paying more in taxes. This type of policy change might lead to a temporary decline in equity markets as investors take profits and lock in lower tax rates on gains realized from stocks that have seen a considerable run-up over the last couple of years. We might also see increased interest in municipal bonds as more affluent investors shift portfolio allocations to avoid the adverse impact that higher tax rates may have on their after-tax yields and the performance of their portfolios.

Furthermore, 2013 will also see the introduction of a 3.8% Medicare contribution tax. This tax will apply to the lesser of a taxpayer’s net investment income or their gross annual income in excess of the threshold amounts. The threshold amounts are $250,000 for married couples, $125,000 for married individuals filing separately, and $200,000 for singles. You should consult your advisor on what constitutes investment income and possible strategies to consider.

In addition, Obama’s re-election likely means continued support for the Federal Reserve and its aggressive quantitative easing measures. With more money being injected into the economy, future inflation remains a meaningful concern for investors. Accordingly, it is likely that we will continue to see investor appeal for inflation-linked bonds, commodities and gold, all of which tend to perform well in an inflationary environment.

Finally, investors should be discussing with their advisors what sector opportunities and risks might exist as we enter the second term of the Obama administration and how to position portfolio investments appropriately. For example, good discussion topics might include the administration’s stricter environmental and financial regulations on the energy and financial sectors. Proactive portfolio management and review is always a good idea, even while we wait out the “lame duck” period.

Year-End Steps for Investors

During this time of uncertainty and market volatility, it is critically important for investors to stay focused on their investment goals and objectives. First, investors should review and rebalance their investment allocations as necessary. Rebalancing a portfolio ensures that investors’ targets for each asset class remain intact and that the portfolio can weather volatile market conditions. According to empirical research, a strategic asset allocation contributes to 90% of a portfolio’s variability over time. Thus, it is in investors’ best interest to rebalance their portfolios periodically, especially during periods of heightened uncertainty. Additionally, as the markets are likely to remain volatile, it may be a good time to make sure your portfolio is positioned appropriately to ensure the portfolio is not taking more risk than is appropriate.

Following a review of the overall portfolio, investors should carefully review the investment managers in their portfolios. Since the markets have dropped significantly in the days following the re-election of President Obama and are likely to remain challenged until a resolution of the fiscal cliff issues, it is important for investors to ensure their investment managers remain suitable for their portfolio. Key areas to assess are historical performance in both up and down markets, manager strategy, and total costs including the direct management fee as well as any custody and trading fees incurred.

Many investors have become well-versed on popular year-end tax planning techniques, which generally involve a review of any gains or losses recognized to date and whether any action should be taken to minimize the tax bite on those gains. However, with the anticipation of tax-rate increases, investors may find it more prudent to discuss accelerating capital gains to take advantage of the lower tax rates. The sneaky wash sale rules, which can disallow losses on positions that a taxpayer re-enters within a short period of time, do not apply to realized gains. Therefore, investors can lock in the benefit of lower 2012 tax rates and reduce the overall tax exposure on the portfolio assets without any real impact to the underlying investments. The current tax rates also make this a particularly opportune time to consider diversifying out of concentrated and/or highly appreciated holdings, easing the tax burden and better positioning the portfolio to weather volatility. For investors who have long-term capital loss carryovers, however, these strategies might not be as effective, since the loss may be better used against the higher tax rates looming on the horizon. In any event, we encourage investors to work with competent tax and investment advisors who can collaboratively analyze, plan, and implement appropriate strategies both at year-end and throughout the year.

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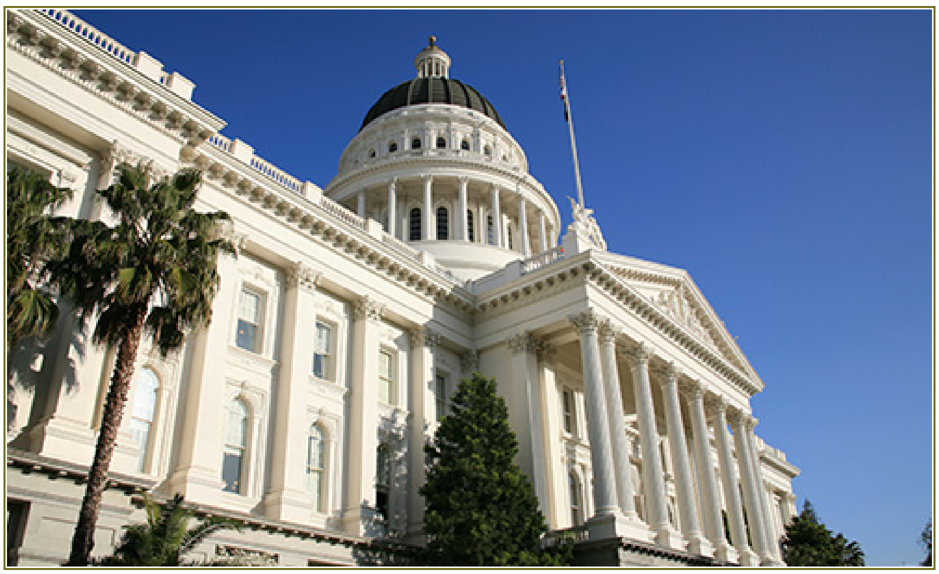
Keeping Up with California's Tax Changes



Proposition 30 prospectively increases the state sales tax rate from 7.25% to 7.5% beginning January 1, 2013 and retroactively increases income tax rates on California taxpayers with incomes exceeding certain threshold limits.

From 2012 through 2018 the marginal tax rates will be increased as follows:

Single Filer Taxable Income	**Joint Filer Taxable Income**	**Head of Household Taxable Income**	**Prior Marginal Tax Rate**	**New Marginal Tax Rate**
$250,001 – $300,000	$500,001 – $600,000	$340,001 - $408,000	9.3%	10.3%
$300,001 –	$600,001 –	$408,001 – $680,000	9.3%	11.3%

$500,000	$1,000,000			
$500,001 – $1,000,000		$680,001 – $1,000,000	9.3%	12.3%
$1,000,000+	$1,000,000+	$1,000,000+	10.3%	13.3%

Taxpayers who have already made their 2012 quarterly estimated tax payments based on the prior marginal tax rates will not be subject to underpayment penalties related to the tax rate increase to the extent any underpayment is attributable to the newly increased rates. Taxpayers making quarterly payments have until April 15, 2013 to pay any additional tax liability resulting from Proposition 30's rate increase.

For more information, see *Proposition 30 – What It Means for California Taxpayers*.

Proposition 39 (California)

Proposition 39 requires most multistate businesses to use a mandatory single-sales factor apportionment formula for tax years beginning on or after January 1, 2013, and to use a market-based approach for sourcing sales other than sales of tangible personal property. Apportioning taxpayers have previously had three options available with respect to apportioning income: a statutorily prescribed three-factor formula with a double-weighted sales factor, an elective single-sales factor formula, and possibly an elective three-factor, evenly-weighted formula under the Multistate Tax Compact. With the exception of the elective single-sales factor formula, sales other than sales of tangible personal property were sourced to California under a greater cost of performance approach. Proposition 39 removes the option to use a three-factor, double-weighted sales formula and requires apportioning taxpayers to source sales other than sales of personal property to California under market sourcing rules. Proposition 39 may also be affected by the final outcome of *Gillette v. Franchise Tax Board*.[1]

For more information, see *Californians Vote to Require a Market-Based Single-Sales Factor.*

Proposition E (City of San Francisco)

Voters in San Francisco approved Proposition E, phasing out San Francisco's current payroll expense tax over a period of five years and phasing in a gross receipts tax. Proposition E is effective January 1, 2014. The current payroll expense tax applies to businesses with more than $250,000 in payroll expenses attributable to San Francisco and is imposed at a rate of 1.5% on the business' total payroll expense in San Francisco. This payroll expense threshold subjects approximately 10% of businesses operating in San Francisco to the payroll expense tax, whereas the gross receipts tax will apply to the apportioned San Francisco gross receipts of *all* businesses conducting business activities in San Francisco at rates varying by industry and contingent upon the actual revenue collected during the payroll expense tax phase out process. San Francisco plans to accelerate or slow down the phase out of the payroll expense tax depending on the revenue collected under the gross receipts tax. The final phase in/phase out rates are to be effective by 2019.

[1] *The Gillette Company, et al. v. Franchise Tax Board*, No. A 130803 (Cal. Ct. App. Oct 2, 2012) [The Franchise Tax Board plans to appeal the Court of Appeal's decision in *Gillette* to the California Supreme Court]

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Disaster Related Tax Deductions: Hurricane Sandy Casualty Loss Deduction

Hurricane Sandy caused unprecedented and extensive damage to property and businesses in the Tri-State Area. If storm-related damage was sustained to a home, personal property, rental property or a business, the federal tax law may allow the affected taxpayers to claim a deduction on their tax return.

This article focuses on property where the reported loss is on an individual income tax return. The ability to deduct the loss relates to several factors, including the nature of the property that sustained damage, the potential for recovery from insurance, whether the property was located in a declared federal disaster area, and whether the damage was complete or partial.

What Type of Property Do I Own?

For tax purposes, casualty losses are divided into three categories of property and the treatment of losses is distinct for each group. One category is business property and includes equipment, a factory building, or even goodwill from an active trade or business. The second category is income-producing property, which is generally investment property that can be real or personal property such as artwork and investment real estate. The third type of property is property held for personal use, such as a home, car, boat or furniture. There are certain ambiguities between the various property types and a fuller explanation of these differences is beyond the scope of this article. Items of mixed use, such as property used for both personal and rental purposes, and the vacation-home rental rules are examples of these ambiguities. You should consult a tax advisor for help in dealing with the intricacies of these rules.

How Much is My Casualty Loss?

For business or income-producing property that was completely destroyed, the loss is limited to the adjusted basis of the property at the time of the casualty event. For business and income-producing property that sustained partial damage or personal-use property either completely destroyed or partially damaged, the calculated loss is the lesser of the adjusted basis of the property or the decline in the fair market value of the property as measured before and after the casualty event. An appraisal is generally required to determine the "before and after" fair market values. Courts have upheld that a casualty that permanently decreases the fair market value of a property can be claimed as a casualty loss even if minimal actual damage was caused to the property itself. Consider the example of a beach house that was worth $5 million before a severe flood. There was only $200,000 of physical damage to the property but, due to permanent impairment to the neighborhood, the fair market value of the property is $3 million after the flood. Courts have accepted that $2 million is the permissible casualty loss deduction as long as the impairment to the value of the home relates to permanent factors and is not transitory in nature.

An alternative way to measure the casualty loss is the cost of repair. This alternative method can be used for less extensively damaged items as long as the repairs do not increase the value of the property to an amount greater than that before the casualty. Also the repairs cannot be made to items that were not actually damaged.

Where Do I Claim The Loss on My Tax Return?

On an individual tax return, casualty losses claimed for personal-use property and income-producing property are treated as itemized deductions. The loss amount for personal-use property must first be reduced by $100 and then by 10% of adjusted gross income (AGI) to determine the amount allowed as an itemized deduction. The 10%-of-AGI limitation prevents many taxpayers from claiming a casualty loss for personal-use property. By comparison, income-producing property is not subject to this limitation. Care must be taken to properly categorize between personal-use and investment property to maximize the deductibility of casualty losses. Losses claimed for business property are deductible in full as a reduction for AGI, an even more favorable tax treatment. For those taxpayers who are concerned about the AMT, the casualty loss is allowed under both the regular and AMT taxing regimes for all types of property.

How Does Insurance Affect My Casualty Loss Amount?

Many valuable items are insured in case of an unexpected loss due to a major storm or other catastrophe. If a personal-use property item that is being claimed as a casualty loss was insured either in whole or in part, a claim must be filed with the insurance company in order to claim a deduction for the insured portion. Likewise, you must exclude any expected reimbursement from the calculated loss. For example, if a car recently purchased for $40,000 was completely destroyed, but was only insured for $30,000, then the casualty loss deduction allowable is $10,000 as the additional $30,000 loss is expected to be recovered through insurance. Should the insurance not pay that amount, a subsequent casualty loss deduction could be claimed for the amount denied by the insurance company. If you do not file an insurance claim, then only $10,000 would be calculated as the loss regardless of whether the insurance company denied the claim. If a taxpayer underestimates the amount of insurance reimbursement, any excess is treated as income when it is actually received. In our example, if the insurance company decided unexpectedly to pay $35,000, the taxpayer would have to pick up the additional $5,000 as income in the year it is received if a $10,000 loss was taken initially.

What Are Benefits of a Federal Disaster Area Designation?

The President has the authority to declare certain areas as Federal Disaster Areas, which can accelerate a tax refund claim when claiming a casualty loss. The idea behind this is if a casualty loss occurred in a Presidentially Declared Federal Disaster Area, the victims of such a large tragedy may be in immediate need of cash to rebuild and repair. Thus, the federal government allows a casualty loss claim to be effective for the tax year immediately preceding the tax year in which the casualty event occurs. Many areas in New York, New Jersey, and Connecticut that were affected by Hurricane Sandy were declared Federal Disaster Areas and, while Hurricane Sandy occurred in tax year 2012, a casualty loss can be claimed for tax year 2011 if the casualty took place in one of those designated areas. This keeps the taxpayer from having to wait until their 2012 tax returns are filed in 2013 to claim the deduction. Since the 2011 tax deadline passed for most calendar year taxpayers on October 15, 2012, an amended return can be filed to claim an immediate refund. The taxpayer has three years from the due date of a return to file an amended return and claim a refund. Importantly, claiming the loss in the prior year is at the election of the taxpayer for disaster area losses. He or she can choose the tax year in which the loss is claimed. If the Hurricane Sandy-loss occurred in a location not declared a disaster area then the loss can be claimed only for the 2012 tax year.

Can a Casualty Loss Generate a Net Operating Loss (NOL)?

Large assets that are lost due to a storm may generate unreimbursed losses that exceed income in the year that the loss is being claimed. Regardless of whether the casualty loss relates to business, income-producing activity or personal-use assets, the loss can generate a Net Operating Loss (NOL), which can be carried to other tax years -- backwards or forwards. Further, although general losses from passive activities may be suspended under the passive activity loss rules, the tax code provides that losses that meet the casualty requirements are not considered passive activity losses and are fully allowable.

What is My Cost Basis Going Forward After Claiming a Casualty Loss?

Once a loss has been claimed for an asset, the taxpayer needs to know what the basis of that asset will be going forward. The basis of the asset must be adjusted downward by the amount of the loss claimed. If a taxpayer were to claim a $500,000 casualty loss on a property whose adjusted basis before the casualty event was $700,000, the basis immediately after taking the loss would be $200,000.

Operating Business - Goodwill

The tax treatment of a casualty loss from an operating business is complex. As mentioned earlier, the general rule is that the loss allowable is equal to the change in the fair market value before and after the casualty event, but limited to the adjusted basis in the property. The fair market value of many businesses may include a significant amount of goodwill. A loss could be based on the permanent impairment of goodwill resulting from the casualty event. Professional tax advice should be sought when dealing with business casualty losses involving goodwill.

Conclusion

While the ugly side of natural disaster may cause immediate turmoil and distress, it is important to know that there are options available through the tax code to help speed up the recovery process. The tax treatment of casualty losses is complex and the distinction between property categories is not always clear. In times of distress, quickly claiming a cash tax refund can accelerate rebuilding a home or business. A tax advisor can navigate this process with you and assist in your recovery effort.

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