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ATTORNEYS AT LAW

General Business Update

Business Casualty Losses

In view of the tragic consequences of the tornado that recently touched down in Americus, we thought it prudent to review business casualty losses.

A casualty is the result of some sudden, unexpected or unusual event. In addition to being sudden and unexpected, actual damage to property must occur to have a casualty loss. If there is no physical damage to property but the property declines in value because of a sudden and unexpected event, the loss in value is not considered a casualty. The most common types of casualties include damage from fire, storms, earthquakes, and accidents. Losses that occur gradually over time do not constitute casualties. Examples of losses that are not casualties include damage from termites, losses from insects or disease, and loss in value of land because of wind erosion.

The cases where business property is fully destroyed versus partially destroyed will briefly be commented upon.

Business Property Fully Destroyed

When a business property is fully destroyed, the taxpayer's entire investment in the property has been lost. The taxpayer may fully recover its investment in the business property prior to recognizing any casualty gain or loss on the destruction. The measure of a taxpayer's investment in a property is its basis. Therefore, the measure of a business casualty loss for fully destroyed business property is the property's basis. For example, assume a tornado in Sumter County destroyed a van that was business property. It was used as a delivery vehicle for an appliance dealership. The van had been purchased for \$26,000, and depreciation taken to date of the tornado on the van is \$8,000.

Question: What is the measure of the loss on the van?

Answer: Because the van was totally destroyed in the tornado, the measure of the loss is the unrecovered investment in the van, its basis. Although the van cost \$26,000, the company has recovered \$8,000 of the cost through depreciation deductions. The unrecovered portion, \$18,000 (\$26,000 minus \$8,000), is the amount of the investment loss.

Most business assets are covered by insurance. Any amounts received from insurance on property subject to a casualty are a capital recovery. Thus, the amount of the loss must be reduced by any insurance proceeds received from the casualty.

Gardner, Willis, Sweat & Handelman, LLP hopes you find the information in this newsletter helpful. This information is intended to be general in nature and is not a substitute for competent legal advice. If you have questions on these or other general business issues, please give us a call at 229-883-2441.

We publish various newsletters regarding other areas of law as well, including employment law and banking law. Please call for information about other newsletters.

Business Property Partially Destroyed

When a casualty occurs and property is not totally destroyed, an estimate of the amount lost because of the casualty must be made. The amount of the real loss from a partial destruction is the decrease in the taxpayer's wealth resulting from the casualty. This can be measured by the decline in the market value of the property that results from the casualty. The decline in the value of the property is:

The fair market value before the casualty
 Less the market value of the property after the casualty
 Equals the decline in value because of casualty

In most cases, this is an adequate measurement of the loss a taxpayer has incurred as a result of the casualty. However, the maximum amount that can be recovered on any property is the amount invested in the property -- its basis. Thus, a loss deduction because of a casualty can never exceed the property's basis. This leads to the following rule for measuring the loss on partially destroyed business property:

The measure of the loss is equal to the lesser of:

- The decline in the value of the property; **or**
- The adjusted basis of the property

The purpose of this measurement rule is to insure that the amount of the loss deducted does not exceed the amount of unrecovered investment in the property. Example: As a result of a tornado, a warehouse used by a business has been damaged. The business paid \$200,000 for the warehouse and had taken \$80,000 in depreciation before the tornado. Appraisals indicate that the warehouse was worth \$300,000 before the tornado. In its damaged state, the warehouse can only be sold for \$100,00.

Question: What is the amount of loss suffered by the taxpayer on the warehouse because of the tornado?

Answer: The value of the warehouse declined \$200,000 (\$300,000 minus \$100,000) because of the tornado damage. However, the taxpayer's unrecovered investment in the warehouse is \$120,000 (\$200,000 minus \$80,000). The taxpayer's loss is the lesser of the decline in value because of the tornado, \$200,000, or its basis in the warehouse, \$120,000. In this case, the maximum amount that the business can recover through a loss deduction is the \$120,000 basis.

As with fully destroyed business property, the calculated loss must be reduced by any insurance proceeds received because of the casualty.

In many instances, the measurement of the decline in the value of a property that results from a casualty poses formidable problems. That is, by definition a casualty is the result of a sudden and unexpected event. This makes it unlikely that the taxpayer had the foresight to have the property appraised shortly before the casualty. After a property has been damaged, assessing its true condition before being damaged is often difficult. Thus, the estimate of decline in value of the property because of the casualty is difficult to obtain. For this reason, the IRS lets the taxpayer use the cost of repairing the property to estimate the decline in value of the property.

We hope you found this useful. Our sincere thoughts and prayers are with the people in the affected areas of Baker, Mitchell, Dougherty, Sumter and Worth Counties.

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