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Attempted Repeal of Personal Casualty Loss Deduction

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On February 26, 2014, Dave Camp, former Congressman and Chairman of the Ways and Means Committee of the U.S. House of Representatives, released the "Tax Reform Act of 2014," (H.R. 1, 113rd Congress) as a discussion draft. The bill was formally introduced to the House on December 10, 2014. The main feature of Camp's plan was the broadening of the tax base coupled with lowering of the individual and corporate tax rates, and repealing or limiting business and individual tax deductions, credits, and income exclusions.

One of the proposals in the Act (Sec. 1406) would repeal the personal casualty and theft losses deductions for individuals. To better appreciate the context of this proposal, it is relevant to note that other deductions would also be repealed, such as medical expenses, non-business state and local taxes, employee business expenses, and some miscellaneous expense). Businesses would continue to be able to deduct casualty losses.

With the repeal of various itemized deductions, Chairman Camp also proposed to increase the annual standard deduction. The proposal estimated that 95% of taxpayers would choose the standard deduction as opposed to itemizing their deductions, thereby resulting in a significant decrease from the one third of taxpayers who itemize under current law.[34]

According to the Internal Revenue Service, a loss is a casualty loss if the damage, destruction, or loss of property results from an identifiable event that is "sudden, unexpected, and unusual."[35] A theft is the "taking and removing of money or property with the intent to deprive the owner of it."[36] For a theft to qualify, it must be considered illegal under state or local law and must have been done with criminal intent. Theft includes taking of money or property through blackmail, burglary, embezzlement, extortion, kidnapping for ransom, larceny, and robbery.

Federal tax law allows a taxpayer to deduct losses caused by fire, storm, shipwreck, other casualty, or theft if they itemize their deductions on their income tax return. Losses are allowed only to the extent that the taxpayer is not reimbursed for the losses through insurance or other compensation. The rationale behind these deductions is to provide some relief to taxpayers who have diminished ability to pay their federal income taxes because of large, unpredictable, and unavoidable losses. These deductions are *generally* limited for individual taxpayers for each loss in excess of $100 and 10 percent of the taxpayer's

[34] Council on Foundations, "Tax reform Act of 2014: Summary of Provisions Affecting Exempt Organizations," July 1, 2014, p.2. http://www.cof.org/sites/default/files/documents/files/Tax-Reform-Act-of-2014%20Summary.pdf
[35] Rev Rul 72-592, 1972-2 CB 101
[36] Rev Rul 72-112, 1972-1 CB 60

adjusted gross income.[37] For example, suppose an individual taxpayer's car worth $25,000 is totally submerged in the flood resulting in a complete loss of the vehicle. The taxpayer filed an insurance claim and received $5,000. Therefore his personal casualty loss is $20,000. Applying the limitations to the taxpayer's AGI (adjusted gross income) of $40,000, the taxpayer can claim a deduction of $15,900. If the deductible casualty loss is large enough an individual taxpayer may generate an NOL (net operating loss) and has the option of carrying that NOL back generally three years or forward for up to 20 years.

The present system of personal casualty and theft losses deductions has several drawbacks. First, these deductions are difficult to administer because they provide an uneven kind of disaster assistance and such assistance is only available to those individuals who itemize their deductions. Second, the amount of the effective assistance (via the deduction) for a given loss increases with the taxpayer's marginal tax rate. Third, valuing the loss may be difficult. For instance, the loss of basic necessities of life does not receive the same tax treatment as the loss of a luxury item, and the tax law does not compensate for both equally. Fourth, a deduction is allowed only for sudden and unexpected losses. For example, a deduction is not allowed if the damage or destruction of trees, shrubs, or other plants is caused by a fungus, disease, insects, worms, or similar pests. However, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss. Finally, the current system may encourage some taxpayers to buy less insurance to protect themselves against disasters because the deductions are allowed only to the extent that the taxpayer is not reimbursed through insurance.

The tax policy analysis below on "Proposed Repeal of Personal Casualty Loss Deduction" uses the ten principles of good tax policy as published by the AICPA[38]. This analysis will help us know the strengths and weaknesses of this proposal for various taxpayers who suffer casualty or theft losses and if this proposal will be beneficial for the economic growth and efficiency of the United States.

[37] IRC §165(h)

[38] http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/Advocacy/DownloadableDocuments/Tax_Policy_Concept_Statement_No.1.doc

Principles of Good Tax Policy Worksheet

Criteria	Application	+/-
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	Elimination of this provision could increase taxes for those unfortunate taxpayers who live in a state prone to natural disasters such as fire, storms, or floods. Therefore, instead of being able to deduct casualty losses to the extent they exceed slightly more than 10% of AGI, the deduction for all would be zero. This would also invalidate deductions for victims of conventional thefts. Vertical Equity: Under the current rule, the taxpayers would be able to claim the deductions only if they exceed the standard deduction, which is $12,600 in 2015 for most taxpayers with a married filing joint return.[39] The proposal attempted to increase the basic standard deduction to $22,000for a married couple filing jointly with the repeal of the personal casualty and theft losses deduction while keeping the charitable and mortgage interest deduction intact.[40] This would result in a decrease in the total number of itemized deductions and a decrease in the tax benefit to some taxpayers who would currently itemize charitable and home mortgage interest deductions. Eliminating the personal casualty and theft loss deductions would negatively impact some taxpayers with relatively high losses, as no deduction would be allowed under the proposal. The current deductions	**-** **-** For vertical equity

[39] Rev Proc. 2014-61, 2014-47 IRB 860
[40] Congress.Gov, "H.R.1 - Tax Reform Act of 2014**,** 113th Congress (2013-2014)," Dec 10,2014 https://www.congress.gov/bill/113th-congress/house-bill/1

	favors high-income taxpayers who obtain greater tax savings per deduction dollar than lower bracket taxpayers, although they have higher AGI floors above which they can take the deduction. Horizontal Equity: The proposal would achieve the horizontal equity concept. The current rule provides the deductions based on the limitations set at $100 per casualty plus 10% of AGI. With the change in the provision, taxpayers with equal abilities to pay would not be affected since the amount of casualty and theft loss is determined by the 10% AGI limitation. It is logical therefore to repeal this deduction because for most taxpayers the deduction has already been effectively unavailable by reason of the floor under the deduction equal to the 10% of adjusted gross income. However, equity and fairness still would not be achieved.	+ For horizontal equity
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Eliminating the personal casualty and theft loss deduction would increase certainty because the definition of casualty and theft, timely claim of insurance, and other elements are too broad and complex. For instance, a deduction is allowed for ornamental shrubs struck by lightening but is not allowed for the same shrubs lost gradually to winterkill. While the law does explain how the amount is to be determined, the calculation itself can be confusing. Even though tax software makes the loss deductions easier to calculate, many taxpayers may not have enough assurance on the correctness of the calculation. Taxpayers may need to take great efforts to figure out which special rule would apply to their particular situation and how to calculate their losses. The regulations pose many complex problems of definition, valuation, and	+

	computation, requiring some of the most difficult factual determinations in taxation. Distinguishing between "sudden losses" versus "progressive deterioration" becomes difficult at times. The IRS has provided a Form 4684 to specifically compute the loss. Because of the complex nature of this deduction, many taxpayers simply lack the tax expertise to compute the loss themselves, thereby forcing them to consult a tax preparer. This results in an added compliance and paperwork costs. Thus, eliminating this deduction would result in considerable tax simplification.	
Convenience of payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Timing is usually a problem in theft situations where the loss is usually claimed in the year of discovery or later if there is a reasonable prospect of recovery. The deductions would likely be deferred in cases when a taxpayer brings about litigation to recover his stolen items. Eliminating the casualty and theft loss deduction altogether would have a positive affect on timing of payment to individual taxpayers.	+
Economy in collection The costs of collecting a tax should be kept to a minimum for both the government and taxpayers.	Eliminating the personal casualty and theft loss deduction provision would improve economy in collection. The IRS would collect fewer forms and need fewer audits to ensure that taxpayers who claim this deduction are in full compliance with the law. Therefore, the cost of administration for the IRS would be greatly decreased. The current rule warrants the taxpayers to keep extensive recordkeeping and devote time and efforts in producing them to determine how much of the deduction would be allowable to them. Elimination of this provision would reduce the recordkeeping burden on taxpayers that would in turn help in diminishing their compliance costs.	+

Simplicity The tax law should be simple, so taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	It could be difficult to claim a casualty loss for damage or theft to personal property because the tax law imposes limitation, special rules, which are difficult to understand. Taxpayers who anticipate claiming such itemized deductions are required to keep extensive recordkeeping. And even when they claim such deductions, the taxpayers frequently make errors regarding what types of casualty or theft losses are properly allowable. Sometimes issues arising out of litigation could last a few years such as when individuals sues insurance company or other party to try to get compensation for the loss. Eliminating the personal casualty and loss deduction would significantly simplify the tax code because the scope of the definition of "casualty" and "theft" is broad. The IRS and many individual taxpayers spend considerable time and money on compliance and administration each year. Eliminating this provision would be cost-efficient for both the IRS and the taxpayers.	+
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	Currently, the personal casualty and theft loss applies to all individuals, trade and business, as well as those in federally declared disaster areas. The proposal attempts to repeal this provision for individual taxpayers while businesses would still be able to deduct the casualty and theft losses. Repealing the provisions for individual taxpayers would greatly affect those taxpayers who live in areas where the chance of being impacted by a casualty is very high. These taxpayers could be motivated to move somewhere else and it would greatly affect the investment in property in that area. Taxpayers who become the victim of theft or fraudulent scheme would also suffer greatly. If the deductions were eliminated, the taxpayers would be more reliant	-

	on insurance to cover them from such losses. A large casualty loss might make their itemized deductions exceed more than their standard deduction for the year. But because only 1/3rd of individual taxpayers itemize, Camp's proposal to increase the standard deduction would come to their rescue.	
Economic growth and efficiency The tax system should not impede or reduce the productive capacity of the economy.	The Camp's proposal to eliminate the personal casualty and theft loss deduction suggests that it would broaden the tax base, and therefore raise tax revenues. Increased revenue could allow a reduction in the corporate (and other) tax rates that, in return, may improve the competitiveness in the US market. Based on the analysis by the Joint Committee on Taxation, the Camp proposal would increase GDP growth by $3.4 trillion, thereby resulting in an additional 1.8 million private sector jobs over the next ten years with increased wages.[41] However, base broadening could have unintended side effects such as effects on savings incentives for low-income taxpayers and creating tax liabilities which they cannot afford to pay.	+
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is	The current provision of casualty and theft loss is quite perplexing. It discriminates against those who insure (since insurance premiums are generally not deductible for individuals on personal-use property) and reimburses taxpayers via a deduction according to a 10% AGI threshold.	+

[41] Tax Reform For Growth, "Dave Camp's plan would yield $700 billion in extra 'dynamic' revenue", *The Wall Street Journal*, Feb 26, 2014 http://www.wsj.com/articles/SB10001424052702304255604579407112591695536

imposed on them and others.	Eliminating the personal casualty and theft loss should improve transparency and visibility. Taxpayers would then know that no such deduction exists for any casualty. Tax reporting and calculations would become more transparent and visible for all taxpayers.	
Minimum tax gap A tax should be structured to minimize non-compliance.	Eliminating the personal casualty and theft loss deduction would reduce the tax gap because the complexity of the provision may lead to accidental or unintentional errors. However, with this proposal taxpayers may illegally evade taxes by claiming business casualty loss on their personal use asset because the deductions for business casualty losses would still be allowed.	+/-
Appropriate government revenues The tax should enable the government to determine how much tax revenue likely will be collected and when.	The government can easily determine how much tax revenue would be collected if this provision is no longer in existence based on historical deductions but future tax increases via the elimination of the deduction would be difficult to predict based on the ever-changing levels of personal casualty deductions every year. According to JCT revenue estimates, this provision taken together with other provisions[42] in the proposal would increase revenues by $858.4 billion over 2014-2023.[43]	+

[42] The revenue estimates for repeal on personal casualty and theft losses are reported as a combined, aggregate revenue effect of a number of separate provisions.
[43] Joint Committee on Taxation, "Estimated revenue effects of Tax Reform Act of 2014 fiscal year 2014-2023(billions of dollars)," *House Ways and Means*, Feb 26, 2014 http://waysandmeans.house.gov/UploadedFiles/JCT_Revenue_Estimate__JCX_20_14__022614.pdf

Applying the rules for personal casualty and theft loss deduction to a fact pattern is not easy and straightforward – typically because of the amount of loss subjectivity. Computational loss rules and the netting requirements of the rules generally result in different tax treatment to taxpayers, who have suffered like economic losses to uninsured or partially insured personal property.

To reduce the inequities and make it easy to administer from the standpoint of tax theory, getting rid of personal casualty and theft loss deduction altogether as suggested by Camp's proposal would be a good option. An alternative to outright repeal of the personal casualty and theft loss deduction would be repeal plus allowance of a deduction for all or a percentage of the cost of premiums for casualty and theft loss insurance covering real property and personal property by individuals on personal-use property. This alternative has the advantage that it not only removes the government from the role of an indirect co-insurer but it also provides a positive incentive to purchase casualty and theft loss insurance. Another alternative would be allowing some deferred tax payment option for taxpayers below a certain income level. This would help the taxpayers who would otherwise face problems paying taxes due to a casualty or theft loss as evidenced by living in a presidential area or having a police report filed for theft loss or an insurance claimed for a casualty loss.