

**Disaster Issue Updates
Louisiana Practitioner Liaison Meeting
February 1, 2007**

**Presented by: Dee Harris and Aaron Steele (Stakeholder Liaison)
and Susan Canavello, Associate Area Counsel**

**Latest questions answered in FAQs for Hurricane Victims
<http://www.irs.gov/businesses/small/article/0,,id=156144,00.html>**

FEMA Payments

(1/23/07) Q: Can you provide an example of how the casualty loss, reimbursement and basis rules work and how the non-recognition rules apply under Internal Revenue Code Sections 121 and 1033?

This question has been moved to the **Grant Proceeds** with a new example

Grant Proceeds

(1/23/07) Q: Can you provide an example of how the casualty loss, reimbursement and basis rules work and how the non-recognition rules apply under Internal Revenue Code Sections 121 and 1033?

A: Below are facts and consequences on how the casualty loss reimbursement and basis rules work.

Example — Version 2

Facts:

TP's pre-Katrina basis in the property is \$215,000

2005: TP has a casualty loss of \$22,000. TP receives insurance reimbursement of \$7,000 and has no reasonable prospect of recovering any other amounts for damage to the home.

2006: TP repairs property at a cost of \$25,000. TP receives LRA grant of \$18,000 to reimburse the portion of the cost of repairs not covered by the insurance reimbursement.

Tax consequences:

2005: Casualty loss deduction = \$15,000 (\$22,000 less \$7,000)

2006: Income due to recovery of benefit of \$15,000 casualty loss deduction from receipt of LRA grant = \$15,000

Taxpayer's basis in the property:

Pre-Katrina basis	215,000
2005 casualty loss deduction	(15,000)
2005 insurance reimbursement	<u>(7,000)</u>
Basis at the end of 2005	\$193,000
2006 Amount of LRA grant in excess of amount of recovery of tax benefit income (18,000 less \$15,000)	(3,000)
2006 repairs	<u>25,000</u>
Basis at the end of 2006	\$215,000

The non-recognition provisions of §§ 121 & 1033 apply only when a taxpayer receives reimbursement/compensation (e.g., insurance proceeds, grants, etc.) in excess of the taxpayer's tax basis in the property, which is not the case in this example.

Filing Extensions

(1/27/07) Q: We filed corporate extensions on March 15th. Does this preclude us from the additional 6 month extension?

A: Extensions received for corporate returns due on March 15, 2006 that are marked with "Hurricane Katrina" in red ink on the top of the form, will be allowed the additional six month extension to April 17, 2007.

(1/27/07) Q: Do we file extensions prior to April 17th with Hurricane Katrina in red on top but without payments? If so should they reflect only (0) amounts rather than actual amounts? Do we file extensions at all or do we wait until August 28 to file an extension? If we are to file by August 28th then does that extend the due date to February 28th 2007?

A: Filing and payment deadlines have been postponed until October 16, 2006. This includes the filing of Form 4868, Automatic Extension of Time to File U S Individual Income Tax Return. You can self identify by calling the 1-866-562-5227 or you may submit Form 4868 no later than October 16, 2006. The Form 4868 should be labeled at the top of the form in red "Hurricane Katrina". Forms 4868 received on or before October 16, 2006 will be granted an automatic 6 month extension of time to April 17 2007. The Form 4868 should be completed to the best of your ability, including your estimate of the tax liability. You are not required to pay the estimated amount of tax due; however, the payment of taxes due is postponed to October 16, 2006. Any underpayment of tax will be subject to penalty and interest beginning October 17, 2006 until the tax is paid in full.

(1/27/07) Q: If a corporation filed a regular extension by March 15 but did not self identify and later determines they need longer than 9/15/06 to file, can they file a

second extension by 8/28/06 and self identify and get an additional six months extension?

A: If a regular extension has already been filed but did not contain the "Hurricane Katrina" disaster designation at the top of the form, then another Form 7004, clearly marked "Hurricane Katrina" in red at the top of the form, should be filed no later than October 16, 2006 in order to get the additional extension to April 17, 2007.

(1/27/07) Q: When is my return due if I filed an automatic extension of time to file before the announcement that the postponed due date was changed to October 16, 2006?

A: The postponements provided by IR-2006-96 and IR-2006-135 apply to a taxpayer even if the taxpayer had timely requested an extension of time to file prior to the granting of the postponements. Thus, a calendar year corporation who on Aug. 15, 2006, timely requested a six-month extension of time to file its 2005 Form 1120 from Aug. 28, 2006, its postponed due date pursuant to Notice 2006-20, are still eligible for the postponement provided by IR-2006-135. Accordingly, the corporation would then have until April 17, 2007, to timely file its return.

Although the postponement changes the automatic extended due date to April 17, 2007, if taxpayers timely requested a six-month extension of time to file their 2005 Form 1120 from August 28, 2006, they would have been processed by IRS with an extended due date of February 28, 2007. These taxpayers should contact the IRS Disaster Hotline at 1-866-562-5227 to have the Service update the postponement to April 17, 2007 if they are unable to file by February 28, 2007. Individual income taxpayers who likewise requested an extension of time to file a 2005 Form 1040 should also contact the Disaster Hotline to have the Service update the postponement to April 16, 2007 if they are unable to file by February 28, 2007.

Taxpayers who have not yet requested an extension of time to file a tax year 2005 return and need additional time to file may request an extension by filing the appropriate form on or before October 16, 2006. The extension form should be clearly marked "Hurricane Katrina" in red at the top of the form.

Taxpayers whose timely six-month extension requests were erroneously denied by the IRS should contact the Disaster Hotline at 1-866-562-5227 to have their accounts accurately adjusted.

***** PLM NOTE – Taxpayers will have extra time to file and pay because April 15 falls on a Sunday in 2007, and the following day, Monday, April 16, is Emancipation Day, a legal holiday in the District of Columbia. (IR 2007-15 is included in your handout). The April 17, 2007 filing due date would be applicable to the 2005 tax returns of taxpayers impacted by Hurricane Katrina and who requested the automatic six-month extension on October 16, 2006.**

Retirement Contributions

(1/23/07) Q: Does the relief provided by the Service for affected taxpayers from the areas of Louisiana, Mississippi, and Alabama most severely damaged by Hurricane Katrina include the time to make deductible contributions to a SEP or SIMPLE plan? If so, what is the last day to make such a contribution? (Note: This FAQ updates and clarifies the information previously posted on 8/25/06, 9/6/06 and 10/3/06.)

A: Yes. The deadline for making deductible contributions to a SEP or SIMPLE plan is postponed. Notice 2006-20 states that the times to perform the acts listed in section 301.7508A-1(c)(1) of the regulations are postponed to 8/28/06. Paragraph (iii) of such section lists the deadline for making contributions to a SEP or SIMPLE plan. However, the IRS will allow deductions for SEP and SIMPLE contributions for tax year 2005 as long as the contribution is made by 10/16/06. If an additional six month extension of time to file was made on or before 10/16/06, then contributions to the SEP or SIMPLE plan have also been extended to 4/17/07. Note: pursuant to section 219(f), contributions to IRAs were required to be made on or before 10/16/06.

(1/27/07) Q: Does the relief provided by the Service for affected taxpayers from the areas of Louisiana, Mississippi, and Alabama most severely damaged by Hurricane Katrina include the time to make contributions to a Keogh plan or an HSA? If so, what is the last day to make such a contribution? (Note: This FAQ updates and clarifies the information previously posted on 10/17/06.)

A: The term "Keogh" plan is not a term found in the Internal Revenue Code, but is a term used in the past to refer generally to certain defined contribution plans that covered self-employed individuals. Current law defines defined contribution plans and authorizes a deduction for contributions to them under Sections 401(a) and 404 of the Code. The IRS will allow deductions for contributions to defined contribution plans, including SEPs and SIMPLEs, by an affected taxpayer as long as the contribution is made by 10/16/06. If an additional six month extension of time to file was made on or before 10/16/06, then contributions to certain defined contribution plans are extended to 4/17/07. Note: pursuant to section 219(f), contributions to IRAs were required to be made on or before 10/16/06.

(1/23/07) Q: Does the relief provided by the Service for affected taxpayers from the areas of Louisiana, Mississippi, and Alabama most severely damaged by Hurricane Katrina include the time to make contributions to an IRA? If so, what is the last day to make an IRA contribution? (Note: This FAQ updates and clarifies the information previously posted on 8/25/06 and 9/6/06.)

A: The deadline for making contributions to an IRA was postponed but ended on 10/16/06. Notice 2006-20 stated that the time to perform the acts listed in section 301.7508A-1(c)(1) of the regulations were postponed to 8/28/06. Paragraph (iii) of such section listed the deadline for making IRA contributions. However, the IRS did allow a

contribution made to an IRA for tax year 2005 by an affected taxpayer as long as the contribution was made by 10/16/06 pursuant to section 219(f).

Casualty Loss Example as Submitted from a Practitioner

Q. Client bought a large apartment complex in the beginning of 2005, it was up for foreclosure and he bought it at a huge discount. His basis in the property after it was fixed up was \$629,300. Hurricane Katrina hit and the property was damaged. His insurance reimbursement was \$1,105,000. He has an itemized statement from the insurance company for the settlement. The fair market value before the storm was \$900,000.

Therefore, he really has a negative decrease in FMV (900,000 less \$1,105,000). Cost of \$629,300 less insurance reimbursement of \$1,105,000 gives him a profit of \$475,700.

1. If he invests the profit and bought another property that is more than \$475,000 can he defer the taxes on the profit? Could this be considered a Section 1033 exchange?
2. If he sells the property in 2005 and buys 2 four-plex apartments, could he defer the taxes on the profit from the casualty loss that would be similar in nature to a 1033 exchange?

A. In general, section 1033 allows a taxpayer to defer recognition of gain realized from certain involuntary conversions of property. When property is converted into money or property not similar or related in service or use through receipt of insurance proceeds, deferral of gain is accomplished if the taxpayer 1) makes the election and 2) timely purchases qualified replacement property "similar or related in service or use" to the property converted. Complete deferral of the conversion gain is available only when the entire monetary proceeds received on account of the conversion are reinvested. If only part of the monetary proceeds is reinvested, gain is recognized to the extent of the nonreinvestment. In general, the entire \$1,105,000 proceeds must be reinvested in property that is similar or related in service or use to avoid any recognition of gain.

Latest Issues Elevated

1. **Guidance on tax benefit rule on LRA payments received in subsequent year.** See the FAQ under Grant Proceeds on page 1
2. **Clarification on reporting of LRA money received. Headliner mentions additions to property would increase basis and offset LRA payment. Where would the amount be reported on Form 1040?**
Please refer to the FAQ under Grant Proceeds that posted on IRS.gov on 1/23/07 which explains the reporting of LRA Grant proceeds when received in a tax year after the year of the casualty loss. It also provides guidance on required adjustments to the taxpayer's property basis. Per the instructions in Publication

525, recoveries are reported on Line 21 of Form 1040 as other income for the tax year of the recovery.

3. How is LRA money reported if no increase in basis and casualty loss claimed in previous year?

Without specific facts and circumstances to address, this is a difficult question to address. The rules and regulations will need to be applied on a case by case basis to determine if the taxpayer is required to report any income due to the LRA proceeds or if the basis of the property needs to be adjusted. In general, if the taxpayer suffers a casualty but the loss does not exceed their standard deduction (taxpayer does not itemize), then the LRA proceeds, up to the amount of the loss, would not be taxable. The taxpayer's basis would be adjusted (decreased) for the amount of the recovery. If the proceeds are used to repair the property, then the reduction in basis due to the LRA proceeds would be offset by the increase to basis from the repairs. Any gain may be deferred under Code Section 121 under the appropriate circumstances.

4. It has been indicated that examination agents are trained in Circular 230 and make referrals to OPR. Since the filing of a casualty loss is a tax return position within Circular 230, what will be IRS position on referrals?

Examination agents are always alert to unethical behavior by practitioners which would warrant a referral. No special procedures have been put in place regarding casualty losses claimed or any other issues relating to the affected areas.

5. Has any policy been determined on estimated tax penalty waivers where there was overlap of returns on extension? Will this be on a case by case basis?

There are waivers available on Form 2210. For those in the affected area that had freezes on their accounts, the penalty will automatically be waived. This is only for the third and fourth quarters of 2005 and the first, second and third quarters of 2006. For anyone else, the penalty waiver will be determined on a case by case basis.

6. There should be more guidance on LRA money, but it should probably answer questions submitted by practitioners.

Several headliners have posted under the Frequently Asked Questions for Tax Professionals addressing how LRA/MDA proceeds should be handled. There is also a Phone Forum scheduled for February 8th that will include a review of guidance regarding LRA/MDA proceeds.

<http://www.irs.gov/businesses/small/article/0,,id=156144,00.html>

The following topics have been updated on the FAQs:

- FEMA Payments (updated 1/23/07)
- Grant Proceeds (updated 1/23/07)

You may also want to refer to the FAQs under Casualty Losses that deal with LRA and MDA Grant proceeds

- Casualty Loss (Valuations and Section 165 (i)) (updated 11/3/06)

7. **We previously mentioned undoing carrybacks which were filed in the beginning of 2006 and end of 2005 before LRA become finalized. Anyway to do this without penalty and interest being paid by the taxpayer?**

Counsel feedback has been requested.

8. **What will the statute of limitations date be on 2004 and 2005 returns due to 7508A extended period and in the additional extension to October 15th?**

ASED (Assessment Statute Expiration Date) are generally tied to the date that a return is actually filed, and CSED (Collection Statute Expiration Date) are tied to the date that taxes are assessed. Thus, for a 2005 income tax return that is timely filed on April 16, 2007 due to the application of disaster relief, the ASED would run from this date (April 16, 2007), and the CSED would subsequently run from the time (if) the Service assessed a tax.

For CSEDs and ASEDs for earlier years (with respect to taxpayers receiving disaster relief due to Hurricanes Katrina and Rita) that were set to lapse during the disaster relief period, our government acts notices postponed the lapsing of those CSEDs and ASEDs until August 28, 2006. See Notices 2006-20 and 21.

Examples:

- a) **What will be the statute date for 2005 extended returns filed 4/17/2007? April 17, 2010?**
Three years from the due date of the return or the date the return is filed whichever is later – April 17, 2010
- b) **If an original 2005 extended return is filed by 4/17/2007 without a casualty loss deduction, then will the taxpayer have until 4/17/2010 to amend and claim the loss?**
Yes, the statute of limitations will run to 4/17/2010.
- c) **If an amended return is filed in 2010 before the statute date of 4/17/2010, then the loss should be carried back to 2000 if a five year carry back loss or 2002 if a three year carry back loss?**
The statute of limitations for the Net Operating Loss (NOL) carryback years will be the same statute of limitations as the NOL tax year (only for NOL adjustments). For a 2005 NOL, the statute for the carryback years will follow the 2005 tax year's statute for the NOL adjustment only. Any carryback years will need to be amended by 4/17/2010.
- d) **Can a 172(b)(3)(c) election be filed on an original 2005 return filed by 4/17/2007 without a casualty loss on the original return?**
Counsel feedback has been requested.

e) **What will be the statute dated for 2004 returns filed on 10/16/2006?
October 16, 2009?**

Yes – October 16, 2009

9. **I am hearing more about the idea of filing the 2005 return not claiming a casualty loss leaving the option open to amend when figures like LRA and insurance settlement become final. What will be your position on this? Will IRS discourage this and/or penalize the taxpayers and preparers?** IRS Counsel has taken a close look at the suggestion that the taxpayers might file their original 2005 returns without taking a casualty loss and then amend to take a reduced loss when they determine their entitlement to grants, thereby avoiding income treatment from the grants. We have found no legal impediment to this suggestion.
10. **We have the issue of filing an original 2005 return by the extended due date and no casualty loss is claimed. Taxpayer then has to amend to claim the 2005 casualty loss since it occurred in 2005. It is too late to do a 165(i) election. Taxpayer includes with the original 2005 return an election to relinquish the carryback of any 2005 NOL. In any case, can IRS handle the amended returns that may be generated if this is done? It also creates issues if the taxpayer cannot elect to relinquish the carryback, then the carrybacks will be 5 and 3 year carrybacks going back as far as 2000. Please see the response to the previous question regarding IRC section 172(b)(3)(c) elections. The taxpayer always has the option to amend their tax returns to make adjustments as warranted by their specific tax situation. IRS policy is to process these amended returns accurately and in a timely manner.**

Additional Issues

We are aware that there are additional issues that need to be addressed. We will continue a proactive approach of identifying issues and work to secure appropriate guidance

Q. GO Zone Bonus Depreciation Extension under the Tax Relief and Health Care Act of 2007- Any idea if a fact sheet will be provided that lists the parishes and counties that qualify.

Counsel has decided to issue guidance on section 120 of the TRHCA of 2007 (along with a separate and different issue involving original use). The guidance under section 120 of the Act will address at least: the eligible counties and parishes, the determination of qualified progress expenditures, how the personal property rule works when there is a multi-story building and the floors are placed in service on different dates, and whether land improvements qualify for the extended placed-in-service date.

Q. Why have erroneous Backup Withholding Notices gone out and how is the IRS addressing a possible systemic problem?

A. We are addressing this situation in two ways. First, as process has been put in place whereby practitioners can provide this information to Stakeholder Liaison Area Manager Craig Crews who, working through HQ Disaster Coordinator Carol Polley, will forward this information to a Campus Service Representative. It will then be checked for receipt date. If filed on, before, or shortly after the 10/16/06 extended due date, the Backup Withholding Notice will be rescinded and letters notifying the appropriate financial entities will be sent out. A second process that is taking place is the extracting of 2004 returns that were on extension as of the time the storm hit (August 2005). These will be manually reviewed and utilizing the same parameters as described above, will be corrected as appropriate.