

Gulf Oil Spill: Questions and Answers

Q-1: Is a taxpayer required to include in gross income payments the taxpayer receives for lost business income, lost wages, or lost profits?

A-1: Yes. The law requires that a taxpayer include in gross income payments the taxpayer receives for lost business income, lost wages, or lost profits. For information on whether estimated tax payments may be required, see Publication 505, Tax Withholding and Estimated Tax.

A self-employed individual who receives a payment that represents compensation for lost income of the individual's trade or business should include the amount of the payment in net earnings from self-employment for purposes of the self-employment tax. For more information about reporting self-employment income and paying self-employment tax, see Publication 334, Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ).

Generally, a payment to an individual to compensate for lost wages will not be wages for purposes of the social security tax and Medicare tax because it is not an actual payment for employment within the meaning of the law. These payments will also generally not be subject to income tax withholding, unless backup withholding applies. See A-2, below, for a discussion of backup withholding. However, if the payment is made by an employer to its own employees, or by a third party to employees of another employer in satisfaction of an obligation of that employer to its employees, the payment may be subject to social security tax, Medicare tax, and income tax withholding.

Q-2: Are payments that are made to an individual for lost business income, lost wages, or lost profits required to be reported to the IRS by the person making the payment?

A-2: Generally yes. A person making payments to an individual for lost business income, lost wages, or lost profits must report the payments to the IRS on a Form 1099-MISC, Miscellaneous Income, if the payments aggregate \$600 or more. Generally, these payments are subject to backup withholding at a rate of 28 percent if the individual fails to furnish the individual's taxpayer identification number to the payor at or before the time of payment.

A payment that is treated as a payment of wages is subject to reporting on Form W-2, Wage and Tax Statement, and to the same social security tax, Medicare tax, and income tax withholding rules that apply to regular wage payments made by an employer to an employee. For more information about withholding from employees' wages, see Publication 15, (Circular E) Employer's Tax Guide.

Under current law, a person making payments to a corporation for lost business income or lost profits is not required to report those payments to the IRS. However, a person who makes payments to a partnership, limited liability company or other non-corporate entity for lost business income or lost profits generally is required to report those payments to the IRS in the same manner as for payments to individuals, and the payments are subject to backup withholding at a rate of 28 percent if the entity fails to furnish its employer identification number to the payor at or before the time of payment.

Q-3: Is a taxpayer required to include in gross income payments the taxpayer receives for property damage or destruction?

A-3: A taxpayer is not required to include in gross income payments the taxpayer receives for property damage or destruction if the payments do not exceed the taxpayer's adjusted basis in the damaged or destroyed property. If the payments for property damage or destruction exceed the taxpayer's adjusted basis in the damaged or destroyed property, the taxpayer will realize gain for federal income tax purposes. If the damage or destruction is an "involuntary conversion," the taxpayer may defer the tax on any gain if the taxpayer purchases qualifying replacement property that costs at least as much as the payments received for the damaged or destroyed property. (Tax is deferred until the qualifying replacement property is later sold.) An involuntary conversion occurs when a taxpayer's property is destroyed, stolen, condemned, or disposed of under the threat of condemnation and the taxpayer receives other property or money in payment, such as a condemnation award or insurance. See Publication 544, Sales and Other Dispositions of Assets. A person making payments for property damage or destruction is not required to file information returns with the IRS reporting the payments.

Q-4: Can a taxpayer claim a casualty loss deduction if payments the taxpayer receives for property that has been damaged or destroyed are less than the taxpayer's adjusted basis in the property?

A-4: A taxpayer may be able to claim a casualty loss deduction if the payments (including insurance proceeds or payments for damages) the taxpayer receives, or reasonably expects to receive, are less than the taxpayer's adjusted basis in the property. See A-5, below, for a discussion of how to compute the possible deduction.

Q-5: How does a taxpayer determine the amount the taxpayer may claim as a casualty loss deduction?

A-5: With respect to personal-use property, the taxpayer generally may claim as a casualty loss deduction the lesser of (1) the difference between the fair market value of the property immediately before and after the casualty; or (2) the adjusted basis of the property. The amount of the deduction is reduced by any

insurance proceeds or other payments the taxpayer receives or reasonably expects to receive. An individual taxpayer must reduce the amount claimed for each casualty loss deduction for personal-use property by \$100, and reduce the total amount of casualty loss deductions claimed for personal-use property for one taxable year by 10 percent of the taxpayer's adjusted gross income.

With respect to business or income-producing property that is partially destroyed, the taxpayer generally may claim as a casualty loss deduction the lesser of (1) the difference between the fair market value of the property immediately before and after the casualty; or (2) the adjusted basis of the property. The amount of the deduction is reduced by any insurance proceeds or other payments the taxpayer receives or reasonably expects to receive. However, if business or income-producing property is completely destroyed and its adjusted basis exceeds its fair market value, the taxpayer may claim a casualty loss deduction equal to the adjusted basis of the property, reduced by payments the taxpayer receives or reasonably expects to receive for the property (including insurance proceeds or payments for damages).

Q-6: How does a taxpayer establish the decrease in the fair market value of the property after a casualty?

A-6: A taxpayer may use either an appraisal or the cost to repair or clean up the property to determine the decrease in fair market value of the property after a casualty.

Q-7: How does a taxpayer report a casualty loss deduction on the tax return?

A-7: A taxpayer claims a casualty loss deduction on the tax return for the year in which the casualty occurred. An individual taxpayer claims a casualty loss deduction for personal-use property by reporting the amount of the loss on Form 4684, Casualties and Thefts, and claiming an itemized deduction on Schedule A, Itemized Deductions, of the taxpayer's return. A taxpayer claims a casualty loss deduction for business or income-producing property on Section B of Form 4684, and on Form 4797, Sales of Business Property, if required. For more information on casualty losses, see Publication 547, Casualties, Disasters, and Thefts, and Publication 584, Casualty, Disaster, and Theft Loss Workbook.

Q-8: Is an individual required to include in gross income payments the individual receives for personal physical injuries or physical sickness, or for emotional distress that is attributable to personal physical injuries or physical sickness?

A-8: No. An individual generally is not required to include in gross income payments the individual receives on account of personal physical injuries or physical sickness. Personal physical injuries include observable bodily harm such as bruises, cuts, swelling, and bleeding. Likewise, an individual is not required to include in gross income payments the individual receives for

emotional distress that is attributable to personal physical injuries or physical sickness. Payments for personal physical injuries or physical sickness, or emotional distress attributable to personal physical injury or physical sickness, are not required to be reported on an information return filed with the IRS by the person making the payment.

Q-9: Is an individual required to include in gross income payments the individual receives for emotional distress (or symptoms of emotional distress such as insomnia, headaches, or stomach disorders) that is not attributable to personal physical injuries or physical sickness?

A-9: Yes. The law requires an individual to include in gross income payments the individual receives for emotional distress (or symptoms of emotional distress such as insomnia, headaches, or stomach disorders) that is not attributable to personal physical injuries or physical sickness. However, an individual excludes from gross income payments for emotional distress up to the amount of medical care expenses the individual paid related to the emotional distress if the individual did not deduct the expenses in a prior taxable year.

Q-10: Are payments made to an individual for emotional distress that is not attributable to personal physical injuries or physical sickness required to be reported to the IRS by the person making the payment?

A-10: Yes. A person making a payment to an individual for emotional distress that is not attributable to personal physical injuries or physical sickness must report the payment to the IRS on a Form 1099-MISC, Miscellaneous Income, if it is \$600 or more. If the individual does not furnish the individual's taxpayer identification number to the payor, the payor must backup withhold on the payment at a rate of 28 percent.