

Casualty Losses Under Sections 162 or 165(c)(2)

TAX SECTION



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The Internal Revenue Code (“IRC”) sometimes provides multiple avenues for a taxpayer to obtain a deduction depending on how the taxpayer characterizes the loss. One example is a casualty loss deducted under either Section 162 or Section 165. Although these two sections may both offer a deduction for the same loss, they are not treated exactly the same under IRC. However, due to changes made by the 2017 Tax Act, taking the deduction under either of these sections may produce the same result.

Section 162 provides the general deduction for trade or business expenses. It is perhaps the broadest section in the IRC—it provides a deduction for almost all expenses or losses incurred by an operating trade or business. That includes both normal expenses associated with running a business and certain losses incurred by the business. Section 162 provides an above-the-line deduction pursuant to Section 62(a)(1). That means the deduction is applied when determining adjusted gross income. Above-the-line deductions are not subject to any limitations or special rules, unlike many below-the-line deductions.

Section 165 is another broad code section that provides a deduction for losses not compensated by insurance or otherwise. Like deductions under Section 162, it can apply to losses incurred in a trade or business pursuant to Section 165(c)(1). However, Section 165(c)(1) deductions are categorized as miscellaneous itemized deductions pursuant to Section 67(b). Miscellaneous itemized deductions prior to 2018 were allowed but subject to a 2% floor. From 2018 to 2025, however, miscellaneous itemized deductions are completely disallowed. Nevertheless, Sections 165(c)(2) and (c)(3) allow certain non-business losses, provided the venture was entered into for profit. Those sections have been used to provide a deduction for losses associated with illegal activities such as embezzlement. However, they might also apply to other losses associated with a money-making endeavor that is not a trade or business. Unlike the deduction provided by Section 165(c)(1), the deductions provided by Sections 165(c)(2) and (c)(3) are characterized as non-miscellaneous itemized deductions under Section 67(b)(3). This means they will be allowed from 2018 to 2025 if the taxpayer elects to itemize.

The 2017 Tax Act also temporarily eliminated the Pease limitation, which capped the deduction taxpayers could receive from itemized deductions.

Because of changes in the 2017 Tax Act, the same loss can be deducted as either an above-the-line Section 162 trade or business loss or as a below-the-line Section 165(c)(2) non-business casualty loss with no difference to the bottom line (excluding the possibility of alternative minimum tax differences, which could be an issue for high income taxpayers). The question of which of these two avenues to use depends on whether the loss is related to a business or instead related to a transaction entered into for profit but is not a business.

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