



# Flynn-Law Newsletter

October 2017  
Special Edition

Law Offices of Stephen M. Flynn

Napa Office: 2151 Main Street, Napa, CA 94559

Santa Rosa Office: 3775 Brickway Blvd.,  
Suite 200, Santa Rosa, CA 95403

[www.smflynn-law.com](http://www.smflynn-law.com)   [smflynn@smflynn-law.com](mailto:smflynn@smflynn-law.com)   707.230.7108

## Napa and Sonoma Ravaged by Fire – Special Disaster Edition

### INSIDE THIS ISSUE

- 1** Introduction
- 1** Loss Settlement (Valuation) Provisions
- 2** Business Interruption Coverage
- 2** Property in Escrow Destroyed by Fire
- 3** Leased Premises Destroyed by Fire
- 3** Taxation of Insurance Proceeds – IRC Sec. 1033
- 4** Deducting Fire Related Losses
- 4** Taxation of Living Expense Insurance Proceeds

As of the date of this writing, devastating wildfires are ravaging Napa, Sonoma and now Solano counties. My home in rural Napa is subject to a mandatory evacuation, but as of today, it appears to have (barely) survived (although we are not out of the woods yet). Thousands were not so lucky. My thoughts and prayers are with all those affected by this disaster.

I have spent the week in Tahoe safely with my family trying to come up with various legal and tax topics which could be helpful to the thousands of people who have lost homes, investments and businesses. This is the last thing people want to think about, but unfortunately, many of these issues are time sensitive and will need to be addressed in the days, weeks and months following the fire.

### First Party Loss Settlement Provisions

This post addresses the loss settlement provisions in property insurance policies. Loss settlement refers to the valuation method used to compensate the insured for a covered loss.

The statutory default rule provides that the insured will be indemnified for the “actual cash value” of the lost property. In the case of a total loss, this means the fair market value of the lost property. In the case of a partial loss, this means the cost to repair, replace or rebuild the lost property, *less depreciation*. The insured has the burden of proving the fair market value or cost of repair. The insurer has the burden of proving the amount attributable to depreciation.

Some policies alter this rule by providing for replacement cost coverage, which does not include any deduction for depreciation. There are three types of replacement cost coverage. Standard coverage covers the replacement cost, up to the policy limits. Extended replacement cost covers the replacement cost, plus either a fixed dollar amount or percentage amount above the policy limits (e.g., 150% of the policy limits). Guaranteed replacement cost covers the full cost of the repair or replacement irrespective of the policy limits.

Although the insured is not required to rebuild the lost property, many policies allow the carrier to withhold the difference between the lower actual cash value of the property and the higher replacement cost until such time as the repairs or replacement are complete. In effect, if the insured does not repair or replace the damaged property, they may be limited to the lower actual cash value.

Please see *Loss Valuation* on page 4

## Business Interruption Coverage

This post addresses standard “business interruption” coverage in commercial property insurance policies. The standard policy language indemnifies the insured for business interruption “during the suspension of operations during the period of restoration.” The suspension of operations must be caused by covered physical loss to property of the insured at the insured premises. Stated differently, the business interruption must be caused by damage to *your* property.

In addition, the coverage is only triggered if there is a *complete* suspension of operations. There is no coverage for a business slowdown or for the interruption of a specific project or contract. For example, in one case, a law firm’s building was flooded, but since the lawyers were able to generate billable hours during that period (albeit at much lower hours than normal), no coverage was allowed.

Business interruption generally indemnifies the insured for net income lost and ordinary operating expenses until such time as the property is restored. Some policies limit the time period, for example, only covering the first twelve months, even if the premises are not restored and business has not commenced again.

Occasionally, the policy itself will set the amount recoverable (e.g., \$1,000 per day), although usually the amount of the insured loss is determined after the loss. In this case, the insured has the burden of proving its lost net income and operating expenses. Because the insured has the burden of proof, it is imperative to have an accurate accounting to prove the net profits of the business when submitting a proof of loss. It is also imperative to understand the different coverages, endorsements, limitations and exclusions so the proof of loss can be drafted to account for these issues.

Additional coverages include extra expense coverage (such as the cost of relocating or hiring additional labor). Rental coverage may also indemnify landlord form lost rental income (even, in some cases, if the property was not leased at the time of the loss).

## Property in Escrow Destroyed by Fire

What happens when property in escrow is destroyed? The default rule is found in Civil Code Section 1662. It provides that if title or possession have not passed, the seller cannot enforce the purchase agreement if a “material” portion of the purchase property has been destroyed. The buyer may, however, elect to enforce the contract and take the property in its damaged condition. Disputes may arise as to whether the property has been “materially” damaged. Under the same rule, if title or possession have passed, the risk of loss is transferred to the buyer who cannot escape or terminate the contract.

Many residential purchase agreements do not address what occurs in the event of damage or destruction, and therefore, the default rules will apply. In commercial purchase agreements, it is common (especially given the longer closing periods) for the agreements to expressly allocate what happens in the event of damage.

Often the contract will distinguish between minor and major damage. For example, damage under \$100,000 may be considered minor and damage over \$100,000 would be major. Often, in the case of minor damage, the buyer must close escrow without a purchase price adjustment, but frequently, the seller will be required to assign any insurance proceeds to the buyer. All these terms can vary from contract to contract.

In the case of major damage, it is common for the buyer to have two options - to cancel the contract, or proceed with the contract without a purchase price adjustment. When the buyer proceeds with the contract, the seller typically assigns the insurance proceeds to the buyer.

Some contracts give the seller the right to replace or repair the damaged property (typically within a given amount of time). If the seller makes the election, the buyer typically must purchase the property at the purchase price and close of escrow is generally extended for a reasonable time to make the repairs without any reduction in the purchase price.

If you are a seller or buyer and the property has been destroyed prior to closing, it is imperative to review the purchase agreement. When the contract addresses damage and destruction, the buyer and seller typically have specific time periods in which to make their elections. Often, the failure to make an election will result in the choice being made for you. For example, sometimes, if the buyer does not elect to terminate within a certain number of days, the buyer is deemed to elect to proceed with the sale.

## Leased Premises Destroyed by Fire

This post addresses what happens when leased premises are destroyed by fire. The default rule is that the tenant may elect to terminate the lease if the premises is totally destroyed (or substantially destroyed). If the tenant exercises this option, the duty to pay rent ends. Note, however, that this rule only applies to the *leased premises*. For example, under a ground lease, the ground tenant has a duty to pay rent even if the building on which the land is located is destroyed.

The default rule is commonly adjusted in most commercial leases. In these cases, the rights and obligations of the parties depend on the lease-specific language. It is not uncommon for leases to distinguish between “partial” damage to the premises and “total” damage to the premises. Typically, in the event of total damage, the lease will terminate. Sometimes, however, the landlord will have the right to continue the lease if they make the needed repairs/replacement within a specific time period.

In the case of partial damage, leases sometimes distinguish between damage which is fully covered by insurance, and damage which is not covered by insurance (or inadequately covered by insurance). Generally, if there is sufficient insurance, the landlord is required to repair the premises and rent is abated (in full or in part) until the premises are usable. When insurance is not available (or is insufficient), the lease may give the landlord or the tenant the right to make the repairs, but will terminate if neither party elects to make the repairs.

Special rules sometimes apply when damage occurs near the end of the lease term. In these cases, sometimes the landlord may elect to terminate the lease. This right can sometimes be trumped (depending on the language of the lease) if the tenant has an option to renew the lease for an additional term.

Rent is generally abated in the case of damage. If the damage is total (and the election is made to replace the premises), all rent is abated. If the damage is partial (and some portion of the premises is usable), generally the rent is only abated proportionately.

Some leases require the tenant to insure its personal property, alterations and trade fixtures. The landlord often has a lien on these insurance proceeds until the tenant makes the required repairs.

As can be seen, what happens after a fire or other casualty to leased premises can vary significantly and often depends on very detailed provisions of the lease. It is important to act quickly to make the required elections before any time periods pass.

## Taxation of Property Insurance Proceeds – IRC Sec. 1033

This post addresses the tax ramifications which result when the property owner receives their insurance payments after a casualty. Under the Internal Revenue Code, the destruction of property is called an “involuntary conversion” and the receipt of insurance proceeds is treated as if the owner had sold the property for the amount of the insurance payments received.

For example, assume you own a property with a basis of \$100,000 which is destroyed by a fire. Assume further that you receive \$400,000 from the insurance company. Under these facts you would have \$300,000 in taxable gain. Talk about adding insult to injury.

Section 1033 of the Internal Revenue Code provides some relief. It says that if you use the insurance money to buy replacement property (or rebuild the destroyed property), you can defer the gain, *if* you rebuild or purchase new property within two years after you receive the insurance proceeds. (This two year period is extended to four years in the case of the loss to a principal residence in a federally declared disaster area.) If the property is rebuilt, it must be finished within two years (or four years in the case of a principal residence in a federally declared disaster area). It is possible to apply for an extension with the IRS to extend these deadlines.

Thus, under the example above, if the \$400,000 is used to purchase a new property, or to rebuild the replaced property, the gain can be deferred and you would take a \$100,000 basis in the new/replaced property if you rebuilt or replace the property within two years after receipt of the insurance proceeds.

Please see [Section 1033](#), on page 4

### Section 1033, from page 3

The rule is a bit more complex for single family homes used as a primary residence. Assume that your principal residence has a basis of \$100,000 and it is destroyed by fire. If you receive \$400,000, you would be able to exclude \$250,000 (if you file a single return) or \$500,000 (if you file a joint return). If you are filing jointly, the full \$400,000 payment would be exempt from taxation. If you are filing jointly, \$50,000 of the payment would be taxable (\$400,000, less \$100,000 basis, less \$250,000 exemption). You would need to use the \$50,000 to rebuild or find a replacement property to exclude this amount.

In order to defer all of the insurance proceeds, *all* of the proceeds need to be used to rebuild or buy replacement property. Thus, if you took the \$400,000 in insurance proceeds, but used just \$300,000 to rebuild (or find replacement property), you would have \$100,000 of taxable gain.

### Loss Valuation, from page 1

In addition, many policies impose time limits. For example, some policies require that the insured enter into a contract to perform the repairs within a fixed amount of time. Other policies require the insured to complete the repairs within a fixed time (at least 12 months, or 24 months in the case of a state declared emergency). The failure to meet these conditions could result in a waiver of the increased replacement cost.

Another issue with replacement cost involves the cost to comply with new building codes and laws. Most policies (through different provisions) do not cover the increased cost of complying with new building codes. Stated differently, they will pay to replace to repair the property *as it was built* (not at today's cost which would reflect additional building code requirements). Some policies have an "ordinance or law" endorsement which does indemnify the insured for the increased cost of rebuilding to current code.

Before preparing a proof of loss, it is imperative to understand the coverages and possible limitations or exclusions so these issues can be addressed from the

## Deducting Fire Related Losses

If your property is destroyed by fire, you may be able to deduct the loss, but the rules are fairly complex.

The amount of the loss is generally the difference between the fair market value of the property before the loss and the fair market value of the property after the loss.

However, the maximum deductible loss is the *lesser of* your adjusted basis in the property or the difference between the fair market value of the property before the loss and the fair market value of the property after the loss.

For example, assume you own a home with a basis of \$100,000. Before the fire, the fair market value of the home was \$400,000. After the fire, the fair market value of the home is just \$100,000 (which corresponds to the value of the land itself). In this case, the maximum loss is the basis of \$100,000, not the actual loss of \$300,000.

From this, further limitations are imposed. First, for personal use property (e.g. your home or personal property like your clothing or furniture) the first \$100 is non-deductible. Second, the loss is reduced by the amount of insurance proceeds received. Third, for personal use property, the remaining loss is only deductible to the extent it exceeds 10% of your adjusted gross income.

Returning to the above example, the maximum loss is \$100,000. You first deduct \$100, leaving \$99,900. Assume further that you receive \$75,000 in insurance proceeds. This leaves a loss of \$24,900.

Assume further that your adjusted gross income is \$50,000. The first \$5,000 (10% of \$50,000) is non-deductible. As a result, only \$19,900 is deductible (\$24,900, less \$5,000).

(The \$100 exclusion and the 10% limitation do not apply in the case of property used in a trade or business (i.e., non-personal use property like an office building or an office computer).

## Taxation of Living Expense Insurance Proceeds

Most homeowners' insurance policies include coverage for living expenses, such as rent and food. This post addresses the tax ramifications of such payments.

Unless the loss occurred in a federally declared disaster area, if the living expense insurance payments are more than the temporary increase in your living expenses, the excess is taxable as ordinary income.

This rule can best be explained by means of an example. Assume your normal living expenses (rent and food) are \$1,000 per month. As a result of a fire, you are forced to move into a hotel and your living expenses (hotel and food out) are \$2,500. The difference between your normal living expenses and your actual living expenses is \$1,500. This is called your temporary increase in living expenses.

If you receive \$2,000 from your insurer for living expense, you would have \$500 in income. This is the difference between the insurance proceeds received (\$2,000) and the temporary increase in living expenses (\$1,500).