Lessons learned: CPAs share tips on disaster recovery

Jerry Ascierto

ON OCT. 19, 1991, CPA Anna Maria Galdieri took a picture of her friend's children on their porch in the Oakland Hills. Galdieri and the children had just finished making Halloween costumes.

[ILLUSTRATION OMITTED]

The next day, the house was destroyed by the worst urban firestorm California had known: 3,000 homes and 1,600 square acres were destroyed.

In October 2003, 750,000 acres and 2,800 homes were destroyed in the Southern California firestorms. And because of the work done to help the Oakland fire victims, those affected by the Southern California fires have clear guidance on many of the issues that face them in the rebuilding process.

Galdieri, an Oakland-based sole practitioner and a natural disaster victim advocate, lectured, wrote articles and talked with the IRS and local members of the U.S. Senate and House of Representatives following the Oakland fires to enact changes to the income tax law and then garner clarification of what that law meant.

For the CPA assisting disaster victims, there are several considerations--from helping victims remember the contents of their homes to disaster-related tax issues--that may go overlooked in the emotion and panic following a natural disaster.

"After a disaster, dealing with the recovery process could be a disaster in itself," Galdieri says.

ENACTMENT OF SECTION 1033 (H)(1)

The enactment of Section 1033 (h)(1) and the issuance of several IRS Revenue Rulings eased the particular challenges victims faced as they rebuilt their lives following a natural disaster.

Galdieri recounts one of her first community meetings, where a firestorm victim stood up and asked her why the insurance money received for his household contents was subject to tax. That comment was the impetus for what became Sec. 1033 (h)(1), enacted in August 1993 and effective for all federally declared disasters occurring after Aug. 31, 1991.

"The Oakland firestorm community ... came together with a common purpose--informing each other about the insurance recovery process and working to enact changes that made a big difference to the rebuilding of communities and homes," Galdieri says.

Prior to Sec. 1033(h)(1), disaster victims faced taxation of their contents money if it was used to rebuild their homes. Sec. 1033 (h)(1) exempts proceeds received for unscheduled personal property from income, and treats proceeds received for real and scheduled personal property as a common pool of funds.

"These provisions allow disaster victims to rebuild their lives as they need," Galdieri says, maintaining that all the proceeds should be exempt. "Disaster victims face an uphill battle to rebuild their lives and their communities destroyed by a disaster.

They don't need the IRS looking over their shoulders during a traumatic time."

Galdieri worked with the local IRS office to bring issues to Washington and out of that work came three rulings that clarified problems disaster victims faced in their recovery.

REVENUE RULINGS

Revenue Ruling 95-22 clarifies that proceeds received for the loss of a home and scheduled personal property can be reinvested in the home and/or contents, and restates that money received for contents is exempt from income, regardless of how the money is used.

"Tax professionals have had a difficult time understanding that not only is the contents money exempt, but that the disaster victim could, under the law, take their proceeds received for the house and scheduled personal property and reinvest it only in contents," Galdieri says. "Of course, no one I worked with did that, but that's what this law says."

That common pool of funds is an important legal distinction, Galdieri says. In the past, money received for contents could only be spent on replacing the contents of one's house. But Galdieri believed greater flexibility in a victim's use of funds was needed. She also worked with the local IRS office to get Rev. Rul. 96-32 issued. Many disaster victims did not want to rebuild on their old lots, and did not know how the sale of their lot would be treated.

With Rev. Rul. 96-32, the IRS allows the proceeds of the sale of the lot to be considered part of the involuntary conversion and deferrable under Sec. 1033 (h)(1) if they met certain conditions.

Some of the changes Galdieri helped enact took a little longer than expected. She says it took until 1996 for the IRS to publicly state that the mortgage interest associated with the destroyed residence continues to be deductible as qualified residential income during the period of reconstruction or replacement.

CPAs also should be aware of Rev. Rul. 93-43, she says. It came about because insurance companies were making lump sum settlements with Oakland disaster victims for their additional living expenses. It was taking years for disaster victims to settle and rebuild, and it wasn't clear when that lump sum settlement would be taxed.

Rev. Rul. 93-43 holds that the determination of whether there is any taxable amount is made once disaster victims move back into their principal residence.

INSURANCE SETTLEMENT

George Kehrer knows a thing or two about disaster recovery. After the Oakland fires robbed him of a home and two businesses, Kehrer devoted his professional resources as an attorney and building contractor to helping disaster victims.

Kehrer is now executive director of CARe--Community Assisting Recovery, Inc.--a Los Angeles-based nonprofit that educates homeowners and professionals in the disaster recovery process. The organization is one of several assisting victims of the Southern California wildfires.

"Most survivors ignore the role of a CPA in their insurance settlement process," says Kehrer. "It's really not until after their settlement that it occurs to them to consult a CPA. And then it may be too late to structure their settlement in a way that avoids some of the tax burdens."

BEWARE THE FIRST OFFER

Kehrer says one of the lessons he learned through the Oakland fires was that clients should not immediately sign a release or accept the first offer.

Policy reform sometimes follows a natural disaster, but if victims signed releases, "they may not be able to take advantage of the reform. Nothing is final until the insured is satisfied," Kehrer says. "It's not final until you take the key, open the door and walk inside; until you inhabit the house."

An initial settlement is something victims can reject.

"Insurance companies try to settle for as little as they can," says Steve Shepherd, CPA, a tax director at Los Angeles-based Richard Moon and Associates. "Victims are distraught and likely to take the first offer without realizing they don't have to."

Victims should negotiate the true costs of replacing their home by having a qualified building professional determine the most appropriate value.

RECKONING THE DAMAGE

To help get a fair settlement, one must first reckon everything lost in the disaster. "The victim has to recreate everything to begin to get a fair settlement from the insurance company," says Galdieri. "And all of the burden is on the victim."

"Close your eyes and try to remember everything in your office or home," she says, "and you haven't just run for your life and saw everything around you destroyed."

There are personal property inventory checklists that help jar one's memory and Galdieri suggests videotaping or photographing the contents of a house. She also suggests victims ask their friends and family for photos of the house or browse store shelves.

But remember: "Keep a copy off-site," says CPA/PFS Meloni Hallock, a member of the board of directors and executive committee of the American Red Cross of Greater Los Angeles, and a member of the AICPA's PFP Executive Committee, which produced the financial portion of the NEFE/AICPA/Red Cross Disaster Recovery Guide.

CASH FLOW AND ADDITIONAL LIVING EXPENSES

When advising disaster victims, Hallock says the first questions often concern cash flow. "They need to figure out how to pay immediate bills, like a hotel room or interim housing," she says.

There are several unseen costs that may affect the victim's assessment of their "additional living expenses," a feature found in most homeowner or renter insurance policies.

"Just getting a new driver's license and documents replaced, those all have a fee. There are so many things you wouldn't have thought to put into your budget, like the cost of replacing garbage cans," Hallock says.

In the panic following a disaster, victims often overlook several resources and instead take out an advance on a credit card. "Some people think, 'I'll deal with it when I get my insurance claim paid.'" Hallock says. "But receiving reimbursement may not match paying their credit card bill. They may create a financial disaster for themselves."

Insurance companies will sometimes give advances for various items of coverage, says Mitch Freedman, a Sherman Oaks-based CPA/PFS and owner of MFAC Financial Advisors Inc., who along with Hallock helped develop the Disaster Recovery Guide. "Your insurance company will likely be willing to provide you with advances without requiring you to settle your claim," he says. "You always can settle later."

FEDERAL RESOURCES

For those without insurance, FEMA grants for individual homeowners range from $5,100 to $25,600. For those with insurance, FEMA generally will deny the grant, but that shouldn't stop one from applying, Kehrer says. The denial letter should be kept, and if one's additional living expenses run out, that letter serves as proof of filing for assistance.

For businesses affected by disasters, the Small Business Administration will loan up to $1.5 million. But one has to apply and be denied by a normal lender to be eligible, Kehrer says.

It's also helpful to know how this financial help is characterized. "Often, financial help available to disaster victims is not taxable," Hallock says.

PATIENCE AND UNDERSTANDING

For a CPA assisting disaster victims, one of the biggest assets may be patience. "Your clients are going to come to you at a time when they're distraught, confused and upset," Freedman says. "It's important for the CPA to be a stabilizing force."

Foremost, a CPA advising disaster victims needs to be empathetic. "A CPA needs to be able to put themselves in the victim's shoes and understand what the victim is going through," Galdieri says. "A fire destroys everything. There's no wallet, Social Security card, identification, appointment calendar, checkbook or tax records left."

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