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Rev. Rul. 77-94

Advice has been requested whether, under the circumstances described below, a self-employed individual may elect to deduct on the individual's Federal income tax return, for the year immediately preceding the year in which a natural disaster occurs, the losses to inventory occasioned by the disaster, for purposes of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954).

The taxpayer, a self-employed individual, incurred a casualty loss to inventory in 1975 as a result of a natural disaster. The area in which the business was operated was subsequently determined by the President of the United States to warrant assistance under the Disaster Relief Act of 1974 (Pub. L. No. 93-288, 1974-2 C.B. 414). The taxpayer proposed to file an amended income tax return for 1974 and elect, pursuant to section 165(h) of the Code, to take the loss against 1974 income, in order to reduce net earnings from self-employment.

Section 1402(a) of the Self-Employment Contributions Act provides that the term "net earnings from self-employment" means that gross income derived by an individual from any trade or business that the individual carries on, less the allowable deductions that are attributable to such trade or business.

Section 1.1402(a)-2 of the Income Tax Regulations states that the gross income and deductions of an individual attributable to a trade or business, for the purpose of ascertaining the individual's net earnings from self-employment, are to be determined by reference to the provisions of law and regulations applicable with respect to the taxes imposed by sections 1 and 3 of the Code (individual income taxes).

Section 165(a) of the Code provides for the allowance of a deduction for any losses sustained during the taxable year which are not compensated for by insurance or otherwise. In the case of an individual, section 165(c) limits the deduction provided for in section 165(a) to losses incurred in a trade or business, and other losses not relevant here.

Section 165(h) of the Code provides that, notwithstanding the provisions of section 165(a), any loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974 may, at the election of the taxpayer, be deducted for the taxable year immediately preceding the taxable year in which the disaster occurred.

Section 1.165-11(b)(3) of the regulations provides that the election provided by section 165(h) of the Code applies only to a loss arising from fire, storm, shipwreck, or other casualty, and otherwise allowable as a deduction for the year in which the loss occurred under section 165(a) and those provisions of sections 1.165-1 through 1.165-10 of the regulations which are applicable to casualty losses. Section 1.165-7(a)(4) of the regulations provides that section 165 does not apply to a casualty loss reflected in the inventories of the taxpayer. However, section 1.165-7(a)(4) denies a deduction under section 165 for a casualty loss to inventory only where

<Page 266>the taxpayer would receive a double benefit by both deducting the loss under section 165 and reflecting the loss as an increase in the cost of goods sold.

Accordingly, the taxpayer may elect to deduct the casualty loss to inventory under section 165(h) of the Code on the Federal income tax return for the preceding year. However, in electing to take the loss under section 165(h), the taxpayer must adjust the opening inventory for the year in which the loss occurred so that the loss will not be reflected again in inventories, giving the taxpayer a double benefit. See Rev. Rul. 55-138, 1955-1 C.B. 223; Lang Broom Co., 9 BTA 39 (1927), acq., VII-1 C.B. 18. Further, if an election is made under section 165(h) the loss must be taken into consideration in the computation of "net earnings from self-employment" for the preceding year for purposes of section 1402(a) of the Self-Employment Contributions Act.