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Chapter 1 – The Law - IRS and Casualty Losses

Casualty Losses (Current Law)

(a) Casualty Defined

Code Section 165(c)(3) permits a deduction for losses arising from "fire, storm, shipwreck, or other casualty, or from theft." (Casualty losses are also deductible for purposes of the alternative minimum tax (AMT). Code Section 56(b)(1)(A) provides that miscellaneous itemized deductions are not allowed for AMT purposes, but Code Section 67(b)(3) provides that the deductions for casualty and theft losses are not miscellaneous itemized deductions. In addition, a personal casualty or theft loss is deductible only if the taxpayer files a timely claim for any insurance covering the loss. Code Section 165(h)(4)(E).)

While losses attributable to fire, storm, and shipwreck are casualty losses, theft losses are not. (Treas. Reg. Sec. 1.165-7(a)(6).)

The definition of the remaining term, "other casualty" has been the subject of decades of litigation. The IRS, analogizing to fire, storm, and shipwreck, has taken the position that a casualty is "the complete or partial destruction or loss of the taxpayer's property resulting from an identifiable event that is sudden, unexpected and unusual in nature." (Rev. Rul. 72-592, 1972-2 C.B. 101. See also Martin Marietta Corp. v. United States, 83-2 U.S.T.C. para. 9607 (Cl. Ct. 1983); Maher v. Commissioner, 76 T.C. 593 (1981), aff'd, 680 F.2d 91 (11th Cir. 1982); Popa v. Commissioner, 73 T.C. 130 (1979); White v. Commissioner, 48 T.C. 430 (1967), acq., 1969-1 C.B. 21; Toten v. Commissioner, T.C. Memo. 1984-603,; Kielts v. Commissioner, T.C. Memo. 1981-329; Rev. Rul. 87-59, 1987-2 C.B. 59.)

(a)(1)Taxpayer's property

In general, only the owner of the damaged property is entitled to deduct a casualty loss. (Albers v. Commissioner, 33 B.T.A. 373 (1935), dismissed, 84 F.2d 994 (6th Cir. 1936), acq., XV-1 C.B. 1. Although outright ownership seems to be essential, bearing the risk of loss under a contract to purchase property may also satisfy this requirement. Collins & Co. v. United States, 193 F. Supp. 602 (D. Mass. 1961), vacated and dismissed, 300 F.2d 821 (1st Cir. 1962); IT 2150, IV-1 C.B. 147 (1925).)

For example, damages paid to the owner of another boat as a result of a collision between the taxpayer's boat and the other boat were not deductible as a casualty loss. (Dosher v. United States, 730 F.2d 375 (5th Cir. 1984); Stoll v. Commissioner, 5 T.C.M. 731 (1946). But see Rev. Rul. 73-41, 1973-1 C.B. 74, where the IRS allowed the tenant's deduction for casualty damage to leased property because the tenant was required to return the property in as good condition as when received.)

In addition, one spouse can deduct only one-half of a loss to property held as a tenant by the entirety (Kraus v. Commissioner, 10 T.C.M. 1071 (1951)).

A parent cannot deduct the loss of property belonging to a child (even though the child is a dependent of the taxpayer). (Draper v. Commissioner, 15 T.C. 135 (1950); Oman v. Commissioner, T.C. Memo. 1971-183.)

A taxpayer is not entitled to a casualty loss deduction for amounts paid to settle another party's claim. (Dosher v. United States, 730 F.2d 375 (5th Cir. 1984); Income Tax Ruling 2150, IV-1 C.B. 147 (1925).)

(a)(2) Identifiable event and causation

The taxpayer must not only identify a casualty event, but also prove that the event caused the loss that was sustained. In Rev. Rul. 59-102, 1959-1 C.B. 200, the IRS stated that there must be a provable event that has a causal relationship to the diminution in value of the damaged property that can be isolated from other events or sequences leading to changes in value of the damaged property. The Tax Court has added, "in determining the cause of the loss, the law does not seek an ultimate cause, but an immediate cause.... The law does not require proof of a storm ... but ... the law does require proof that a storm, shipwreck, or other casualty has occurred and that it caused the loss." Dvorkovitz v. Commissioner, T.C. Memo. 1966-11.

A loss is deductible only in the year that it was sustained, i.e., the year when the identifiable event occurred. Therefore, when in doubt as to the year in which the loss was sustained, take a deduction in the earlier year. This reduces the chance of a complete disallowance of deduction under the statute of limitations if the IRS decides that the deduction was taken for the wrong year.

In some cases, if it appears likely that some casualty caused the taxpayer's loss, the taxpayer is not required to identify the specific event. Thus, for example, taxpayers were allowed a casualty loss for goods lost after the United States pullout from Vietnam (See Popa v. Commissioner, 73 T.C. 130 (1979), acq., 1981-2 C.B. 2.), and during the revolution in Iran (See Clem v. Commissioner, T.C. Memo. 1991-414.), even though it was possible the loss was not caused by a casualty and the taxpayers could not specify what casualty in fact damaged their property.

A casualty loss is allowed only for actual physical damage to property as a direct result of the casualty. A decrease in value of property due to the occurrence of a nearby casualty that does not touch the taxpayer's property or the possibility of a future casualty is not deductible. For example, in Kendall v. Commissioner, T.C. Memo. 1958-163, the taxpayer claimed a casualty loss deduction on beachfront property after he was informed by a potential buyer that the buyer would not pay as much for the property because of the hazard of future damage that might be caused by violent storms similar to those which had occurred in the preceding year. The Tax Court denied the taxpayer's claim for a casualty loss deduction because the loss in the value of the house was not the result of physical damage to the house caused by a storm.

In Thornton v. Commissioner, 47 T.C. 1 (1966), the Tax Court denied a casualty loss deduction for a decline in the market value of a residence attributable to a fear of recurring floods, but that was not caused by actual physical damage to the residence. The court stated that a decline in market value not attributable to any actual physical depreciation is too uncertain to be allowed as a casualty loss deduction. (See also Boswell Co. v. Commissioner, 34 T.C. 539 (1960), aff'd, 302 F.2d 682 (9th Cir), cert. denied, 371 U.S. 860 (1962) (taxpayer was not allowed a loss deduction for claimed losses resulting from the flooding of farm lands in a reclaimed lake bed.

A temporary loss of the use of the property was not equivalent to a loss of the property and the taxpayer did not present any actual evidence to prove the amount of salt that was added to the property); Peterson v. Commissioner, 30 T.C. 660 (1958) (casualty loss deduction denied for fluctuation in the market value of property due to flooding); Citizens Bank v. Commissioner, 28 T.C. 717 (1957), aff'd, 252 F.2d 425 (4th Cir. 1958) (casualty loss deduction denied for decline in the value of the bank's building after the bank's basement was flooded and the bank could no longer use the basement for the storage of records).)

In Pulvers v. Commissioner, 48 T.C. 245 (1967), aff'd per curiam, 407 F.2d 838 (9th Cir. 1969), a casualty loss deduction was denied because, although there was an immediate decline in the value of the taxpayer's home as a result of a landslide that destroyed neighboring homes, there was no actual damage to the taxpayer's property.

In Kamanski v. Commissioner, T.C. Memo. 1970-352, aff'd, 477 F.2d 452 (9th Cir. 1973), the taxpayer was allowed to deduct the amount of loss suffered due to the physical damage inflicted on his house by a landslide. However, an additional loss in market value attributable to buyer resistance and the unwillingness of financial institutions to make loans in the area was not allowed as a casualty loss. (See also Caan v. Commissioner, No. CV 98-4833-GHK (C.D. Cal. Feb. 26, 1999), and Chamales v. Commissioner, T.C. Memo. 2000-33 (buyer resistance arguments by O.J. Simpson's neighbors unsuccessful); Solomon v. Commissioner, T.C. Memo. 1980-87 (casualty loss denied where buyer resistance to purchasing a flood-damaged, flood-prone property was not permanent); Rev. Rul. 66-242, 1966-2 C.B. 56 (buyer resistance arising after flood, and which was short lived, did not establish a deductible casualty loss where it represented a mere fluctuation in value).)

The Eleventh Circuit distinguished some of these cases in Finkbohner v. Commissioner, 788 F.2d 723 (11th Cir. 1986), where there was a permanent loss in value because a flood had totally destroyed several homes near the taxpayer's home and changed the character of the neighborhood. The court concluded that a temporary decline in value due to flooding does not justify a casualty loss deduction because, although the market will decline sharply on the occurrence of a natural disaster, it will rebound when the disaster is no longer fresh in people's minds. On the other hand, a permanent decline in value, attributable to permanent changes in the neighborhood or acts of public officials, that will outlast the fresh recollection of the disaster does justify a casualty loss deduction.

Citing Finkbohner, a district court held that taxpayers were not entitled to a casualty loss deduction for the diminution in value of their citrus groves as the result of a series of freezes, finding that any loss in value to the property was the result of buyer resistance and not a permanent decline. Philmon v. United States, No. 98-246-C.V.-T-24(A) (M.D. Fla. 1999).

(a)(3) Sudden event

An "other casualty" must be a sudden event, as opposed to gradual damage. Damage attributable to "progressive deterioration ... through a steadily operating cause" is not a casualty loss. Rev. Rul. 59-102, 1959-1 C.B. 200. Thus, casualty loss treatment has been denied for losses to trees and livestock caused by disease (See, e.g., Coleman v. Commissioner, 76 T.C. 580 (1981) (Dutch elm disease); Burns v. United States, 174 F. Supp. 203 (N.D. Ohio 1959), aff'd per curiam, 284 F.2d 436 (6th Cir. 1960) (Dutch elm disease); Moriarity v. Commissioner, T.C. Memo. 1984-249, (oak wilt disease); Campbell v. Commissioner, T.C. Memo. 1973-101, aff'd, 504 F.2d 1158 (6th Cir. 1974) (destruction of livestock due to disease); Rev. Rul. 61-216, 1961-2 C.B. 134 (death of livestock due to disease).), or from dry rot (Hoppe v. Commissioner, 42 T.C. 820 (1964), aff'd, 354 F.2d 988 (9th Cir. 1965); Chipman v. Commissioner, T.C. Memo. 1981-194; Rowley v. Commissioner, T.C. Memo. 1979-338.), water damage (See, e.g., Feldman v. Commissioner, T.C. Memo. 1984-420; Purdy v. Commissioner, T.C. Memo. 1966-186; Wilson v. Commissioner, T.C. Memo. 1963-188, aff'd per curiam, 340 F.2d 609 (5th Cir.), cert. denied, 382 U.S. 108 (1965).), water erosion (United States v. Lattimore, 353 F.2d 379 (9th Cir. 1965); Pryor v. Commissioner, T.C. Memo. 1987-80; Rev. Rul. 53-79, 1953-1 C.B. 41.) and engine damage caused by wear and tear, even if a worn part suddenly fails. (Corbaley v. Commissioner, T.C. Memo. 1984-201; Mader v. Commissioner, T.C. Memo. 1966-176; Wold v. Commissioner, T.C. Memo. 1963-154; Rice v. Commissioner, T.C. Memo. 1956-258; Leet v. Commissioner, T.C. Memo. 1955-13, aff'd, 230 F.2d 845 (6th Cir. 1956).)

Ordinarily, damage caused by insects is not considered sudden, even if the manifestation of the damage is sudden, such as when a building collapses due to termite damage. (Dodge v. Commissioner, 25 T.C. 1022 (1956); Feinstein v. United States, 173 F. Supp. 893 (E.D. Mo. 1954); Fay v. Helvering, 42 B.T.A. 206 (1940), aff'd per curiam, 120 F.2d 253 (2d Cir. 1941); Notter v. Commissioner, T.C. Memo. 1985-391; Cristo v. Commissioner, T.C. Memo. 1982-514; Rev. Rul. 87-59, 1987-2 C.B. 59, amplified by Rev. Rul. 90-61, 1990-2 C.B. 39; Rev. Rul. 63-232, 1963-2 C.B. 97; Rev. Rul. 57-599, 1957-2 C.B. 142, modified by Rev. Rul. 79-174, 1979-1 C.B. 99; Rev. Rul. 55-327, 1955-1 C.B. 25; GCM 39427 (October 25, 1985); GCM 39101 (December 21, 1983).)

A number of cases have found that the particular termites that damaged a taxpayer's property acted in a "sudden" fashion (See, e.g., Rosenberg v. Commissioner, 198 F.2d 46 (8th Cir. 1952); Buist v. United States, 164 F. Supp. 218 (E.D.S.C. 1958); Shopmaker v. United States, 119 F. Supp. 705 (E.D. Mo. 1953).), although the IRS has rejected this "fast termite" entomology. (Rev. Rul. 63-232, 1963-2 C.B. 97.) The courts and the IRS agree, however, that a mass insect attack that killed trees within five to ten days is a casualty. (Black v. Commissioner, T.C. Memo. 1977-337; Nelson v. Commissioner, T.C. Memo. 1968-35; Rev. Rul. 79-174, 1979-1 C.B. 99, distinguished by Rev. Rul. 87-59, 1987-2 C.B. 59, amplified by Rev. Rul. 90-61, 1990-2 C.B. 39.)

Courts have permitted casualty loss deductions for damage caused over a period of weeks or months. For example, in Bailey v. Commissioner, T.C. Memo. 1983-685, the Tax Court allowed a casualty loss deduction for slippage of land that damaged the taxpayer's home over a two-month period. Similarly, the Tax Court allowed a casualty loss deduction where blasting damaged the taxpayer's home over a period of months. Durden v. Commissioner, 3 T.C. 1 (1944), acq., 1944 C.B. 8.

The suddenness requirement can be illustrated by comparing two administrative rulings. In Income Tax Ruling 2231, IV-2 C.B. 53 (1925), the Treasury ruled that the bursting of hot water pipes caused by an air obstruction was a casualty. (This ruling was modified on another issue, GCM 16255, XV-1 C.B. 115 (1936); GCM 16255 was obsoleted by Rev. Rul. 69-31, 1969-1 C.B. 307.) On the other hand, in Rev. Rul. 70-91, 1970-1 C.B. 37, the IRS ruled that damage to a water heater that burst due to rust and corrosion was not a casualty loss. Note, however, that the IRS did rule in Rev. Rul. 70-91 that the consequent water damage to household furnishings was a casualty loss.

A drought is another context in which the suddenness issue arises. The IRS has ruled that most droughts lack this requirement. Rev. Rul. 77-490, 1977-2 C.B. 64. However, the Tax Court has held that a record drought that resulted in the withering of the taxpayer's ornamental lawn, shrubs, and plants within three or four months gave rise to a deductible casualty loss. Ruecker v. Commissioner, T.C. Memo. 1981-257. A casualty loss deduction also was allowed for structural damage to a house caused by the loss of moisture in the subsoil due to a drought so severe that it was declared a national disaster. Stevens v. Commissioner, T.C. Memo. 1984-365. According to the court, the shrinkage in the soil and the resulting damage to the house took place over a short period of time and was not a progressive or gradual deterioration.

In a similar situation, however, the Tax Court denied a casualty loss deduction where a drought was the initial cause of progressive deterioration to a home that occurred over the next two years. Short v. Commissioner, T.C. Memo. 1988-40. The court did note, however, that the taxpayers may have been better able to support a casualty deduction if they had claimed the loss in the year following the drought when the damage first became apparent because they would have been more likely to satisfy the suddenness requirement.

(a)(4) Unexpected and unusual events

An "other casualty" must be an unexpected and unusual event. An unexpected event is one the taxpayer is not anticipating and does not intend. An unusual event is one that is not a day-to-day occurrence or one that is not typical for the activity in which the taxpayer is engaged.

If an event occurs regularly, it is not sufficiently unexpected or unusual. For example, a heavy rainfall occurring at approximately the same time every year is not unexpected. Portman v. United States, 683 F.2d 1280 (9th Cir. 1982). Similarly, an accident during a car race is not a casualty because accidents are not unusual. PLR 8227010.

In Heyn v. Commissioner, 46 T.C. 302 (1966), acq., 1967-1 C.B. 2, the Tax Court minimized the issue of foreseeability in assessing a casualty loss. In that case, a landslide occurred at the site where the taxpayer's house was being built. In spite of the fact that the contractor was advised by the engineers of the need to provide adequate support, he failed to provide such shoring and an earthslide occurred. The court concluded that the landslide was a casualty because it possessed the characteristics of a sudden and violent movement of a large mass of earth and the fact that it could have been avoided did not prevent the event from being considered a casualty.

With respect to floods and high water, the key appears to be whether the event is unusual in nature. For example, in Ferris v. United States, 62-1 U.S.T.C. para. 9448 (D. Vt. 1962), a homeowner, whose garage walls had contained small cracks from the time he first occupied the premises was entitled to a casualty loss deduction for damage caused to his garage and the apartment overhead when one wall collapsed. The subsoil hydraulic action that caused the damage was an "other casualty" because:

1) statistical weather data showed excess precipitation,

2) there was evidence of numerous similar cave-ins in the area,

3) the court's own observation that the sudden collapse of the foundation of the home was unusual, and

4) the opinion of the government's sole witness that the damage was cumulative was without basis in experience or technical knowledge.

Damage from freezing will constitute a casualty loss only if the freeze is unusual or unexpected in nature. For example, in Montgomery v. Commissioner, 6 T.C.M. 77 (1947), the court allowed a deduction for damage to exotic plants in an unexpected Florida freeze. (See also Carloate Industries v. United States, 354 F.2d 814 (5th Cir. 1966) (loss of a citrus grove because of a freeze was a casualty loss); Seward City Mills v. Commissioner, 44 B.T.A. 173 (1941) (damage to taxpayer's mill by unusual ice formations exerting force against the foundation of the mill, causing settling, was a casualty. Such unusual ice formations had never before existed at the taxpayer's mill and resulted from a combination of causes, the occurrence of which was not anticipated by the taxpayer). But see Phillips v. Commissioner, 9 T.C.M. 501 (1950) (casualty loss deduction denied for the repair of automobile when left outside and the motor froze); Greenbaum v. Commissioner, 8 B.T.A. 75 (1927) (frozen water pipes not a casualty loss).)

Although negligence by definition involves the failure to avoid a foreseeable injury (4 P. Keeton & W. Prosser, The Law of Torts section 31, at 169 (5th ed. 1984).), damage caused by negligence can be a casualty loss in some circumstances, although the courts and the IRS have not been consistent. The regulations describe automobile accidents caused by negligence as casualties, but not accidents caused by willful conduct. Reg. Section 1.165-7(a)(3).

The Tax Court has held that a taxpayer's negligent destruction of his wife's ring in a garbage disposal was a casualty. Carpenter v. Commissioner, T.C. Memo. 1966-228. Similarly, a casualty loss deduction was allowed for the loss of a diamond from a ring when a husband accidentally slammed a car door on his wife's hand. (White v. Commissioner, 48 T.C. 430 (1967), acq., 1969-1 C.B. 21; Rev. Rul. 72-592, 1972-2 C.B. 101.) However, a taxpayer who accidentally flushed his wife's rings down the toilet was denied a casualty loss deduction. Keenan v. Bowers, 91 F. Supp. 771 (E.D.S.C. 1950). The treatment of automobile accidents is also difficult to reconcile with a denial of casualty loss treatment for damage caused by pets. (Diggs v. Commissioner, 281 F.2d 326 (2d Cir. 1960) (casualty loss deduction denied for breakage of china and glassware by the family pet).) The courts have upheld the IRS in denying a casualty loss to a taxpayer for a fetus that his wife aborted. Riley v. Commissioner, 234 F.3d 1273 (2000), aff'g, T.C. Memo. 1999-363.

The courts have granted a casualty loss deduction for vandalism where vandals broke into a house being built for the taxpayer and damaged household appliances (See Davis v. Commissioner, 34 T.C. 586 (1960), acq., 1963-2 C.B. 4.), and where the taxpayer's art objects were found damaged or destroyed when the taxpayer moved into a new apartment. (United States v. Lattimore, 353 F.2d 379 (9th Cir. 1965). But see Hananel v. Commissioner, T.C. Memo. 1991-386, aff'd, 977 F.2d 578 (5th Cir. 1992) (City of Chicago's towing and crushing taxpayer's illegally parked car was "not unexpected").)

(b) Amount of Loss for Business Property

(b)(1) Amount deductible

The amount of the casualty loss for damage to property that is used in a trade or business or for the production of income is the lesser of the taxpayer's adjusted basis of the property or the difference in the fair market value of the property immediately before and after the casualty. Reg. Section 1.165-7(b)(1). However, if property used in a trade or business or for the production of income is totally destroyed, and if the fair market value of such property immediately before the casualty is less than its adjusted basis, the adjusted basis of such property is the amount of the loss. Reg. Section 1.165-7(b)(1)(ii).

Boyle's Est. v. CIR, 82 TCM (CCH) 488, 491 (2001) ("adjusted basis . . . for purposes of calculating the casualty loss . . . must be its basis as of the date of the casualty"; cost of replacement cannot be included).

The basis of property damages or destroyed by casualty is reduced by the amount of the deduction allowable under §165 and by the amount of any insurance or other compensation received or recoverable in the year the casualty loss is sustained. (See, e.g., Rev. Rul. 71-161, 1971-1 CB 76.) The adjusted basis is then increased by any capital expenditures made to repair or restore the damaged property. (See Prop. Reg. §1.263(a)-3(g)(1)(iii) (requiring capitalization of costs or repairing "damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss . . . or relating to a casualty event).)

The adjusted basis of property lost by casualty is calculated as of the date the casualty occurred, and it does not include the cost of replacing the property. Estate of Boyle v. Commissioner, T.C. Memo. 2001-235.

This limit on the amount deductible is applied separately for each single, identifiable item of damaged property. Reg. Section 1.165-7(b)(2)(i).

(b)(2) Treatment of business casualty gains and losses

Casualty gains and losses relating to business and investment property are subject to Code Section 1231, under which gains and losses from the "involuntary conversion" of "property used in the trade or business" and capital assets held for more than one year are aggregated. (A casualty gain may not be recognized if the property destroyed by a casualty is replaced with property similar or related in service or use under Code Section 1033. If Code Section 1033 applies, gain is recognized only to the extent that the proceeds of the conversion exceed the amount used to purchase the replacement property.

Any tangible property acquired and held for productive use in a business is treated as similar or related in service or use to property that (1) was held for investment of for productive use in a business, and (2) was involuntarily converted as a result of a Presidentially declared disaster, under Code Section 1033(h)(2), effective for disasters for which a Presidential declaration is made after 1994, in taxable years ending after that date.)

An accidental poisoning of crops can constitute an involuntary conversion with the result that the taxpayer who owns the crops can elect to use any damages received to buy similar property and defer the recognition of gain. PLR 199937050. Losses, including losses not compensated by insurance or otherwise, on the destruction (in whole or in part) of property used in a trade or business, or capital assets held for more than one year are treated as losses from involuntary conversions. Code Section 1231(a)(4)(B).

In the case of an involuntary conversion arising from fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business, or any capital asset held for more than one year, Code Section 1231(a) does not apply to such conversion (whether a gain or loss) if during the taxable year the recognized losses from such conversions exceed the recognized gains from such conversions. Code Section 1231(a)(4)(C). For those casualty gains and losses subject to Code Section 1231, if the recognized losses exceed the recognized gains, all are treated as ordinary gains and losses. If gains exceed losses, the gains and losses are aggregated with all other Code Section 1231 gains and losses. If these aggregated gains exceed losses, the gains and losses are treated as long-term capital gains and losses (subject to the Code Section 1231(c) recapture provision). Code Section 1231(a)(1). If the aggregated losses exceed the gains, all are again treated as ordinary. Code Section 1231(a)(2).

For net operating loss purposes, a casualty loss to personal use property is treated as a business loss. Code Section 172(d)(4)(C). Therefore, if it exceeds the taxpayer's income in the year of its deduction, it can be carried back three years (rather than two years, which applies to net operating losses generally) and carried forward for twenty years. The taxpayer can get a quicker refund by applying for a tentative carryback adjustment on Form 1045, Application for Tentative Refund.

A taxpayer's loss of a deposit in a qualified financial institution due to the institution's bankruptcy insolvency may be treated as either a capital or ordinary loss. Code Section 165(l)(1) permits a taxpayer to elect to treat a reasonably estimated loss on a deposit in a qualified financial institution as a Code Section 165(c)(3) casualty loss incurred during the taxable year. Under Code Section 165(l)(5), in lieu of the previous election, the taxpayer may elect to treat the loss as a Code Section 165(c)(2) ordinary loss incurred during the taxable year.

The ordinary loss election is subject to two important limitations. First, it may be made only with respect to losses that are not, in whole or in part, federally insured. Second, the deduction is only available with regard to aggregate losses of $20,000 on deposit (to the extent not insured under state law) in the institution. Code Section 165(l)(5)(B). However, if the loss actually sustained exceeds $20,000, it may be deducted in the final determination year, when it qualifies as a non-business bad debt under Code Section 166.

If the loss claimed under either election exceeds the actual loss ultimately sustained, the excess must be included in income in the determination year. On the other hand, a deduction under Code Section 166 is available to the extent that the loss actually sustained exceeds the reasonable estimated loss. Notice 89-28, 1989-1 C.B. 667.

Reg. Section 301.9100-8(d)(3) specifies the time and manner for determining the amount of the loss and for making either election. An election may be made either for the first taxable year in which a reasonable estimate of the loss can be made or for a later taxable year that is prior to the taxable year in which the loss is sustained. The amount of the loss is determined by the difference between the taxpayer's basis in the deposits and the amount reasonably estimated to be recovered, taking into account all facts and circumstances reasonably available to the taxpayer as of the date of the election.

The election may be made by filing Form 4684, Casualties and Thefts. If the forms and instructions do not make reference to or request information concerning this election, on an appropriate line or space the taxpayer should clearly indicate the name of the institution, include the language "Insolvent Financial Institution Election," and include the calculation of the reasonably estimated loss claimed.

(c) Amount of Loss for Personal Use Property

(c)(1) Determining amount of casualty loss

The determination of the amount of a personal casualty loss begins with the same rule as for business property: The loss is the lesser of the adjusted basis of the property or the difference in the property's fair market value immediately before and after the casualty. Reg. Section 1.165-7(b)(1). The amount of the loss also is reduced by any insurance recovery and salvage value. (Code Section 165(a); Reg. Section 1.165-1(c)(4). The amount of the deductible loss also is subject to certain limitations imposed by Code Section 165(h).) Also, as with business property, expenses incident to the casualty are not part of the casualty loss. Thus, the cost of temporary accommodations or other increases in the taxpayer's living expenses caused by a casualty are not part of the casualty loss (Millsap v. Commissioner, 46 T.C. 751 (1966), acq., 1967-1 C.B. 2, aff'd, 387 F.2d 420 (8th Cir. 1968); Mulholland v. Commissioner, 16 B.T.A. 1331 (1929); Rev. Rul. 59-398, 1959-2 C.B. 76.), nor is the cost of towing a damaged automobile (Cramer v. Commissioner, 55 T.C. 1125 (1971), acq., 1971-2 C.B. 2.), or fencing in a damaged residence. (Cornelius v. Commissioner, 56 T.C. 976 (1971), acq., 1977-2 C.B. 1.) Similarly, the cost of reimbursing the driver of the other car in the accident for damages incurred is not part of the casualty loss. Peyton v. Commissioner, 10 B.T.A. 1129 (1928).

Unlike business property, however, the amount of the loss is limited to the lesser of fair market value or the taxpayer's adjusted basis, even if the property is totally destroyed. Reg. Section 1.165-7(b)(1)(ii). In addition, value and basis are determined on an aggregate basis for a property, rather than for each single identifiable item of property. See Reg. Section 1.165-7(b)(2)(i).

Limitations on deductibility of amount of casualty loss

An individual taxpayer's non-business casualty or theft loss is deductible only to the extent the loss exceeds $100 ($500 in 2009), and only to the extent the losses for the year exceed 10 percent of adjusted gross income (AGI). Code Section 165(h).

$500 (2009) FLOOR: A non-business casualty or theft loss of an individual is deductible only to the extent it exceeds $500 (2009). Code Section 165(h)(1). The floor does not apply to business property. Each casualty is subject to the floor. If there is more than one casualty causing loss to the same property, the amount of each loss must be reduced by the amount of the floor. On the other hand, if a single casualty damages several items of the taxpayer's property, the floor applies only once. Similarly, if a single casualty causes losses in more than one year, the floor applies only once. Whether damage to property is the result of a single casualty or more than one casualty is a facts and circumstances determination. However, events that are closely related in origin generally give rise to a single casualty. For example, wind and flood damage from a hurricane would be the result of a single casualty. Reg. Section 1.165-7(b)(4)(ii).

Each joint owner of property is subject separately to the floor. Reg. Section 1.165-7(b)(4)(iii). A husband and wife filing a joint return are considered a single taxpayer to whom a single floor applies, but the floor applies separately to married taxpayers who file separate returns. Reg. Section 1.165-7(b)(4)(iii). The floor applies only to the personal use portion of property used for both business and personal use purposes. Reg. Section 1.165-7(b)(4)(iv).

THE 10 PERCENT OF ADJUSTED GROSS INCOME (AGI) FLOOR: If personal casualty losses for any taxable year exceed personal casualty gains for such year, the excess is deductible only to the extent that it exceeds 10 percent of the taxpayer's AGI for the taxable year. This limitation applies only after the loss from each casualty is reduced by the $500 (2009) floor. (Code Section 165(h)(2)(A)(ii); Code Section 165(h)(3).) AGI is computed by deducting personal casualty losses to the extent of personal casualty gains. Code Section 165(h)(5)(A).

A personal casualty gain is the recognized gain from any involuntary conversion of non-business property arising from fire, storm, shipwreck, other casualty, or from theft. Code Section 165(h)(4)(A). A personal casualty loss is any loss of non-business property arising from the same types of events. Code Section 165(h)(4)(B).

If the personal casualty gains for any taxable year exceed the personal casualty losses for such taxable year, all gains and losses are treated as capital gains and losses. Code Section 165(h)(2)(B). In this event, the losses are not subject to the 10 percent AGI floor. (Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 987.)

(d) Method of Valuation

The regulations provide two methods for determining the decline in fair market value of property damaged in a casualty (for both business and personal use property), the appraisal method and the cost of repairs method. Reg. Section 1.165-7(a)(2).

(d)(1) Appraisal

The first method that can be used to measure the amount of damage to property caused by a casualty is to obtain a competent appraisal of the fair market value of the property immediately before and immediately after the casualty. Reg. Section 1.165-7(a)(2)(i). The appraisal should consider the effect of a general market decline affecting the undamaged, as well as the damaged property, in order to isolate the actual loss resulting from the casualty. Reg. Section 1.165-7(a)(2)(i). The appraiser's knowledge of sales of comparable property, conditions in the area, familiarity with the taxpayer's property before and after the casualty, and the method he uses in ascertaining the amount of loss are all important elements of the appraisal. Maduza v. Commissioner, T.C. Memo. 1961-249.

The purchase price of the property is not relevant in determining value, unless the property was purchased shortly before the casualty. Similarly, the sales price of property sold shortly after a casualty may be the best evidence of value after the casualty. Woods v. Commissioner, T.C. Memo. 1960-72. A court may also make its own estimate of value based on the taxpayer's testimony. (Kenerly v. Commissioner, T.C. Memo. 1975-139; Scharf v. Commissioner, T.C. Memo. 1973-272, aff'd without opinion, 535 F.2d 1250 (4th Cir. 1976).)

(d)(2) Cost of repairs

The second method used to measure the amount of damage to property caused by a casualty is the cost of repairing the property. Reg. Section 1.165-7(a)(2)(ii). This method can only be used when the property is actually repaired. The taxpayer must show that the repairs were necessary to restore the property to its condition immediately before the casualty and that the amount spent for the repairs is not excessive. The cost of repairs is taken into account only to the extent that the property is restored but not improved; the repairs should not increase the property's value compared to what it was immediately before the casualty. Reg. Section 1.165-7(a)(2)(ii).

The cost of repairs is not a limit on the amount of the loss; it is a basis for a computation of the amount of loss. The amount of the loss can be greater than the cost of repairs if the property is not restored to its value before the casualty. Brush v. Commissioner, T.C. Memo. 1962-124.

If repairs restore the property to its original condition, no additional loss is allowed. For example, in Jenard v. Commissioner, T.C. Memo. 1961-70, the taxpayer argued the very occurrence of a fire decreased the fair market value of his building in an amount in excess of the repair cost due to the fear of a prospective buyer that there may have been latent structural weaknesses caused by the fire which were not repaired. The Tax

Court, however, refused to take into account the "groundless fears" of prospective buyers.

The cost of replacement has also been used as evidence of the amount of the loss. (Rev. Rul. 66-303, 1966-2 C.B. 55. See also Clapp v. Commissioner, 321 F.2d 12 (9th Cir. 1963), acq., 1964-1 C.B. 4 (replacement cost used as evidence of fair market value prior to casualty); but see Hernandez v. Commissioner, 72 T.C. 1234 (1979) (replacement cost of an air conditioner rejected as evidence of amount of loss because taxpayer did not show that the cost of the replacement unit did not exceed the value of the unit destroyed).)

The actual amount of the loss may be greater than the cost of replacement property, such as when mature trees or plants are replaced with younger trees. Zardo v. Commissioner, T.C. Memo. 1982-94. The cost to remove debris and otherwise clean up a damaged property can also be used as evidence of the amount of the loss. (Waldrip v. Commissioner, 81-2 U.S.T.C. 9653 (N.D. Ga. 1981); Stuart v. Commissioner, T.C. Memo. 1961-186; Rev. Rul. 71-161, 1971-1 C.B. 76.)

(e) Setoffs

A casualty loss (like any loss) is deductible only to the extent it is not compensated for by insurance or otherwise. Code Section 165(a). If the amount of reimbursements exceed the taxpayer's adjusted basis in the property, the taxpayer realizes a gain unless the gain can be excluded from income as the sale of a home or can be deferred as an involuntary conversion. (Code Section 1033 provides special treatment for gains from an involuntary conversion.)

If, in the year of the casualty, the taxpayer has a claim for reimbursement of the loss, and there is a reasonable prospect that she will be reimbursed for part or all of the loss, the taxpayer must subtract the expected reimbursement to compute the loss. Reg. Section 1.165-1(c)(4) and Reg. Section 1.165-1(d)(2)(ii). If the reimbursement in the later year turns out to be less than expected, the additional loss is claimed in that year. Reg. Section 1.165-1(d)(2)(ii). If the reimbursement exceeds the amount deducted, the taxpayer does not go back to the deduction year to recompute the loss. Instead, to the extent required under the tax benefit rule, the taxpayer includes it in income in the year it is received. Reg. Section 1.165-1(d)(2)(iii). The home sale exclusion and the involuntary conversion deferral do not apply to amounts subject to the tax benefit rule, but may apply to other portions of the reimbursed amount.

Insurance expenses that do not compensate for the casualty do not reduce the loss and are income. Accordingly, insurance payments for normal family living expenses, due to the loss of use of the family's income, are income. But payments for additional living expenses, such as for additional transportation expenses or for restaurant meals, need not be included in income. Code Section 123; Reg. Section 1.123-1.

An individual must show that a grant, award, gift, or loan with respect to a casualty was not a reimbursement to avoid a reduction in the amount of the loss. In addition to insurance, compensation can include condemnation awards, cancellations of federal relief loans, reimbursement under the Federal Disaster Relief Act, cash gifts to rehabilitate property, payments from an urban renewal agency and certain payments to businesses affected by the World Trade Center attacks made by the Empire State Development Corporation. (Rev. Rul. 71-160, 1971-1 C.B. 75; Rev. Rul. 71-161, 1971-1 C.B. 76; Rev. Rul. 76-144, 1976-1 C.B. 17; Notice 2003-18, 2003-1 C.B. 699. Grant payments made by the Empire State Development Corporation under the World Trade Center (WTC) Business Recovery Grant Program are reimbursements for casualty losses. Grant payments made under the WTC Small Firm Attraction and Retention Grant Program and the WTC Job Creation and Retention Program are not reimbursements for casualty losses.)

(f) Year of the Casualty Loss Deduction

A casualty loss (like any loss) generally must be claimed in the year sustained. Reg. Section 1.165-7(a)(1). Usually, this is the year in which the casualty occurs. However, the loss may be deductible in a later year if the loss is not determinable until a later year. For example, in United States v. Barret, 202 F.2d 804 (5th Cir. 1953), the taxpayer's trees were damaged by a severe Florida freeze and the taxpayer attempted to salvage them during the next two years. When it became evident he could not, he claimed a casualty loss. The Fifth Circuit allowed the claim in the later year.

A casualty loss that is subject to a claim for insurance or other reimbursement for which there is a reasonable prospect of recovery is not allowed in the year of the casualty. These losses may only be deducted in the year in which the reasonable prospect of recovery no longer exists or in which compensation is received for less than the amount of the loss. Reg. Section 1.165-1(d)(2)(i). A taxpayer who properly deducts a loss in one year and receives reimbursement in a later year must include the reimbursement in his gross income, as provided in Code Section 111. (Reg. Section 1.165-1(d)(2)(iii). Under the tax benefit rule of Code Section 111, a recovery is includible in income to the extent the prior loss deduction reduced taxable income.)

If an estate suffers a casualty loss of property during settlement, the loss may be allowed as a deduction in computing the taxable income of the estate. Reg. Section 1.165-7(c). The deduction is only allowed if the loss was not allowed as a Code Section 2054 loss during administration in computing the taxable estate of the decedent and if a statement is filed in accordance with Reg. Section 1.642(g)-1.

There are two central facts about this election. First, the amount of the potential deduction for a personal casualty loss is greater under the estate tax than it is under the income tax, since there are no limitations. Second, if the deduction offsets an otherwise fully taxable portion of the estate, it may be worth more (on a dollar-for-dollar basis) as an estate deduction than it would be as an income tax deduction, since the applicable estate tax rate on the net estate (40%) will generally be higher than the income tax rate on net income (39.6%).

The deduction can be split between the estate tax return and the income tax return. If the estate tax deduction has not been finally allowed and the appropriate statement is filed, claiming a deduction in computing the estate's income tax return is not barred on the estate tax return. Reg. Section 1.642(g)-2. Delay filing the statement until it is clear that an income tax deduction is preferable. Once filed, the statement precludes the right to claim an estate tax deduction for the loss.

(g) Casualty and Theft Losses of Passive Activity Property

In general, a taxpayer is allowed to deduct passive activity deductions only to the extent of her passive activity gross income for the year. (Code Section 469(a); Reg. Section 1.469-2T(b)(1).) A deduction is a passive activity deduction if it arises in connection with the conduct of a passive activity. Reg. Section 1.469-2T(d)(1). The regulations, however, exclude casualty and theft losses (as defined in Code Section 165(c)(3)) as deductions from characterization as a passive activity deduction. (Reg. Section 1.469-2(d)(2)(xi).) However, the exemption is inapplicable if losses that are similar in cause and severity occur regularly in the conduct of the activity. Reg. Section 1.469-2(d)(2)(xi).

Passive activity rules will not limit losses arising from a natural disaster, such as a hurricane, but may operate to disallow the shoplifting losses of a retail store or the accident losses of a car rental business. (The casualty exception applies to all taxpayers subject to the passive activity rules who sustain a loss during a tax year that begins after 1989. However, a taxpayer sustaining such losses during a pre-1990 tax year may elect to treat such losses as a non-passive deduction on a return or amended return for such year. Notice 90-21, 1990-1 C.B. 332. Although the regulations do not indicate how this election is to be made, taxpayers would be wise to indicate that they are making such election by attaching a statement to their return or amended return. Taxpayers filing amended returns to take advantage of the casualty loss exemption must also recompute and reallocate their disallowed passive activity loss and credit on amended returns for all other affected years for which returns have been filed. Notice 90-21, 1990-1 C.B. 332. The amount and allocation of the disallowed loss and credit for l989 and future years must reflect any change in the taxpayer's carryovers. See Reg. Section 1.469-1T for details on allocating the PAL loss and credit.)

Reimbursements of casualty losses from passive activities by insurance or otherwise, are also excluded from the definition of passive activity income. Reg. Section 1.469-2(c)(7)(vi). This exclusion applies only to casualty and theft loss reimbursements that are included in gross income under Reg. Section 1.165-1(d)(2)(iii) (relating to reimbursements of losses that the taxpayer deducted in a prior taxable year), and only if the deduction of the loss was not a passive activity deduction. Reg. Section 1.469-2(c)(7)(vi). It does not apply to any other current or prior year deductions, whether from the activity in which the lost or damaged property was used or from any other activity. This exclusion for casualty and theft reimbursements is provided because such reimbursements are included in gross income only to the extent necessary to offset the tax benefits of any deduction that the taxpayer claimed with respect to the loss.

Applying this principle to the passive activity computation, the reimbursement amount included in gross income should not be treated as passive activity gross income if the deduction for the loss was excluded from passive activity deductions.

Under Code Section 469(g), losses from an activity are allowed without limitation if the taxpayer disposes of his entire interest in the activity to an unrelated person in a fully taxable transaction. This rule is inapplicable, however, unless all of the assets used or created in the activity, including land, are disposed of. Thus, a casualty or theft loss involving property used in an activity does not constitute a complete disposition of the taxpayer's interest in the activity unless the casualty or theft loss results in the loss or theft of all property used or created in the activity. Notice 90-21, 1990-1 C.B. 332.

This exclusion from the passive activity rules does not change the treatment of a casualty or theft loss for purposes other than Code Section 469. Notice 90-21, 1990-1 C.B. 332. For example, if a casualty totally destroys property used in a trade or business or held for the production of income and the property's fair market value immediately before the casualty is less than its adjusted basis, the amount of the loss taken into account under Code Section 165 is the property's adjusted basis. Reg. Section 1.165-7(b)(1)(ii). However, the loss must be determined by reference to a single, identifiable property damaged or destroyed. Reg. Section 1.165-7(b)(2)(i).

A casualty or theft loss incurred in a passive activity is not a personal casualty loss and, thus, is not subject to the limitation and other rules applicable to personal casualty losses. (Code Section 165(c)(3); Code Section 165(h).) Such a loss may be treated as a Code Section 1231 loss. However, the Code Section 1231 rules are inapplicable to involuntary conversions of property from fire, storm, shipwreck, or other casualty, or from theft, if the recognized losses from such conversions exceed the recognized gains. Code Section 1231(a)(4)(C).

Taxpayers who sustain losses attributable to a disaster occurring in an area later determined to warrant assistance from the Federal government may elect to deduct the loss for the tax year immediately preceding the tax year of the disaster. (See Code Section 165(i).) Under Notice 90-21, 1990-1 C.B. 332, this throw-back election may apply to casualty losses excluded from passive activity deductions.

Chapter 2 - Casualty Losses (History)

The concept of "casualty" is also relevant in other contexts. A deductible loss to business or income-producing property is sustained only if there has been a "closed transaction"; a mere decline in market value may not be deducted (*Reg.* § 1.165(1)(b)). If an individual's business or investment property is damaged or destroyed by a casualty of a type giving rise to a deduction under § 165(c)(3) in the case of property held for personal use, the event is a closed transaction permitting the resulting loss to be deducted under § 165(c)(1) or § 165(c)(2) (*Reg.* § 1-165-7(b)(1); *Kupiszewski v. CIR*, 23 TCM (CCH) 1559 (1964), aff'd *per curiam*, 366 F.2d778 (5^{th} Cir. 1966).

If the taxpayer is a corporation (not subject to § 165(c)), a casualty loss to property is sufficiently definitive to permit a deduction under § 165(a) (*Reg.* § 1-165-7(a)(1) – *See, Martin Marietta Corp. v. US*, 3 Cl. Ct. 453, 83-2 USTC ¶ 9607 (1983) – ground water suddenly flooded, but ensuing decrease in value resulted from improved understanding, made possible by flood, of geological features or property, rather than from physical damage from flood; no closed transaction because no casualty loss).

The deductibility of casualty losses attributable to property held for personal use is an exception to the normal rule denying deductions for personal, living, and family expenses. (*See, IRC* § 1231(a) – *IRC* § 123 (reimbursement for living expenses when taxpayer's principal residence is damaged or destroyed by casualty]. *See, also*, *IRC* § 165(i) permitting losses from officially declared disasters to be deducted sooner than other losses, which applies only to "casualty" losses but embraces business as well as personal property); *IRC* § 172(d)(4)(C) – computation of net operating loss, and *IRC* § 1.165-7(b) – method of computing casualty loss to business property).

The deductibility of casualty losses attributable to property held for personal use is an exception to the normal rule denying deductions for personal, living and family expenses (*IRC* § 262). In 1963, when Congress imposed the "$100 non-deductible floor" on the deduction of personal casualty losses, the Senate Finance Committee explained both the deduction and the $100 restriction as follows:

[I]n the case of non-business casualty and theft losses, it is appropriate in computing taxable income to allow the deduction only of those losses which may be considered extraordinary, non-recurring losses, and which go beyond the average or usual losses incurred by most taxpayers in day-to-day living. In view of this, it is believed appropriate to limit the casualty loss deduction to those losses or thefts above a minimum amount. The minimum selected was $100 per casualty loss, since this corresponds approximately with the "$100 deductible" insurance carried by many individuals in the United States with respect to such losses. This means that, no deduction will be allowed in the case of an ordinary "fender bending" accident or casualty, but that casualty and theft losses will continue to be deductible (over the $100) in those where they are sufficient in size to have a significant effect upon an individual's ability to pay Federal income taxes.

A “second floor,” restricting the deduction for all losses in excess of the $100 floor to the amount by which the aggregate exceeds “10 percent of adjusted gross income,” was added in 1982 to, among other things, further refine the process of “identify[ing] extraordinary casualty losses that should be taken into account by the tax system because of their impact on an individual’s ability to pay taxes.”

The casualty deduction is not confined to losses reducing the cash available to the taxpayer. For example, in *Cox v. United States*, the Court of Appeals for the Ninth Circuit held that a taxpayer could deduct a loss attributable to salt water intrusion that reduced the value of property for residential development, even though the loss was not remediable and hence did not result in out-of-pocket expenses for repairs, and despite the fact that the property, although worth less than before the casualty, continued to be worth more than its original cost.

According to the court:

[I]n granting the government’s motion for summary judgment, the district court relied on its perception of the legislative intent behind the casualty-loss deduction. Some catastrophes, the court said, might so impair a taxpayer’s financial position that he could not pay income taxes. Because the loss involved in this case did not affect taxpayers’ cash flow, did not require expenditures for repairs and did not compromise the taxpayers’ originally intended use of the property, the court held that the loss was not the type of casualty loss for which Congress had provided a deduction.

The financial plight of the individual who has suffered a casualty loss was, no doubt, one of the motivations for designing the casualty-loss deduction; and the diminished taxpaying capacity of such a person certainly justifies the deduction. But the statute, the regulations, and the case law do not predicate the deductibility of a casualty loss on the individual’s taxpaying capacity or on the out-of-pocket nature of the loss. Furthermore, there is no requirement that the damage to property be repaired or repairable, nor any required demonstration of a reduced capacity to pay one’s taxes.

The district court also indicated that the loss was not deductible because it represented only a decrease in “unrealized appreciation.” Neither the statute nor the regulations differentiate between casualty losses to property which has appreciated and casualty losses to property which has not. One of the examples cited in [Regulation § 1.165-7(c)(3), relating to ornamental shrubs], shows that casualty-caused damage to a piece of property whose fair market value is greater than its adjusted basis can lead to a deduction, even though part of the loss represents “unrealized appreciation.” (*Cox v. US*, 537 F.2d 1066, 1068 (9th Cir. 1976); *see, David v. CIR*, 47 TCM (CCH) 1249 (1984) [citing *Cox* for the well-established rule allowing loss as to property with unrealized appreciation even where no out-of-pocket expense].

The distinction between “extraordinary non-recurring losses” and “the average or usual losses incurred by most taxpayers in day-to-day living” (S. Rep. No. 830, 88th Cong., 2d

Sess., reprinted in 1964-1 CB (pt. 2) 505, 561) not only underlies the deduction floors, but it has also led the IRS and courts to define the term "casualty" to exclude the ordinary vicissitudes of life, such as the physical deterioration of a personal residence or automobile in normal use. When property of this type is damaged or destroyed by casualty, it is necessary to separate the loss attributable to the casualty from any decline in the property's value that may have occurred between the date of its purchase and the casualty, since only the former is deductible under § 165(c)(3).

Section 165(c)(3) is restricted to <u>losses "of property</u>" and does not allow deductions for losses from bodily injuries or similar personal misfortunes, consequential damages (*e.g.*, hotel expenses incurred when a personal residence is destroyed by fire), or premiums on policies of fire insurance. (*See, York v. CIR*, 33 TCM (CCH) 988 (1974) – auto collision insurance premiums not deductible; Rev. Rul. 59-398 1959-2 CB 76 (living expenses). Compare *Pulvers v. CIR*, 48 TC 245 (1967), aff'd *per curiam*, 407 F.2d 838 (9th Cir. 1969) (no deduction for temporary decline in value of taxpayer's residence resulting from landslide in public street) with *Stowers v. US*, 169 F.Supp. 246 (SD Miss. 1958) (deduction allowed where landslide permanently blocked paved access to taxpayer's home).

Even if there is a loss of property, no deduction is allowed if the lost item would have been included in income had it been received in due course (*e.g.*, a farmer's lost crops or an author's royalties embezzled by an agent); that the amount was not taken into income adjusts for the taxpayer's loss, and a deduction under § 165(c)(3) would be duplicative. (*See, Hort v. CIR*, 313 US 28, 32-33 (1941) – "[n]othing in predecessor of § 165(c) indicates that Congress intended to allow petitioner to reduce ordinary income actually received and reported by the amount of income he failed to realize"; *Ward v. US*, 428 F.2d 1288 (Ct. Cl. 1970), cert. Denied, 400 US 1008 (1971) – no deduction for fire damage to zero-basis timber; *Alsop v. CIR*, 290 F.2d 726, 728 (2nd Cir. 1961) - § 165(c)(3) "can hardly be read as permitting a deduction for the deprivation of income [that a cash basis] taxpayer has not received"; Rev. Rul. 68-531, 1968-2 CB 80 – where citrus grove damaged by hurricane, deduction allowed for damage to trees but not for loss of ripening fruit because costs of growing fruit were deduction. *See, also, Foust v. CIR*, 74 TCM (CCH) 799 (1997) – government disaster payment for lost crops included in income because crops had zero basis); *Squirt Co. v. CIR*, 51 TC 543, 548 (1969), aff'd, 423 F.2d 710 (9th Cir. 1970) – amount claimed for "loss of use of the land during its period of rehabilitation" after freeze killed citrus was nondeductible loss of future profits).

Similarly, no deduction is allowed for casualties to and thefts of inventory because the costs of the damaged or stolen items are included in the cost of goods sold. (Reg. §§1.165-7(a)(4), 1.165-8(e); *Kikalos v. CIR*, 75 TCM (CCH) 1924 (1998) (stolen inventory).)

Finally, the loss must result from physical damage to the property. Thus, while the cost of clearing away debris may be deductible (Rev. Rul. 71-161, 1971-1 CB 76 – removal of debris contributing to loss of damaged property's market value), no deduction is allowed for a general decline in the value of undamaged property as a result of public resistance to buying property in a casualty damaged area. (*See, Pulvers v. CIR*, 48 TC 245 (1967), aff'd *per curiam*, 407 F.2d 838 (9th Cir. 1969) [no deduction for temporary decline in value of taxpayer's residence resulting from landslide that destroyed three neighboring homes]. Compare *Thornton v. CIR*, 47 TC 1 (1966) [decline in market value of residence attributable to fear of recurring floods not deductible] with *Finkbohner v. US*, 788 F.2d 723 (11th Cir. 1986 [where taxpayer's property suffered minor physical damage in flood that had much greater effect on neighboring homes, deduction allowed for entire decline in value of taxpayer's property due to flood, including that resulting from removal of majority of houses in neighborhood], and *Radding v. CIR*, 55 TCM (CCH) 1029, 1034 (1988) [*Thornton* and *Finkbohner* turn on distinction between "mere fluctuation in value, or temporary buyer resistance" and "loss of value due to PERMANENT buyer resistance after a flood"; taxpayer failed to establish permanent diminution in value beyond cost of actual repairs.)

Neither can the cost of fences, dams, or other protective devices be deducted. (*See, Austin v. CIR*, 74 TC 1334 (1980) [no deduction for cost of removing pine trees to protect taxpayer's property against possible future damage from collapse]; *Cornelius v. CIR*, 56 TC 976, 981 (1971) (acq.) [cost of towing car nondeductible; query result if taxpayer proved expense was precondition to repairs needed to restore loss of value]; *Rev. Rul.* 76-134, 1976-1 CB 54 [cost of protective works and of moving houses from original locations to prevent future storm damage not deductible]. *See also, Pulvers v. CIR*, 48 TC 245 (1967), aff'd *per curiam*, 407 F.2d 838 (9th Cir. 1969); *Stowers v. US*, 169 F.Supp. 246 (SD Miss. 1958).)

The deduction for a casualty loss ordinarily belongs to the owner of the affected property. However, if a tenant or other person with custody of the property must make good the damage, the owner is not entitled to a deduction because the loss is "compensated for by insurance or otherwise" within the meaning of § 165(a), and the person who must repair or replace the property suffers the loss and is entitled to the deduction. (*Rev. Rul.* 73-41, 1973-1 CB 74 [tenant allowed deduction for costs of restoring property to original condition], ARR 269, 3 CB 158 (1920) (bailee), declared obsolete by *Rev. Rul.* 68-575, 1968-2 CB 603, presumably on procedural rather than substantive grounds. Compare *Gyro Eng'g Corp. v. CIR*, 33 TCM (CCH) 1343 (1974) [short-term lessee allowed deduction even in absence of duty to repair] with *Bonney v. CIR*, 247 F.2d 237, 238 (2nd Cir. 1957) [tenant under no obligation to make repairs denied casualty loss deduction; loss must be apportioned between landlord and tenant's interests but court rejected cost of repairs as measure of tenant's loss].

See also, Collins v. US, 193 F.Supp. 602 (D. Mass 1961), aff'd without discussion of this issue, 303 F.2d 142 (1st Cir. 1962) [deduction allowed for payment to be released from contract to purchase residence following damage by hurricane]; *Leedy-Glover Realty & Ins. Co. v. CIR*, 13 TC 95, 108 (1949), aff'd *per curiam*, 184 F.2d 833 (5th Cir. 1950) [repayment of third party's funds embezzled by taxpayer's employee deductible when made, not when embezzlement occurred].)

Since § 165(b) limits the deduction to the taxpayer's adjusted basis, a tenant or other non-owner apparently qualifies for the deduction only if basis is shown (*e.g.*, capitalized costs of tenant improvements). (*See, Sanborn v. CIR*, 46 TCM (CCH) 1435 (1983) [seller-lessee in sale-leaseback denied deduction for casualty occurring after sale because it had no basis in property immediately after sale and failed to show capitalization of post-sale improvements); *Miller v. CIR*, 34 TCM (CCH) 528, 529 (1975) [no deduction for cost of repairing rental car held on short-term rental because casualty loss deduction may not exceed the taxpayer's basis and "taxpayer has a basis only in property in which he has an ownership interest"). *Rev. Rul.* 73-41, 1973-1 CB 74, by which the IRS gave its blessing to at least some tenant deductions, makes no reference to basis. *See also, Miller v. CIR*, 34 TCM (CCH) 528 (1975) [no casualty loss deduction for cost of repairing another person's car damaged by taxpayer's negligence].)

An indirect interest in damaged property is not sufficient, even if the taxpayer's own net worth is adversely affected. (*See, West v.* US, 259 F.2d 704 (3rd Cir. 1958) [hurricane damage to artificial lake and dam owned by private club; held, club member may not deduct diminution in value of leasehold and cottage, which were not physically damaged); *Keith v. CIR*, 52 TC 41 (1969) (acq.) [similar facts, but deduction allowed on showing that taxpayer had fee interest in lake bed and club owned only an easement]), as in the case of shareholders whose stock reflects damage to corporate property *(see, Sas-Jaworsky v. CIR*, 24 TCM (CCH) 630 (1965), aff'd *per curiam*, 379 F.2d 337 (5th Cir. 1967)), or parents who replace damaged property belonging to their children (*see, Scharf v. CIR*, 76-1 USTC ¶ 9330 (4th Cir. 1976) (not officially reported) [Tax Court denied deduction to parents for household contents belonging to child and destroyed by fire; remanded for reconsideration in light of fact that child was under age 21]; *Oman v. CIR*, 30 TCM (CCH) 767 (1971) [deduction denied because damaged automobile owned by taxpayer's son]; *Draper v. CIR*, 15 TC 135 (1950) [no deduction for property of taxpayer's 21-year-old daughter destroyed by fire in college dormitory, even though she was still dependent on parents for support]. *See also, Rev. Rul.* 75-347, 1975-2 CB 70 [where damaged property was held in tenancy by entirety and spouses file separate returns, each must deduct one half of loss, even though one spouse pays entire cost of repairs); *Kamins v. CIR*, 54 TC 977 (1970) [same as to community property].)

If ownership of property is divided between a life tenant and remaindermen, the Tax Court holds that each is entitled to a ratable portion of a casualty loss deduction, but the Court of Appeals for the Second Circuit has allocated the entire deduction to a life tenant who occupied and repaired a residence that was damaged by hurricane and could not be occupied unless restored. (*Bliss v. CIR*, 156 F.2d 533, 535 (2nd Cir. 1958) [deciding case "on the basis of the unusual fact situation now before us"]; *Steinert v. CIR*, 33 TC 447 (1959) (acq.) [reasserting apportionment rule after *Bliss* appellate decision]).

To be deductible under § 165(c)(3), the taxpayer's loss must "arise from fire, storm, shipwreck, or other casualty, or from theft." (When enacted in 1913, the statutory predecessor of § 165(c)(3) was restricted to losses from fire, storm, or shipwreck; the words "or other casualty, and from theft" were added in 1916. *Revenue Act* of 1916, Pub. L. No. 271m 38 Stat, 756, 759; *Revenue Act* of 1913, Pub. L. No. 16, § II, 38 Stat. 114, 167; § 165(c)(3) of the *Internal Revenue Code*, 36 U. Chi. L. Rev. 220 (1968).)

In construing the term "other casualty," the courts have looked for characteristics similar to those of fire, storm, and shipwreck, an approach that reflects both the canon of statutory construction and the legislative policy of restricting the deduction to "extraordinary, nonrecurring losses" that go beyond the average or usual losses incurred by most taxpayers in day-to-day living, such as the progressive deterioration of property through ordinary wear and tear and the mere passage of time.

In a 1972 ruling, the IRS described the essential elements of a "casualty" as follows:

The courts have consistently upheld the Internal Revenue Service position that an "other casualty" is limited to casualties analogous to fire, storm, or shipwreck. The Service position has been that a casualty is the complete or partial destruction or property resulting from an identifiable event of a sudden, unexpected, and unusual nature….

To be "sudden" the event be one that is swift and precipitous and not gradual or progressive.

To be "unexpected" the event must be one that is ordinarily unanticipated that occurs without the intent of the one who suffers the loss.

To be "unusual" the event must be one that is extraordinary and nonrecurring, one that does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damage occurred, and one that does not commonly occur in the ordinary course of day-to-day living of the taxpayer.

(*Rev. Rul.* 72-592, 1972-2 CB 101. The ruling does not cite its judicial sources, but it is a summary of several frequently quoted cases, including *Chicago, St. L&NO Ry. V. Pullman S. Car CO.*, 139 US 79, 86 (1891) ["unknown cause or … unusual effect of a known cause," occurring "by chance and unexpectedly"]; *Fay v. Helvering*, 120 F.2d 253 (2nd Cir. 1941) ["an accident, a mishap, some sudden invasion by a hostile agency; [casualty] excludes the progressive deterioration of property through a steadily operating cause"]; *Matheson v. CIR*¸ 54 F.2d 537, 539-540 (2nd Cir. 1931) ["sudden, unexpected, or unusual cause," as distinguished from "ordinary wear and tear," "steady labefaction from wind and weather," and "progressive decay or corrosion, occurring without any unusual action by the elements"]. *See also, Rev. Rul.* 59-102, 1959-1 CB 200 (as used in § 1033, the term "destruction" involves the same tests as "casualty" except suddenness).

IRC § 165(c)(3) has been held to provide no deductions: kitchen pipes that ruptured in the same year as a flood (*Heyn v. CIR*, 46 TC 302, 309 (1966); *see, Keenan v. Bowers*, 91 F.Supp. 771 (EDSC 1950); *Oliver v. CIR*, 73 TCM (CCH) 2035 (1997) [insufficient proof that rupture was not due to gradual deterioration; insurer denied flood-related claim]), a cracked engine block in a car driven without antifreeze (*Mohiuddin v. CIR*, TCM (CCH) 659 (1996); compare *Wolf v. CIR*, 67 TCM (CCH) 2327 (1994) [deduction allowed where engine seized up on when being driven from service station after routine maintenance; engine failure due to negligence of repairman, not ordinary wear and tear] with *Corbaley v. CIR*, 47 TCM (CCH) 1570 (1984) [airplane engine destroyed when exhaust valve stem snapped; no casualty] and *Newton v. CIR*, 57 TC 245 (1971) (acq.) [burned-out auto engine; no casualty]), a vase broken by a taxpayer's cat (*Dyer v. CIR*, 20 TCM (CCH) 705, 706 (1961) [taxpayer claimed that loss was attributable to cat's neurotic behavior rather than to her "ordinary perambulations"], and moth damage to a fur coat (*Rev. Rul.* 55-327, 1955-1 CB 25. For other unsuccessful claims, see *Kamanski v. CIR*, 447 F.2d 452 (9th Cir. 1973) ["buyer resistance" with respect to house not physically damaged]; *Caan v. US*, 99-1 USTC ¶ 50.349 (CD Cal. 1999) [alleged loss in value of house near that of O.J. Simpson, resulting from his trial and attendant publicity]; *Mann v. US*, 77-2 USTC ¶ 9486 (ND Ill. 1977) (not officially reported) [new car was "lemon"]; *Adams v. CIR*, 36 TCM (CCH) 1219 (1977) [construction of interstate highway near taxpayer's home]).

Losses by governmental confiscation or seizure also are not ordinarily casualties. (*See, Powers v. CIR*, 36 TC 1191 (1961) [confiscation of taxpayer's Volkswagen by East German authorities was despotic act, not casualty]; *Rev. Rul.* 69-354, 1969-1 CB 58 [perishable food discarded due to postponement of social event on imposition of curfew]. But see *IRC* § 165(i) (repealed in 1976) [casualty losses allowed for property confiscated by Cuban authorities]; *IRC* §§ 127(a), 127(b) (1939) (no counterpart in the 1954 Code) [destruction or seizure of property during military operations in World War II]; *IRC* §§ 1331-1337 (repealed in 1976) (treatment of war loss recoveries); *Popa v. CIR*, 73 TC 130 (1979) (acq.) [loss of property on evacuation from Vietnam at end of war attributed to destruction or pilferage, not confiscation; deduction allowed). *See, also, Billman v. CIR*, 73 TC 139, 141 (1979) [worthlessness of Vietnam currency was nondeductible loss; "we smell a difference between being struck by lightning and having your property burned by fire and having your currency lose its value because of economic events"); *Vance v. CIR*, 36 TC 547 (1961) [repossession of taxpayer's household furniture by finance company when ex-wife failed to keep up payments and wrongfully took property from house on her departure; no casualty]).

The distinction between sudden and extraordinary calamities and those developing slowly has led to the classification of earthquakes, floods, lightning, and a "mass attack" of insects as "casualties." (*See, Butschky v. US*, 82-1 USTC ¶ 9139 (D. Md. 1981) (not officially reported) [damage from unusually heavy rain in hurricane]; *Pantzer v. US*, 64-2 USTC ¶ 9641 (SD Ind. 1964) (not officially reported) [freezing of ornamental trees and shrubs because of "exceptionally cold temperatures" combined with brilliant sunshine and subsequent warm period]; *Nelson v. CIR*, 27 TCM (CCH) 158 (1968) [mass attack of beetles, capable of killing trees in five to 10 days]; *Rev. Rul*. 79-174, 1979-1 CB 99 (accord with *Nelson* case); *Coburn v. CIR*, 12 TCM (CCH) 275 (1953) [storm resulting in flood]; *Grant v. CIR*, 30 BTA 1028 (1934) ["underground disturbance" resulting in sudden subsidence of surface]; *Rev. Rul.* 76-134, 1976-1 CB 54 [high-water and flood damage, but not gradual erosion or inundation at still-water levels), but to the exclusion of rust, corrosion, and Dutch elm disease. (*See, Portman v. US*, 683 F.2d 1280 (9th Cir. 1982) [damage to house from settling after rain storms; rain was unusual, but not extraordinary in amount]; *Maher v. CIR*, 680 F.2d 91 (11th Cir. 1982) [destruction of coconut palms caused by "lethal yellowing"; review of prior cases]; *Appleman v. CIR*, 338 F.2d 729 (7th Cir. 1964), cert. denied, 380 US 956 (1965) [Dutch elm disease not sufficiently unexpected]; *Matheson v. CIR*, 54 F.2d 537 (2nd Cir. 1931) [gradual deterioration from rust and corrosion]; *Coleman v. CIR*, 76 TC 580 (1981) [Dutch elm disease]. Compare *Rev. Rul.* 87-59, 1987-2 CB 59 [trees suddenly killed by insects were initially usable as timber, but they rotted over nine months: "the period of time from the precipitating event … to the identifiable event that fixes the loss … determines the suddenness of the … loss"] (not officially reported) [occurrence causing damage is casualty if "sudden" even though it takes weeks or months for full extent of damage to develop).

The proper treatment of termite damage produced a split among the courts of appeals, an IRS ruling that the loss is due to casualty if it occurs within a short period of time, and finally a 1963 ruling, based on later scientific evidence, that the damage is never sufficiently sudden to qualify for deduction under § 165(c)(3) (*Rev. Rul.* 63-232, 1963-2 CB 97 [citing earlier cases and ruling]; *see, Craven v. US*, 69-1 USTC ¶ 9244 (D. Del. 1969) [not officially reported] [issue submitted to jury, which held in favor of government]; *Rowley v. CIR*, 38 TCM (CCH) 1297 (1979) [dry rot comparable to termite damage; too slow]).

Damage from drought has similarly elicited a variety of responses, depending on how sudden the event is perceived to be. According to the IRS, the death of trees and shrubs from drought, even if unusually prolonged, is not a casualty, but subsoil subsidence resulting from drought might qualify (compare *Rev. Rul.* 66-303, 1966-2 CB 55 [drought generally not casualty], with *Ruecker v. CIR*, 41 TCM (CCH) 1587 (1981) [loss of ornamental plants and shrubs from severe and prolonged drought was casualty]; *see, Rev. Rul.* 54-85, 1954-1 CB 58 [damage to residential property from "relatively" rapid and severe subsoil shrinkage resulting from unusually severe drought; casualty]; *Stevens v. CIR*, 48 TCM (CCH) 531 (1984) [same]).

It is necessary to separate the inevitable deterioration of property caused by rain, wind and fluctuating temperatures from damage attributable to unexpected and sudden extremes in these forces. This distinction may have a geographical dimension. If an engine block unprotected by antifreeze cracks in cold weather, the event hardly qualifies as a casualty in the Arctic, though it might in Florida (*see, Mohiuddin v. CIR*, 72 TCM (CCH) 659 [cracked engine block in car driven in the Southeast without antifreeze; no casualty]).

To be deductible, a loss must exceed the $100 nondeductible floor established in 1964. Citing the fact that in enacting the $100 floor, Congress recognized that minor accidents otherwise qualify as casualties, the Tax Court has observed:

The casualty need not be of great or near-tragic proportions in order to qualify …. The kitchen grease fire which escapes control and causes but little loss is no less a fire and no less a casualty for purposes of section 165(c)(3) than the metropolitan holocaust. We see no reason why a different standard of scale should apply to loss occurrences which fall within the "other casualty" category; they too are deductible under the statute when the events giving rise to the loss, judged by the accepted and essential casualty characteristics, … smack sufficiently of casualty or accident proceeding from an unknown cause or resulting in an unusual effect of a known cause.

(*White v. CIR*, 48 TC 430, 435-437 (1967) [acq.])

The size of the loss may have a bearing on whether it is an unexpected event. Even before the $100 floor was imposed, a taxpayer who dropped a cup and saucer on the kitchen floor was not entitled to deduct the loss, but similar clumsiness in handling a Picasso ceramic could be properly viewed as a casualty. (*See, White v. CIR*, 48 TC 430 (1967) (acq.) [accidental slamming of auto door on taxpayer's wife's hand, causing diamond to fall from ring, was casualty]; *Carpenter v. CIR*, 25 TCM (CCH) 1186 (1966) [same for engagement ring damaged by garbage disposal]; *see, also, Kielts v. CIR*, 42 TCM (CCH) 238, 240 (1981) [deduction allowed for diamond that disappeared from setting during shopping; jeweler testified that he had never seen a diamond simply fall out of setting without "traumatic cause"; taxpayer not required to "pinpoint the exact moment of the loss when, as here, some precipitating event must have occurred in the hour between taxpayer last observed her ring intact and the time the empty setting was discovered"]. But see, *Keenan v. Bowers*, 91 F.Supp. 771 (EDSC 1950) [no deduction for careless flushing of wife's diamond ring down toilet]).

When § 165(c)(3) was in its infancy, the IRS tried to confine its scope to losses attributable to natural forces, such as storms. When presented with a claim for damage to a taxpayer's automobile while his chauffeur was on a joyride, the Court of Appeals for the Second Circuit flatly rejected the "natural cause" limitation, pointing out that the statute referred not only to "storm" but also to "fire" and "shipwreck." (*Shearer v. Anderson*, 16 F.2d 995 (2nd Cir. 1927) [The complaint failed to make clear whether the damage was caused by negligent driving or icy roads, but the court held that either qualifies as a "casualty"]).

Since the latter events can be caused by careless Boy Scouts and drunken navigators, the court saw no reason to restrict the term “casualty” to acts of God. The IRS promptly accepted this decision, and the regulations were amended in 1931 to cover damage to a taxpayer’s automobile, not only when caused by other vehicles but also when attributable to the taxpayer’s own faulty driving, unless “due to the willful act or willful negligence of the taxpayer.” (IT 2408, VII-1 CB 85 (1928), declared obsolete by *Rev. Rul.* 69-43, 1969-1 CB 310. The ruling excluded the taxpayer’s “willful act or negligence” but the 1931 regulations inserted the word “willful” before negligence. Reg. 74, art. 171 (1931). For the current version of this provision, see Reg. § 1.165-7(a)(3). *See also, Blackman v. CIR*, 88 TC 677, 682(1987) [no deduction where taxpayer intentionally set fire to wife’s clothes and negligently burned house down; “gross negligence on the part of the taxpayer will bar a casualty loss deduction”]).

The Tax Court has expanded on the distinction between negligence and willful behavior as follows:

[M]ere negligence on the part of the owner-taxpayer has long been held not to necessitate the holding that an occurrence falls outside the ambit of “other casualty.” … Needless to say, the taxpayer may not knowingly or willfully sit back and allow himself to be damaged in his property or willfully damage the property himself. In the instant case, while one or both of the petitioners may have acted negligently, certainly it cannot be said that either petitioner acted willfully or in a grossly negligent manner.

(*White v. CIR*, 48 TC 430, 435 (1967) [acq.]).

Similarly, the Tax Court has held that a casualty loss may be deductible even if it was foreseeable:

The Government argues that the landside was not a “casualty” within the meaning of section 165(c)(3) because it was merely the product of (a) anticipated hazards of building on petitioner’s property, a steep hillside lot with an unstable soil condition, and (b) faulty shoring provided by the contractor. We think that this position takes an unduly narrow view of the statute.

The physical characteristics of the landslide were plainly those normally associated with a casualty. It involved a sudden and violent movement of a large mass of earth that was cataclysmic in character, and was similar in nature to a fire, storm, or shipwreck…. That it might have been foreseen or that it might have been prevented by the exercise of due care by the contractor are factors which in our opinion do not require that the landside be denied classification as a casualty.

Foreseeability may be a circumstance to be taken into account in determining whether a particular event is a casualty. But foreseeability alone is not conclusive. Meteorological forecasts may well forewarn a cautious property owner to take protective measures against an oncoming hurricane, but any ensuing losses may nevertheless be storm or casualty losses within the meaning of the law. Nor is negligence a decisive factor. Automobile accidents are perhaps the most familiar casualty today. Yet the owner of the damaged vehicle is not deprived of a casualty loss deduction merely because his negligence may have contributed to the mishap….

We are unable to perceive any distinction between a casualty loss arising from an automobile collision and one resulting from a landslide. Certainly, in the absence of gross negligence, the mere fact that the automobile owner negligently failed to have faulty brake linings replaced or that he negligently took a calculated risk in driving with smooth tires would not deprive him of a casualty loss if his vehicle were damaged in an accident occurring as a result of either of those conditions. The accident would nonetheless qualify as a casualty, notwithstanding the owner's negligence or that the accident was the consequence of his having taken a calculated risk in respect of known hazards. And it seems clear to us that petitioner's position in respect of the landslide is no weaker.

(*Heyn v. CIR*, 46 TC 302, 307-308 (1966). *See, Hayutin v. CIR*, 31 TCM (CCH) 509 (1972), aff'd, 508 F.2d 462 (10th Cir. 1975) ["faulty construction was merely an element in the causative chain and was not a proximate cause of the … damage"]).

Under § 165(k), losses resulting from a presidentially recognized disaster are sometimes allowed as casualty losses even if they would not qualify under the foregoing definition. (Also, losses qualifying under this rule may be deducted on the taxpayer's return for the year preceding the year in which the disaster occur.)

This rule applies if:

1. The taxpayer's residence is located in an area determined by the President to warrant federal assistance under the Disaster Relief and Emergency Assistance. (This act "empowers the President to declare an area affected by a disaster (including storms, floods, earthquakes, landslides, mudslides, hurricanes, tornadoes, fires, and explosions) either an "emergency" or a "major disaster area." [Staff of Joint Comm. on Taxation, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1165 n.47 (Comm. Print 1984)];

2. The disaster makes the residence unsafe for use as a residence; and

3. Within 120 days after the president's determination, a state or local government orders the taxpayer to demolish or relocate the residence.

The rule is meant to cover taxpayers whose residences are not physically damaged, and thus would not qualify for the casualty loss deduction under the general rules, but "whose residences [are] condemned because of a threat of further destruction or because their residences [are] otherwise … rendered uninhabitable by the disaster" (Staff of Joint Comm. on Taxation, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1165 (Comm. Print 1984)).

To satisfy the requirement that the disaster make the residence unsafe, the residence must be rendered materially more dangerous after the disaster than it was before the disaster, and the danger must be from a materially increased risk of future destruction arising from the disaster. For example, in a storm disaster area, loss from a demolition or relocation order based on a finding that the residence was rendered unsafe by nearby mudslides would be treated as a casualty loss under the provision. By contrast, any decline in the value of a residence resulting from pre-existing dangerous conditions (*e.g.*, by reason of location in a historically storm-prone region) does not constitute a casualty loss, even if the house is condemned" (Staff of Joint Comm. on Taxation, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 1166 (Comm. Print 1984)).

Casualty Loss/Amount Deductible:

To determine the amount of the casualty loss deduction, it is necessary to:

1. Measure the taxpayer's loss;

2. Take account of any insurance recovery, other compensation, or salvage value; and

3. Apply the non-deductible floors.

Measuring Taxpayer's Loss:

The basis for determining the amount of any loss (including casualty losses) is the adjusted basis used in determining the taxpayer's loss on a sale or other disposition of the property (*IRC* § 165(b)). In the case of a personal residence, automobile, or other item held exclusively for personal use, the adjusted basis is ordinarily cost, with adjustments for improvements, prior casualty deductions, and some other receipts, expenses and tax allowances. If there is a difference between the asset's basis for computing gain and its basis for computing loss (*e.g.*, under § 1015(a), relating to property acquired by gift), the latter must be used, even if the property is held solely for personal use so that any loss on sale would be nondeductible. (*Reg.* § 1.165-7(b)(1)(ii). *See, Pickering v. CIR*, 37 TCM (CCH) 1765 (1978), aff'd, 79-2 USTC ¶ 9616 (2nd Cir. 1979), cert. denied, 444 US 1008 (1980) [failure of proof on issue of basis sometimes overlooked to permit allowance of small casualty loss if court can infer that deduction does not exceed basis].)

For example, if an uninsured painting costing $1,000 but worth $5,000 is totally destroyed by fire, the loss is $1,000. Since the unrealized appreciation has not been taken into income, it does not figure into the computation of the deduction. Indeed, if the taxpayer recovered $5,000 from an insurance company or tort-feasor, there would be a gain of $4,000.

If the painting was held solely for personal pleasure and was worth only $750 at the time of the fire, the casualty loss is only $750. The full adjusted basis of $1,000 is not allowed in this case because the pre-fire decline in value of $250 is not attributable to the casualty. Under *Helvering v. Owens*, decided by the Supreme Court in 1939, the loss from casualty is the lesser of the property's adjusted basis and its value immediately before the casualty (*Helvering v. Owens*, 305 US 468 (1939); *see, Reg.* § 1-165-7 (b)(1)(ii)).

The *Owens* principle does not apply to property used in the taxpayer's trade or business or held for the production of income. When such property is destroyed by casualty, the casualty closes out a loss equal to the full amount of the property's adjusted basis, all of which is sustained in a business or profit-oriented activity (*Reg.* § 1.165-7(b)(1) (last sentence). If property is converted from personal to business or income-producing uses, the lower of its value or adjusted basis at the time of conversion is used in computing a casualty loss, with adjustments for post-conversion events; *see, Reg.* § 1-165-7(a)(5)). In this instance, the casualty is merely the event that marks recognition of the loss, and the deduction is not limited to the loss caused by the casualty.

In computing the casualty loss when several integrally related assets (*e.g.*, land and improvements) are involved, the regulations distinguish property held for personal use from property used for business or income-producing purposes. In the latter situation, the loss is computed by reference to each "single, identifiable property" that is damaged or destroyed. (*Cox v. US*, 371 F.Supp. 1257, 1261 (ND Cal. 1973) [loss of "unexpected and unrealized appreciation collateral to [taxpayer's] original investment" not deductible], vacated and remanded, 537 F.2d 1066 (9th Cir. 1976). The appellate court relied in part on Regulation § 1.165-7(b)(3), Example 2 (ornamental shrubs), although there the adjusted basis of the damaged property exceeded its value after the casualty. *Reg.* § 1-165-7 (b)(2)(i); *see, Weyerhaeuser Co. v. US*, 92 F.3d 1148 (Fed. Cir. 1996) [volcanic eruption of Mt. St. Helens caused damage to taxpayer's timber holdings, including timber stands, logging road systems, and railroad; held, each of seven road systems, entire railroad, and each "subdivision of [the] taxpayer's forest holdings [aggregated for purposes of] tracking the adjusted basis in the timber' was single, identifiable property]; *Westvaco Corp. v. US*, 639 F.2d 700 (Ct. Cl. 1908) [taxpayer's timber damaged by storms and fires; held, all standing timber in district directly affected by each casualty was single, identifiable property); *Carloate Indus., Inc. v. US*, 354 F.2d 814 (5th Cir. 1966) [citrus grove land and trees not treated as single unit]; *Keefer v. CIR*, 63 TC 596 (1975) [office building and land separate units]; *see also, Rosenthal v. CIR*, 416 F.2d 491 (2nd Cir. 1969) [allocation of basis of timber tract to trees damaged in ice storm].)

According to the regulations, in determining the amount of a casualty loss, a property's fair market value immediately before and after the casualty shall "generally be ascertained by competent appraisal." (*Reg.* § 1.165-7(a)(2)(i).)

Supplemental instructions issued by the IRS stress the importance of the appraiser's knowledge of the conditions in the area and familiarity with the taxpayer's property, the value of photographs, and industry "bluebooks" for automobiles. (*IRS Pub. No. 547*, "Casualties, Disasters, and Thefts (Business and Non-business)" 4 (1998); *see also, IRS Pub. No. 561,* "Determining the Value of Donated Property" 4-6 (1996) [listing several sources of information on valuing particular items, including books, art objects and stamps]; *Bowers v. CIR*, 42 TCM (CCH) 1659 (1981) [computation of loss attributable to destruction by tornado of ornamental trees around taxpayer's home; analysis of relevant factors].)

The cost of repairs is "acceptable evidence" of the loss in value if the repairs are necessary to restore the property to its pre-casualty condition, are not excessive in amount, and are confined to the casualty damage, and if the property's value after the repairs does not exceed its pre-casualty value. (*Reg.* §1.165-7(a)(2)(ii).)

The latter condition is easily satisfied in some circumstances (*e.g.*, the replacement of a broken window), but some repairs almost inevitably add value to the property. (*See, Bailey v. CIR*, 47 TCM (CCH) 321 (1983) [loss from sudden subsidence of soil did not include cost of new retaining walls, which greatly reduced precasualty subsidence]; *Root v. CIR*, 42 TCM (CCH) 241 (1981) [full cost of repairs not deductible because they put properties in better condition than before casualty].)

The loss may exceed repair costs if repairs cannot restore the property to its pre-casualty value. (*See, Finkbohner v. US*, 788 F.2d 723 (11th Cir. 1986) [flood caused minimal physical damage to taxpayer's property but substantially diminished fair market value because extensive damage to neighboring property made prospective buyers wary of neighborhood; held, loss is full decline in fair market value, including portion resulting from buyer resistance, and is not limited to cost of repairs]; *Conner v. US*, 439 F.2d 974 (5th Cir. 1971) [decline in market value fully deductible, even though in excess of repair costs]; *Thornton v. CIR*, 47 TC 1, 6 (1966) ["in some cases fair market value of damaged property will decline to a far greater extent than can be measured by the yardstick of the cost of repair; once damaged, some property cannot regain its former fair market value no matter how carefully, painstakingly, or expensively repaired"].)

Section 165(k) sometimes allows a casualty loss deduction to a taxpayer ordered to relocate a residence as a result of a presidentially declared disaster. The measure of this loss is the difference between the residence's value before the disaster and its value after the disaster but before the relocation or, if less, the taxpayer's adjusted basis. (Staff of Joint Comm. on Taxation, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1166 (Comm. Print 1984).)

Appraiser's fees and other expenses incurred to establish a deductible loss are not part of the casualty loss itself, but they may be deducted under § 212(3) (expenses of establishing a tax liability) if the taxpayer itemizes deductions.

Insurance Recoveries, Other Compensation, and Salvage Value:

Amounts paid by *tort-feasors* are not casualty losses as to them, but they may be deducted under § 162 or § 212 if incurred in a trade or business or a profit-seeking activity. *See, Dosher v. US*, 730 F.2d 375, 377 (5th Cir. 1984) (no deduction for payment to owner of home that taxpayer negligently drove into; taxpayer's money is lost by casualty only if "the actual currency or coinage is physically damaged or destroyed"); *Tarsey v. CIR*, 56 TC 553 (1971).

Section 165(a) permits losses to be deducted only if "not compensated for by insurance or otherwise." Expenses incurred in obtaining reimbursement for a casualty loss are part of the loss or an offset against the recovery. (*See, Spectre v. CIR*, 25 TCM (CCH) 519 (1966) [loss fully covered by insurance, but taxpayer's legal fees deductible]; *Jeffrey v. CIR*, 12 TCM (CCH) 534 (1953).)

If compensation for the loss or the property's salvage value is collected in the year of the casualty, these offsets are taken into account at that time in computing the uncompensated loss, if any. Conversely, if there is no reasonable prospect of a recovery, the entire loss is taken into account when sustained, and any unexpected subsequent recovery is taken into income when received, subject to the tax benefit doctrine. (*See, Reg.* §§ 1.165-1(d)(2)(ii), 1.165-1(d)(2)(iii); *Montgomery v. CIR*, 65 TC 511 (1975) [insurance recovery taxed when received, in view of earlier deduction with tax benefit].)

In the intermediate situation, where the taxpayer has "a claim for reimbursement with respect to which there is a reasonable prospect of recovery," but this claim is not settled during the year of the casualty, "no portion of the loss" that may be reimbursed by this claim is deductible "until it can be ascertained with reasonable certainly whether or not such reimbursement will be received. (*Reg.* § 1.165-1(d)(2)(i); but see, *Hensler, Inc. v. CIR*, 73 TC 168 (1979) (acq. in result) [business expense deduction allowed for repairs to business property damaged by casualty, despite possibility of insurance recovery].)

According to the Tax Court, in the case of *Ramsay Scarlett & Co. v.* CIR, 651 TC 795, 811-812 (974), aff'd, 521 F.2d 786 (4th Cir. 1975):

A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor…. The standard for making this determination is an objective one, under which this Court must determine what was a "reasonable expectation" as of the close of the taxable year for which the deduction is claimed…. The standard is to be applied by foresight, and hence, we do not look at facts whose existence and production for use in later proceedings was not reasonably foreseeable as of the close of the particular year. Nor does the fact of a future settlement or favorable judicial action on the claim control our determination, if we find that as of the close of the particular year, no reasonable prospect of recovery existed. [*Emphasis added.*]

(*See, Jeppsen v. CIR*, 128 F.3d 1410 (10th Cir. 1997) [taxpayer had reasonable prospect of recovering funds stolen by stock broker]; *Dawn v. CIR*, 675 F.2d 1077 (9th Cir. 1982) [later suit evidenced reasonable prospect of recovery]; *Scofield's Est. v. CIR*, 266 F.2d 154 (6th Cir. 1959) [loss from trustee's diversions, discovered in 1935, deductible in 1948 on conclusion of litigation by successor trustee]; *Harwick v. CIR*, 184 F.2d 835 (5th Cir. 1950) [insurance for shipwreck]; *Johnson v. CIR*, 41 TCM (CCH) 849 (1981) [deduction in year of fire, not when lawsuit was finally settled, since prospect for recovery was very uncertain]; *Grace v. CIR*, 34 TCM (CCH) 992 (1977) [deduction for loss of interest in credit union denied for 1971 to taxpayer filing claim in 1974 to participate in judicial distribution of debtor's assets].)

In a common situation – a reasonable prospect of reimbursement, falling short of certainty – the taxpayer can deduct the loss currently only if and to the extent it exceeds the potential recovery. For example, a deduction may be taken for the amount by which the loss exceeds the taxpayer's insurance policy limit if the insurance is the only possible source of reimbursement. The balance of the loss must be held in abeyance pending resolution of the uncertainty, to be deducted if it exceeds the amount collected or if the claim is abandoned. In the latter case, the taxpayer must show that the claim has in fact been abandoned (*e.g.*, by the execution of a release) or that the abandonment did not serve an extraneous purpose. (*Reg.* § 1.165-1(d)(2)(i) ["objective evidence" of abandonment]).

The treatment of taxpayers who refrain from pressing valid claims against their insurers, presumably to guard against cancellation of coverage or increased premiums, has a long history. Although the courts first denied the deduction, later decisions allowed a covered loss to be deducted if the taxpayer unequivocally waived the insurance claim.

See, Hills v. CIR, 691 F.2d 997 (11th Cir. 1982) [after repeated burglaries, taxpayers did not file insurance claim, fearing non-renewal of policy; loss held not compensated for by insurance]; *Miller v. CIR*, 733 F.2d 399 (6th Cir. 1984) [same]; *Grigsby v. CIR*, 47 TCM (CCH) 620 (1982) [same].)

Congress intervened in 1986, denying the § 163(c)(3) deduction for any loss covered by insurance unless "the individual files a timely insurance claim with respect to such loss." (*IRC* § 165(h)(4)(E) [applicable to losses sustained in taxable years after 1986].)

Amounts received because of a casualty are not necessarily compensation for damage to or destruction of the taxpayer's property. For example, insurance proceeds compensating for loss of the use and occupancy of business property or for additional living expenses are not ordinarily considered compensation for property and, thus, do not reduce the taxpayer's casualty loss.

(Section 123 excludes insurance proceeds received for certain living expenses from gross income. Before § 123 was enacted in 1969, these amounts usually were gross income and did not reduce the casualty loss deduction. *Millsap v. Cir*, 387 F.2d 420 (8th Cir. 1968); *Rev. Rul.* 59-360, 1959-2 CB 75, declared obsolete by *Rev. Rul.* 72-619, 1972-2 CB 650. But see, *Conner v. US*, 439 F.2d 974 (5th Cir. 1971) [insurance compensating for temporary living quarters not gross income but reduces casualty loss]. *See also, Oppenheim's, Inc. v. Kavanagh*, 90 F.Supp. 107 (ED Mich. 1950) [business interruption insurance included in gross income as compensation for loss of profits].)

Similarly, benefits paid to victims of disasters may or may not be allocable to damaged property. (*See, Spak v. CIR*, 76 TC 464 (1981) [public agency's payment equal to value of house destroyed in flood is compensation for loss, but relocation payment is not]; *Rev. Rul.* 71-161, 1971-1 CB 76 [federal disaster relief benefits reduce casualty loss]; *Shanahan v. CIR*, 63 TC 21 (1974) [same]; *Rev. Rul.* 76-144, 1976-1 CB 17 [disaster relief in excess of casualty loss is nontaxable general welfare receipt]; *Rev. Rul.* 75-28, 1975-1 CB 68 [disaster relief received after casualty deduction taken in earlier year]. *See also, Rev. Rul.* 73-408, 1973-2 CB 15 [agricultural benefits included in gross income to extent in excess of farmer's basis in damaged crops].)

The $100 and 10 Percent Floors

Section 165(h) imposed two floors on the casualty loss deduction of § 165(c)(3). Section 165(h)(1) disallowed the first $100 of the loss from each casualty or theft. Under § 165(h)(2), the deduction for losses in excess of $100 per casualty or theft was limited to the amount by which the aggregate of these losses for the year (reduced by gains on insurance and other recoveries on account of casualties) exceeds 10 percent of the taxpayer's adjusted gross income.

(The 10 percent rule only applies in taxable years after 1983. The $100 floor was enacted in 1964. Until 1982, the statutory language applied the $100 floor to all "property not connected with a trade or business," but the regulations also exempted property held for the production of income. *Reg.* §§ 1.165-1(c)(3), 1.165-7(b)(4)(i)(b). *See, S. Rep.* No. 830, 88th Cong., 2nd Sess., reprinted in 1964-1 CB (pt. 2) 505, 562 [$100 floor limits personal losses "as distinct from those associated with a trade or business or transactions entered into for profit"]. After amendment in 1982, § 165 (c)(3) applies only to "property not connected with a trade or business or a transaction entered into for profit," and the floors only apply to losses "described in § 165(c)(3)." *IRC* §§ 165(h)(1), 165(h)(3)(B).)

Under the $100 rule, if one item of property is damaged in two or more separate casualties in a single taxable year, the floor is applied independently to each casualty. If two or more assets are damaged in the same casualty, however, the rule only strips $100 from the entire loss. (*Reg.* § 1.165-7(b)(4)(ii) [whether damage is from single casualty or from two or more separate casualties is question of fact; events closely related in origin, such as winds and flood caused by hurricane, are one casualty].)

When jointly owned property is damaged or destroyed, each owner's loss is subject to the $100 floor unless the owners are husband and wife, in which event there is only one $100 disallowance if they file a joint return (*IRC* § 165(h)(4)(B); *Reg.* § 1.165-7(b)(4)(iii)).

If property serving both personal and business purposes is damaged by casualty, the floor applies only to the part of the loss allocable to the personal element. For example, if an automobile used one half for business and one half for pleasure suffers an otherwise deductible loss of $150, the $75 business loss is fully deductible, but the $75 personal loss is eliminated by the $100 floor (*Reg.* § 1.165-7(b)(4)(iv)).

The 10 percent floor applies to the personal casualty gains and losses of every individual. The limitation also applies to estates and trusts, even though these entities do not usually use the concept of adjusted gross. An estate's or trust's adjusted gross income is specially computed for this purpose in the same manner as it is computed for individuals, except that administration expenses (if not taken as an estate tax deduction) are allowed in computing adjusted gross income. (*IRC* §§ 165(h)(4)(C), 165(h)(4)(D).)

A "personal casualty loss" is an excess over $100 of an uncompensated loss resulting from casualty property that is "not connected with a trade or business or a transaction entered into for profit." (*IRC* § 165(h) (3)(B). In applying these rules, a husband and wife filing a joint return are treated as one individual. *IRC* § 165(h)(4)(B).)

A personal casualty gain is realized, for example, if an insurance recovery exceeds the basis of property lost by casualty. Personal casualty gains and losses for the taxable year are aggregated.

If there is net loss:

1. The gains are included in gross income as ordinary income;

2. Losses are deductible to the extent of these gains; and

3. Losses in excess of gains are deductible only to the extent they exceed 10 percent of adjusted gross income.

(*IRC* § 165(h)(2)(A).) In this case, the gains and an amount of loss equal to the gains are included in determining adjusted gross income, with the consequence that personal casualty gains and losses neither increase nor decrease adjusted gross income. *IRC* § 165(h)(4)(A). An excess of losses over gains (to the extent deductible under the 10 percent rule) is an itemized deduction.

If there is net gain, each gain and loss is reported as capital gain or loss (*IRC* § 165(h)(2)(B)). In this situation, the gains and losses are included in computing adjusted gross income. (*IRC* § 62(a)(3).)

Chapter 3 – Ancillary Problems

Year of Deduction:

Section 165(a) allows a deduction for "any loss sustained during the taxable year." This ordinarily means that the loss is to be deducted in the year of the casualty itself, but there are several qualifications and exceptions to this general principle:

1. Delayed Damage: In unusual circumstances, a taxpayer may be unable to determine promptly whether a storm or other casualty has damaged property or, if so, the extent of the loss. In such a case, the loss is not "sustained" until the effects of the casualty can be observed and evaluated.

(*US v. Barret*, 202 F.2d 804, 806 (5th Cir. 1953) [freeze in winter of 1943-1944; damage "latent and uncertain" until 1946, when remedial efforts abandoned and trees removed; held, although "injury" occurred in 1943-1944, "loss" was not sustained until it became "ascertainable" in 1946); *Oregon Mesabi Corp. v. CIR*, 39 BTA1033 (1939) (acq.), appeal dismissed, 109 F.2d 1014 (9th Cir.1940) [fire killed trees in 1933; timber rendered worthless when attacked by insects and fungi in 1934 and 1935; held, losses sustained in 1934 and 1935 as well as in 1933].)

2. Reimbursement Claims: The taxpayer has a reasonable prospect of recovering the loss from an insurer or tort-feasor, the deduction must be postponed until the claim is resolved, settled, or abandoned.

3. Disaster Losses: To speed up economic recovery from widespread disasters, § 165(i) permits taxpayers, at their election, to deduct casualty losses in the taxable year immediately preceding the year of a disaster if it is officially declared eligible for federal assistance under the Disaster Relief and Emergency Assistance Act.

(*See, Reg.* § 1.165-11. For lists of disasters qualifying under § 165(i) during various years, *see, Rev. Rul.* 99-13, 1999-10 IRB 4 (1998); *Rev. Rul.* 96-13, 1996-1 CB 18 (1995); *Rev. Rul.* 95-17, 1995-1 CB 10 (1994); *Rev. Rul.* 94-14, 1994-1 CB 72 (1993); *Rev. Rul.* 92-111, 1992-2 CB 58 (1992); *Rev. Rul.* 91-69, 1991-2 CB 38 (1991); *Rev. Rul.* 91-10, 1991-1 CB 48 (1990). *See, Matheson v. CIR*, 74 TC 836 (1980) (acq. in result) [invalidating 90-day time limit imposed by *Reg.* § 1.165-11(e) for revoking election].

Section 165(i) applied to both personal casualty losses and to losses to property used in a trade or business or acquired in a transaction entered into for profit, which are governed by § 165(a), rather than § 165(c)(3). *See, Reg.* § 1.165-11(a).

Section 165(i) also applies to condemnation and relocation losses deductible as casualty losses under § 165(k).)

Chapter 4 - The Tax Benefit Rule

Generally, the full amount of any recovery of a previously deducted or credited amount must be included in gross income. However, under the tax benefit rule, a previously deducted or credited amount is not included in gross income to the extent the deduction or credit did not reduce the amount of tax imposed in the prior year. Code Section 111. In other words, taxpayers must include a recovery in income in the year the recovery is received, but only up to the amount by which the deduction or credit the taxpayer took for the recovered amount reduced the taxpayer's tax for the earlier year.

The total of all taxable recoveries are generally reported as other income on Form 1040. Form 1040A or Form 1040EZ may not be used. However, refunds of state and local income taxes must be reported separately on their own line on Form 1040.

A taxpayer who receives a state or local income tax refund of $10 or more will receive a payee statement during January of the following year on Form 1099-G, Certain Government Payments, reporting the refund. Code Section 6050E.

Taxpayers who recover an item from the same tax year are not required to include the recovery in income except to the extent it exceeds the amount of the item. For example, a taxpayer who receives a property tax rebate in the same year the taxes were paid is not required to include the rebate in gross income except to the extent that the rebate exceeds the real property tax paid by the taxpayer. The amount of the rebate, however, reduces the taxpayer's real property tax deduction. CCM 200721017.

Common recoveries include refunds, reimbursements, and rebates of itemized deductions, and may also include some non-itemized deductions (such as previously deducted bad debts) as well as items for which the taxpayer previously claimed a tax credit. See Reg. Section 1.111-1(a)(2). The reimbursement of a previously deducted casualty or theft loss may be a recovery of an itemized deduction. Reg. Section 1.165-1(d)(2)(iii).

Refunds of federal income taxes are never included in income because they are never allowed as a deduction from income.

Not all refunds are treated as recoveries. For example, where a taxpayer claims a deduction under Code Section 164 for his real property taxes, and in the next year the taxpayer receives a state income tax credit against those real property taxes, the credit is not a taxable recovery of the real property taxes. Instead, the taxpayer's state income tax, which is also deductible under Code Section 164, is reduced. However, if the state income tax credit is refundable, the amount by which the credit exceeds the taxpayer's state income tax is includable in income as a recovery of real property taxes. CCA 200842002.

A recovery does not include the gain resulting from the receipt of an item which exceeds the deduction or credit previously allowed for such item. For example, if a $100 bond originally purchased for $40 and later deducted as worthless is collected on to the extent of $50, the $10 gain is not a recovery and cannot be excluded from income under the tax benefit rule. Reg. Section 1.111-1(a)(2). Similarly, if a recovery of state taxes paid exceeds the amount of tax actually paid, then the excess is not a recovery and is includable in gross income. CCM 200504027. Also, in the case of a recovery of a previously deducted charitable contribution, if the property returned by the qualified charitable organization has appreciated in value, the amount subject to the tax benefit rule is limited to the value of the property when it was originally contributed. (Rev. Rul. 76-150, 1976-1 C.B. 38; Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967).)

The addition of a carryover that has not expired by the year of recovery is treated as a tax benefit. Rosenburg v. Commissioner, 96 T.C. 451 (1991). Because the taxpayer received a tax benefit from the additional carryover, the carryover is treated for purposes of the tax benefit rule as decreasing the taxpayer's tax in the year the carryover was generated. Therefore, the recovery of the item that generated the carryover must be included in gross income in the year of recovery even though the carryover has not yet reduced any tax. Code Section 111(c). Similarly, if a bad debt arising from worthless securities or from certain non-business bad debts is treated as a loss from the sale of a capital asset, the recovery of the bad debt is subject to the tax benefit rule regardless of whether the bad debt generated capital losses or ordinary losses, or whether the loss was used as a deduction in the year the loss arose or was instead treated as a capital loss carryover. Reg. Section 1.111-1(a)(4). If the bad debt generated a capital loss, then the recovery amount is treated as capital gain. Likewise, the recovery of an ordinary loss would be treated as ordinary gain. (Deely v. Commissioner, 73 T.C. 1081 (1980); Arrowsmith v. Commissioner, 344 U.S. 6 (1952).)

The recovery of an itemized deduction is eligible for the tax benefit rule only if the taxpayer elected to itemize her deductions for the taxable year in which the deduction could be claimed, rather than taking the standard deduction. See Rev. Rul. 70-86, 1970-1 C.B. 23. Further, the recovery of an item that was previously claimed as an itemized deduction is includable in income under the tax benefit rule in an amount equal to the lesser of (1) the amount of the recovery or (2) the amount by which the itemized deductions exceeded the standard deduction. Rev. Rul. 92-91, 1992-2 C.B. 49.

A computation statement should be attached to the return to show why the income reported due to the tax refund is less than the amount shown on Form 1099-G, Certain Government Payments. IRS Publication 525, Taxable and Nontaxable Income.

Chapter 5 - Net Operating Losses

Carrybacks and Carryforwards (General Rule)

After the statutory net operating loss for a taxable year has been determined, the amount of the NOL deduction for that year is calculated based on the amount of the statutory loss and any carrybacks and carryforwards of losses from other years. A loss may be carried only to certain years and must be carried to them in a specified order.

An NOL generally can be carried back to each of the two taxable years preceding the loss year (Code Section 172(b)(1)(A)(i)) and carried forward to each of the 20 taxable years following the loss year. Code Section 172(b)(1)(A)(ii). However, small businesses can elect to carry back any NOL for 2008 back three, four, or five years. See Section 48.3(b)(1). Similarly, any NOL for any taxable year ending during 2001 or 2002 may be carried back to each of the five taxable years preceding the loss year, although the taxpayer can elect not to have this provision apply.

NOLs arising in taxable years beginning before August 6, 1997 generally could be carried back three years and carried forward 15 years. (Reg. Section 1.172-4(a)(1)(ii); Young v. United States, 103 F. Supp. 12 (W.D. Ark. 1952), aff'd, 203 F.2d 686 (8th Cir. 1953).)

Exceptions

Small businesses can elect to carry back losses for 2008 tax years three, four, or five tax years. Similarly, a longer carryback period was available for NOLs arising in 2001 and 2002.

In addition to these rules applicable to specific periods, some types of losses are subject to special rules on carrybacks. Such rules apply with respect to certain losses resulting from casualties, specified liability losses, excess corporate equity reduction interest losses, and losses relating to REITs. (Code Section 172(b)(1) Taxpayer Relief Act of 1997, Pub. L. 105-34, Sections 1082(a)(1) and (2).)

Small Business Losses for 2008

In general, small businesses can elect to carry back 2008 NOLs three, four, or five years, instead of two years. Code Section 172(b)(1)(H). This election applies to the taxpayer's NOL for any tax year ending in 2008, or, at the taxpayer's election, any tax year beginning in 2008. Code Section 172(b)(1)(H)(ii). It can be made for only one tax year. Code Section 172(b)(1)(H)(iii).

A small business for this purpose is any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) the average annual gross receipts (as determined under Code Section 448(c)) of which are $15 million or less. Thus, the election can be made by small businesses, partners in partnerships that are small businesses, shareholders in S corporations that are small businesses, and sole proprietors. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

In determining whether a partnership, S corporation, or sole proprietorship qualifies as an eligible small business, the gross receipts test applies at the partnership, corporate, or sole proprietorship level. Rev. Proc. 2009-26, 2009-19 I.R.B. 935. See Section 503.3(a) for aggregation rules that apply.

A partner in a partnership can make the election for its distributive share of the qualifying partnership income, gain, loss, or deduction that is both allocable to the taxpayer and allowed in calculating the taxpayer's applicable 2008 NOL. Similarly, an S shareholder can make the election for its pro rate share of the qualifying S corporation income, gain, loss, and deduction that is allowed in calculating the shareholder's applicable 2008 NOL. An owner of a sole proprietorship can make the election for the qualifying sole proprietorship income, gain, loss, and deduction that is allowed in calculating the taxpayer's applicable 2008 NOL. The amount of the taxpayer's applicable 2008 NOL that the taxpayer can carry back is limited to the lesser of the taxpayer's items of income, gain, loss, or deduction that are allowed in calculating the taxpayer's applicable 2008 NOL and are from one or more partnerships, S corporations, or sole proprietorships that qualify as eligible small businesses, or the taxpayer's applicable 2008 NOL. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

This election generally must be made by the due date, including extensions, for filing the taxpayer's return for the tax year of the NOL. Code Section 172(b)(1)(H)(iii). However, in the case of a tax year ending before February 17, 2009, it can be made at any time before April 17, 2009. Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(d)(2).

Once made, the election to use a carryback other than two years is irrevocable. Code Section 172(b)(1)(H)(iii).

A taxpayer can make the election either on an original return or by filing the appropriate form:

(1) A taxpayer makes the election on an original return by attaching a statement to the taxpayer's timely filed federal income tax return for the tax year in which the applicable 2008 NOL arises. The statement must state that the taxpayer is making the election and specify the length of the NOL carryback period elected by the taxpayer (3, 4, or 5 years). If the taxpayer's tax year of the applicable 2008 NOL ends before February 17, 2009, the taxpayer must make the election on or before the later of the due date (including extensions of time) of the taxpayer's return for that taxable year or April 17, 2009.

(2) A taxpayer that did not make the election on its original return can make the election by filing the appropriate form applying the NOL carryback period chosen by the taxpayer:

For corporations: Form 1139, Corporation Application for Tentative Refund, or Form 1120X, Amended U.S. Corporation Income Tax Return.

For individuals: Form 1045, Application for Tentative Refund, or Form 1040X, Amended U.S. Individual Income Tax Return.

For estates or trusts: Form 1045, or amended Form 1041, U.S. Income Tax Return for Estates and Trusts.

A taxpayer that makes the election by filing an amended return must file the return for the earliest taxable year to which the taxpayer is carrying back the applicable 2008 NOL. The taxpayer should not file an amended return for the applicable 2008 NOL taxable year. The appropriate form must be filed on or before the later of the date that is 6 months after the due date (excluding extensions) for filing the taxpayer's return for the taxable year of the applicable 2008 NOL or April 17, 2009. No statement or label is required with the appropriate form. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

The procedures in (2) also apply for taxpayers that want to revoke a prior election to revoke an election to forego the carryback period. In addition, the taxpayer should type or print across the top of the appropriate form "Revocation of NOL Carryback Waiver Pursuant to Rev. Proc. 2009-19." The taxpayer must file the revocation and new election under ?172(b)(1)(H) on or before April 17, 2009. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

If a taxpayer makes this election, the special rule for losses from casualties does not apply for that year. Code Section 172(b)(1)(H)(i)(III).

The IRS is to prescribe anti-abuse rules, including anti-stuffing rules, anti-churning rules, including rules relating to sale-leasebacks, and wash sales rules. Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1121(c).

Losses Resulting from Casualties

NOLs of individuals arising from a fire, storm, shipwreck, other casualty, or theft, and NOLs of a small business or a taxpayer engaged in a farming business attributable to losses incurred in federally declared disaster areas, may be carried back for three years. Code Section 172(b)(1)(F). However, qualified disaster losses incurred in 2008 and 2009 can be carried back for five years. Code Section 172(b)(1)(J). In addition, these amounts may be deducted for alternative minimum tax purposes. Code Section 56(d)(3).

Qualified disaster losses are the lesser of the sum of the deductible casualty for the taxable year attributable to a federally declared disaster occurring before December 31, 2010, and occurring in a disaster area and the deduction for the taxable year for qualified disaster expenses, or the net operating loss. Taxpayers can elect not to have the five year carryback apply. The election must be made by the due date, including extensions, of the taxpayer's return for the year, and once made is irrevocable. Code Section 172(j).

A small business is any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) the average annual gross receipts (as determined under Code Section 448(c)) of which are $5 million or less. A farming business is the trade or business of farming and includes the trade or business of operating a nursery or sod farm or raising or harvesting trees bearing fruit, nuts, or other crops, or other ornamental trees (other than an evergreen tree that is more than six years old at the time it is severed from the roots). Code Section 263A(e)(4).

Procedure

Unless the carryback period is relinquished, an NOL must be carried to the earliest of the taxable years to which it can be applied. Code Section 172(b)(2).

Any excess is carried over to the other taxable years, in order. Thus, unless an earlier year is permitted under one of the exceptions, an NOL is first carried back to the second preceding taxable year. The portion of the loss that remains unabsorbed in the second preceding taxable year is then carried to each of the other taxable years in chronological order. A 2003 NOL is carried back first to 2001. Any unabsorbed amount is carried to 2002. Any still-unabsorbed amount is then carried forward.

A taxable year that is shorter than a full twelve-month year is counted as a full taxable year in determining the years to which the loss may be carried. (Taxpayer Relief Act of 1997, Pub. L. 105-34, Section 1082(c).) Years for which assessment is barred are also counted. Calumet Industries, Inc. v. Commissioner, 95 T.C. 257 (1990). Similarly, the IRS takes the position that years discharged in bankruptcy are counted. FSA 200039007.

An individual taxpayer carrying back an NOL files either Form 1045, Application for Tentative Refund, or Form 1040X, Amended U.S. Individual Income Tax Return. Estates and trusts not filing Form 1045 must file an amended Form 1041, U.S. Income Tax Return for Estates and Trusts, for each carryback year to which the NOL is applied. An individual taxpayer carrying forward an NOL lists the NOL deduction as a negative figure on the "other income" line of Form 1040.

A corporate taxpayer carrying back an NOL files either Form 1120X, Amended U.S. Corporation Income Tax Return, or Form 1139, Corporation Application for Tentative Refund. Form 1139 may not be filed before filing the return for the NOL year, but if used must be filed no later than one year after the NOL year. If Form 1120X is used, it must be filed within three years of the due date, including extensions, for filing the return for the year of the NOL. A corporate taxpayer carrying forward an NOL enters the amount on Form 1120, Schedule K, line 12.

Every taxpayer claiming an NOL must attach a statement showing all the important facts about the NOL, including a computation showing how the taxpayer figured the NOL deduction. Reg. Section 1.172-1(c).

In the case of consolidated groups, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a pro rata basis. Reg. Section 1.1502-21T(b)(1).

If any part of a net operating loss is not absorbed by the end of the carryforward period, it is lost. Although the NOL provisions provide some measure of income averaging, they do not ensure that all losses are deductible. However, there are ways to ensure that an NOL carryforward is not lost.

Relinquishing the Carryback Period

A taxpayer may elect to relinquish the carryback period with respect to any net operating loss for any taxable year. Code Section 172(b)(3). If a taxpayer does not make this election and fails to carry back a loss to the earliest prior year, the amount of NOL that may be deducted in another year is reduced by the amount of the NOL that would have been absorbed in a prior year. (Eisenberg v. Commissioner, T.C. Memo. 1963-78; see Messina v. United States, 202 Ct. Cl. 155 (1973).)

Although carrying an NOL back to a preceding tax year typically results in an immediate refund, a taxpayer may wish to relinquish the carryback period if tax rates in the previous two years are lower than the rates expected in succeeding years. At higher tax rates, the same dollar amount of loss produces larger tax savings.

If an election to relinquish the carryback period is made, the entire carryback period must be relinquished. Code Section 172(b)(3). The taxpayer may not elect to forgo only certain years.

Under the special rules for NOLs arising in 2001 and 2002, however, a taxpayer may choose to carry losses back to the fifth preceding year or the second preceding year, or forego a carryback altogether.

Furthermore, the election, once made for any taxable year, is irrevocable for that year. (Code Section 172(b)(3). Because the election is irrevocable, a taxpayer cannot disregard an election based on a material mistake of fact. TAM 199937020. See also, Welch v. Commissioner, 204 F.3d 1228 (9th Cir. 2000) (when taxpayer did not properly make the election, he failed to establish that the alleged NOL had not already been absorbed).)

The IRS has provided a limited amount of relief from this rule for NOLs arising in 2001 and 2002 and for NOLS arising in 2008.

A bankruptcy trustee, however, has the authority to avoid a debtor's irrevocable election to carry NOLs forward as a fraudulent transfer. United States v. Sims, 218 F.3d 948 (9th Cir. 2000). Once an election has been avoided, it is as if it never happened, and the trustee can elect as he sees fit. Estate of Russell v. United States, 927 F.2d 413 (8th

Cir. 1991). Where a trustee in bankruptcy is barred by the bankruptcy law's statute of limitations from exercising the avoidance power, however, the election made by the bankrupt to relinquish the carryback period may not be challenged. In re Home America T.V.-Appliance Audio, Inc., 232 F.3d 1046 (9th Cir. 2000).

The election to relinquish the carryback period must be made by the due date (including extensions) for filing the taxpayer's return for the taxable year in which the NOL for which the election is to be in effect was generated. (In TAM 9144043, the National Office advised that notations written in the margin on the taxpayer's returns that included the word "elect" were affirmative statements that provided enough information to allow the losses incurred to be carried forward in accordance with an election under Code Section 172(b)(3).) The IRS does not have the authority to grant an extension of time for making the election. (PLR 8333001; PLR 8107111; PLR 8229035; PLR 8339056; PLR 8549057. See also PLR 8405041 (reaffirms position taken in PLR 8339056).)

The election is made by attaching a statement to the return for the taxable year indicating the section under which the election is being made and setting forth the information to identify the election, the period for which it applies, and the taxpayer's basis for making the election. Reg. Section 301.9100-12T(d). An election to forgo the carryback may be made in an amended return only if the amended return is filed before the due date of the original return. Reg. Section 301.9100-12T(b)(1). Despite this rule, the IRS has provided limited relief for NOLS arising in 2001 and 2002, as discussed in Section 48.3(e).

In Young v. Commissioner (83 T.C. 831 (1984), aff'd, 783 F.2d 1201 (5th Cir. 1986). PLR 8929033; (the election to relinquish the carryback period cannot be made on an amended return filed after the due date for the loss year, even if the original return filed did not show a loss).), the Tax Court held that failure to make a timely election in the manner prescribed irrevocably deprived the taxpayer of the right to forgo the carryback period, even though, in other documents filed, that taxpayer did not manifest an intent to forgo such period. Thus, a taxpayer who fails to comply with the requirement that the return be accompanied by a separate statement with information identifying the election has not made a valid election. Klyce v. Commissioner, T.C. Memo. 1999-198. The Tax Court has held an election to be valid, however, where it met the standards prescribed in the regulations, but the taxpayer cited the incorrect Code section. (Powers v. Commissioner, T.C. Memo. 1986-494, reaff'd, T.C. Memo. 1993-125. See also Carlstedt Assn. v. Commissioner, T.C. Memo. 1989-27.)

If the original return has been timely filed (by the extended due date) the election can still be made on an amended return filed within six months of the due date, excluding extensions, of the original return. Reg. Section 301.9100-2.

Rules for 2001 and 2002 NOLs and Tax Years

NOLs arising during 2001 and 2002 can be carried back five years, rather than the normal two years. Code Section 172(b)(1)(H), prior to amendment by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(a). A taxpayer may elect not to have the five-year carryback period apply. Code Section 172(k), prior to repeal by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(b). In this case, the normal two-year carryback period, or, if eligible, a three-year carryback period, applies, unless the taxpayer elects to forgo the carryback period entirely.

In general, the election to forgo the five-year carryback must be made by the due date, including extensions, of the return for the taxable year of the NOL and once made is irrevocable for that year. Code Section 172(k), prior to repeal by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(b). See Rev. Proc. 2002-40, 2002-1 C.B. 1096, for how to make this election.

Code Section 172(f)(1)(A) and (B). With respect to affiliated groups, the Supreme Court has held that an affiliated group's product liability loss must be figured on a consolidated, single-entity basis, not by aggregating product liability losses separately determined company by company. United Dominion Industries, Inc. v. United States, 532 U.S. 832 (S.Ct. 2001) rev'g 208 F.3d 452 (4th Cir. 2000).

See Sealy Corporation v. Commissioner, 171 F.3d 655 (9th Cir. 1999), affg, 107 T.C. 177 (1996)(relating to the deductibility of legal and accounting expenses); Host Marriott Corporation v. United States, 267 F.3d 363 (4th Cir. 2001), affd 113 F.Supp. 2d 790 (D. Md. 2000) (relating to the deductibility of interest accrued on federal tax deficiencies); Intermet Corporation & Subsidiaries v. Commissioner, 117 T.C. 133 (2001) (relating to the deductibility of state tax deficiencies and interest on federal and state tax deficiencies); United States v. Balsam Corporation, 232 B.R. 160 (E.D.Mo. 1997), aff?d, No. 98-1225EM (8th Cir. 1998) (relating to the deductibility of tort losses); Major Paint Company v. United States, 334 F.3d 1042 (Fed. Cir. 2003), affg sub nom. Standard Brands Liquidating Creditor Trust v. U.S., 53 Fed. Cl. 25 (Fed. Cl. 2002) (relating to the deductibility of capitalized bankruptcy costs).

Conclusion

For the reasons stated herein, Taxpayer casualty loss for the Property is increased by the $50,000 she expended (from her personal savings) to repair and renovate the Property. This additional $50,000 is an addition to the Taxpayer’s adjusted cost basis in the property.

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Gary S. Wolfe received his Juris Doctorate from Loyola Law School in 1982, where he was President of the Tax Law Society.

From 1982 through the present, Gary has been in private practice in Beverly Hills and Los Angeles.

Gary is an international tax attorney representing clients for IRS audits, international tax planning, and asset protection.

Previously, Gary was the managing partner of a tax and business law firm, which represented Fortune 500 companies (IBM, ITT) and financial institutions (Sterling Bank, First Charter Bank.) Gary now provides case management for international litigation.

In 1997, Gary completed the Team Beverly Hills civic leadership training.

From 1997-1999 Gary was Vice-President and Member of the Board of Trustees of The Greystone Foundation, Beverly Hills, California.

From 1995-2001, Gary was the Chief Financial Officer and a Member of the Board of Directors of the Le Faubourg Honore Homeowners Association, Beverly Hills, California.

Since 2004, Gary has been conducting private seminars throughout California on the IRS, International Tax and Asset Protection.

As of July 2017, Gary Wolfe has internationally published 18 books and 100+ articles on International Tax Matters. He has received 33 international tax awards from 11 different Global Expert Societies. Click here for complete list.

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