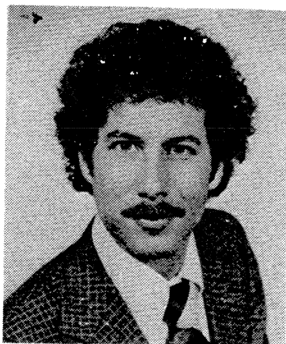
Casualty Losses from Storm Damage

By ERIC P. ROTHENBERG

Losses sustained from storm damage are deductible under Section 165. Three approaches for computing the loss have proven to be successful—the appraisal method, the cost-of-repair method and the hybrid method. The author analyzes these alternatives and, additionally, provides some notes on tax return preparation and documentation.



Eric P. Rothenberg, attorney and CPA, is a senior tax accountant with Arthur Andersen & Co., in Boston, Massachusetts.

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Many people suffered losses from storm damage to their house, trees, and shrubbery as a result of the heavy snows last winter. Such losses are deductible under IRC Section 165. The taxpayer must exercise great care in determining the amount of the loss, the extent and timing of the deduction and the proper inclusion of cleanup expenses. The following analysis details the care required for those determinations and additionally provides special notes on tax return preparation and documentation.

The Amount of the Loss

Three different approaches for determining the amount of the loss have been successful. Each is described below in its order of acceptance by the Internal Revenue Service.

Appraisal Method

Reliable appraisals of the value of the property immediately before and after the casualty are generally regarded as the best evidence of the decline in value measuring the amount of loss sustained. In this connection, the regulations provide:

> In determining the amount of loss deductible under this section, the fair market value of the property immediately before and

immediately after the casualty shall generally be ascertained by competent appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property.[1]

Note that, although the costs of appraisals, appraisal photographs and other evidence substantiating the amount of the casualty loss do *not* form a part of the casualty loss deduction, such costs are deductible as an itemized deduction by the individual taxpayer as a cost of determining his tax liability.[2]

The IRS suggests that an appraisal "be made by an experienced and reliable appraiser. The appraiser's knowledge of sales of comparable property conditions in the area, his familiarity with the property before and after the casualty, and the method he uses to ascertain the amount of loss are important elements in proving a casualty loss." [3] Since the measure of the loss is the decline in value, original costs will rarely be relevant except insofar as the issue of adjusted basis is concerned. However, where the asset in question was purchased shortly before the casualty, its cost may be relevant. Thus, it has been held that, where a residence was purchased ten months prior to the casualty event, original cost is indicative of the value of the residence before the casualty.[4] By the same token, the sales price of the property shortly after the casualty may be construed as the best evidence of "value after" notwithstanding the evidence of an appraisal, which would otherwise tend to indicate value to be less than sales price. It should be pointed out that, where appraisals detail a decline in value in an amount greater than cost to repair, and the taxpayer is unable to show that the property has not been brought to pre-casualty condition as a result of the repairs, the taxpayer will be in no position to claim a deduction in excess of cost to repair. In short, where cost of repair has brought the property to original condition, the courts will conclude that appraisals detailing the decline in value are not the most reliable benchmark for determining the amount of the sustained loss. And, where the measure of the decline in value clearly takes into account indirect loss, the cost of repair will be accorded great weight.

Cost-of-Repair Method

Where property is partially destroyed, the cost of repair to its original state may be regarded as acceptable evidence of the decline in value of the property resulting from the casualty.[5] However, the taxpayer must show: (a) the repairs are necessary to restore the property to its condition immediately before the casualty; (b) the amount spent for such repairs is not excessive; (c) the repairs do not care for more than the damage suffered; and (d) the value of the property after the repairs does not, as a result of the repairs, exceed the value of the property immediately before the casualty.[6] As a practical matter, the taxpayer may be confronted with the situation in which the repairs do not, in fact, restore the property to its original value, in which case the decline in value should be the measure of the loss. However, if a portion of the appraised loss is due to a stigma that attaches to the property in the minds of prospective purchasers as a result of the casualty rather than inherent damage that cannot be repaired, the taxpayer may find it difficult to deduct more than the cost of repair. Thus, it is the position of the IRS that the "reduction in value of property because it is in or near a disaster is not a casualty. A loss is allowed only for the actual physical damage to your property resulting from the casualty." [7] It should be recognized that, while the cost of repair is often competent evidence of the decline in value, it is not a substitute method of evaluation. Therefore, a showing of the cost to repair is not competent evidence to show the decline in value if that evidence is not indicative and corroborative of such decline. However, the taxpayer is entitled to deduct the amount of his loss (that is, the decline in market value as a result of the casualty) notwithstanding it exceeds the cost of repair, if such repair does not bring the property to its original condition.

Hybrid Method

Several cases suggest a third alternate hybrid approach to determine the post-casualty fair market value. This method computes the post-casualty fair market value by subtracting from the pre-casualty fair market value the cost of repairs actually completed plus the cost of repairs that still need to be done to restore the

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[1] Reg. Sec. 1.165-7(a)(2)(i).

[2] "Tax Information on Disasters, Casualty Losses, and Thefts," IRS Pub. 547, 1978 ed., p. 2 (hereafter, "Tax Information").

[3] Id.

[4] *John A. Babett*, CCH Dec. 27,980(M), 25 TCM 637 (1966).

[5] Reg. Sec. 1.165-7(a)(2)(ii).

[6] Id.

[7] Tax Information, cited at footnote 2, at 3.

property to its pre-casualty physical condition.[8] This method, as well as the above method, suggests an important question: Must the cost-of-repair methods be followed with actual expenditures for repair? In *Lutz v. Commissioner,*[9] the Court made mention of the fact that the taxpayer did not have the estimated repairs completed, but the Court rested its opinion on evidence that the repair work actually completed did bring the property back to its pre-casualty condition. It also noted that the estimate of repairs included exploratory work to more accurately determine the extent of damage. Since the taxpayer had never had any of the exploratory work done, the estimate failed as evidence of the decline in value. Therefore, the estimate for repairs had not failed as the measure of loss because the taxpayer had not followed with actual expenditures. Rather, it failed because actual costs could only be determined after repairs were begun. Thus, to the extent the taxpayer puts forth estimates of repair work, the taxpayer must ensure that the estimate accurately reflects what expenditures would be necessary.

Determining the Amount and Timing of Deduction

Basis Limitations.—Casualty losses in excess of the adjusted basis of the property damaged or destroyed are not deductible.[10] If the adjusted basis in the property is zero, there is no deductible loss. Most property is acquired by purchase, and its basis is its cost. But, if property has been subject to depreciation, previous casualty losses or other recovery adjustments, the basis of the property must be reduced to reflect these amounts. Any expenditures for capital improvements should be added to basis. The result of the above increases and decreases is the adjusted basis of the property. If the property is acquired in a taxable or nontaxable exchange, if it is involuntarily converted into money or other property, or if it is acquired by gift, then the adjusted basis of the property must be determined under Section 1011.

Insurance Limitations.—Insurance proceeds or other compensation received or *expected* to be received must be used to reduce the amount of the loss. Section 165(a) states that the deductible loss is that portion of the loss "not compensated for by insurance or otherwise." Several court decisions have held that phrase to mean "not covered by insurance."[11] Most recently, in *Bartlett, II v. U. S.,*[12] the court held that, where the taxpayer failed to assert a claim against his insurance company, the loss did not "arise from fire, theft, shipwreck, or other casualty." Instead, the loss was held to be due to his deliberate election not to collect money under a contract of insurance. Although at least one Tax Court is split on this issue,[13] the taxpayer must give careful consideration to the IRS position that "compensated" means "covered."

The deductible loss must also be reduced by the amount of anticipated insurance recovery, even though the taxpayer does not receive payment until a later tax year. If he later receives less than the amount originally estimated, the difference may be deducted in such later year. If the taxpayer receives more than the original estimate, he must include the excess recovery in income for the year of recovery. The tax for the prior year, cannot be recomputed through an amended return.[14]

Timing the Deduction.—Whether a casualty loss is sustained on business or personal property, the rules for the year of deduction would be the same. Ordinarily, they are deductible in the year in which sustained, regardless of when the damages are repaired or the property is restored.[15] A loss is sustained during the taxable period if it is evidenced by a closed and completed fact, fixed by identifiable events from which it can be determined that a loss has in fact been sustained. Thus, if an actual physical loss occurs as a result of fire, flood, hurricane or other casualty, and the extent of the damage is fixed, then a loss is sustained in the taxable year when the casualty occurs. Then, except as provided below, the loss is deductible in the year sustained.

The Code contains a special relief provision for a taxpayer who sustains a loss attributable to a disaster occurring in an area that is later determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974.[16] Under this provision, the taxpayer may elect to deduct his loss on his return for the immediately preceding tax year. If the election is made, the loss will

[8] *Anne Marie Hagerty*, CCH Dec. 33,094(M), 34 TCM 356 (1975); *Miree v. U. S.*, 62-2 USTC ¶ 9756 (DC Ala.).

[9] CCH Dec. 33,812(M), 35 TCM 661 (1976).

[10] *W. A. Belcher*, 60-2 USTC ¶ 9733 (DC Ala.); Sec. 165(b); Reg. Sec. 1.165-7(b)(1).

[11] *Bartlett, II v. U. S.*, 75-2 USTC ¶ 9648, 397 F. Supp. 216 (DC Md.); *Morgan v. Commissioner*, CCH Dec. 35,060(M), 37 TCM 524 (1978).

[12] Id.

[13] *Axelrod v. Commissioner*, CCH Dec. 30,771, 56 TC 248 (1971).

[14] Reg. Sec. 1.165-1(d)(2)(iii).

[15] *S. S. White Dental Mfg. Co.*, 1 USTC ¶ 235, 274 U. S. 398 (1927).

[16] Sec. 165(h).

be treated as having occurred in such preceding year. For example, a calendar-year taxpayer who suffers a disaster loss any time during 1978 may elect to deduct it on his 1977 return, or he may wait and deduct it on his 1978 return in the regular manner.

Cleanup Expenses

The expenses of removing debris and the cost of required cleanup work have been held to constitute part of the deductible casualty loss.[17] Until recently, the IRS apparently took a contrary view unless the cleanup expense related to business property, in which case the expenditures would be deductible as a business expense. Presently, however, it is the position of the IRS that the cost of debris removal may be used, like the cost of repairs, as evidence of the amount of the casualty loss sustained.[18] The IRS also points out that the cost of debris removal must be capitalized and added to the basis of the property. The problem encountered in substantiating the amount of cleanup expenses is essentially evidentiary in nature. If the taxpayer is relying on the cost of repair to original condition as evidence of the decline in value, he should ensure that such evidence includes the amount of cleanup expenses. If the taxpayer is relying on the evidence of the value before and after the occurrence resulting in loss, he should ensure that the evidence of the value after the casualty takes into account the amount of cleanup expenses to be incurred. Where the cost of repairs to restore the property to original condition is used as the measure of loss, cleanup expenses have been held to be considered part of the repair cost. Aside from cleanup expenses, the courts appear to take a narrow view concerning the expenses incurred that are incident or related to the casualty event itself.

Special Notes

Tree Damage.—There was extensive tree dam- to Massachusettes homes from the blizzard in February, 1978. Several points should be borne in mind in determining the amount deductible. In the case of damage to, or destruction of, ornamental trees and shrubs, the cost of replacement (though not dispositive of the decline in value) is regarded by the IRS as acceptable evidence of the decrease in value.[19] Although the IRS's ruling was basically concerned with nonbusiness personal property, there is no reason to assume that this approach is not equally applicable to business property. But, the replacement of *mature* trees and shrubs with seedlings is hardly a replacement of equal value. In other words, the actual decline in value will likely have been *greater* and should be advanced as the amount of the loss, if it can be shown. Some taxpayers, who replaced lost trees with seedlings and sought the full loss, have attempted to value the lost trees under formulas that have appeared in articles.[20] Some of the formulas provide for determining the value by multiplying the number of square inches in a cross-section of the tree at a certain height by a specified value. Others provide adjustments for such additional factors as height, species, location, and condition of the trees. These methods, which are considered to produce a hypothetical value, have been explicitly rejected by the IRS [21] and are likely to be challenged.

Secondly, and this point bears on the type of property, is the matter of basis. Casualty losses in excess of cost basis of the property lost are not deductible. However, in the case of personal assets, the trees and shrubs are regarded as an integral part of the real estate and no separate allocation is necessary. If the taxpayer originally planted the trees and shrubs, his basis therein is likely to be less than the decline in value. However, since the trees and shrubs are regarded as an integral part of the realty, the measure of the loss, in terms of the adjusted basis limitation, is limited to the entire basis of the realty, not that of the trees or shrubs. Thus, the taxpayer may be entitled to a deduction based on the decline in value, which is greater than the adjusted basis which would have been allocated to the shrubs had that been required. This is true even where the basis in the trees is known.[22]

Casualty Loss Documentation.—The burden of proof is upon the taxpayer to substantiate the fact that he had a loss and the amount thereof. The matter of adequate and complete proof is extremely important. The cases indicate that a taxpayer should be prepared to support a claim for a casualty loss deduction with evidence showing:[23]

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[17] *Lena L. Steinert,* CCH Dec. 23,877, 33 TC 447 (1959); *Bruno v. Erikson,* 67-1 USTC ¶ 9400 (DC Ore., 1967); *Ralph Walton,* CCH Dec. 24,827(M), 20 TCM 653 (1961).

[18] Rev. Rul. 71-161, 1971-1 CB 76 (1976).

[19] Id., and Rev. Rul. 66-303, 1966-2 CB 55.

[20] See, for example, "How to Figure What Your Tree's Worth," Robert T. Van Tress, *Chicago Daily News,* September 11, 1959.

[21] Rev. Rul. 68-29, 1968 CB 74.

[22] Reg. Sec. 1.165-7(b)(3), ex. 3.

[23] *Greenwood Packing Plan,* CCH Dec. 12,418, 46 BTA 430 (acq.); *Kraus,* CCH Dec. 18,648(M), 10 TCM 1071.

(1) The nature of the incident constituting the alleged casualty; when the alleged casualty occurred; and that the loss occurred as a direct result of the casualty.

(2) That the taxpayer is the owner of the property with respect to which a casualty loss deduction is claimed.

(3) A description of the damaged property and its location.

(4) The cost or other basis of the property, evidenced by purchase contract, deed, etc. (improvements should be supported by checks, receipts, etc.).

(5) If the property is depreciable, depreciation allowed or allowable.

(6) The fair market value of nonbusiness property immediately before and after the casualty as ascertained by complete and competent appraisal.

(7) Salvage value.

(8) The amount of any insurance or other compensation recovered or expected to be received for damages to the property, including the value of repairs, restoration, and cleanup provided without cost by disaster relief agencies or others.

Return Preparation.—Taxpayers may deduct losses only on property held for personal use if they elect to itemize their deductions. Furthermore, the deduction under Section 165(c)(3) of the Code in respect of a loss from a single casualty is limited to that portion of the loss that is in excess of $100. When applying the $100 limitation, you must determine whether there is a single casualty or number of casualties. A separate $100 limitation applies to each casualty.

Conclusion

To preserve the amount of the loss, a competent appraisal of the decline in fair market value of the entire realty should be obtained. An acceptable alternative is to measure the loss by costs of repair. The amount deductible is limited to the adjusted basis of the entire realty and is subject to the $100 exclusion. Cleanup expenses may be considered in the appraisal or may be added to the cost of repair or replacement. The loss may be deductible in the year sustained or, if a disaster loss, in the prior year. And, most important, great care should be taken to ensure complete and adequate documentation of the loss. ●

Tax Cut Complaints

In a letter to Finance Minister Jean Chrétien January 23, the Consumers Association of Canada complained that consumers are not seeing lower prices as a result of the drop to 9 from 12% in sales tax announced by the Minister in his November 16 budget.

The consumer group claimed that manufacturers and distributors are reaping the benefits. It suggested that the government collect its tax at the retail level instead of at the manufacturing level so that consumers would be sure to benefit from the reductions.

Mr. Chrétien said that there has been no indication the cut is not being passed on but suggested that the government expected there would be some cases where it was not.

Consumer Affairs Minister Warren Allmand said that his department has received very few complaints that manufacturers are not passing on the sales tax cut. He added, however, that there is no doubt that "we won't have the same capacity as the AIB (Anti-Inflation Board) to monitor prices."

Saskatchewan New Democratic Party MP Lorne Nystrom is seeking a government commitment that one agency be assigned to make sure that "the $1-billion cut is not kept by the corporations as a gift, but is indeed passed on to the consumers where it belongs."—CCH OTTAWA LETTER, Vol. XIV, No. 5, Jan. 29, 1979.