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CASUALTY LOSSES IN ALL THEIR GUISES: BUT WHAT IS DEDUCTIBLE?

by Robert W. Wood

The tax treatment of casualty losses has hardly been considered a sexy topic among transactional tax lawyers, nor by high-level tax lawyers who plot and plan for the most favorable tax treatment for companies and entrepreneurs. Instead, by its very nature, it invites discussion of something that did not go well. It is, in the words of one tax lawyer, damage control.

The law surrounding the tax treatment of casualty losses has largely been influenced by a piecemeal episodic fluttering of cases, many inconsistent and unhelpful. Much of the discussion, for example, focuses upon just how unexpected the loss truly is (as if this should make a world of difference). It is not possible in these few pages to give a fair and unbiased (if I am even capable of writing in an unbiased way!) account of the tax treatment of casualty losses. Instead, I will give an episodic review of some of the more recent cases, with the particular case on unusual.

O.J. Cases

Let's begin with the notion that casualty losses may not start with termites under the property (and the inevitable debate about whether the termite loss was sudden and unexpected — please!). Instead, consider *Gerald Chamales v. Commissioner*, T.C. Memo 2000-33 (Feb. 3, 2000). In this case, the taxpayers contract to purchase a \$2.85 million home adjacent to the Brentwood Park residence of O.J. Simpson. Bad luck for the taxpayers. They contracted to buy the house shortly before the murders of Nicole Brown Simpson and Ronald Goldman. Nonetheless, the taxpayers went through with the purchase. Thereafter, though, they claimed a \$750,000 casualty loss on their tax return (the tax return was for 1994, the appropriate year).

The whopping casualty loss was based on estimates by their local real estate agents that the value of the property had declined between 30% and 40% as a result of the media frenzy following O.J.'s arrest. Specifically, the taxpayers argued that the media publicity, the sightseers in the area, and all of the attendant refuse (and even urination and defecation), permanently reduced the value of their property. Nonetheless, the taxpayers demolished most of the home in late 1994 and began a reconstruction project costing almost \$2 million. Other neighbors performed similar renovations.

In Tax Court, Mr. and Mrs. Chamales claimed the casualty deduction. The Tax Court denied the deduction without a great deal of difficulty. Public interest at the time continued in Simpson's former residence (particularly at the time of trial) and the court found that the difficulties of the taxpayers were not the kind of damage that would justify a Section 165 casualty loss. Indeed, the public and media attention was not the type of occurrence that would constitute a casualty. The court cleverly analogized this situation to a fire, storm or shipwreck (no comparison here!) and found that the situation could not be classified as an "other casualty."

Furthermore, the court concluded that only physical damage to or permanent

abandonment of the property could be recognized as a deductible casualty loss. Any damage here was a mere temporary decline in market value, clearly not something that would spell physical damage to or require permanent abandonment of the property.

The court cited one other federal case involving somewhat similar facts (at least based on the double murders alleged to have been committed by O.J. Simpson). That case was *Caan v. U.S.*, 99-1 U.S.T.C. ¶50,349 (Cent. Dist. Calif. 1999). More about the Caan case in a moment. Citing the Caan case, though, the Tax Court in Chamales noted that the Ninth Circuit (out of which both Caan and Chamales came) only recognizes casualty losses that arise from physical damage to property. The murders and later media frenzy were physical acts, but, according to the court, they did not cause physical damage or a casualty loss to the taxpayers' property.

No Penalty

Interestingly, although rather firmly denying the deduction, the Tax Court in Chamales refused to impose the 20% accuracy-related penalty under Section 6662 that the IRS had so vehemently argued. The Tax Court found that the taxpayers established reasonable cause and good faith for the deduction taken on their return. They had contacted their real estate agent about the decline in the value of the property. They had sought advice from their accountant concerning the propriety of the casualty loss deduction. So, said the court, information on the return also made full disclosure of the reason for the claimed deduction. Disclosure, as we all know, tends to cure penalty impositions.

The Caan case preceded Chamales in its treatment of these arguments.

Surprisingly, the Internal Revenue Code and the Treasury Regulations do not define the term "casualty loss." Courts have determined on a case-by-case basis what constitutes such a loss. To satisfy the current test, the event causing a loss must be identifiable, damaging to property, sudden, unexpected or unusual in nature. *White v. Commissioner*, 48 T.C. 1334 (1980); *Portman v. United States*, 683 F.2d 1280 (9th Cir. 1982).

Caan argued that the murders were an identifiable event. The Caan's residence which they just purchased in 1993, less than one year before the murders, is only a few blocks from O.J. Simpson's now infamous former residence. As a result of the double murders, they argued, the taxpayers have suffered substantial and irreparable damage to the value of their home. The damage was quantified at over \$400,000 by an accredited appraiser. This diminution in value was coupled with physical damage to the Taxpayer's property from vagrants, tourists and media personnel who deposited trash on their property, urinated on their lawn, defecated in their bushes, and continue to cause excessive noise, traffic and pedestrian flow. The Taxpayers also argued that their safety was compromised by vagrants. The diminution in value, the physical damage, the cost of the fence, and the increased flow from outsiders are all calculable damages to the Taxpayers' property.

The government argued in response that the legislature never intended the term casualty to include an event caused at the hands of man. This does not explain how fire appears on the list of casualties appearing in Code Section 165(c)(3). Fire, although occurring in nature, is more often than not a man made disaster, as are shipwrecks,

which are predominantly caused by human error. Indeed, if man made casualties are not deductible losses (as the government now asserts) why does Internal Revenue Service Publication 547 explain how to calculate damages caused by car accidents, which are all caused by man? As the Internal Revenue Service's own publication seems to recognize, jurisprudence has been open to casualty losses created at the hands of man. Allowable losses have included, car accidents, a diamond ring accidentally placed in a garbage disposal and destroyed, and even negligent workmanship in building a home. Carpenter v. Commissioner, 25 T.C.M. 1186 (1966) (diamond ring); Marx v. Commissioner, 62 T.C.M. 1370 (1991) (negligent workmanship). The Taxpayers disagreed with the government's position that murder, a man made casualty, is excluded from the recoverable casualty losses.

The act of murder was accomplished in an instant and within days, frenzy surrounding the event began to have its effect on the Taxpayer's property. Given the magnitude of the damage to the property, "days" is a very short amount of time. For perspective, even slow casualties such termite damage, and damage to trees caused by beetle infestation, have qualified as sudden. Rosenberg v. Commissioner, 198 F.2d 46 (8th Cir. 1952) (termites); and Black v. Commissioner, 36 T.C.M. 1347 (1977) (beetles). The casualty event of murder was instantaneous, but the effects have been ongoing and permanent.

Perhaps the leading case that might have helped the taxpayers in both Caan and Chamales was Finkbohner v. United States, 788 F.2d 723 (11th Cir. 1986). There, the taxpayers claimed a casualty loss to their home as the result of a flood that occurred in April and May of 1980. Floodwaters from an adjacent creek entered and severely damaged several of the dozen homes in the taxpayer's cul-de-sac, but only damaged the grounds and driveway of the taxpayer's home. Based on expert testimony, the taxpayers claimed a greater than 25% reduction in the value of their home. Additional testimony showed that even the local tax assessor reduced the property tax assessment on their home. The loss, except for very minor physical damage, was based on permanent damage to the marketability of their property leading to permanent buyer resistance.

The permanent buyer resistance was based on factors that had forever changed and markedly diminished the amenities and attractiveness of their home. In Finkbohner, the taxpayers noted that local authorities demolished seven of the twelve homes on the Finkbohner's cul-de-sac forbidding reconstruction. The loss of neighbor homes placed the Finkbohner's home in a "lonesome neighborhood, more exposed to crime, and with diminished privacy in view of the proximity of heavily traveled streets and bridges."

The government in Finkbohner failed to prove that the loss should be limited to physical damage, and that "buyer resistance" should be excluded from consideration. "Buyer Resistance," according to the defendant, is "any reason an otherwise 'willing buyer' might have, except the cost of physical repair, for not paying the full asking price for the property." As the Circuit Court pointed out, the government's semantics allow for a loss of fair market value as required by the regulations, but in reality the defendant only allows deductions to the extent of physical damage.

The Finkbohner court went on to state that Treasury Regulations do not address the problem of fair market loss created by buyer resistance. The government argument that physical damage is required, in the view of the court, pays "lip service" to the fair market value loss calculation required by Section 165(c)(3) and the corresponding

regulations. Any change to the formula that a reduction in fair market value constitutes a loss should be made by the [“purpose and policy” of the] statute itself.

In its insightful reasoning the Finkbohner court recognized that a case of buyers resistance based on permanent damage, and not on a temporary fluctuation due to “the fresh recollection of a disaster” or the fear of future casualty, qualifies as a casualty loss.

Other Casualty Loss Situations

It would be remiss to think that most of the interesting current casualty loss cases involve the double murders which brought such notoriety to the Simpson estate. These two cases aside, there are still other casualty loss cases that deserve mention. In particular, it is always interesting (and controversial) when the IRS revokes one of its own published rulings, either concluding that its own position was too harsh, or that its position was too liberal (shame on them!). Indeed, sometimes, the IRS is prevailed upon to change a published ruling position because of case law.

Such was the position with two recent court decisions and the IRS’ response. The two court decisions were Westvaco Corp. v. U.S., 639 F.2d 700 (Court of Claims 1980) and Weyerhaeuser v. U.S., 92 F.3d 1148 (1996), reversing in part and affirming in part, 32 Fed. Cl. 80 (1994), cert. denied, 519 U.S. 1091 (1997). In light of these cases, the IRS reconsidered and revoked two revenue rulings that dealt with timber casualty losses. Those two rulings are Revenue Ruling 69-9, 1966-1 C.B. 39 and Revenue Ruling 73-51, 1973-1 C.B. 75.

What’s All the Fuss?

These prior rulings and cases involve the requirement that a casualty loss must be determined by reference to a single identifiable property that is damaged or destroyed by a casualty. That requirement emanates from the regulations, specifically Section 1.165-7(b)(2). Way back in 1966, Revenue Ruling 66-9, 1966-1 C.B. 39, posited two interrelated concepts: (1) the definition of a single identifiable property; and (2) the sufficiency of the damage that gives rise to the casualty loss. Revenue Ruling 66-9 held that in a case of casualty losses to timber, the “single identifiable property” was a quantity of timber (not a tree!).

Thus, the units (board feet, log scale, cords or other units of wood) that were still units in standing trees that were available and suitable for exploitation and use by forest industries did not qualify. Whatever this unit of wood was, if it was rendered unfit for use by the casualty, that would qualify. However, Revenue Ruling 66-9 only considered the total destruction of the timber to be legally sufficient to trigger a casualty loss. Mere damage (even serious damage) was not enough.

Along came Revenue Ruling 73-51, repeating the learning of Revenue Ruling 66-9 about the definition of a single identifiable property. Revenue Ruling 73-51 went on to hold that physical damage in that case, broken crowns or root damage that stunted tree growth to merchantable trees, did not result in the existing timber being rendered unfit for use. Thus, it seemed at the time as though Revenue Ruling 73-51 put the last nail in the wooden coffin (sorry!) about a portion of the timber being merely damaged, not absolutely destroyed.

What About the Case Law?

In Westvaco, the court held that the single identifiable property damaged or destroyed included all of the taxpayer's standing timber in the particular district that was directly affected by each casualty, not just the units of timber contained in the trees that were suffering mortal injury. The court there enunciated the standard that the appropriate single identifiable property was any unit of property that has identifiable adjusted basis, and that is reasonable, logical and identifiable in relationship to the area affected by the casualty. Perhaps most importantly, the court also held that the allowable loss would not be limited to the merchantable units of timber that were totally destroyed.

In the Weyerhaeuser case, the court held that the single identifiable property damaged or destroyed by several forest fires (and by a volcanic eruption affecting the taxpayer's timber property) was the block of property affected. It was that subdivision of the taxpayer's forest holdings that were selected by the taxpayer as a means of tracking the adjusted basis in the timber. This adjusted basis tracking is set out in Regulation Section 1.611-3(d)(1). In Weyerhaeuser, the court referred to the Westvaco case, allowing the casualty loss for trees that were damaged but were not rendered wholly worthless.

Revenue Ruling 99-56

Revenue Ruling 99-56, 1999-51 I.R.B. 767, takes stock of all this authority, and revokes the prior two rulings (Revenue Rulings 66-9 and 73-51) in light of the Westvaco and Weyerhaeuser cases. As such, it should be easier to qualify for a casualty loss deduction in the timber industry.

Business vs. Personal

Finally, consider the recent case of **Miguel Martin v. Commissioner**, T.C. Memo 2000-56 (Feb. 26, 2000). There, the taxpayer disallowed a claimed casualty loss to a resident. But the facts are interesting, highlighting the difference between the personal casualty loss and the business casualty loss.

The story starts in 1993, when the taxpayers moved out and listed the property for sale (in October 1993). A few months later, on January 17, 1994, the Northridge earthquake hit southern California. The taxpayers had been making improvements to the residence before then to enhance its value for purposes of sale. After the earthquake, they made repairs necessitated by the earthquake damage. About four days after the earthquake (miraculously!) the taxpayers rented the residence.

They spent about \$60,000 in earthquake-related repairs and other improvements on the property. After the earthquake, they filed a claim with their insurance company, who estimated that the repairs necessary to address earthquake damage would cost just over \$9,000. They also consulted a real estate company, which estimated that the property had lost \$30,000 in value as a result of the earthquake, both attributable to the actual damage and to the risks that might be perceived by potential buyers of damaged older homes in areas prone to earthquake damage.

Thus, the taxpayers claimed a \$25,000 business casualty loss based on the notion that the property was held for rental, or for sale at the time of the earthquake. The matter

wound up in Tax Court. The Tax Court addressed the amount of the loss, holding that the loss was limited to the amount of actual damage which the court found to be \$9,221 (exactly the insurance adjuster's figure). The court found that the other amounts spent on the property were for improvements and renovations, unrelated to the earthquake damage.

The most interesting part of the case is the Tax Court treatment of the claim that the property had been converted from personal use to business use. The court found that the taxpayers no longer used the home as a principal residence in January 1994. They had, after all, moved out of the home, moved some of their furnishings out, and had begun substantial repairs and renovation on the property. Nonetheless, the court found that they had not "definitively" converted the property to rental or other income-producing property at the time of the earthquake.

Why? Although they had listed the property for sale, some of their furniture still remained in the home (ouch!). The court found that leasing the property just four days after the earthquake would not place the taxpayers over the line necessary to convert the personal residence into income-producing property. Thus, the Tax Court held that the loss was not a business casualty loss (deductible under the more favorable provisions of Section 165(c)). Instead, the court found that it was a personal casualty loss. As such, it was subject to a \$100 exclusion (that, of course, is not big deal), and it had to exceed 10% of the taxpayer's adjusted gross income in order to be deductible. This latter 10% threshold (see Sections 165(c)(3) and 165(h)). This 10% threshold operates as a material disadvantage to the mere residential/personal casualty loss deduction.

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