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Clearing the Debris: Tax Treatment of Casualty Losses

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The events of September 11 have left in their wake all kinds of intangible debris, extending even into the world of taxation. Many in the real estate community need to resolve a variety of issues in order to unravel their tax position and they may find the results surprising. One set of such issues relates to casualty loss deductions. Note, however, that although casualty is usually associated with loss, it can also result in taxable gain, where the taxpayer recovers insurance proceeds in excess of his or her basis in the damaged or destroyed asset.

What kind of property qualifies for a casualty loss deduction? Section 165 of the Internal Revenue Code tells us that a deduction is allowed for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." Both the Code and Treasury regulation section 1.165-7(a)(1) make it clear that a casualty loss is deductible whether incurred in a trade or business, in a transaction entered into for profit, or even with respect to property unconnected to a trade or business or a transaction entered into for profit. Thus, we have a rare situation in which a personal expenditure can give rise to a tax deduction (for example, the purchase of a car which is later destroyed).

How Much Is Deductible?

How is the casualty loss computed? Subsection (b)(1) of the same regulation provides the formula for computing the loss. The loss equals *the lesser of* (i) the diminution in value as a result of the casualty (the fair market value of the property immediately before the casualty, less the fair market value of the property immediately after the casualty) and (ii) the tax basis of the damaged property.

A host of harder questions remains, such as what is a casualty loss? Are the owners of retail real estate located in downtown Manhattan eligible for a casualty loss deduction because customer traffic has drastically decreased? Is physical loss required? If so, where there is some physical damage, is all collateral nonphysical damage included in the deduction?

Little authority exists with respect to many of these issues, but as in other areas impacted by the events of September 11, litigation is likely to clarify the law over the next few years. The starting point for these questions is the abstruse language of Treasury regulation section 1.165-7(a)(2):

(2) *Method of valuation.* (i) 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.

Does the phrase "general market decline affecting undamaged ... property which may occur simultaneously with the casualty" deny a deduction for collateral intangible consequences of physical damage? In other words, does this regulation limit deductions to physical damage?

A thorough examination of this issue is beyond the scope of this article; however, a brief look at the following case is helpful. In *Finkbohner v. U.S.*, 788 F.2d 723 (11th Cir. 1986), a flood damaged a number of homes in the taxpayer's cul-de-sac; however, the waters damaged only the driveway and grounds on the taxpayer's property, leaving the house untouched. The taxpayer claimed a loss measured by reduced value because of "buyer resistance" to the area (since buyers now focused on the flood risk) and because the municipal authorities permanently removed the other residential lots in the cul-de-sac (for safety reasons). The Government took the position that only physical damage gives rise to a casualty loss deduction. The court held, to the contrary, that the total permanent loss of value is deductible, but the court went on to hold that buyer resistance to the area because of the flood risk was only temporary, whereas removal of the other houses in the cul-de-sac created a permanent loss of value.

While *Finkbohner* clearly stands for the proposition that damage need not be only physical, it remains unclear whether the court would have allowed a casualty loss deduction had the flood waters not reached the Finkbohners' property at all. Moreover, while *Finkbohner* makes the scope of the regulation (and its reference to "general market decline") unclear, on similar facts an earlier revenue ruling held against the taxpayer because the taxpayer could not prove permanent loss of value. Therefore, even assuming that *Finkbohner* is right, the burden of proving permanent nonphysical damage may prove insurmountable in most cases.

When Is the Loss Deductible?

If there is no reimbursement, a casualty loss is generally deductible in the year sustained. If, as of the end of the taxable year during which the loss is sustained, the taxpayer has a claim for reimbursement with a reasonable prospect for recovery, the deductible loss is reduced by the maximum reimbursement recovery possible. For example, if in year 1 a taxpayer sustains a loss of \$100, but has an insurance claim with a reasonable prospect of recovery for \$80, he may deduct only \$20 in year 1. If in year 2, it becomes clear that his insurance company will pay only \$50, he deducts \$30 in year 2 (\$100 loss, less \$20 deducted in year 1, less \$50 recovery).

Internal Revenue Code section 165(i) contains a special rule, under which:

any loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act may, at the election of the taxpayer, be taken into account for the taxable year immediately preceding the taxable year in which the disaster occurred.

This means that "September 11" losses suffered by calendar year taxpayers may be claimed on returns for the year 2001, the year in which the loss was sustained, or the year 2000, the immediately preceding taxable year.

When we discuss arcane issues of taxation, the eyes of our fellow lawyers frequently glaze over. Nevertheless, just as we are now witnessing a very public dispute, involving billions of dollars, over the interpretation of a few words in an insurance contract, so too, the tax dollars at stake over the outcome of the issues discussed here, and similar issues now percolating just below the public's awareness, can be enormous.

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