ABA SECTION OF TAXATION
Casualty Loss Restoration Rule Panel
Washington D.C.
May 6th, 2011

- IRC § 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. The amount of the loss is the lesser of either 1) the amount equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty or 2) the property's adjusted basis as determined under IRC § 1011.[1] Generally, losses are deductible in the year in which they are sustained, regardless of if or when the damages are repaired or the property is restored. Thus, if a taxpayer experiences damage to its property by means of a casualty such as a storm, and that property is uninsured, the taxpayer is required to effectuate the deduction under IRC § 165 in the year the damage was incurred, notwithstanding whether the taxpayer has or eventually does incur costs to repair the property. Whether costs are incurred to repair property damaged by a casualty event, are completely irrelevant, except for the fact, as discussed below, that the taxpayer can use the amount of repairs to measure the casualty loss.

- *Treas. Reg*. §1.165-7(a)(2)(ii) provides that the cost of repairs can serve as evidence of the diminution of value of property, provided the taxpayer can show that (1) the repairs are necessary to restore property to its condition immediately before the casualty, (2) the amount spent for such repairs is not extensive, (3) the repairs do not care for more than the damage suffered, and (4) the value of the property after the repairs does not exceed the value of the property before the repair. Even where, however, a taxpayer chooses to use repair costs to measure the diminution in property as a result of the casualty, the taxpayer is not deducting the repair costs themselves. The IRC § 165(a) deduction will result in a decrease in the taxpayer's historical basis in the affected SIP as determined under IRC § 1016(a)(1). In addition, the deduction cannot exceed the taxpayer's adjusted basis in the property. Thus, if a taxpayer's loss is greater than the amount of basis in the property, the taxpayer's IRC § 165 deduction is limited by that amount of basis, notwithstanding whether that taxpayer incurred more costs to repair or restore the property.

- Proposed Treas. Reg. § 1.263(a)-3(g)(1) (iii) provides generally that "[a] taxpayer must capitalize amounts paid to restore a unit of property if the restoration is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under Section 165, or relating to a casualty event described in Section 165.

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[1] *See* IRC §165-7(b) (1) and 165-7(b)(1)(ii) *referring to* IRC §1011 relating to determining adjusted basis for loss from the sale or other disposition of property. *See also* Treas. Reg. §1.165-1(c).

- The preamble to the re-proposed regulations indicates that the IRS and Treasury believe that when a taxpayer properly deducts a casualty loss, the nature of the damage resulting from the casualty is such that any repairs made to restore the property after the casualty should not be treated as ordinary and necessary repair costs under Section 162.

- If a taxpayer who experiences damage to its property as a result of casualty event subsequently chooses to restore the property back to its original condition, the determination of whether the costs incurred should be expensed or capitalized is entirely unrelated to the issue of whether the taxpayer previously claimed a casualty loss under IRC § 165. Rather, the proper treatment of those costs turns on whether they are ordinary and necessary under IRC § 162 or betterments as defined in IRC § 263(a).

- Generally, IRC § 162 allows a deduction for all the ordinary and necessary business expenses paid or incurred in the taxable year in carrying on a trade or business. The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but rather maintain it in an ordinarily efficient operating condition, may be deducted as an expense, provided the plant or property account is not increased by the amount of such expenditures

- IRC § 263(a) disallows a deduction for capital expenditures incurred for new buildings, betterments, or improvements made to increase the value of an asset. Similarly, IRC § 263(A) requires taxpayers to capitalize all direct labor and material costs as well as any indirect costs properly allocable to the production of property. Capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use.[2]

- The determination of whether certain costs are deductible as a repair under IRC § 162 or must be treated as capital expenditures under IRC § 263 generally depends on the taxpayer's particular set of facts. The courts have upheld the position that there is no hard and fast rule as to what constitutes an ordinary and necessary expense, and each case must be decided on its own facts.[3] If the expenditure returns the taxpayer's property to the state it was in before the situation prompting the expenditure arose, and does not make the relevant property more valuable, more useful, or longer-lived, then it is usually deemed a deductible repair.[4] If, on the other hand, the expenditure materially enhances the value, use, life expectancy, strength or capacity of the property as compared with its status prior

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[2] Treas. Reg. §1.263(a)-1(b)

[3] *R.R. Hensler, Inc. v. Commissioner*, 73 T.C. 168 (1979) (*citing Welch v. Helvering*, 290 U.S. 111,115 (1933); *Deputy v. Dupont*, 308 U.S. 488 (1940)).

[4] *Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 337 (1962),* nonacq. on other grounds, *1964-2 C.B. 8.*

to the condition necessitating the expenditure, this expenditure is capital in nature.[5]

- AM 2006-006: the IRS concluded that, pursuant to Rev. Rul. 71-161 and *Plainfield-Union Water Co*., taxpayers, "cannot take both a loss deduction and a business expense deduction as a result of one casualty."[6] There, the IRS stated, as a matter of law, that where a taxpayer effectuates a casualty loss deduction under IRC § 165 for amounts incurred to restore its property to its pre casualty condition, all of the costs incurred to restore the property must thereafter be capitalized pursuant to IRC § 263.

- In Rev. Rul. 71-161 the IRS held that, pursuant to the facts before it, the taxpayer was not entitled to a deduction under IRC § 162 for costs incurred for the removal of debris and the repair of its property after it was damaged by a casualty event. Rather, the IRS explained that because those costs were in the nature of the replacement of the part of the property that was damaged, they should be capitalized and added to the basis of the property.

- In AM 2006-006, the IRS cites *Plainfield-Union Water Co.* as example of case law that bolsters its position that as a matter of law, a company is not entitled to effectuate a deduction pursuant to both IRC§§ 165 and 162. There, in determining whether the cleaning and lining of water pipes should be expensed under § 162 or capitalized under § 263, the court painstakingly examined all of the relevant facts and held that cost incurred could be expensed.[7] Moreover, in concluding, the Court underscored that whether an item should be expensed under IRC § 162 or capitalized under IRC § 263(a) is clearly a factual, not legal, issue:

> We have given full consideration to the entire factual context of the instant case. The useful life, strength, value, and capacity of the cleaned and lined water pipes were not increased by the expenditure in issue. Said expenditure did not make the relevant water main suitable for any new or additional use. Said main continued to be used in the normal course of petitioner's operations as a water company. Viewing the record as a whole, we hold that the cleaning and cement lining of the Maple Avenue main in 1957 was a repair, the cost of which is deductible under § 162(a).[8]

[5] Id. at 338.
[6] AM 2006-006
[7] *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962)
[8] *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 341.

- In Hensler, Inc. v. Commissioner[9] the taxpayer's machinery and equipment (which was currently being used to execute a construction contract) was severely damaged by flooding and was covered to a depth from 4 to 30 feet by dirt and debris.[10] The IRS argued that the plaintiff was not entitled to a deduction for the uncovering, repair, and replacement of the equipment as a necessary business expense under IRC § 162, but was rather required to deduct the loss under IRC § 165.

  - The Court disagreed with the IRS, determining that the taxpayer was entitled to a deduction under IRC § 162 for the repair and replacement of the damaged property notwithstanding the fact that that property was initially damaged by reason of a casualty event. Specifically, the Court explained:

    > Clearly expenses incurred by reason of casualty may be deducted under § 162 if the expenses in question meet the requirements of that section i.e. that they are ordinary and necessary expense paid or incurred in carrying on any trade or business. There is no suggestion in the statutory language or legislative history of § 162 or its predecessors that a business expense may not be deducted under that section because it is specifically allowable as a deduction under some other section of the code.[11]

- In *PLR* 199903030 the IRS concluded that if the taxpayer incurs costs simply to restore their business properties to their pre-disaster state, and such costs do not materially enhance the value, use, life expectancy, strength or capacity of such property beyond that state, then these costs are currently deductible under IRC § 162 as repair expenses, irrespective of the determination of whether the taxpayer has incurred a deductible casualty loss.

- The tax court in *Hensler* specifically states that costs incurred for removal should be currently expensed under IRC § 162. As mentioned above, the tax court in *Hensler* specifically held that the taxpayer was entitled to a deduction under IRC § 162 for the costs incurred from removing the mud and dirt and other debris that covered its machines as a result of the casualty. Furthermore, the IRS has specifically addressed the treatment of removal costs in Rev. Rul. 2000-7 where it held that:

    - ▪ if the retirement and removal of a depreciable asset occurs in connection with the installation or production of a replacement asset, the costs incurred

[9] *R.R. Hensler, Inc. v. Commissioner*, 73 T.C. 168 (1979)
[10] *R.R. Hensler, Inc. v. Commissioner*, 73 T.C. 168 (1979).
[11] *R.R. Hensler, Inc. v. Commissioner*, 73 T.C. 168 (1979).

in removing the retired asset are not required to be capitalized as part of the replacement asset.[12]

- In Rev. Rul. 2000-7, a telecommunications company removed and retired two telephone poles, and subsequently replaced them with new poles. In determining that the removal costs should be currently deducted as an expense, the court explained that the costs of removing an asset have always been allocated to the removed asset and are therefore deductible; and the fact that a particular removal project is part of a more comprehensive replacement project should not operate to change that analysis.[13] As such, the IRS concluded that the removal costs should be allocated to the retired asset (the individual poles) - not capitalized into the new assets under either 263(a) or 263A.[14]

- *Treas. Reg*. §1.167(a)-8 provides rules governing the gain and loss consequences of the retirements of assets. The regulations describe the differing tax consequences of the retirement of assets based on whether the asset is sold or exchanged and based on whether the asset is disposed of or abandoned by the taxpayer. Retirements resulting from sales of assets are to be governed by §1002 and §1231 as appropriate, while retirements effected through the exchange of assets are to be governed by § 1002, §1031, and § 1231. In the event that an asset is retired and the taxpayer has not received consideration or otherwise exchanged such asset the amount of deduction shall be dependent upon whether or not the asset has been disposed of by the taxpayer. Per *Treas. Reg*. §1.167(a)-8(a)(3), assets retired but still retained by the taxpayer will have their loss "measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater…". The regulations go on to stipulate that such a retirement must be either an abnormal retirement or a normal retirement from a single asset account or from a multiple asset account in which the depreciation rate is based on the maximum expected life of the longest lived asset contained in the account. *Treas. Reg*. §1.167(a)-8(a)(4) provides that if a taxpayer physically abandons the asset (with the intent being irrevocably to discard the item) the taxpayer is entitled to a deduction equal to the basis in such asset.

- Rev. Proc. 2011-26 provides guidance for recent legislative changes amending the bonus depreciation rules under §168(k)(2) and §168(k)(5). Included in the revenue procedure are specific rules regarding when certain "components" of larger self-constructed property may qualify for bonus depreciation even before the larger self-constructed property is itself placed into service. The revenue procedure defines "component" as "intended to refer to any part used in the

[12] Rev. Rul. 2000-7, C.B. 712, (Feb. 8, 2000).
[13] Rev. Rul. 2000-7, C.B. 712, (Feb. 8, 2000) (where the IRS relied on its previous analysis in Revenue Ruling 74-455, where it held that where an asset is either retired or disposed of, and the taxpayer takes the salvage proceeds into income, the corresponding removal costs must be charged to expense and properly treated as a deduction against income).
[14] Rev. Rul. 2000-7, C.B. 712, (Feb. 8, 2000).

manufacture, construction, or production of the larger self-constructed property, which may or may not be the same as the asset for depreciation purposes or the same as the unit of property for purposes of other Code sections."

- In *Hubinger v. Commissioner*, 36 F.2d 724 (1929) a taxpayer who owned a building that he rented out for business purposes attempted to deduct a loss following a fire that damaged this building. Several years prior to the fire, the property had been valued at $125,000. At the time of the fire the property was valued at $225,000. The taxpayer took as his loss deduction the amount of necessary repairs net of insurance proceeds equal to $41,142. First, the court rejected the notion that the repair expenditures could be treated as "ordinary and necessary" business expenses owing to the fact that they lacked the characteristic of being "ordinary." The court went on to state that if any deduction were to be available to the taxpayer it would be in the nature of a loss deduction either as a loss incurred in a trade or business or as a loss "arising from fires, storms, shipwreck, or other casualty, or from theft". The court ultimately disallowed the deduction on the basis that by failing to prove a salvage value he had also failed to prove a loss at all. In the words of the court:

    - In the present case there was no proof of a loss. The salvage value of the property after the fire was not shown, and if we should assume that it was the value before the fire, less the cost of reconditioning (or $ 225,000 -- $ 70,000), there remained damaged property worth $ 155,000, a sum far more than the value of $ 125,000 on March 1, 1913.