WALDRIP v. UNITED STATES
81-2 U.S.T.C. ¶9653
48 AFTR2d 81-6031

Editor's Summary

Key Topics

CASUALTY LOSSES
• Basis limitation of deduction
• Insect loss
• Nonbusiness property

Facts

Shade trees on the taxpayers' residential property were killed by an attack of southern pine bark beetles and the taxpayers claimed a deduction for this loss under Section 165(c)(3).

That section provides that the amount of a casualty loss deduction equals the difference between the property's fair market value before and after the casualty but in no event may the deduction exceed the adjusted basis of the property before the loss. Since the difference in pre- and post-casualty fair market value exceeded adjusted basis, the deduction was limited to the adjusted basis figure. However, the taxpayers asserted that they were entitled to deduct costs incurred to clean up the property in addition to the amount of adjusted basis.

District Court

HELD: For the Government. A casualty loss deduction sustained with respect to either business or nonbusiness property may not exceed that property's pre-casualty adjusted basis. The Court noted that, while other cases took account of clean up costs to determine a casualty loss deduction, such costs, there, were relevant to determine before and after fair market value. The clean up costs were never treated as an amount deductible in addition to adjusted basis. That amount is the ceiling for deductibility in all cases.

Case Text

O'KELLEY, District Judge: Lee R. Waldrip instituted this action pursuant to 28 U.S.C. §1346(a)(1) in order to recover income taxes and interest which he claims were erroneously assessed by the Internal Revenue Service (hereinafter" IRS") for his tax year which ended on April 30, 1975. On April 3, 1981, the parties agreed to enter into a stipulation of facts and submit the case to the court for a decision on the merits on the basis of those stipulations and their respective briefs. This opinion and order incorporates the court's findings of fact and conclusions of law pursuant to rule 52(a), Federal Rules of Civil Procedure.

It is undisputed that, because of an attack of southern pine beetles on his property, the plaintiff suffered a casualty loss within the meaning of 26 U.S.C. §165(c) for his taxable year ending April 30, 1975. The sole question for the court's decision is the correct amount that the plaintiff is entitled to deduct as a result of that casualty loss. The plaintiff contends that he is entitled to deduct $32,210.00: $16,734.00 as the pre-casualty adjusted basis of the property, plus $14,700.00 in clean-up expenses as a post-casualty adjustment to basis, plus $876.00 as an appraisal fee, minus $100.00. The defendant contends that the plaintiff is entitled to deduct $16,634.00: $16,734.00 as the pre-casualty adjusted basis of the property minus $100.00. Both parties agree that the roadmap to calculating the amount of the allowable deduction is found in 26 C.F.R. §1.165-7(b), which provides in part as follows:

> (b) *Amount deductible*--(1) *General rule.* In the case of any casualty loss whether or not incurred in a trade or business or in any transaction entered into for profit, the amount of loss to be taken into account for purposes of section 165(a) shall be the lesser of either--
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> (i) The amount which is 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
>
> (ii) The amount of the adjusted basis prescribed in §1.1011-1 for determining the loss from the sale or other disposition of the property involved.

The parties are also in agreement that the amount calculated under subsection (b)(1)(ii) of the above-quoted regulation is less than the amount calculated under subsection (b)(1)(i).[1] The parties disagree, however, as to whether the appraisal fee and clean-up expenses incurred by the plaintiff should be included in "[t]he amount of the adjusted basis prescribed in § 1.1011-1 for determining the loss from the sale or other disposition of the property involved." 26 C.F.R. § 1.165-7(b)(1)(ii).

As to the appraisal fee, the defendant contends that Mr. Waldrip could have deducted the $876.00 fee under section 212 of the Internal Revenue Code (dealing with expenses for production of income) but cannot deduct it under section 165(c) of the Code. Because Mr. Waldrip failed to set forth a claim that his appraisal fee was deductible under section 212 in his claim for refund, the defendant argues that he cannot do so now. The plaintiff concedes that the appraisal fee might well have been deducted under section 212 of the Code rather than under section 165(c), however, he argues that it is nevertheless deductible under section 165(c) as part of the post-casualty adjusted basis of the property. For the reasons stated below with respect to clean-up expenses, the court concludes that the appraisal fee is not deductible under section 165(c); and, because he did not claim a deduction under section 212 in his claim for refund, the court concludes that he is not entitled to the deduction. See *United States v. Felt & Tarrant Co.* [2 USTC ¶708], 283 U.S. 269 (I931); *Tucker v. Alexander,* 275 U.S. 228 (1927).

The plaintiff contends that clean-up expenses are properly includable within the meaning of "adjusted basis" as that term is used in 26 U.S.C. § 1.1011-1[2] and that they are properly deductible under 26 U.S.C. §1.165-7(b)(1)(ii) even though they were incurred *after* the casualty occurred. In support of this contention, the plaintiff argues that clean-up expenses have been generally recognized by the courts as constituting a portion of the casualty loss. [3] The plaintiff

further argues that because clean-up expenses are an out-of-pocket expense borne by the taxpayer as a result of the casualty, they are proper additions to basis in arriving at the adjusted basis for determining the limits of the allowable deduction under section 1.165-7(b)(1)(i). The plaintiff contends that allowing him to deduct out-of-pocket expenses in addition to his pre-casualty adjusted basis in the property does not defeat the purpose for requiring the cap on the allowable deduction because he would not be claiming a deduction for unrealized appreciation of the property. The plaintiff further contends that allowing the deduction would more nearly fulfill the purpose behind the statute: compensating the taxpayer for either his actual economic loss or for his out-of-pocket loss if his out-of-pocket loss is less than his economic loss.

The defendant counters that under 26 U.S.C. § 165(c), the taxpayer's pre-casualty adjusted basis in the affected property is an absolute upper limit on the amount he may deduct for any loss that he may incur. *Helvering v. Owens,* 305 U.S. 468 (1939). See *Rosenthal v. Commissioner,* 416 F. 2d 491,497 (2d Cir. 1969). The defendant notes that when courts have permitted clean-up costs to be deducted in the past, they have used clean-up costs as a *measure* of the loss [4] under 26 C.F.R. §1.165-7(b)(1)(i) and not as adjustments to basis under 26 C.F.R. §1.165-7(b)(1)(ii). *E.G., Black v. Commissioner* [CCH Dec. 34, 665], 36 T.C.M. (CCH) 1347 (1977); *Walton v. Commissioner* [CCH Dec. 25,413(M)], 20 T.C.M. (CCH) 653 (1961). Furthermore, the defendant asserts that the cases which have touched on the question presented to the court have indicated that clean-up expenses are includable as a measure of the loss under (b)(1)(i) but are not deductible in addition to the taxpayer's pre-casualty adjusted basis under (b)(I)(ii). *Stuart v. Commissioner* [CCH Dec. 24,910(M)], 20 T.C.M. 938 (CCH) (I 961); *Bliss v. Commissioner* [CCH Dec. 22,250], 27 T.C. 770 (1957), *rev'd on other grounds,* [58-2 USTC ¶9618] 256 F. 2d 533 (2d Cir. 1958). The defendant therefore argues that the plaintiff should not be allowed to deduct $14,700.00 in clean-up expenses over and above his basis in the property.

The court concludes that it must agree with the defendant. In tax refund suits, the plaintiff taxpayer bears the burden of proving that the amount assessed against him was erroneous and the specific amount to which he is entitled as a result thereof. *Helvering v. Taylor* [35-1 USTC ¶9044], 293 U.S. 507 (1935); *United States v. Pfister* [53-2 USTC ¶9477], 205 F. 2d 538 (8th Cir. 1953). This court has not found any authority to support the proposition that a taxpayer may include clean-up expenses as a post-casualty adjustment to basis for computing a casualty loss under 26 C.F.R. § 1.165-7(b)(1)(ii). In fact, to the extent that the cases address the question, they are not favorable to the plaintiff's position. See *Ward v. United States* [70-2 USTC ¶9518], 428 F. 2d 1288 (Ct. Cl. 1970), cert. denied, 400 U.S. 1008 (1971); *Stuart v. Commissioner* [CCH Dec. 24,910(M)], 20 T.C.M. (CCH) 938 (1961); *Bliss v, Commissioner* [CCH Dec. 22,250], 27 T.C. 770 (1957), *rev'd on other grounds,* [58-2 USTC ¶9618], 256 F. 2d 533 (2d Cir. 1958). If, as the plaintiff suggests, the clean-up expenses he incurred are Proper adjustments to basis, [5] any future disposition of the property within the meaning of 26 U.S.C. §1101 Will take that into account.

Accordingly, and for the above-stated reasons, the court finds that the plaintiff is entitled to a casualty loss for his tax year ending April 30, 1975 in the amount of $16,634,00. The attorney for the defendant shall submit a proposed judgment within 20 days.

1 The plaintiff claims an actual economic loss of $81,576.00, consisting of $66,000.00 in permanent diminution of the value of his property, plus $14,700.00 in clean-up expenses and $876.00 for an appraisal fee. Therefore, the plaintiff's loss as calculated under 26 C.F.R. 1.165-7(b)(1)(i) is far in excess of either of the amounts the parties respectively contend are deductible under 26 C.F.R. 1.165-7(b)(1)(ii).

2 26 C.F.R. §1.1011-1 provides:
"[t]he adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost or other basis prescribed in section 1012 or other applicable provisions of subtitle A of the Code, adjusted to the extent provided in sections 1016, 1017, and 1018 or as otherwise specifically provided for under applicable provisions of internal revenue laws.

3 The plaintiff concedes, however, that none of these cases speak directly to the issue of whether clean-up expenses are deductible over and above the taxpayer's adjusted basis in the property immediately *prior* to the casualty.

4 26 C.F.R. § 1.165-7(a)(2)(ii) provides:
"[the cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that (a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amounts 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.

5 The only authority which the plaintiffs cite for the proposition that clean-up costs are an adjustment to basis under 26 U.S.C. §1101 is Rev. Rul. 71-161, 1971-I C.B. 76, which stands for the dubious proposition that clean-up expenses are deductible as a casualty loss *and are* post-casualty adjustments to basis.