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Appreciation Under The Casualty Loss

By ALAN L. FELD

According to the author, who asserts that the regulations allow an overly generous casualty loss deduction for partial losses on appreciated property, untaxed gain in the form of unrealized appreciation should be taken into account when determining a partial loss. Alan L. Feld is a professor of law at Boston University.

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Federal income tax deductions ordinarily require an expenditure of funds previously taken into account for tax purposes or that will be taken into account in the future. Loss of income or gain anticipated by the taxpayer, but not taxed, generally does not give rise to an offset against other income.[1] The statutory framework for the casualty loss deduction, Code Section 165, appears to accord with this general rule. Subsection (b) states that the basis for determining the amount of any loss deduction shall be the taxpayer's adjusted basis. Nevertheless, as the regulations apply this statute to partial losses from casualty,[2] the deduction enjoys considerable enhancement from untaxed gain in the form of unrealized ap-

[1] See *Alsop v. Commissioner,* 61-1 USTC ¶ 9472, 290 F. 2d 726 (CA-2) (theft of royalties not included in income). As to bad debts, see Reg. Sec. 1.166-1(e). The one significant exception to this pattern, the deduction for charitable contributions of appreciated property, is justified as an additional aid to institutions that provide a significant public benefit. But in the absence of some similar nontax objective, the benefit of a deduction flows from after-tax income, not pre-tax income. Alternatively, a deduction sometimes does arise when the gain simultaneously comes into income. See Rev. Rul. 69-181, 1969-1 CB 196.

[2] Reg. Sec. 1.165-7.

preciation.[3] The resultant revenue loss to the Treasury may exceed $100 million annually.[4]

Partial Loss from Casualty: Statutory and Regulatory Differences

An example will illustrate the problem. An individual paid $10,000 for an antique Chinese vase. The vase is now worth $30,000. In a storm, a sudden gust of wind blows another object against the vase and chips it. The value of the vase is now $21,000.[5]

The statutory direction to base a determination of loss on adjusted basis by itself provides no clear rule for this case. Conceivably, the statute might afford no deduction to the taxpayer since the current value of the vase, $21,000, will more than cover the taxpayer's investment in it, $10,000. The taxpayer has suffered no "loss" of his investment and hence no deduction is justified.[6] Moreover, apart from Section 165 itself, the taxpayer probably has not "realized" the loss since he has not closed out his investment in the property.[7]

The regulations, however, provide a different rule. The taxpayer may deduct as the measure of his loss the lesser of (a) the reduction in value by reason of the casualty or (b) the adjusted basis for the entire property. The taxpayer determines the value of the property immediately before the casualty and reduces that amount by the value immediately after the casualty; in the example, $30,000 less $21,000. He then compares this amount, $9,000, with the adjusted basis in the property, here $10,000. If it is less than adjusted basis, it is deductible in full; if it is more, only the adjusted basis in the property is deductible. In the example, the taxpayer may deduct $9,000.[8]

The regulation formula appears to address the problem the Supreme Court resolved in *Helvering v. Owens,*[9] partial destruction of depreciated assets. When a person buys property for personal use, the property may depreciate in value but the Code provides no reduction in basis. After a casualty, the difference between the value of the property and its adjusted basis reflects loss of value from ordinary use as well as sudden loss. The regulation seeks to confine the Section 165 deduction to the loss attributable to the casualty. The first example in the regulations concerns damage to an automobile used for nonbusiness purposes. The automobile, purchased for $3,600, declines in value from $2,000 immediately before the collision to $1,500 afterwards. A literal application of the statutory directive, to base the amount of the deduction on adjusted basis, might suggest that the starting point of the computation is the taxpayer's original price of $3,600. Instead, the regulation formula limits the deduction to the loss in value attributable to the event.

Both the regulation example and its general rule parallel the *Owens* case. Although the regulation result is correct on those facts, the regulation produces an anomalous result on ours. Here taxpayer retains his vase with a value of $21,000 yet obtains a tax deduction for $9,000.[10] The regulation allocates all of the decline in value to the taxpayer's investment and allocates unrealized appreciation in full to the surviving part of the asset; in effect it allows a deduction measured by the decline in appreciation in the asset, up to the adjusted basis.[11]

[3] Other grounds for criticizing the casualty loss deduction exist, but will not be discussed here. They include: the difficulty in some cases in determining what is a "casualty"; the practical difficulty in measuring and validating "loss" based on pre-casualty value; the incidence of the deduction by income class; and the inefficiency in creating incentives to self-insure rather than buy casualty insurance with nondeductible premiums. Some of these are analyzed in a Report by the Comptroller General of the United States, *The Personal Casualty and Theft Loss Deduction: Analysis and Proposals for Change* (Dec. 5, 1979).

[4] The Treasury estimated the total revenue cost of the casualty and theft deduction for 1980 at $475 million. A significant number of the claims for casualty loss involve partial destruction of property.

[5] The question of how to account for appreciation of the asset in measuring the deduction of a partial casualty arises without regard to the business, investment or personal use of the property, compare *Cox v. U. S.*, 76-2 USTC ¶ 9529, 537 F. 2d 1066 (CA-9) and *Donald Strutz,* CCH Dec. 37,100(M), 40 TCM 757 (1980), or the period of ownership, and without taking account of the depreciation in value of "wasting" assets used for personal purposes. See Epstein, "The Consumption and Loss of Personal Property and the Internal Revenue Code," 23 *Stanford Law Review* 454 (1971).

[6] A district court took this view, *Cox v. U. S.*, 74-1 USTC ¶ 9210, 371 F. Supp. 1257 (N. D. Cal., 1973), vacated and remanded, 76-2 USTC ¶ 9529, 537 F. 2d 1066 (CA-9), but the government apparently did not urge its adoption on appeal.

[7] Reg. Sec. 1.165-1(b) requires a loss generally to be evidenced by "closed and completed transaction."

[8] For simplicity, the statutory subtraction of $100 per casualty under Sec. 165(c)(3) is omitted.

[9] 39-1 USTC ¶ 9229, 305 U. S. 468 (1939).

[10] To be sure, his basis in the property is reduced to $1,000. But that does not answer the problem of why the tax law in effect deems the loss to have been incurred entirely from the taxpayer's investment rather than from the unrealized appreciation.

[11] The next examples in Reg. Sec. 1.165-7(b) involve property whose value before the casualty exceeds adjusted basis. The inappropriate treatment of appreciation in these examples is concealed by two facts: value is less than adjusted basis immediately after the casualty, so

In addition, the regulation produces odd results if we vary the numbers in the example. As noted, a loss of $9,000 produces a deduction of $9,000. If the amount of the loss is $15,000, the taxpayers may deduct only $10,000, the full adjusted basis. If the vase is completely destroyed the deduction remains $10,000. As these examples suggest, the deductible amount bears little relationship either to the taxpayer's loss of investment or to the reduction in his net worth caused by the casualty.

Disposition of Part of an Appreciated Asset: Recognition of Gain

An analogous question, how to allocate adjusted basis and unrealized appreciation when the taxpayer disposes of part of an appreciated asset, arises in the context of gain recognition. The regulations and cases make an allocation that defers recognition. They treat the return on part of an appreciated asset as derived first from adjusted basis, then from appreciation, deferring recognition of gain to the extent possible. In a part sale, gift transaction, the vendor-donor of an appreciated asset first recovers his investment and does not treat appreciation as realized. Thus, if a woman sells to her son for $9,000 a vase worth $30,000 and having a basis of $10,000 in her hands, the regulations treat the price as recovery of basis, with no recognition of gain or loss.[12] Similarly, when someone sells an indivisible part of a property the proceeds apply to recover basis first, without gain recognition, notwithstanding a general adjuration to a taxpayer who sells less than all the property to apportion basis equitably among the several parts of the property.[13] Thus, a taxpayer who disposed of an easement on appreciated property, for which a basis allocation was thought impossible, treats sales proceeds first as a recovery of investment.[14] In both situations, income would be speculative because the taxpayer (or a party who takes the same basis in the property) continues to own the property and enjoy its risks and rewards. No full realization has taken place. Similarly, when the issue is recognition of loss based on unrealized appreciation, no recognition should take place when the taxpayer retains the asset with enough value to recover adjusted basis. Under this approach, a deduction should be allowed only to the extent that the value after the casualty is less than the adjusted basis.

Equitable Allocation of Loss

But this rule may be thought too harsh. The taxpayer has suffered some loss through the casualty and a partial realization might be thought more appropriate than none. Rather than allow full deductibility up to basis, a middle ground, one that allocates the loss equitably between basis and unrealized appreciation, may be used. An allocation rule to accomplish this result is simply stated: Determine the tentative loss, the difference in value before and after the casualty. Multiply this amount by a fraction whose numerator is the adjusted basis of the property and whose denominator is the fair market value before the casualty. The product is the deductible amount. In the original example, the tentative loss of $9,000 would be multiplied by ten-thirtieths so that the deductible loss would be $3,000. If the loss instead were $15,000, half the value, the deduction rises to $5,000, half the investment. Only when the vase is completely destroyed does the taxpayer deduct the full $10,000.

Adjustment for Repair: Proposed Allocation Rule

Section 165 allows a deduction whether the taxpayer makes any further expenditure to repair the property or not. If he does not, the formula just stated properly allocates the loss between adjusted basis and appreciation. But if the taxpayer does make an additional investment in the property to repair the effects of the casualty, the deduction should reflect this fact. He should deduct repair costs up to the amount of loss and apply the allocation formula suggested above only to the portion of the loss for which the taxpayer makes no out-of-pocket expenditure.

With this adjustment for out-of-pocket repairs, the proposed allocation rule for casualty losses on appreciated assets is as follows:

1. Determine the tentative loss from the casualty as at present, by subtracting post-casualty value from pre-casualty value.

2. Deduction consists of (a) out-of-pocket expenditures for repair up to the tentative loss and (b) the product of any balance of the tentative loss multiplied by the ratio of adjusted basis to fair market value. ●

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that a deduction is clearly justified in some amount; and the amount of appreciation is relatively small and enhances the deduction only moderately.

[12] Reg. Sec. 1.1001-1(e). The statute applies a different rule to charitable donees, Sec. 1011(b).

[13] Reg. Sec. 1.61-6(a).

[14] *Inaja Land Co., Ltd.*, CCH Dec. 16,085, 9 TC 727 (1947), acq., 1948-1 CB 2; Rev. Rul. 70-510, 1970-2 CB 159.