

Casualty Repairs Under the Proposed Capitalization Regs

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In March 2008, proposed regulations were reissued addressing the treatment of expenditures incurred on tangible assets. The proposed regulations provide that if a taxpayer claims a casualty loss deduction, then all repair expenditures incurred relating to that casualty, must be capitalized.

Jacobson questions the rationale behind this position. He argues that repair expenditures resulting from casualty events should be subject to the same rules as repair expenditures resulting from noncasualty events.

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In March proposed regulations (REG-168745-03) were reissued on the treatment of expenditures incurred regarding tangible assets.¹ The proposed regulations replaced an earlier set of proposed regulations issued in August 2006.² The March proposed regulations are intended to provide guidance on determinations of whether an expenditure related to tangible property must

be capitalized under section 263.³ The proposed regulations pay particular attention to the treatment of amounts expended to restore tangible property, and propose rules for addressing the thorny question of what constitutes a unit of property. These topics are critical to determining whether an expenditure must be capitalized under section 263.

Buried deep within the proposed regulations, the IRS proposes a major change regarding repairs arising from casualty losses. The proposed regulations provide in essence that if a basis adjustment is made because of either a casualty loss deduction or the receipt of insurance proceeds from a casualty event, the subsequent costs incurred to repair the damage must be capitalized.⁴ This conclusion is reached by declaration. The rules and principles in the remainder of the proposed regulations are ignored for the purpose of determining whether the casualty repair expenditures must be capitalized.

The proposed regulations will have a fundamental impact on casualty loss deductions claimed under section 165 — a provision that is not even purported to be the focus of the proposed regulations. The premise for the change regarding casualty repairs, as set forth in the regs' preamble, is questionable at best. The proposed regulations would change decades of acceptable practice and would also appear to be inconsistent with congressional intent to the extent intent can be gleaned from the Gulf Opportunity Zone Act of 2005⁵ (GO Zone Act) enacted as a result of Hurricane Katrina.

I. Overview of Casualty Loss Rules

The rules governing casualty losses are found in section 165 and reg. section 1.165-7. If not compensated by insurance or otherwise, taxpayers are permitted to recognize losses arising from "fire, storm, shipwreck or other casualty."⁶ The measure of loss is the difference between the fair market value of the property immediately before and immediately after the casualty as ascertained by competent appraisal.⁷ As an alternative to an appraisal, the regulations permit the cost of repairs to the damaged property (with limitations) to be used as evidence of the amount of the loss.⁸

The amount of the loss that may be deducted is limited to the adjusted basis of the property involved.⁹ The basis of the damaged property must be reduced by

³All references to sections are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

⁴Prop. reg. section 1.263(a)-3(g)(1)(iii).

⁵P.L. 109-135 (2005).

⁶Reg. section 1.165-7(a)(1).

⁷Reg. section 1.165-7(a)(2)(i).

⁸Reg. section 1.165-7(a)(2)(ii).

⁹Reg. section 1.165-1(c)(1) and -7(b)(1).

¹73 Fed. Reg. 12,837 (Mar. 10, 2008).

²71 Fed. Reg. 48,589 (Aug. 21, 2006).

the casualty loss allowable.¹⁰ For purposes of applying the basis limitation rule, the property that is looked to is the single, identifiable property damaged or destroyed.¹¹ The regulations do not define single, identifiable property.

Essentially, the law allows uninsured taxpayers to accelerate a future benefit (that is, depreciation) to assist them during a difficult time.

II. IRS Approach to Casualties

A. Pre-2006

A deduction for casualty losses has been permitted since the original Internal Revenue Act.¹² Regulations on the valuation of a casualty loss have been in place in essentially the same form for almost 50 years.¹³

The regulations provide two alternative ways for determining the amount of a casualty loss.¹⁴ The first is by appraisal. The second is by reference to the cost of repairs. There is no statutory, regulatory, or judicial authority that requires that damaged property be repaired in order for the owner to be entitled to a casualty loss under section 165. Using appraisals is always permissible to compute the amount of a casualty loss. The casualty loss provisions permit the recovery of a prior investment (adjusted basis) in the damaged property. The casualty loss provisions do not address the treatment of current or future expenditures to repair the damaged property in the event the repairs are undertaken.¹⁵

The fact that the cost of repairs is acceptable as evidence of the loss of value in the property does not convert the casualty loss deduction into a deduction for the cost of repairs. The cost of repairs is simply an acceptable proxy for determining the reduction in value caused by the casualty. If the casualty loss provisions were intended to address the treatment of repair expenditures, the basis limitation rule would not be needed because the focus of attention would be on current expenditures.

The regulations provide that the cost of repairs to the property is acceptable as evidence of loss of value if the taxpayer can establish that:

- the repairs are necessary to restore the property to its condition immediately before the casualty;
- the amount spent for such repairs is not excessive;
- the repairs do not care for more than the damage suffered; and
- 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.¹⁶

¹⁰Reg. section 1.1016-6(a) and Rev. Rul. 71-161, 1971-1 C.B. 76.

¹¹Reg. section 1.165-7(b)(2)(i).

¹²Tariff of 1913, Ch. 16, 38 Stat. 114 (1913), Section II (B).

¹³T.D. 6445, 1960-1 C.B. 93.

¹⁴See *supra* notes 7 and 8.

¹⁵Indeed, the treatment of expenditures (if any) incurred to repair the damaged property fall squarely within the purview of the reissued proposed regulations.

¹⁶See *supra* note 8.

In 1999 the IRS released a chief counsel advice (CCA) on the interrelationships among sections 162, 165, and 263.¹⁷ The CCA was from the National Office to the North Central District and responded to the question as to how, after a flood, a taxpayer should treat the expenditures relating to the restoration of business property to pre-flood condition. The CCA notes that although the cost of repairs is not deductible as a casualty loss, it can serve as evidence of the diminution in FMV. It further notes that a taxpayer deducting a casualty loss measured by repair costs is not deducting the repair costs themselves because a casualty loss must result in a corresponding basis reduction.

In discussing the treatment of the costs to repair the damaged property, CCA 199903030 states that "these costs may be deducted under section 162 or they may be capitalized under section 263(a)." The CCA instructs the district to apply the traditional standards used in making determinations under sections 162 and 263(a) to the taxpayer's particular set of facts. It is impossible to read this CCA and come away with the view that repairs cannot be deducted if a casualty loss has been claimed.

B. Post-2005

In AM 2006-006, the IRS took the position publicly for the first time that if a loss is deductible as a casualty loss under section 165, the cost of repairing the property cannot be deducted as repairs but must be capitalized under section 263 (New Position). On April 27, 2007, the IRS's industry director for natural resource and construction issued a field directive on the examination of section 165 casualty losses. It reiterated the New Position in AM 2006-006 that if a casualty loss is claimed, the cost of the subsequent repairs must be capitalized.

Finally, both sets of proposed regulations¹⁸ provide that any costs to repair property that was the subject of a casualty loss (or for which a basis reduction occurred because of the receipt of insurance proceeds) must be capitalized.

C. The IRS's Rationale for Its New Position

One of the arguments the IRS has used to support the New Position is that the position is really not new. The IRS argues that Rev. Rul. 71-161¹⁹ specifically applies the principles of the New Position.²⁰ In that ruling, the issues concerned the income tax consequences of reimbursements for debris removal where a portion of the reimbursement was received in the year of the casualty and an additional portion was received unexpectedly in a subsequent year. The ruling acknowledges that the presence of debris contributes to the loss of FMV and the cost of removal may be used as evidence of the amount of the casualty. The ruling provides that to the extent the taxpayer was reimbursed for the debris removal during the year of the casualty, a casualty loss is not allowed. To

¹⁷CCA 199903030, Doc 1999-3330, 1999 TNT 15-36.

¹⁸See *supra* notes 1 and 2.

¹⁹Rev. Rul. 71-161, 1971-1 C.B. 76.

²⁰AM 2006-006, Doc 2005-24054, 2005 TNT 229-8; Large and Midsize Business Field Directive on the Examination of Section 165 Casualty Losses #1 (Apr. 27, 2007).

the extent that reimbursement was not anticipated and sufficient basis existed, a casualty loss for decline in value measured by the unreimbursed debris removal was permitted. In the subsequent year in which the remainder of the reimbursement was unexpectedly received, gross income was realized except to the extent of the operation of section 111 regarding an exclusion for the recovery of amounts deducted which did not result in a tax benefit.

After addressing the operation of the casualty loss rules to reimbursements, the ruling addresses the treatment of the costs incurred to remove the debris. It provides:

In the instant case, the cost of debris removal and repair of casualty damage is in the nature of replacement of the part of the property that was damaged. Accordingly, these costs should be capitalized and added to the taxpayer's basis in the property. See section 1016(a)(1) of the Code.²¹

The above language appears to be the basis of the IRS's statement, in AM 2006-006 and the subsequent field directive, that its position has been that a single casualty cannot give rise to both a casualty loss deduction and a business repair expense deduction. This would appear to be a strained and revisionist interpretation of Rev. Rul. 71-161. A statement prefaced by the words "In the instant case" is not normally interpreted as stating a rule of general application. The result could easily be different in another situation in which the cost of removal and repair was not in the nature of a replacement. From 1971 through 2005 the IRS had not suggested that Rev. Rul. 71-161 was intended to be interpreted in the manner it now suggests.

The legal support for the New Position in the preamble to the 2008 proposed regulations provides:

The 2006 proposed regulations required a taxpayer to capitalize amounts paid to repair property if the taxpayer properly deducted a casualty loss under section 165 with respect to a unit of property and the amounts paid restore the unit of property to a condition that is the same or better than before the casualty. The casualty loss rule provided in the 2006 proposed regulations was criticized. In general, commentators thought there should be no link between the recognition of a casualty loss under section 165 and the determination of whether the cost to replace the property destroyed (in part or in whole) after a casualty event constitutes a capital expenditure. However, significant authority implies that a casualty-type event generally may only be characterized either as an extraordinary event (thus giving rise to a "loss" under section 165), or as an ordinary and necessary event in the operation of a trade or business (thus giving rise to an ordinary and necessary deduction under section 162). See, e.g., *R.R. Hensler, Inc. v. Commissioner*, 73 T.C. 168, 179 (1979), *acq.*, (1980-2 CB 1); *Hubinger v. Commissioner*, 36 F.2d 724, 726 (2d Cir. 1929), *cert. denied*, 281 U.S. 741 (1930). Thus, a casualty is not an ordinary

event, and the cost to repair property damaged by a casualty is not an ordinary expense. Stated differently, a loss under section 165 represents a destruction of property necessitating a replacement, which is capital, while an ordinary event generally represents damage to property necessitating a repair, which may or may not be capital. Because the restoration cost resulting from a loss is not ordinary, it is not allowed as an ordinary and necessary expense under section 162, but is treated as a capital expenditure under section 263(a). Although it is clear that a casualty event generally results in two economic costs to the taxpayer (the destruction of the previously invested capital and the costs to replace the destruction), the event giving rise to both of these costs is the same.

In *Hubinger v. Commissioner*,²² the taxpayer's building, which was rented for business purposes, was damaged by fire. The taxpayer spent \$70,872 reconditioning the building and recovered \$29,730 through insurance. The IRS disallowed a casualty loss because the taxpayer was not able to establish the adjusted basis in the building, nor was it able to establish the amount of the damage caused by the fire.²³ Also, the taxpayer was not permitted to deduct the repair expenditures as an ordinary and necessary business expense because the court was unable to determine what portion of those expenditures, if any, was ordinary and necessary.

Although there is language in the *Hubinger* opinion that can be read to infer, as the IRS argues, that a casualty loss does not include any damage that would qualify as an ordinary and necessary business expense, the IRS's interpretation is not convincing.

The inference is premised at least in part on the view that the repair of property caused by a devastating fire can never be regarded as ordinary. In the Second Circuit's view, ordinary expenses "are those due to wear and tear and trifling accidental causes." Four years after *Hubinger* was decided, the Supreme Court gave the term "ordinary" a more expansive meaning than did the Second Circuit. In *Helvering v. Welch*,²⁴ the Supreme Court said:

Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

²²*Hubinger v. Commissioner*, 36 F.2d 724 (2d Cir. 1929), *aff'g* 13 B.T.A. 960, *cert. denied*, 281 U.S. 741 (1930).

²³Regulations permitting the use of the cost of repairs as a measure of damages were not to be promulgated for another 32 years. See *supra* note 13.

²⁴*Helvering v. Welch*, 290 U.S. 111 (1933).

²¹Rev. Rul. 71-161, *supra* note 19.

The preamble to the proposed regulations also relies on *Hensler Inc. v. Commissioner*.²⁵ The taxpayer in *Hensler* did construction projects involving the excavation and transportation of large quantities of dirt, rock, and other materials. As a result of a series of storms and flooding, its equipment became buried in mud and debris and was damaged. At issue was the treatment of the expenses incurred for the uncovering, cleaning, repairing, and replacing of the damaged equipment (in excess of the insurance recovery). The IRS argued that if expenses are incurred as the result of a casualty, they are deductible only as losses under section 165. The first question addressed by the Tax Court was whether the expenditures constituted ordinary and necessary business expenses. After addressing and rejecting the IRS's view of *Hubinger*, the court concluded that the expenditures were deductible under section 162.

The Tax Court noted in *Hensler* that in advancing its argument, the IRS relied heavily on *Hubinger*. The Tax Court observed that in *Hubinger*, the Board of Tax Appeals seemed to be distinguishing between ordinary and necessary business expenditures and capital expenditures, and it believed the court of appeals was dealing with the same distinction. In discussing *Hubinger*, the Tax Court said:

Most subsequent cases which have relied on *Hubinger* involved repair items which were capital outlays. Implicit in cases decided under similar factual circumstances is the holding that repair expenses are currently deductible as long as the repair involved did not prolong the life of a property, increase its value, or make it adaptable to a different use. The fact that the damage resulted from a casualty was not controlling. The nature of the expense rather than the event that occasioned it was the important factor for consideration.²⁶

The second question considered by the Tax Court in *Hensler* was phrased in the alternative; it asked if the expenditures were not deductible under section 162 but only under section 165, what was the timing of the deductions when viewed in the context of the outstanding insurance claims? The Tax Court concluded that it was unnecessary to address this question because it was an alternative contention and it had already decided in favor of the taxpayer regarding the first issue. In a footnote, however, the Tax Court said:

Petitioner's argument for a current casualty loss deduction is alternative only, and neither party addresses the question of whether petitioner may be entitled to both a deduction under sec. 162 and a casualty loss deduction under sec. 165. Nor has petitioner taken the position that the insurance recovery is given consideration only in reduction of the casualty loss. Consequently, we have not considered such issues.²⁷

Considering the Tax Court's statement that it did not consider the issue because it was not raised, and its rejection of the IRS's reading of *Hubinger*, it is difficult to find the source of the support the government finds in *Hensler*. Neither *Hubinger* nor *Hensler* provides significant support for the New Position.

The preamble to the proposed regs also suggests that all repair expenditures must be capitalized following a casualty event to ensure consistency in the tax treatment of similarly situated taxpayers. It compares a taxpayer who as a result of a casualty must replace its destroyed property with a new unit of property with a taxpayer who as a result of the same casualty suffers damage to a lesser degree. The preamble states that the first taxpayer would have to capitalize its repair costs, whereas, without a consistency requirement, the second taxpayer might argue that its repair costs were currently deductible under section 162.

First, one can take issue with the conclusion that the two taxpayers are similarly situated. Outside the tax realm, they are similarly situated in that they have been adversely affected by the same storm or other casualty. However, in a tax sense they are not similarly situated. The first taxpayer has suffered more extensive damages than the second taxpayer. It may be abundantly clear that the first taxpayer has to capitalize its repairs, whereas the second taxpayer may be permitted to claim a current deduction or may be in a gray area where reasonable people can differ. These results are not inconsistent. For tax purposes, the similarity of their situations (being adversely affected by the same storm) is far outweighed by the differences in their situations (the nature of the expenditures necessary to bring each to a point they were before the casualty event).

Second, the incentive for the second taxpayer to characterize its repairs as currently deductible does not result from the casualty loss provisions. The incentive arises from the fundamental difference between sections 162 and 263(a). Taxpayers are always going to consider whether their repair expenditures are currently deductible or must be capitalized — whether damages are caused by a casualty event or not.

Third, and of greatest concern, is the logic on which the inconsistency described in the preamble is premised. The IRS's rationale appears to be that if the event is extraordinary so as to be treated as a casualty event for purposes of section 165, it is inconsistent to treat the costs incurred to repair the resulting damage as ordinary under section 162.

The inconsistency that the preamble describes and the proposed regulations allegedly cure is an artificial inconsistency created by ignoring decades of how the IRS and the courts have interpreted the term "ordinary" as used in section 162. Under the reasoning in the preamble, if a weather-related event, perhaps a hurricane, is considered to be an extraordinary event giving rise to a casualty loss, that same hurricane cannot satisfy the requirement of ordinary for purposes of section 162. The fallacy of the IRS's logic is that it is not the hurricane that must satisfy the ordinary requirement for purposes of section 162; it is

²⁵*Hensler Inc. v. Commissioner*, 73 T.C. 168 (1979).

²⁶*Id.* at 180.

²⁷*Id.* at n. 9.

the taxpayer's response that must be ordinary. In *Helvering v. Welch*,²⁸ the Supreme Court made it clear that the cause of the expenditure may be a once in a lifetime event for the taxpayer. What must be ordinary is the taxpayer's response to the situation. See also *Kornhauser v. United States*, 276 U.S. 145 (1928). The IRS has also recognized on several occasions that the paying of an expense may be ordinary even if it does not occur frequently as long as the paying of that expense is a common and accepted practice.²⁹

It follows that in the event of a hurricane, the ordinary requirement of section 162 will be satisfied if experience shows that the subsequent payments (presumably for cleanup and repair) are the common and accepted practice in the business involved. In most businesses that have suffered a casualty, the common practice would be to incur cleanup and repair expenditures. The concern over consistency discussed in the preamble does not arise if the term "ordinary" as used in section 162 is interpreted in the same manner it has been for decades.

III. Other Considerations

A. GO Zone Act

The interrelationship among sections 162, 165, and 263 is not a subject that has been directly addressed legislatively. All of the provisions track their historical roots to the Tariff Act of 1913,³⁰ and there is little enlightening legislative history. There is, however, recent legislation that, although it does not specifically address the issue, does point in one direction.

The GO Zone Act was enacted to provide tax relief to affected taxpayers in the wake of hurricanes Katrina, Rita, and Wilma. The GO Zone Act added section 1400N to the code.³¹

Section 1400N(k) provides for a special five-year carryback period for net operating losses to the extent they are related to Hurricane Katrina. Among the enumerated deductions that can contribute to an NOL that is eligible for this special five-year carryback are casualty losses³² and repair expenses³³ to the extent they are attributable to Hurricane Katrina. Although there is not any specific discussion of the New Position, it would appear that Congress believed that a single casualty event can give rise to both casualty losses under section 165 as well as currently deductible repair expenses under section 162. The presence of both casualty losses and repair expenses contributing to an NOL under section 1400N(k) points to this conclusion. This would appear to put Congress at odds with the proposed regulations' position that an event sufficiently destructive to invoke

the casualty loss provision of section 165 cannot also be the subject of repair costs that are ordinary and necessary under section 162.

Section 1400N(f) concerns certain demolition and cleanup costs. In its description of the law regarding the treatment of debris removal before the GO Zone Act, the staff of the Joint Committee on Taxation said:

The treatment of the cost of debris removal depends on the nature of the costs incurred. For example, the cost of debris removal after a storm may in some cases constitute an ordinary and necessary business expense which is deductible in the year paid or incurred. In other cases, debris removal costs may be in the nature of replacement of part of the property that was damaged. In such cases, the costs are capitalized and added to the taxpayer's basis in the property. For example, Revenue Ruling 71-161, 1971-1 C.B. 76, permits the use of clean-up costs as a measure of casualty loss but requires that such costs be added to the post-casualty basis of the property.³⁴

Section 1400N(f) permits a deduction of 50 percent of certain debris removal or demolition costs related to Hurricane Katrina that would otherwise be capitalized.

When subsections (f) and (k) of section 1400N as well as the JCT staff's explanation of prior law are taken together, it is easy to conclude that the GO Zone Act was predicated on a belief that casualty losses and currently deductible repair expenditures are not mutually exclusive under the code.

B. The Roles of Sections 162, 165, and 263

The casualty loss rules of section 165 are designed to permit the victim of a casualty to recover all or a portion of a *prior* investment. If basis has previously been recovered, a reduction in FMV caused by a casualty event will not result in a casualty loss. This is accomplished by the basis limitation rule, which prevents a casualty loss in excess of basis. The casualty loss rules permit recognition of loss at a point of time earlier than is generally permitted. Normally, a taxpayer is not permitted to recognize the reduction in the value of an asset it holds until the asset is the subject of a closed and completed transaction.³⁵ This generally occurs at disposition, retirement, abandonment, etc. The casualty loss rules deviate from this practice by permitting loss recognition even though the taxpayer retains the property. Although it is unstated, it is not an unfair jump to conclude that the deviation from the principle of a closed and completed transaction is designed to assist casualty victims.

The cost of repairs is not a critical factor in establishing a casualty loss deduction. There is no requirement under the casualty loss rules that repairs ever be made, and the reduction in FMV can be ascertained through the use of

²⁸*Welch*, *supra* note 24.

²⁹See Rev. Rul. 79-412, 1979-2 C.B. 264; Rev. Rul. 58-479, 1958-2 C.B. 60; Rev. Rul. 57-502, 1957-2 C.B. 118; Rev. Rul. 56-359, 1956-2 C.B. 115; GCM 39352 (Apr. 12, 1985).

³⁰See *supra* note 13.

³¹GO Zone Act, section 101.

³²Section 1400N(k)(2)(B)(i).

³³Section 1400N(k)(2)(B)(v).

³⁴Technical Explanation of the Revenue Provisions of H.R. 4440, The Gulf Opportunity Zone Act of 2005 as passed by the House and the Senate, prepared by the staff of the Joint Committee on Taxation, Dec. 16, 2005, JCX-88-05.

³⁵Reg. section 1.165-1(b) and -1(d)(1); *Rockwell International Corp. v. Commissioner*, 77 T.C. 780 (1981).

an appraisal. In fact, for many years before the promulgation of T.D. 6445 in 1960, the use of repair costs as a measure of the reduction of FMV was not even permitted.³⁶ With certain limitations, the cost of repairs can be used to determine the reduction in FMV, but a casualty loss deduction is not a deduction for the cost of repairs. In the final analysis, the casualty loss provisions permit a taxpayer to recover a prior investment more rapidly than it would have had some event other than a casualty caused the reduction in FMV.

Sections 162 and 263 address the treatment of a *current* expenditure — in this instance repair costs. The proposed regulations draw on almost a century of case law and IRS guidance to provide a road map for deciding which repair expenditures must be capitalized. Unlike for casualty losses, the extent of unrecovered prior investment is not critical for determining whether section 162 or section 263 is applicable. What is critical is the effect the repairs will have on the property being repaired. Will the repairs extend the useful life of the property, enable it to perform a different function, etc? These factors, while critical to a section 162/263 analysis, are irrelevant for a section 165 analysis because first and foremost there is no required current expenditure to examine — just a reduction in FMV.

C. Neutralizing the Casualty Loss Deduction

The casualty loss rules provide a benefit to a victim of a casualty by permitting it in some instances to recognize a loss earlier than otherwise permitted. The New Position reclaims all or a portion of the casualty loss deduction by requiring the capitalization of repairs relating to the same casualty that would have otherwise been currently deductible.

Casualty losses are not the result of “planned transactions” entered into by willing parties. They occur as the result of unplanned events that rise to the level of casualties. Congress has chosen to provide victims of casualties with a tax benefit. That benefit is the recognition of a loss at a point in time earlier than would otherwise be permitted. There is a cost imposed on this benefit. The taxpayer must reduce its basis by the amount of the casualty loss recognized. A basis reduction is appropriate because, to the extent a casualty loss has been recognized, the taxpayer has recovered its basis. The casualty loss deduction is a timing benefit in that it permits the recovery of a taxpayer’s basis more rapidly than would otherwise be permitted.

The New Position imposes an additional cost on a taxpayer claiming a casualty loss. The additional cost is a timing cost that results from having to capitalize an expenditure that would otherwise be currently deductible. This additional cost can reduce or completely eliminate the benefit of the casualty loss deduction.

³⁶*Samuel Greenbaum v. Commissioner*, 8 B.T.A. 75 (1927).

A taxpayer who is the victim of a casualty, claims a casualty loss deduction, reduces its basis, and then uses its own resources (unreimbursed by insurance) to restore its property to the state it was in before the casualty is not abusing the system. There is no justification for causing it to give back the timing benefit of the casualty loss deduction by imposing a capitalization requirement on expenditures that would otherwise be currently deductible. Repairs arising from the occurrence of a casualty event should be subject to the same rules as repairs that do not arise from the occurrence of a casualty event.

IV. Conclusion

The revised proposed regulations would make sweeping changes to the rules on casualty repairs. This is achieved by disallowing a current deduction for repair expenses if the taxpayer is able to claim a casualty loss or receive insurance proceeds that result in a basis reduction.

The two cases the IRS relies on to support its position do not do so. *Hubinger* has not been interpreted by the courts in the manner suggested by the IRS. In fact, in *Hensler* the Tax Court stated that its interpretation of *Hubinger* is not in line with the interpretation given to it by most other courts. In *Hensler*, the Tax Court, through a footnote, explicitly states it has not reached the issue the IRS invokes it for.

In recent legislation spurred by Hurricane Katrina, Congress enacted provisions that are difficult to reconcile if you accept the premise of the proposed regulations that a single casualty event cannot be the impetus for both a casualty loss and deductible repairs. This should be taken into consideration as the IRS proposes to indirectly, but dramatically, alter the casualty loss landscape.

Also, the differences in the objectives of the capitalization rules and the casualty loss rules should be considered. Based on the existence of a casualty event, the proposed regulations manufacture an inconsistency between the treatment of different expenditures made at different times governed by different code sections that are designed to accomplish different objectives and are evaluated by different factors. The New Position puts a tremendous amount of weight on the existence of a casualty event — a factor of questionable relevance.

The IRS should withdraw the portion of the proposed regulations dealing with the treatment of repairs arising from casualty events. It should give serious consideration to whether the “consistency” it strives for can be justified by its reasoning. This is not a situation in which an arbitrary rule is needed simply to provide guidance. The entire body of the proposed regulations is intended to provide guidance to determine which expenditures, including repairs, must be capitalized. This guidance could, and should, apply to all repairs, regardless of whether they emanate from a casualty event or a non-casualty event.