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Comptroller General

OF THE UNITED STATES

The Personal Casualty And Theft Loss Tax Deduction: Analysis And Proposals For Change

The personal casualty and theft loss deduction provided by section 165(c) (3) of the Internal Revenue Code and sections 1.165-7 and 1.165-8 of the Treasury Regulations cannot be administered in an even-handed manner. Both taxpayers and tax administrators have difficulty applying the regulations governing personal casualty and theft loss deductions. The regulations pose many complex problems of definition, valuation, and computation, requiring some of the most difficult factual determinations in taxation.

Tax relief afforded by the loss deduction is erratic and unrelated to financial capacity to pay an income tax. Moreover, the provision lends itself to fraud and abuse. Consequently, the administrative difficulties in enforcing the provision far exceed whatever small tax relief may be afforded in particular hardship cases.

Congress should reassess the need to retain the personal casualty and theft loss deduction provision. GAO suggests several alternatives for Congress to consider.

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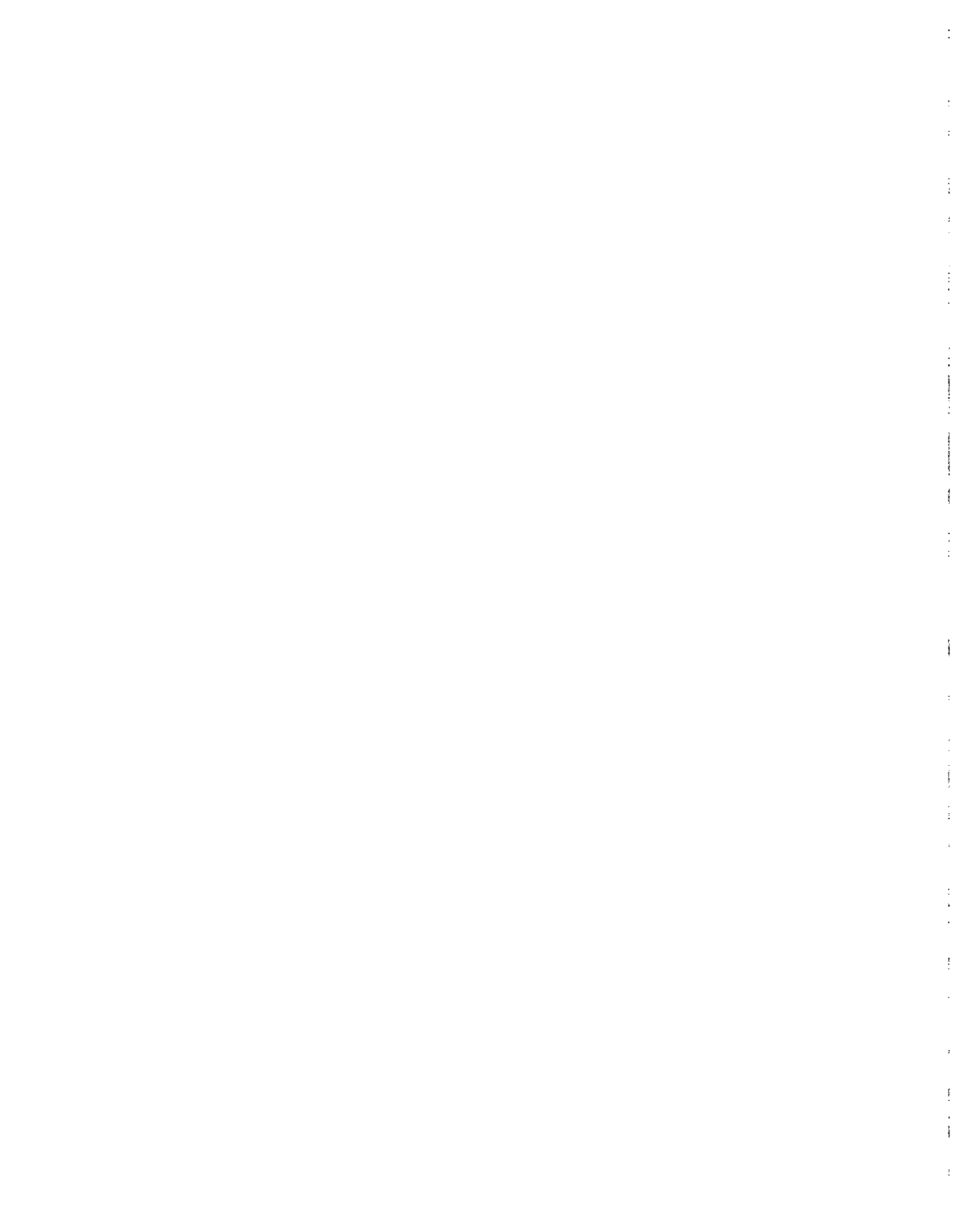


COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

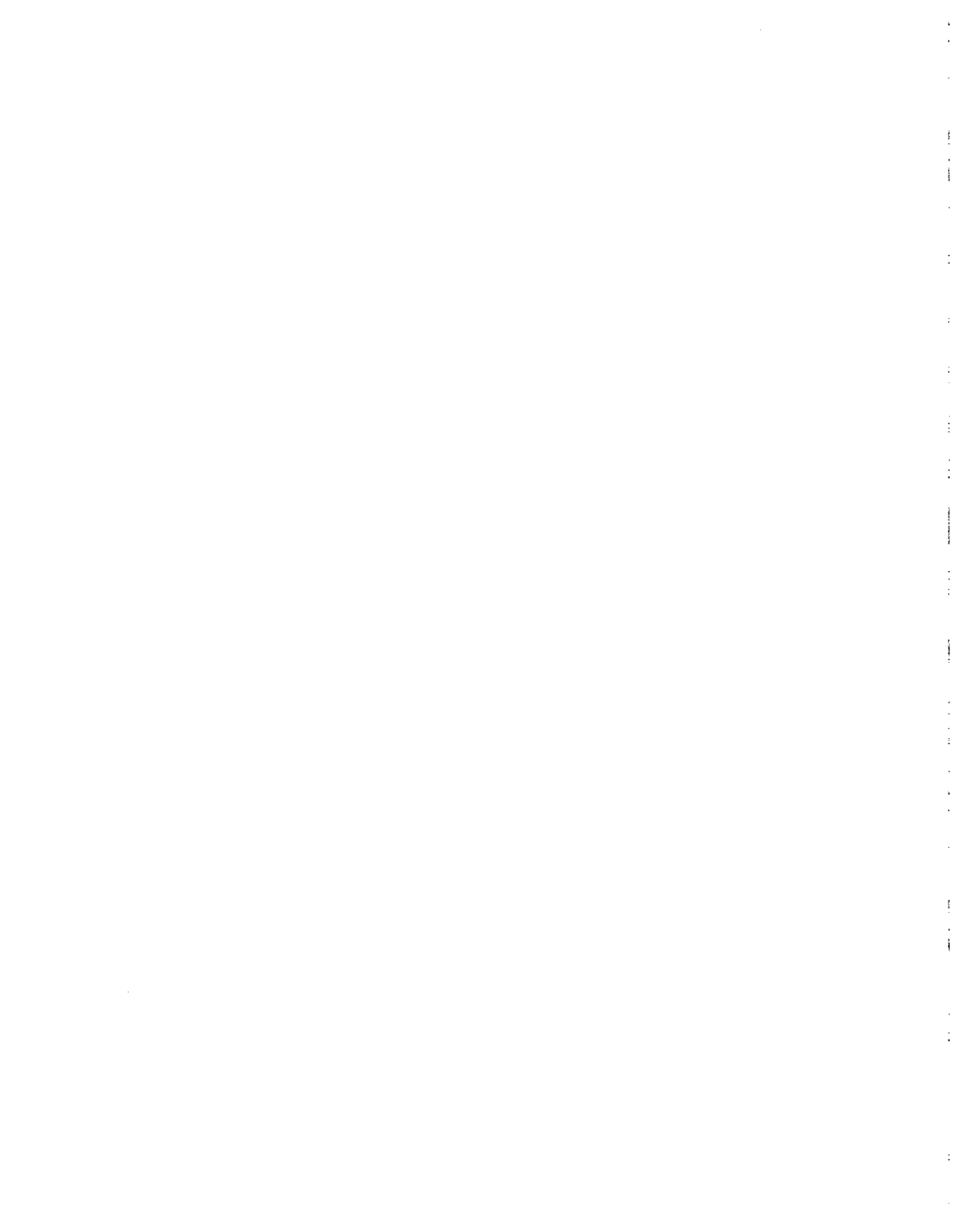
B-137762

To the Chairman and Vice Chairman
Joint Committee on Taxation
Congress of the United States

This report, one in a series in response to your Committee's request that we examine ways to simplify the tax laws, addresses problems of administration of the personal casualty and theft loss deduction provision. We recommend that the Congress reassess the need to retain the personal casualty and theft loss deduction provision in its present form and suggest several alternatives for the Congress to consider.

As arranged with your Committee, unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from its date. At that time, we will send copies to interested parties and make copies available to others upon request.

Comptroller General
of the United States



COMPTROLLER GENERAL'S REPORT TO THE JOINT COMMITTEE ON TAXATION CONGRESS OF THE UNITED STATES

THE PERSONAL CASUALTY AND THEFT LOSS TAX DEDUCTION: ANALYSIS AND PROPOSALS FOR CHANGE

DIGEST

This report examines the factual and legal issues which arise out of proposed deficiencies based upon disallowance of a deduction for personal casualty and theft losses and sets forth alternative proposed amendments to the Internal Revenue Code and Treasury Regulations designed to reduce controversy in this issue area.

POLICY JUSTIFICATION FOR THE DEDUCTION IS NOT CERTAIN

The legislative history of the personal casualty and theft loss deduction is silent as to the public policy considerations underlying original enactment of the provision in 1867. The provision is included in the President's Tax Expenditures Budget under the budget functional category "Personal Investment" on the ground that it is needed "to reduce income tax liabilities for taxpayers in special circumstances." The inference is that the special circumstances have a significant bearing on financial capacity to pay an income tax. Under present tax rules, the special circumstances include both uninsured personal losses and personal losses following partial insurance reimbursement. The result in either case is to make the Government a coinsurer of losses to nonincome-producing property held for personal use.

GAO based its findings and conclusions on a detailed examination of 124 randomly selected cases pending in the Appellate Division of IRS and 32 decided court cases. GAO also examined IRS data on compliance levels and Statistics of Income for the personal casualty and theft loss deduction provision.

IRS Statistics of Income data based on unaudited returns show that the casualty and theft loss deduction was claimed on about 2 million returns

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in 1976. The deduction claimed per return as a percentage of per return adjusted gross income decreases sharply and continuously as income levels rise. However, it cannot be inferred from this data that the deduction serves an ability-to-pay function for low income taxpayers unable to afford the cost of insurance. The Taxpayer Compliance Measurement Program of the IRS shows that, of the non-business taxpayers in the income class under $10,000, more than 78 percent made an error in claiming the personal casualty and theft loss deduction.

Most of the taxpayers in the sample of 124 contested cases were in the higher income levels and sustained a loss with respect to uninsured or underinsured personal assets. The average adjusted gross income for all taxpayers in the sample was $33,054. Sixty-nine percent of the items of property for which these taxpayers claimed personal casualty or theft losses were uninsured. Of the remaining 31 percent of property items which were insured, 37 percent were underinsured.

Moreover, 27 percent of the loss property in the 124 sample cases consisted of ornamental trees and shrubbery and miscellaneous personal property. The complete or partial destruction or loss of this kind of property does not significantly affect financial capacity for income tax purposes.

A detailed examination of the policy justification for the personal casualty and theft loss deduction is contained in chapter 3.

THE REGULATIONS ARE DIFFICULT TO APPLY

Section 165(c)(3) of the Internal Revenue Code allows an individual an itemized deduction for losses arising from a "fire, storm, shipwreck, or other casualty, or from theft" if, under section 165(a), such losses are "not compensated for by insurance or otherwise."

Under Treasury Regulations, the general rule for computing the amount of loss resulting from a personal casualty or theft is an amount equal to the lesser of (1) loss of fair market value or (2) adjusted cost basis.

A study prepared under IRS' Taxpayer Compliance Measurement Program, which estimated the frequency and amount of error for each line item on individual returns filed for tax year 1973, shows that taxpayer compliance is lower for the personal casualty and theft loss deduction than for any other line item except the medical expense deduction. Over 64 percent of taxpayers covered by the Program's sample deducted the wrong amount of casualty and theft loss.

GAO does not know to what extent the high error rate may be attributable to the fact that Schedule A of Form 1040 does not track the computation formula of the regulations. Form 4684, applicable to loss of multiple items of property and to multiple casualty losses, tracks the computation formula of the regulations but use of this form is not mandatory. GAO found a low level of use of this form by taxpayers in the 124 sample cases.

The 124 sample contested cases examined by GAO show that personal casualty and theft loss cases are seldom settled on the basis of the loss computation rules of the regulations. There is a decreasing level of compliance with the literal requirements of the regulations at successive stages of the appeals process, reflecting the fact that settlement of contested losses is reached by negotiation on the basis of litigating hazards.

It is no criticism of IRS administrative and compliance effort that enforcement of the personal casualty and theft loss deduction rules is erratic. The regulations require some of the most difficult factual determinations known to the income tax: "sudden loss" versus "progressive deterioration," fair market value, capital versus noncapital repair costs.

These factual questions constitute 40 percent of the issues raised in the sample of contested cases examined.

A detailed discussion of the Internal Revenue Code and regulations is presented in chapter 2. GAO's examination of the compliance problems involved in administering the personal casualty and theft loss deduction provision is discussed in chapter 4.

REGULATIONS RULES ARE INEQUITABLE

Two inequities result from the personal casualty and theft loss computation rules: one is a result of the computation-of-loss rules of the regulations; the other is a result of the netting requirements of section 1231.

The regulations allow a personal casualty or theft loss deduction for the lower of loss of value or cost basis. The purpose of this rule is to limit the amount of the allowable loss deduction to "the actual loss resulting from damage to the property."

This purpose is achieved in the case of loss sustained to depreciated-value, depreciable personal property (e.g., an automobile) where the market value immediately preceding the casualty reflects the capital value which the taxpayer has recovered through use of the property prior to the loss. This purpose is not achieved in the case of loss sustained to appreciated-value, depreciable personal property (e.g., a house) or to nondepreciable personal property (e.g., precious jewelry and artifacts). In both of these cases, the regulations rule fails to take into account (1) recovery of capital through use prior to the casualty and (2) increases in market value occurring before the casualty caused by a shift in market demand.

The result is to accord different tax treatment to taxpayers who have suffered like economic losses to uninsured or partially insured personal property. The taxpayer whose appreciated-value property is partially destroyed is accorded more favorable treatment than the taxpayer whose appreciated-value property is completely destroyed. With respect to the partial destruction cases, the taxpayer whose loss of market value is less in dollar amount than adjusted cost basis is preferred over the taxpayer whose loss of market value is greater than adjusted cost basis.

The netting rules of section 1231 add a further inequity. Under section 1231, personal casualty and theft losses are an offset against investment and business capital gains if net gains (personal, investment, and business) exceed net losses. The result of netting is to allow a tax-

payer with net section 1231 gains to deduct his personal casualty or theft loss from section 1231 gains and also to elect the zero bracket amount (before 1977 the standard deduction). In all other circumstances, the personal casualty or theft loss deduction is allowable only if the taxpayer elects to itemize.

RECOMMENDATIONS TO THE CONGRESS

The Congress should reassess the need to retain the personal casualty or theft loss deduction provision in its present form. (See pp. 62 to 70.)

In making such a reassessment the Congress could consider several alternatives.

--Repeal the personal casualty or theft loss deduction. The estimated revenue gain to the Treasury would be $425.2 million.

--Repeal the personal casualty or theft loss deduction and allow a deduction for all or a percentage of the cost of premiums for casualty and theft loss insurance covering real property and personal effects. The annual estimated revenue loss would be $1.25 billion if a deduction for the entire cost of premiums were allowed. This revenue loss measure could be reduced to approximate the revenue loss of the present casualty or theft loss deduction by limiting the deduction to a percentage of the annual premium cost with a ceiling imposed.

--Limit the allowable deduction to an amount in excess of a stated percentage of adjusted gross income. The revenue loss of a deduction with a 10 percent limitation would be $311.2 million, $114 million less than the present casualty loss deduction.

Additionally, this alternative could limit the personal casualty loss deduction to loss caused by fire, storm, volcano, earthquake, food, shipwreck, theft, and auto-automobile accident. Also, the loss property could be limited to a building or structure which is the taxpayer's principal residence and to motor vehicles and ships.

--Amend section 1231 to remove the casualty or theft loss of personal property from the netting rules applicable to gains and losses from investment assets and depreciable business assets. This change would not have a significant revenue effect.

--Repeal section 172(d)(4)(c) and treat an excess personal casualty or theft loss as a net long-term capital loss carryover under section 1212(b). This change would not have a significant revenue effect.

--Amend the calculation of loss rules of Regulations §1.165-7(b)(1) applicable to the casualty loss of nonincome-producing personal property to limit recognition of the amount of loss to adjusted cost basis, reduced by changes in market value unrelated to the casualty. This change would not have an appreciable revenue effect.

TREASURY COMMENTS

Treasury agrees with GAO that among the alternatives the Congress should consider in reassessing the need for the personal casualty or theft loss provision are repeal of the provision or enactment of a floor-type limit on the deductibility of the loss realized. (See pp. 68 to 69.)

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ABBREVIATIONS

AGI	Adjusted gross income
GAO	General Accounting Office
IRS	Internal Revenue Service
TCMP	Taxpayer Compliance Measurement Program

CHAPTER 1

INTRODUCTION

This report is the second in a series designed to cover eight issue areas which are a principal source of taxpayer-Internal Revenue Service (IRS) controversy, both at the administrative level and in the courts. 1/ These eight issue areas are:

1. Exclusion of scholarships and fellowships.
2. Deduction of educational expenses.
3. Deduction of personal casualty losses.
4. Unreported income.
5. Definition of taxable compensation.
6. Definition of trade or business.
7. Deduction of travel expenses.
8. Application of support test for children of divorced parents.

Our work, done at the request of the Joint Committee on Taxation, is a part of the larger effort by the Congress and the administration to simplify the Federal income tax laws. Our purpose in identifying and analyzing separately the principal sources of taxpayer-IRS controversy is to generate information on the basis of which to assess the impact of tax administration on tax policy. The public policy goal represented by a tax provision necessarily is frustrated if the provision is a frequent subject of dispute--for whatever reason.

Further, a high level of tax controversy poses a real threat to the voluntary self-assessment system. Audit resources are limited. When tax rules are ambiguous or are perceived to be unfair, it is to the advantage of taxpayers to resolve debatable items in their own favor. If

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1/The first two issue areas are covered in our report, "Changes Needed in the Tax Laws Governing the Exclusion for Scholarships and Fellowships and the Deduction of Job Related Educational Expenses" (GGD-78-72, Oct. 31, 1978).

a taxpayer is audited and a deficiency proposed, the financial outlay required to dispute the item either through administrative channels or by litigation can be relatively low. If a taxpayer chooses the Tax Court route, he does not have to pay the proposed deficiency in advance. Under the new small tax cases procedure of the Tax Court, he can litigate his case without an attorney. Further, as administrative rules and judicial precedents proliferate, taxpayers come increasingly to perceive it to be to their advantage to carry their cases through litigation in the Tax Court despite a record of favorable Government wins. In the personal casualty and theft loss area, as in several other tax areas, the point has been reached where the large volume of precedent generated by the formal administrative and judicial conflict-resolution process, instead of reducing the level of tax controversy, has itself become a contributing cause of controversy.

SCOPE OF REPORT

This report examines two aspects of the personal casualty or theft loss deduction:

--The principal legal and factual issues which generate taxpayer-IRS controversy.

--The equity and incentive policy considerations which underlie the deduction.

At the district level during the fiscal year ended June 30, 1976, 1,461 (3.7 percent) of the 39,146 individual income tax cases closed by district conferees were classified under the principal issue of personal casualty or theft loss deduction. At the Appellate Division level for fiscal year 1976, 19,493 nondocketed tax cases were closed by appellate conferees or by the filing of a petition. Of this total, about one percent, representing 179 cases, arose out of deficiencies based upon disallowance of a personal casualty or theft loss deduction.

Chapter 2 summarizes the current law and provides data on the legal and factual issues most frequently in dispute under code section 165(c)(3) and Regulations §§1.165-7 and 1.165-8. Chapter 3 examines the equity and incentive aspects of the personal casualty or theft loss deduction. Chapter 4 examines the enforcement and compliance problems created by the personal casualty or theft loss deduction.

This program provides information on the level of taxpayer compliance by income class. We considered only the level of compliance with the personal casualty or theft loss deduction provision.

--Personal casualty or theft loss data furnished by the IRS Statistics Division, using the Tax Model of Individual Income Tax Returns for 1976.

Our data base does not include returns examined at the district level in which personal casualty or theft losses are involved. We therefore have no knowledge of the average size of adjustments or the reasons for the adjustments at that level. The IRS reporting system does not have sufficient capacity to permit separate reporting of personal casualty or theft losses except as covered by the TCMP survey.

CHAPTER 2

THE REGULATIONS RULES ARE COMPLEX AND RESULT IN INEQUITIES

INTRODUCTION

Section 165(c)(3) allows an individual an itemized deduction for losses arising from "fire, storm, shipwreck, or other casualty, or from theft" if, under section 165(a), such losses are "not compensated for by insurance or otherwise." This provision is a statutory exception to the general rule that losses of nonbusiness, nonincome-producing property are not recognized for tax purposes. 1/

The regulations rules governing the personal casualty or theft loss deduction are complex and difficult to apply. Moreover, they reach an incorrect result in the case of loss to appreciated-value depreciable property and nondepreciable property. The netting rules of Section 1231 add a further complexity and discontinuity to the tax treatment of personal casualty and theft losses. As explained in greater detail in chapter 4, our study of 124 sample contested cases shows that personal casualty and theft loss cases are seldom settled on the basis of the loss computation rules of the regulations.

LEGISLATIVE HISTORY

There is no legislative history on the congressional intent underlying the original enactment of the personal casualty or theft loss deduction. The provision was first enacted in 1867 as an amendment to the Revenue Act of 1864. The amendment allowed deductions only for nonbusiness "losses actually sustained during the year arising from fire, shipwreck." In 1870, Congress extended the deduction to cover losses from "floods." The unconstitutional Income Tax Act of 1894 redrafted the deduction to read "losses actually sustained during the year * * * arising from fire, storms, or shipwreck, and not compensated for by insurance or otherwise." The 1894 language was reenacted by the Revenue Act of 1913 and again amended in 1916 to add the words

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1/Loss of a personal asset is not deductible for tax purposes because income derived from the use and enjoyment of personal assets and from unrealized appreciation in value is not recognized for tax purposes. The decrease in net worth attributable to the depreciation (using up of) or loss of personal assets and the costs incurred to maintain personal assets also are not recognized for tax purposes.

"other casualty or from theft."

The first statement of congressional intent is set forth in the committee reports to the 1964 amendment to section 165(c)(3). This amendment limited the personal casualty or theft loss deduction to the amount of loss sustained in excess of $100 for each separate casualty. The explanation given for this amendment indicates that Congress regarded the deduction as a tax relief provision, not as a refinement of the definition of net taxable income. 1/

> "Your committee believes that in the case of nonbusiness casualty and theft losses, it is appropriate in computing taxable income to allow the deduction only of those losses which may be considered extraordinary, nonrecurring losses, and which go beyond the average or usual losses incurred by most taxpayers in day-to-day living. In view of this, your committee believes that it is appropriate to limit the casualty loss deduction to those losses or thefts above a minimum amount. The minimum selected by your committee was $100 per casualty loss, since this corresponds approximately with the '$100 deductible' insurance carried by many individuals in the United States with respect to such losses. This means that no deduction will be allowed in the case of an ordinary 'fender bending' accident or casualty, but that casualty and theft losses will continue to be deductible (over the $100) in those areas where they are sufficient in size to have a significant effect upon an individual's ability to pay Federal income taxes." House Report No. 749, 88th Cong., 1st Sess., 52 (1963).

The Tax Reform Act of 1969 amended section 1231 to make it clear that the "netting" requirement of

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1/The tax relief aspect of the personal casualty or theft loss deduction is reinforced by the fact that it is the only personal deduction which is allowable for purposes of computing the net operating loss of an individual under section 172. Section 172(d)(4)(C); Regulations §1.172-3 (a)(3)(iii).

that section applies to casualty or theft losses of personal property. That is, casualty losses of personal property, as well as losses of investment and business property, must first be offset against capital gains. 1/ If the overall position of taxpayer under section 1231 is a gain, the personal casualty or theft loss is an offset against capital gain income. It is not treated as an itemized deduction. If the overall position of taxpayer is a loss, the personal casualty or theft loss can be claimed as an itemized deduction, provided taxpayer does not elect the zero bracket amount (before 1977 the standard deduction.)

IT IS DIFFICULT TO COMPUTE A CASUALTY OR THEFT LOSS

Under the regulations, the same computation rules apply to determine the amount of loss resulting from a casualty as from a theft except that in the case of a theft loss, the fair market value of the property after the theft is considered to be zero. 2/

The regulations do not expand on the statutory definition of casualty. In particular, they do not define "other casualty" beyond defining as a casualty collision damage to an automobile, including damage resulting "from the faulty driving of the taxpayer or other person operating the automobile" provided such damage "is not due to the willful act or willful negligence of the taxpayer or of one acting in his behalf." Losses resulting from a casualty are covered by Regulations §1.165-7; theft losses are covered by Regulations §1.165-8.

The general rule for determining the amount taken into account under section 165(c)(3) as a casualty or theft loss is the same for both business or investment property and for personal, nonincome-producing property. It is the same for depreciable personal property (e.g., a house or automobile) as for nondepreciable personal property (e.g., jewelry, art objects). The loss is an amount equal to the lesser of (1) the difference between fair market value before the casualty and fair market value after the casualty or (2) the adjusted basis. 3/

1/Regulations §1.1231-1(b).

2/Regulations §1.165-8(c).

3/Regulations §1.165-7(b)(1).

The amount of loss allowable as a deduction under section 165(a) is reduced by insurance or other reimbursement received.

In the case of the total destruction or theft of business or investment property, the amount of the loss deduction is the adjusted basis reduced by insurance or other reimbursement. 1/ The regulations are drafted in terms of the theft or total destruction of depreciated-value, income-producing property where the fair market value before the casualty is less than adjusted basis. In fact, in the case of income-producing property, the loss allowable is limited to adjusted basis in any case where the fair market value after the casualty is zero, whether the fair market value before the casualty is less than or greater than adjusted basis.

In the case of loss through partial destruction of depreciated-value, income-producing property, the dollar amount of the loss caused by the casualty is the correct measure of loss because decline in value unrelated to the casualty event has been recovered through depreciation or could be recovered through sale of the remaining property at a loss after the casualty.

On the other hand, if depreciated-value, income-producing property is totally destroyed by casualty or is stolen, the casualty or theft is not, strictly speaking, the measure of the loss. It is a taxable event, the occasion for realizing and recognizing the entire loss of taxpayers' unrecovered capital investment, including loss through decline in market value occurring before the casualty or theft and not previously taken into account by depreciation.

The method of aggregating property for purposes of computing loss depends upon whether the property to which the loss applies is income-producing property (business or investment) or is personal, nonincome-producing property. With respect to income-producing property, the amount deductible as the result of a casualty is computed separately for each item damaged or destroyed. With respect to per-

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1/Regulations §1.165-7(b)(1).

sonal, nonincome-producing property, the amount deductible as a result of a casualty is computed with respect to the entire property. 1/

For all property, income- and nonincome-producing, fair market value must be established by "competent appraisal." 2/ The cost of repairs which are not so extensive as to amount to a capital expenditure are "acceptable as evidence of the loss of value." 3/

In the year of loss by casualty or theft, 4/ the amount of the loss is a deduction from adjusted gross income to reach taxable income, assuming that the "netting" provisions of section 1231 do not apply. This means that the deduction is not a tax relief measure for the taxpayer who does not elect to itemize his personal deductions. Further, the tax saving generated by the deduction is offset by the tax value of the standard deduction (zero bracket amount) foregone by taxpayers for whom the only or principal itemized deduction is a personal casualty or theft loss. If the allowable loss exceeds adjusted gross income reduced by all other allowable itemized deductions, the excess is available as a net operating loss carryforward. The carryforward is an offset against gross income to reach adjusted gross income. This means that in carryforward years, but not in the year of loss, taxpayer can deduct the casualty or theft loss and elect the standard deduction (zero bracket amount). 5/

The tax saving value of the deduction is a function of the taxpayer's marginal tax rate applied to the dollar amount of the loss. This means that the higher the income

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1/Regulations §1.165-7(b)(2)(ii).

2/Regulations §1.165-7(a)(2)(i).

3/Regulations §1.165-7(a)(2)(ii).

4/Section 165(h) of the code provides an exception for qualified disaster losses which may, at the election of the taxpayer, be deducted for the taxable year immediately preceding the taxable year in which the disaster occurred.

5/IRS tabulates and reports the net operating loss separately only for purposes of computing the minimum tax on tax preference income for individuals. We therefore do not know the significance, as a factor, of the double allowance of the standard deduction and a personal casualty loss carryforward.

level of the taxpayer the higher the tax value of the casualty or theft loss deduction. For example, $1,000 of loss sustained by a taxpayer in a 70 percent marginal tax rate bracket is worth $700; the same amount of loss sustained by a taxpayer in a 30 percent bracket is worth $300. Moreover, since in the usual case the size of the loss decreases with income, the $100 floor on the amount of the allowable deduction reduces the taxsaving value of the deduction disproportionately more for a person with a low income.

With respect to all property partially destroyed, the adjusted basis of the property in the hands of the taxpayer after the casualty must be reduced by the amount of the allowable loss deduction plus insurance, if any, received; and the basis must be increased to reflect the cost of repairs not deducted as a loss. If the insurance or other compensation received is greater than the adjusted cost basis, a capital gain is realized. Taxable gain plus the cost of repairs which are not deducted as a loss are added to the after-casualty basis.

Application of section 1231
of the Internal Revenue Code

Different computation of loss rules apply under section 1231 of the code. If, in one taxable year, taxpayer has both personal and investment casualty or theft gains and losses and capital gains and losses from the sale or exchange or involuntary conversion of business assets, and if the sum of the section 1231 gains exceeds the sum of the section 1231 losses, the casualty or theft losses of personal property are an allowable offset against the business and investment gains (including sales and exchanges) taxed as long-term capital gain whether or not taxpayer itemizes his deductions. However, if the sum of personal, investment, and business casualty and theft losses (not taking into account gains and losses on the sale of depreciable business property) exceeds the sum of such casualty and theft gains, the personal casualty and theft losses are not netted with the section 1231 gains and losses, but are deducted separately from ordinary income, provided, of course, that taxpayer elects to itemize his deductions.

The following three-step computation is required to determine whether the "netting" provisions of section 1231 apply:

1. Add together all personal, investment, and business casualty and theft gains and losses. If losses exceed gains, the netting provisions do not apply. Personal casualty and theft losses are deducted against adjusted gross income to reach taxable income.

2. If casualty gains exceed casualty losses in step (1) above, the netting provisions apply. Add together all personal, investment, and business casualty and theft gains and losses <u>plus</u> all gains and losses from the sale or exchange of depreciable business property. If the gains exceed the losses, the net gain is taxable as long-term capital gain.

3. If the losses exceed the gains in step 2, the business and investment losses are deductible from gross income to reach adjusted gross income and the personal casualty and theft losses are deductible from adjusted gross income to reach taxable income.

IT IS DIFFICULT TO DEFINE AND VALUE A PERSONAL CASUALTY LOSS

"Other casualty" is defined by case law

Losses caused by an "other casualty" are deductible. However, it is not certain what loss events are includible within the statutory term "other casualty."

Neither the statute nor the regulations define "other casualty." An analysis of cases in which the definition of "other casualty" has been the principal issue indicates that there are four evidentiary requirements which, in some combination, must be satisfied in order for a taxpayer to claim

a loss deduction. 1/ These prerequisites require the taxpayer to show that the loss was

--unexpected and occurred by chance 2/ or

--was an unusual effect of a known cause 3/ or

--resulted from a sudden, identifiable event which is isolated from other events or sequences that could have caused loss of value 4/ or

--resulted from the intervention of a hostile agency over which taxpayer had no control. 5/

Except in the case of involuntary conversion, absence of the suddenness factor is alone sufficient to support disallowance of a casualty loss deduction. 6/

1/The statistically significant variables were determined by examining all of the cases classified by IRS under the uniform issue number 0165.04-14, "other casualty" for the period July 1967 through June 1978. Of the 32 total reported decisions, 9 were rejected because incorrectly classified; 6 were rejected because the issue concerned burden of proof of loss issues and did not reach the definitional question. The 17 cases decided on the basis of the definitional issue consist of 14 Tax Court memorandum opinions, 2 Tax Court opinions and one opinion of the Second Circuit Court of Appeals. Factor (3), the "suddenness" requirement, was a criterion in 88.2 percent of the cases; the other three factors each have a weight of 23.5 percent.

2/Appleman v. United States, 338 F. 2d 729 (7th Cir. 1964).

3/Matheson v. Commissioner, 54 F. 2d 537 (2d Cir. 1931).

4/Matheson v. Comissioner, supra. The IRS has followed the Matheson case in administrative rulings involving casualty losses. Rev. Rul. 79, 1953-1 C.B. 411; Rev. Rul. 72-592, 1972-2 C.B. 101. See Rev. Rul. 61-216, 1961-2 C.B. 134, in which the Treasury stated: "Suddenness is an essential element of a casualty for purposes of section 165(c)(3) * * *."

5/Fay v. Helvering, 120 F. 2d 253 (2d Cir. 1941).

6/Estate of Fuchs, 413 F. 2d 503 (2d Cir. 1969) (confiscation of a residence by the government of Czechoslovakia.) To the same effect see Rev. Rul. 59-102, 1959-1 C.B. 200; Rev. Rul. 66-334, 1966-2 C.B. 302.

Table 2-1 on page 14 shows how the cases are placed with respect to each factor and who won. Each factor which is a decision variable is marked by either a plus or a minus sign. A plus sign means that the court found in favor of the government on the issue. A minus sign means that the court found against the government on the issue. A zero sign means that the factor was not an element in the decision. The number before each decision shows the number of cases conforming to the fact pattern which characterizes that decision.

Table 2-1

DECIDED CASES	event was not unexpected; it did not occur by chance	event was not an unusual effect of a known cause	event was not a sudden, identifiable happening	there was no intervention by a hostile agency	DECISION
(1) Jack Farber 57 TC 714;	-	-	-	+	T
(2) David Adams TCM 77-308;	+	+	+	O	G
(2) Clarence Daugetter, Jr. TCM 77-56;	+	+	+	O	G
(1) Howard Stacey TCM 70-127;	+	O	+	O	G
(1) Samuel Dubin TCM 76-256;	+	O	O	+	G
(2) Paul W. Black; TCM 77-337	0	0	-	0	T
(9) Brooks Round-tree TCM 68-165;	O	O	+	O	G
(9) Edward Benner TCM 77-162;	O	O	+	O	G
(9) Lauren Whiting TCM 75-38;	O	O	+	O	G
(9) Ira Edens TCM 74-309;	O	O	+	O	G
(9) Eric Rose TCM 72-39;	O	O	+	O	G
(9) William Bryan TCM 71-198;	O	O	+	O	G
(9) Harvey Banks TCM 71-109;	O	O	+	O	G
(9) Henry Berry TCM 69-162;	O	O	+	O	G
(9) Ellery Newton 57 TC 245;	O	O	+	O	G
(2) Sid Klawitler TCM 71-289;	O	O	-	O	T
(1) Estate of Fuchs 413 F. 2d 503 (2d Cir. 1969)	O	O	O	-	T

LEGEND:

+ = The factor is present and the Court found for the Government.
- = The factor is present and the Court found for the taxpayer.
O = The factor is not present.
(Number) = Number of decided cases conforming to this pattern with respect to the factors.
T = Decision for taxpayer.
G = Decision for Government.

The judge-made rule which can be derived from the "other casualty loss" cases may be expressed as follows:

> A loss event qualifies as "an other casualty" if the event is a sudden, identifiable occurrence which can be isolated from other events or sequences which might also lead to loss of value. The fact that the taxpayer, with due care, might have been able to prevent the happening of the loss event will not disqualify the event as a casualty if otherwise it meets the test of suddenness. Facts showing that the loss event was unexpected, occurred by chance, or was an unusual effect of a known cause are evidence that it is an isolated occurrence.

A listing of the loss events covered by the 13 cases in Table 2-1 which resulted in judgment for the Government indicates the kind of administrative and compliance problems created by the attempt of taxpayers to fit losses caused by deterioration through use and other personal losses into the casualty loss mold. Loss deductions were claimed, and disallowed, for traffic noise, death of a horse by colic, faulty construction of a retaining wall, soil erosion, college expenses incurred for a son who was drafted, a leaky roof, settling of a house due to gradual subsoil shrinkage (two cases), cost of laying a cement sidewalk, metal fatigue in an automobile engine (three cases), and erosion of an access road. Taxpayer wins involved loss due to the mistaken application of chemicals to a lawn, expropriation of foreign situs realty, sudden subsoil shrinkage following heavy rains, and beetle infestation of trees.

<u>The case-law definition of "other casualty" has little precedent value</u>

Uniform enforcement of the "other casualty" loss provision of the statute is virtually impossible because any personal loss resulting from the unavoidable vicissitudes of life is likely to appear as a "sudden" loss of net worth to the taxpayer--and he will so argue if it means a saving in income tax. The IRS will settle if the examiner believes that there is some merit to the taxpayer's perception of his loss.

Our examination of 124 contested casualty loss cases shows that, despite the fact that the legal definition of "other casualty" is clearly stated and consistently applied by the courts, taxpayers display considerable ingenuity in

effecting a percentage settlement of proposed deficiencies based on the deduction of personal losses. For example, a claimed loss of $5,000 caused by the dry rot of a pleasure yacht was settled by allowance of a $1,500 loss deduction because the evidence did not clearly establish whether the rot had occurred over a 2-month or over a 23-month period. Each side was prepared in the event of trial to call an expert witness who would testify to a 2-month period (for the taxpayer) or a 23-month period (for the Government).

In another case, a taxpayer claimed a casualty loss of $525 for food stored in a 15-year old freezer where the food spoiled because the freezer thermometer broke while the taxpayers were on vacation. The appellate conferee conceded the issue and allowed the full amount of the loss claimed because "to them (i.e., the taxpayers) the loss was sudden and unexpected and it seems to be simply a matter of interpretation."

In another case an employee in a city water department claimed a $2,000 casualty loss deduction for legal fees incurred to press a damage claim arising out of the failure of the city to promote the taxpayer to labor foreman. Taxpayer contended that payment of the fee amounted to an involuntary conversion because the attorneys "simply took his money." He sued the attorneys to recover the $2,000 fee and deducted the amount when his suit was dismissed. The appellate conferee disallowed the $2,000 fee as a casualty loss in the year claimed (1973) but allowed the fee as a business expense deduction for the year of payment (1970) under a liberal interpretation of the provisions of sections 1311 through 1314.

Valuation of loss property is a significant source of controversy

When property subject to a casualty loss is valued, the effect is to establish a surrogate market price for a transaction that has not occurred. "Value" is an elusive concept, difficult to define and subject to varying interpretations. "Fair market value" for tax purposes, and generally, is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." 1/ The regulations do not provide valuation guidelines for property loss by casualty. They require only that market value

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1/Regulations §20.2031-1(b), applicable to valuation for estate and gift tax purposes.

before and after the casualty be established by competent appraisals. 1/ However, it is very difficult to determine accurately the market value of a personal asset even under the most favorable of circumstances. Appraisals by IRS personnel are especially difficult because typically they are made long after the casualty has occurred. As a practical matter, in contested cases where the issue in dispute concerns market value, the dollar value of the loss allowed more often than not reflects an approximate mean of the appraisal values assigned to the loss by taxpayer's expert and the IRS engineer-agent.

The difficulty of proving fair market value is a significant source of confusion and litigation in the casualty loss area. For the 124 disputed cases covered by our sample, disagreement between IRS and taxpayers concerning fair market value of the property damaged or destroyed was the second most frequent reason for asserting a proposed deficiency. 2/

Especially difficult is the problem of valuing ornamental trees and shrubbery damaged or destroyed by weather. The administrative position of the IRS is set forth in Revenue Ruling 68-29, 1968-1 C.B. 74:

> In determining the amount of a casualty loss to nonbusiness residential property, shade and ornamental trees are considered an integral part of the real property having no separate value. Therefore, any loss for damage to the trees resulting from a casualty must, to be allowable, be the result of an actual decrease in the value of the property as a whole. While the actual cost of replacing the trees is not necessarily conclusive in determining the amount of the loss, it may, where appropriate, serve as evidence of the decrease in value of the property.

Compliance activity in this area is cast in terms of a contest between tree-lovers (taxpayers) and engineer-agents. The problem does not lend itself to an easy solution. Although Revenue Ruling 68-29 does not allow use of a shade tree evaluation formula, the regulations would

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1/Regulations §1.165-7(a)(2)(i).

2/Failure to substantiate the amount of the loss claimed was the most frequent reason for asserting a proposed deficiency. See chapter 4.

appear to support the position of taxpayers who claim a loss deduction based upon application of one of the many shade tree evaluation formulas, supported by an expert appraisal. However, use of a shade tree evaluation formula typically produces a loss figure greatly in excess of loss of market value for the property as a whole. For example, in one case, if the average value claimed for the trees lost had been applied to the number of trees remaining, the total value of the trees remaining would have exceeded the assessed value of the property.

Representative of the kind of problem involved is the following case which was settled. A taxpayer claimed a loss of $50,000 for damage to trees on property which the appellate conferee described as "park-like, having broad lawns, blessed with majestic trees extending over five rolling acres." The taxpayer secured several appraisals which supported the amount of loss claimed. The IRS engineer agent placed little value on the damaged trees and recommended that the loss allowed be limited to debris-removal costs of $12,000. The engineer's report concluded that "it did not appear to the engineer that there was any substantial decrease in the value of the property as a whole due to damage caused by the wind storm." The appellate conferee attached some value to the trees for market valuation purposes and allowed a loss deduction of $22,000 to $24,000" to cover loss of market value of $14,000 and cleanup costs, not yet established, of from $8,000 to $10,000.

Allowance of a casualty loss deduction in any amount for loss resulting from the destruction of ornamental trees is open to question on equity grounds. Loss of this kind does not directly affect taxable capacity. It may be disagreeable to look out upon frozen bushes or fallen trees. However, the taxpayer who suffers this kind of a loss is still housed; his ability to earn a living and his health have not been impaired. The effect of applying the casualty loss deduction provision to ornamental trees and shrubs is to recognize for tax purposes loss of value that is realized but which does not directly affect ability-to-pay in the year of loss. Of course, if the entire real property is sold, the loss recognized is offset by the

increased capital gain attributable to the reduction in basis. 1/ This may occur in the year of loss or in a later year.

Cost of repairs rule is difficult to apply

The cost of repairs rule is simple to state but difficult to apply. Under the regulations, for measurement of loss purposes, cost of repairs limited to restoring damaged property to its condition immediately before the casualty is acceptable as evidence of loss of value. 2/ For business expense deduction purposes, a repair is any expenditure which neither prolongs the depreciable life of the property nor increases the basis of the property. 3/

This rule reflects the underlying distinction made for tax purposes between repairs to depreciable personal property (regarded as personal living expenses) and improvements to depreciable personal property (regarded as additions to basis and recovered on disposition at a gain

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1/This distinction between realization and recognition of loss of value is difficult for taxpayers to grasp. Further, it is not clear that taxpayers do in fact reduce the basis of property partially destroyed by casualty to reflect the amount of loss deducted. As a practical matter, it is difficult, if not impossible, for an agent, on examination of a sales transaction, to determine whether the cost basis, proved by the deed of sale, for example, has been reduced to reflect a loss occurring many years in the past. In one case covered by the sample, the taxpayer, an accountant, claimed a $16,230 casualty loss for damage to ornamental trees located on the lawn of his personal residence. In the year following the loss year, he sold the property at a gain computed on the basis of cost without reductions for the $16,230 loss claimed. This fact was brought to light only because the taxpayer's return for the loss year was audited and still open in the year of sale.

2/Regulations §1.165-7(a)(2)(ii).

3/Regulations §1.162-4.

but not recoverable by depreciation during the period of use.) In practice, the attempt to apply the distinction between repairs and capital improvements to personal property damaged by a casualty has generated substantial taxpayer-IRS controversy.

The distinction between repairs and capital improvements is determined by (1) the amount of the expenditure and (2) the period over which the benefits derived from the expenditure can be expected to last. Application of these criteria frequently differ depending on whether the property in question is business or personal.

With respect to business property and personal property partially destroyed by casualty, it is to the advantage of the taxpayer to argue that the amount expended, in relation to the period of use, qualifies the outlay as a repair so that the cost can be recovered currently. 1/ With respect to personal property restored after loss due to gradual deterioration, it is to the advantage of the taxpayer to argue that the amount expended, in relation to the period of use, qualifies the outlay as a capital improvement. In such case, while taxpayer cannot recover his cost by depreciation over the period of use, he can recover the cost by adding it to basis for purposes of determining the amount realized in the event of sale at a gain.

In any event, cost of repairs is not a correct measure of loss-of-value to depreciable personal property partially destroyed by casualty. If taxpayer retains the property damaged by casualty, cost of repairs is not a correct measure of loss because the taxpayer will recover his cost through use. If taxpayer does not retain the property damaged by casualty, cost of repairs is not a correct measure of loss because such costs can be either deducted as "fix-up costs" or added to basis for purposes of determining gain or loss. 2/

1/Of course, in the case of business property, repair costs are recoverable in any event. The effect of capitalization is to postpone recovery over the period of the useful life of the repairs or until sale at a step-up in basis.

2/Rev. Rul. 72-118, 1972-1 C.B. 227.

THE COMPUTATION RULES REACH AN INCORRECT TAX RESULT

Objective of the computation rules

Under the regulations the measure of casualty or theft loss to personal property is the lower of loss of fair market value or adjusted basis. This measure of loss applies to the partial destruction, total destruction, or theft of both appreciated-value and depreciated-value personal property. It applies also to both depreciable and non-depreciable personal property.

The objective of the regulations rules is to limit the amount of the allowable casualty loss deduction, due to damage to personal property, to "the actual loss resulting from damage to the property." 1/ Three structural defects in the loss computation rules of Regulations §1.165-7 and Code Section 1231 result in failure to achieve this objective.

--The first defect is the failure of Regulations §1.165-7 to take into account recovery of capital through use prior to occurrence of the casualty.

--The second defect is the failure of Regulations §1.165-7 to take into account shifts in market value unrelated either to depreciation through use or to the occurrence of the casualty.

--The third defect, based on section 1231, is the requirement that personal casualty and theft losses be netted with business and investment casualty and theft gains and losses and gains and losses on the sale of depreciable business property in cases where personal, investment, and business casualty and theft gains exceed casualty and theft losses.

The result of all three of these defects is to accord different tax treatment to taxpayers who are in like economic or financial circumstances and incur the same dollar amount of losses. The taxpayer whose appreciated-value property is partially destroyed is treated more favorably than the taxpayer whose property is either completely destroyed or stolen. With respect to the partial destruction cases, the taxpayer whose loss is less than adjusted basis is preferred over

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1/Regulations §1.165-7(a)(2)(1).

the taxpayer whose loss is equal to adjusted basis and the taxpayer whose loss is equal to adjusted basis is preferred over the taxpayer whose loss is greater than adjusted basis.

How can the objective of the regulations rules be achieved?

This difference in tax treatment could be avoided to a considerable extent if recognition of the amount of casualty loss to personal property were limited to the actual loss resulting from the casualty or theft. If recognition of the amount of loss realized at the time of casualty or theft were limited to taxpayer's adjusted cost basis, reduced by capital recovered through tax free use, the result would be in all cases to limit the allowable loss deduction to the amount of loss caused by the casualty or theft. However, as a practical matter, it is impossible to separate changes in market value unrelated to use from changes in market value which reflect physical deterioration through use and to place a value on recovery of capital through use, whether or not the use is reflected in physical deterioration. A second best solution, and one which is more precise and equitable than the present rule, is to compute the allowable loss on the basis of adjusted cost basis reduced by the sum of the fair market value after the casualty or theft and by the absolute value of the change in market value occurring before the casualty or theft.

For computation-of-loss purposes, the change in market value occurring before the casualty or theft consists of either (1) unrealized appreciation in market value not taken into income and hence having no basis for tax purposes, or (2) unrealized depreciation in market value which is a nondeductible personal loss even if realized by occurrence of a casualty or theft. 1/ Such change in market value may consist also of some amount of capital recovered through use if such use is reflected in a physical deterioration of the

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1/The two examples of casualty loss to depreciable personal property in Regulations §1.165-7(b)(3) concern loss to a depreciated-value automobile and loss to a house and shrubbery which have depreciated in value. It, therefore, is not obvious from a reading of the regulations that the effect of the lower of loss of value or adjusted basis rule, applied to loss of personal property, is to allow a double recovery of capital consumed through use and a deduction for appreciation in value not taken into income.

property sufficient to affect market value. In the case of personal assets, capital recovered through use cannot, as a practical matter, be valued apart from its effect (if any) on market value. And since it is neither taken into income nor substracted from cost basis during the period prior to the loss event, it cannot be separately accounted for at the time of the loss event. Therefore, for computation-of-loss purposes, the absolute value of the change in market value occurring before the loss event is the difference between the fair market value immediately before the casualty or theft and the adjusted cost basis at the time.

Specific examples

The principles involved can easily be explained by simple arithmetic examples which vary a common fact situation.

Casualty loss of appreciated value, depreciable personal property

Case (1) Partial destruction of appreciated-value property; loss in value is less than adjusted basis.

Consider the case of a house having an adjusted cost basis of $40,000, a useful life of 40 years, and a fair market value on the date of the casualty of $52,000. The maximum insurance coverage is 10 percent of cost or $4,000. A casualty occurs at the end of the tenth year of use. The fair market value of the house immediately after the casualty is $20,800.

Under the lower of adjusted basis or loss of fair market value rule of the regulations, taxpayer is regarded as having sustained a casualty loss of $31,200. He is entitled to a section 165(a) deduction of $27,200 computed as follows:

Value before casualty	$52,000
Less: Value after casualty	20,800
Value of property destroyed	31,200
Adjusted cost basis	40,000
Loss taken into account	31,200
Less: Insurance received	4,000
Deduction allowable a/	$27,200

a/For purposes of illustration the $100 floor of section 165(c)(3) is ignored.

The $31,200 casualty loss computed under the regulations includes recovery of net appreciation in value consisting of some amount of unrealized appreciation in value due to shifts in market supply-demand conditions and not reflected in income, plus some amount of capital investment recovered through tax-free use and neither taken into income nor subtracted from basis, and minus physical depreciation reflected in market price. It includes also some amount of the original capital investment not recovered through use and lost as a result of the casualty.

Under existing regulations, the basis of the house after the casualty is $8,800 ($40,000 cost basis minus $27,200 loss deduction minus $4,000 insurance recovery). Were the house to be sold for $20,800 on the day after the casualty, taxpayer would realize the $12,000 net appreciation in value as a capital gain notwithstanding that a substantial portion of the net appreciation in value had been included in the $31,200 ordinary loss. If the sales proceeds are reinvested in a second personal dwelling, the gain realized would not be recognized. The basis of the new house would be reduced by the $12,000 not recognized.

It is impossible to quantify the separate components of market value, consisting of cost basis, recovery of cost through use, appreciation in value, and physical depreciation reflected in price. Therefore, as a practical matter, it is not possible accurately to compute the amount of loss resulting from a casualty or theft. The best approximation can be achieved by limiting the amount of recognized loss to adjusted cost basis reduced by the sum of the market value, if any, which remains after the loss event and the absolute value of the change in market value occurring before the loss event. On this basis, the taxpayer in the above example would be entitled to a section 165(a) deduction of $3,200, computed as follows:

Adjusted cost basis	$40,000
Less: Value after casualty	20,800
Tentative loss taken into account	$19,200
Less: Insurance received	4,000
Tentative loss allowable a/	$15,200
Less: before-casualty change in value b/	12,000
Deduction allowable	$ 3,200

a/As under the existing regulations rule, if insurance received were in excess of adjusted cost basis, a taxable gain would be realized.

b/Before-casualty increase in value is realized only to the extent that it reduces the tentative loss allowable. However, the tentative loss allowable would never be reduced below zero. This means that if the appreciation in value, reduced by depreciation through wear reflected in market price, is greater than the tentative loss, it is treated as a nondeductible personal loss.

The basis of the house after the casualty would be $32,800 ($40,000 cost basis minus $3,200 loss deduction minus $4,000 insurance received). If, after the casualty, taxpayer sells the house at its market value of $20,800, he would realize a nondeductible personal loss of $12,000--equal in amount to the net unrealized appreciation in value not taken into income at the time of the casualty event.

Case (2) partial destruction of appreciated-value property; loss in value equals adjusted basis.

Assume the same facts as in case (1) except the loss in market value caused by the casualty equals adjusted basis, or $40,000. Thus, the fair market value of the house immediately after the casualty is $12,000. On these facts, the casualty loss computed under the regulations is $40,000 and the section 165(a) deduction is $36,000. The basis of the house after the casualty is zero. If later there is a change in market conditions and taxpayer sells the house, let us say, for $20,800, the full amount of the $12,000 pre-casualty net appreciation in value plus $8,800 of capital not recovered through tax-free use is taxed as capital gain. This is a less favorable tax treatment than that accorded under the regulations rule to taxpayer in case (1).

If the amount of loss recognized were limited to the actual loss resulting from the casualty, the taxpayer in the above example would be entitled to a section 165(a) deduction of $12,000, computed as follows:

Adjusted cost basis	$40,000
Less: Value after casualty	12,000
Tentative loss taken into account	28,000
Less: Insurance received	4,000
Tentative loss allowable	24,000
Less: Before-casualty change in value	12,000
Deduction allowable	$12,000

The basis of the house after the casualty would be $24,000 ($40,000 cost basis minus $12,000 loss deduction, minus $4,000 insurance received). If the property were sold at market value immediately after the casualty, the realized $12,000 loss, which would consist in part of untaxed appreciation in value and in part of recovery of capital through use, would not be recognized.

Case (3) Partial destruction of appreciated-value property; loss in value is greater than adjusted basis.

Assume on the facts described in case (1) that the fair market value of the property after the casualty is $4,000. Under the regulations rule, taxpayer is regarded as having sustained a casualty loss of $40,000, which is less than the $48,000 loss of market value. His section 165(a) deduction is $36,000. Although taxpayer has suffered a loss of value of 92 percent of market value in this case, he recovers only 83 percent of this loss. This is compared to a 100-percent recovery for the partial-destruction losses described in case (1) and (2), where the loss of value was equal to or less than adjusted basis. Under existing rules the adjusted basis of the house after the casualty is zero ($40,000 cost basis, minus $20,000 loss deduction, minus $4,000 insurance received). If sold for $4,000, the realized $12,000 loss would not be recognized.

Case (4) Complete destruction or theft of appreciated-value property.

Assume on the facts described in case (1) that the appreciated-value property is completely destroyed. 1/ Under the regulations rule taxpayer's casualty loss taken into account is $40,000 and his recognized loss allowable is $36,000, both figures being the same as in the partial destruction cases where the loss in value is equal to or greater than adjusted basis. Thus, the taxpayer whose appreciated-value property is totally destroyed or is stolen is treated less favorably than the taxpayer whose appreciated-value property is partially destroyed. To illustrate: in case (4) taxpayer's value loss is 100 percent; his percentage recovery is 77 percent. In case (3) taxpayer's value loss is 92 percent; his percentage recovery is 83 percent.

Under the regulations rule for computing casualty losses, the lower the percentage loss of value, the higher the percentage recovery through the tax system, in the absence of insurance. This inverse relationship between percentage casualty loss and percentage recovery by deduction is the same for loss of capital investment as for loss of appreciation in value. The percentage relationships, based on the facts given in the four hypothetical cases, are as follows:

1/In the case of a house, this is an unrealistic assumption except in those instances where coastal land physically slides into the ocean. Nevertheless, Regulations §1.165-7(b)(2)(ii) requires that the entire cost of the land on which a house is located be added to the cost basis of the loss property for purposes of computing the amount of the loss. If the house has appreciated in value and the land value is substantial in relationship to the house value, the unintended effect of this rule may be to give taxpayer a loss deduction where no loss was in fact incurred. For example, assume that the cost basis of the land is $20,000, of the house $35,000, and that the fair market value of the house is $50,000 at the time it burns to the ground. The value in the land remains at $20,000. Assume further that taxpayer receives $35,000 insurance reimbursement. Under the lower of cost basis or loss of market value rule, taxpayer can claim a casualty loss deduction of $15,000 ($50,000 loss of market value - $35,000 insurance).

	Loss allowed under existing regulations	Loss recognized under existing regulations	Loss realized	Percentage recovery through tax system
Case (1)	$27,200	$31,200	$31,200	100
Case (2)	36,000	40,000	40,000	100
Case (3)	36,000	40,000	48,000	83
Case (4)	36,000	40,000	52,000	77

a/The loss recognized exceeds the loss allowable as a deduction by the amount of insurance or other reimbursement received.

In short, the casualty and theft loss deduction provision is not and cannot be administered in an even-handed manner with respect to the casualty or theft loss of appreciated-value, personal property.

--It is impossible as a practical matter to ascertain accurately the loss caused by the loss event.

--It is impossible as a practical matter to separate loss of capital investment from loss of appreciation in value.

Moreover, the existing regulations rule is unadministrable because it is virtually impossible, at the time of the sale of loss property, to determine whether the cost basis has been reduced to reflect the amount of loss deducted in a prior casualty-loss year.

Casualty or theft loss of depreciated value, depreciable personal property

There are two reasons why the market value of property immediately preceding a casualty may be less than adjusted cost basis. The decline in value may reflect physical deterioration through use or it may represent shifts in market demand unrelated to use.

As in the case of appreciated-value property, it is impossible as a practical matter to assign a separate dollar value to depreciation through use and/or through changes in

market demand. Since the lower of adjusted basis or loss of fair market value removes from the amount of the recognized casualty loss a decline in value attributable to both or either cause, the regulations rule reaches a correct result in the case of the casualty or theft loss of depreciated-value property.

A casualty or theft loss to depreciated-value property where the before-loss decline in value reflects both physical deterioration and fall in market demand typically involves loss to an automobile, boat, private airplane, fur coat or comparable durable consumer good where fashion is a component of market value. For example, consider the case of an automobile having a cost basis of $10,000 and a useful life of five years. At the end of the first year of use, the automobile is severely damaged in a collision. The fair market value of the automobile immediately before the casualty it $5,000; the value immediately after the casualty is $1,000. Since the factor of insurance affects the amount of the loss deduction under section 165(a) but not the calculation of loss, assume the owner is not insured. Under the regulations taxpayer sustains a casualty loss of $4,000, computed as follows:

Value before casualty	$ 5,000
Less: Value after casualty	1,000
Value of property destroyed	4,000
Adjusted cost basis	10,000
Loss taken into account	$ 4,000

The loss taken into account under the regulations is equal to the loss caused by the casualty, as measured by adjusted cost basis reduced by the sum of fair market value after the casualty and the absolute value of the change in market value occurring before the casualty.

Adjusted cost basis	$10,000
Less: Value after casualty	1,000
Tentative loss allowable	9,000
Before-casualty change in value realized	5,000
Loss taken into account	$ 4,000

Casualty loss of nondepreciable, personal property

Nondepreciable personal property such as precious jewelry or metals and fine arts generally do not deteriorate through use and frequently appreciate in market value through time. Further, the market value does not reflect the fact that in each year the owner has recovered some part of his investment through use.

The effect of applying the same loss computation rules to personal property which does not deteriorate through use and to depreciable personal property is to create discontinuities between the tax treatment of losses to depreciable and nondepreciable personal property. Consider the theft of a diamond ring and of an automobile, neither asset insured. The cost basis of each property is $5,000. Each asset is stolen 3 years after the date of purchase. The fair market value of the diamond on the date of the theft is $5,000; for the automobile it is $2,000. The $5,000 value of the diamond does not reflect the recovery of cost through use. The $2,000 value of the automobile reflects depreciation through use ($1,000 each year for 3 years). The owner of the diamond can deduct $5,000 as a theft loss; the owner of the car can deduct $2,000 only.

If both assets had appreciated $3,000 in value due to changes in market demand unrelated to use (let us say the diamond had a fair market value before the theft of $8,000 and the car of $5,000), both taxpayers could deduct the full amount of their original captial investment as a casualty loss without discounting for the imputed income derived from use. If both assets had declined in value by $1,000 due to changes in market demand unrelated to use, the fair market value of the diamond would be $4,000 on the date of the theft; for the automobile it would be $1,000. The owner of the diamond could still deduct $4,000 as a theft loss. However, the owner of the automobile could deduct only $1,000.

The netting rules of section 1231 are inequitable

While the scope of this study is concerned primarily with individual losses resulting from a casualty or theft with respect to personal property, complex computational problems exist where personal casualty or theft losses occur in the same year as gains and losses from the involuntary conversion of income-producing business and

investment assets. If the total of casualty, theft, and involuntary conversion gains to business, investment, and personal property exceeds the total of losses, the total net gain may be added to the net gains, if any, realized on the sale of depreciable business property in the same taxable year and the aggregate net gain taxed at the favorable capital gain rate. The effect of netting personal casualty and theft gains and losses with business and investment involuntary conversion net gains is to cause a difference in tax treatment among taxpayers in like financial circumstances depending upon the fortuitous occurrence of a personal casualty or theft loss in the same year as occurs a larger involuntary conversion gain from income-producing property.

For example, assume that a taxpayer, married and filing a joint return, has ordinary income of $14,000, involuntary convesion gain of $6,000, and a section 165(c)(3) personal casualty loss of $4,100. Under present law the taxpayer has adjusted gross income and tax table income of $14,800 against which the zero bracket amount of $3,200 applies ($14,000 + .40($6,000 - $4,000)). This means that he can deduct the entire loss in excess of $100 and also take full advantage of the $3,200 zero bracket amount. A second taxpayer having exactly the same gross income and the same dollar value personal casualty loss, but with long-term gain derived from the sale of a personal or investment asset, would have adjusted gross income of $16,400 ($14,000 + .40($6,000)). On a joint return his tax table income is $15,600 ($16,400 - ($4,000 - $3,200)). This means that he can deduct only $800 of the loss in excess of $100.

There is no policy reason why tax relief under the personal casualty and theft loss provision of section 165(3) should be different depending upon whether taxpayer realizes a gain on the involuntary conversion of depreciable business property, investment property, and personal property in excess of personal casualty or theft losses sustained in the same year.

CONCLUSION

The personal casualty and theft loss deduction provision is inherently unadministrable in an even-handed manner. In the case of depreciable personal property, it is impossible, as a practical matter, to determine accurately the depreciated value of the asset at the time of loss. The result is a difference in tax treatment between owners of personal assets who do not incur a casualty or theft loss and who cannot

deduct depreciation through use and owners of nonbusiness assets who, as a result of a casualty or theft loss, in effect recover depreciation through use.

Further, with respect to all nonbusiness property, depreciable and nondepreciable, the effect of the casualty and theft loss deduction is to allow a loss deduction for capital recovered through use prior to the casualty or theft and not taken into income.

Finally, with respect to the casualty or theft loss of appreciated-value property, it is impossible, as a practical matter, to separate loss of capital investment from loss of appreciation in value. As a result, the owner who incurs a partial casualty or theft loss of appreciated-value property recovers the entire appreciation in value lost by the casualty or theft, and not previously taken into income, without reduction for the amount of his capital investment recovered through use prior to the casualty. Incorporating the personal casualty loss provision into section 1231, applicable to the treatment of gain or loss realized on the disposition of depreciable business and investment assets, further compounds these problems.

CHAPTER 3

POLICY BASIS FOR THE PERSONAL

CASUALTY AND THEFT LOSS DEDUCTION

INTRODUCTION

In this chapter, we examine the policy basis for the personal casualty loss deduction. Our data is drawn from several different sources. It consists of the 124 cases in the sample of contested proposed deficiencies; the 6 returns of high income taxpayers for 1975 and 1976 which were nontaxable because of a claimed casualty or theft loss deduction; and tax return information reported in the Statistics of Income, Individual for 1976.

ABILITY TO PAY ASPECT IS AMBIGUOUS

The underlying policy justification for allowance of a personal deduction for the casualty or theft loss of personal, nonincome producing property is that loss of or damage to a home, automobile, or other essential personal asset affects significantly the ability of a taxpayer to pay a tax out of current income.

However, the ability-to-pay aspect of the casualty and theft loss deduction is ambiguous under existing tax computation rules. The existence of the zero bracket amount (standard deduction) means that the tax-saving value of the deduction to low income taxpayers who would not otherwise elect to itemize is less by the amount of the zero bracket amount multiplied by the applicable marginal rate. The structure of progressive rate schedules means that the tax-saving value of the deduction increases as a function of progression and is not reduced by the zero bracket amount if the total of itemized deductions claimed equals or exceeds the applicable zero bracket amount.

IRS statistics of income data show that the casualty and theft loss deduction was claimed on about 2 million returns in 1976. 1/ Table 3-1 below shows that 75 percent of these returns reported adjusted gross income (AGI) of over $14,000.

1/The data, reproduced in full in app. III, was furnished by the IRS' Statistics Division using the Tax Model of Individual Income Tax Returns. The figures are estimates based on samples.

Table 3-1
Number of Returns Claiming
Casualty and Theft Loss Deductions
(Statistics of Income Data)
(1976)

AGI class	Number	Percent	Cumulative percent
$ 1 < 2,000	850	0.04	0.04
2,000 < 5,000	17,389	0.87	0.91
5,000 < 9,000	148,870	7.45	8.36
9,000 < 14,000	324,338	16.23	24.59
14,000 < 25,000	830,234	41.55	66.14
25,000 < 200,000	672,094	33.63	99.77
200,000 and over	4,558	0.23	100.00
Total	1,998,333	100.00	

However, there are some taxpayers in the lowest adjusted gross income levels who do not have a reduced ability to pay. These taxpayers may receive exempt income such as municipal bond interest and one-half of net long-term capital gains in excess of net short-term capital losses and/or their adjusted gross income may be entirely offset by such tax preferences as the excess of percentage over cost depletion and accelerated depreciation.

As a result, it is more appropriate to examine casualty and theft losses claimed on returns classified by expanded income class. 1/ Table 3-2 on page 35 shows the number of returns and amount of reported casualty and theft losses by expanded income estimated by the Treasury Department's Individual Income Tax Simulation Model. The data show that 78.5 percent of the casualty and theft loss returns reported expanded income of $15,000 and over.

1/As used here the term "expanded income" is generally a taxpayer's adjusted gross income plus items of tax preference income (not otherwise included in adjusted gross income). See The President's 1978 Tax Program, Department of the Treasury, p. 17.

Table 3-2
Number of Returns with Casualty and Theft Losses and the Amount of Reported Casualty and Theft Losses by Expanded Income (1978 law and income levels)

Expanded Income Class	Number of returns	Percent	Amount of loss ($ millions)	Percent
Less than $ 5,000	4,319	0.2	0	0
5,000 - 10,000	136,958	7.7	106	7
10,000 - 15,000	243,546	13.6	224	14
15,000 - 20,000	350,692	19.6	293	18
20,000 - 30,000	554,899	31.0	425	26
30,000 - 50,000	381,651	21.3	379	24
50,000 - 100,000	90,012	5.1	85	5
100,000 - 200,000	21,152	1.2	69	4
200,000 and over	5,722	0.3	28	2
Total	1,788,951	100.0	1,609	100

The casualty and theft loss deduction differs from the other itemized, ability-to-pay deductions in that it is not based upon a discretionary consumption expenditure. It is an involuntary loss of net asset value which, in most cases, could have been reduced or avoided by insurance. In substance, a casualty or theft loss is a discretionary loss of net asset value.

There are two ways to assess the effect of a casualty or theft loss on taxable capacity: (1) by the ratio of loss sustained to adjusted gross income by income class; (2) by the ratio of loss sustained to total itemized deductions claimed by income class.

Tax return data for 1976 1/ indicate that the casualty and theft loss deduction claimed per return as a percentage of per return adjusted gross income decreases sharply and continuously as income levels rise. This indicates that the casualty and theft loss deduction may serve a real ability-to-pay function for low income taxpayers who presumably cannot afford the cost of insurance, but that the deduction is not justified on ability-to-pay grounds for higher income taxpayers. (See Table 3-3 on page 36.)

1/See appendix III.

Table 3-3
Casualty and Theft Loss Deduction
as a Percent of Adjusted
Gross Income (AGI)
(Statistics of Income Data)
(1976)

AGI class	Percent
$ 1 < 2,000	440
2,000 < 5,000	26
5,000 < 9,000	14
9,000 < 14,000	7
14,000 < 25,000	4
25,000 < 200,000	2
200,000 and over	1

The average dollar amount of casualty and theft loss claimed per return, broken down by income class, indicates further that, except in the lower income brackets, the casualty and theft loss deduction is not justified on the grounds of reduced financial capacity to pay an income tax. (See table 3-4 below.)

Table 3-4
Casualty and Theft Loss Deduction
Per Return by AGI Class
(Statistics of Income Data)
(1976)

AGI class	Casualty and theft loss per return
$ 1 < 2,000	$4,894
2,000 < 5,000	1,071
5,000 < 9,000	1,036
9,000 < 14,000	806
14,000 < 25,000	682
25,000 < 200,000	808
200,000 and over	4,934

The data show that taxpayers in the lowest ($1<$2,000) AGI class and taxpayers in the highest ($200,000 and over) AGI class have casualty and theft loss deductions per return averaging $4,900 compared to an average of only $775 for taxpayers in the $2,000 to $200,000 AGI classes. The large casualty and theft losses claimed by high and low income taxpayers indicate a lack of adequate insurance coverage by low-income taxpayers who may not be able to afford the premium costs and by high-income taxpayers who self-insure.

The tax return data for 1976 1/ show further that the casualty and theft loss deduction claimed per return as a percentage of per return itemized deductions also decreases steadily and dramatically as income levels rise. Not surprisingly, the casualty and theft loss deduction is a significant percentage of itemized deductions for lower income taxpayers who would not have elected to itemize deductions had it not been for the casualty or theft loss. (See Table 3-5 below.)

Table 3-5
Casualty and Theft Loss Deduction as a Percent of Itemized Deductions (Statistics of Income Data) (1976)

AGI class	Percent
$ 1 < 2,000	59
2.000 < 5,000	29
5,000 < 9,000	29
9,000 < 14,000	20
14,000 < 25,000	13
25,000 < 200,000	9
200,000 and over	4

The ability to pay aspect would also appear to be a very important consideration for low-income taxpayers. But the Statistics of Income data can be a misleading indicator of whether the casualty and theft loss deduction is justified on ability to pay grounds. Statistics of Income data are taken from unaudited returns. As set forth in detail in chapter 4, about 78 percent of the taxpayers with adjusted gross income of less than $10,000, who had their returns audited by IRS in its most comprehensive audit program, the Taxpayer Compliance Measurement Program, made a mistake in claiming the casualty or theft loss. The overall error rate was about 64 percent for all taxpayers who claimed the casualty or theft loss deduduction and were audited. Data are not available to indicate the exact nature of the taxpayers' mistakes or the percentage of the mistakes which ran in the taxpayers' favor. In our sample of 124 contested cases, failure to substantiate was the most frequently cited reason for disallowing the deduction. Thus, we believe most low-income taxpayers probably incorrectly claimed the loss or could not substantiate it.

In money terms the ability-to-pay aspect would appear to be a substantial one considered across all taxpayers

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1/See Appendix III.

covered by the sample. Because of the small number (124) of cases in the sample of contested deficiencies and the concentration of cases in the income level of $25,000 to $50,000, it is not meaningful, vis-a-vis the sample, to break down by income level the casualty and theft loss deduction as a percentage of adjusted gross income. The percentage distribution of the casualty and theft loss deduction across all cases is summarized in Table 3-6 below.

Table 3-6
Casualty and Theft Loss
Deduction as a Percent of Adjusted
Gross Income (AGI)
(Sample Cases)

Casualty and theft loss deduction as a percent of AGI	Number of cases	Percent of cases	Cumulative percent of cases
0 - 3	14	11	11
4 - 10	15	12	23
11 - 20	24	20	43
21 - 50	28	23	66
51 - 100	11	9	75
Over 100	31	25	100
Total	123 a/	100	

a/AGI is unknown for one case in the sample.

In over half of the sample cases the loss claimed exceeded the sum of the deductible discretionary consumption items. As shown in Table 3-7 below, the loss claimed comprised 50 percent or more of total itemized deductions claimed in 57 of the cases included in the sample.

Table 3-7
Casualty and Theft Loss Deduction as a
Percent of Total Itemized Deductions
(Sample Cases)

Casualty and theft loss deduction as a percent of itemized deductions (note a)	Number of cases	Percent of cases	Cumulative percent of case
0 - 19	11	10	10
20 - 39	26	24	34
40 - 49	9	9	43
50 - 59	10	9	52
60 - 79	14	13	65
80 - 99	19	18	83
100 and over	18	17	100
Total	107 b/	100	

a/Includes only those casualty and theft losses deducted by taxpayers as personal itemized deductions.

b/Of the remaining 17 cases in the sample, itemized deductions are unknown for 10, and no portion of the casualty or theft loss claimed was a personal itemized deduction (§1231 property) for 7.

The ability-to-pay aspect is less clear when the percentage losses are considered together with the fact that 27 percent of the loss property consisted of trees, shrubbery, and miscellaneous personal property (see Table 3-8 below) and that losses from "other casualty" comprised the largest single category of contested loss claims. (See Table 3-9 on page 40.) As explained in chapter 2, *infra*, in most cases involving the issue of whether taxpayer has sustained an "other casualty" loss, there is present an element of loss resulting from deterioration through use.

Table 3-8
Type of Property

Properties	Number of cases	Percent of cases
Personal dwelling	59	31
Contents of personal dwelling	43	23
§1231 property	19	10
Automobile	16	9
Trees and shrubbery	13	7
Other	38	20
Total	188 a/	100

a/Although there were 188 types of property involved in the reported casualty and theft losses, in some cases taxpayers combined types of property in reporting the amount of the losses. As a result, there were only 161 items of property for which detailed information concerning the casualty was available.

The kinds of property in the category of loss to "other" property included personal assets and expenditures not generally regarded as affecting financial capacity for tax purposes. For example, taxpayers attempted to claim losses for such personal expenses as burial costs, legal fees, anticipated medical expenses and loss of earnings, living expenses while furniture was in storage, demolition losses with respect to nonbusiness property, and the cost of removing a driveway erroneously installed on a neighbor's property.

Table 3-9
Type of Casualty or Theft

Casualty or Theft	Number of cases	Percent of cases
Flood	31	25
Fire	23	19
Theft and Vandalism	14	11
Wind	12	10
Automobile Accidents	8	7
Other	34	28
Total	122 a/	100

a/The type of loss was unknown for two cases in the sample.

DEDUCTION IS A TAX INCENTIVE TO SELF-INSURE

Because the tax-saving value of the casualty or theft loss deduction increases as a function of progression, at some point it is advantageous for high income taxpayers not to insure or to underinsure and seek partial reimbursement for loss through the tax savings generated by the loss deduction. The point at which it is advantageous to self-insure, in whole or in part, will, of course, be different for each taxpayer depending upon his marginal tax rate, personal assets subject to loss, probability of loss occurring within a given time period, premium costs, and the discount rate. In general, it is advantageous for a taxpayer to self-insure if the present value of his expected tax and insurance premium savings exceeds his expected insurance reimbursement. 1/

In our examination of 124 Appellate Division cases, we found one case of a high income taxpayer who stated that he had opted not to insure precious jewelry because he had determined that the cost of insurance premiums, less reimbursement, exceeded the tax saving value of a loss deduction, given his estimate of the probability of loss by theft. The jewels were stolen from his house, however, and the taxpayer claimed a loss deduction for the full appreciated market value of the jewels in the year of loss.

The actual income and deduction figures reported on his return illustrate the kind of considerations which

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1/See Appendix II for explanation of the mathematical relationships which underly the choice between self-insurance and the purchase of insurance.

underlie the individual decision to self-insure. The taxpayer reported a gross income of $130,280 and total itemized deductions (including the theft loss) of $107,643, leaving a net income (disregarding personal exemptions) of $22,637. The tax saving value of the $88,165 theft loss claimed was about $46,000 (more than half of the value of the stolen jewelry).

Using different assumptions as to the taxayer's personal discount rate and the period of time he expected to enjoy the jewelry before it was stolen, we have calculated the levels of annual insurance premiums that would leave the high income taxpayer in our example indifferent as to whether to purchase insurance.

Table 3-10
Annual Insurance Premiums
(note a)

Expected time before loss	Personal Discount Rate 10%	5%
40 years	$95.27	$349.05
20 years	$736.18	$1,275.18
10 years	$2,645.66	$3,352.31

a/Assumes $130,280 gross income, $22,637 taxable income, $88,165 insurance reimbursement, and a $46,000 tax saving in the year of the theft loss.

The insurance rate for jewelry is about 20 cents per $100 of value if the insured stores the jewelry in a vault and from $1 to $3 per $100 if not. The annual premium to insure $88,165 of jewelry varies from $176.33 to $2,644.95. (See Table 3-11.)

Table 3-11
Premiums Required to Insure
Jewelry Worth $88,165

Rate (per $100 of value)	Annual premium
$ .20	$ 176.33
1.00	881.65
2.00	1,763.30
3.00	2,644.95

Comparing the figures in Tables 3-10 and 3-11, it is apparent that if the high income taxpayer in our example had a 10 percent discount rate and if his expected time before loss was at least 40 years, he would have chosen to insure himself and not purchase insurance irrespective of the rate of insurance, (i.e., $95.27 is below all the figures in Table 3-11). Similarly, if his expected time before loss had been 20 years, he would have chosen to purchase insurance only if the annual premium were less than $736.18, (i.e., he would have purchased insurance only at the $.20 per $100 rate). As the numbers in the two tables show, there are several different sets of assumptions concerning discount rates, expected time before loss, and insurance premium rates that made it economical for this individual to recover a theft loss through a tax deduction in lieu of insurance reimbursement.

However, if this taxpayer could have estimated only the probability that his jewelry might be stolen, he would have based his insurance decision on the level of annual premiums taking into account the probability of theft. Table 3-12 shows the level of annual insurance premiums that leaves the taxpayer indifferent as to whether to purchase insurance, assuming different probabilities of theft. As can be seen by comparing the figures in Tables 3-11 and 3-12, the taxpayer will choose to use the theft loss deduction provision to insure himself if (1) the insurance rate is $3 per $100 and his annual probability of theft is .01 or less, or (2) the insurance rate is $1 per $100 or more and his annual probability of loss listed in Table 3-12 will make it economical for the taxpayer to insure himself using the theft loss provisions.

Table 3-12
Annual Insurance Premiums
With Different Probabilities
(note a)

Annual probability of theft	Annual insurance premium
.1	$12,956
.05	6,478
.025	3,239
.02	2,591
.01	1,296
.005	648
.002	259

a/Assumes yearly gross and taxable incomes, reimbursement amounts, and tax savings equal to those in Table 3-10. Also assumes that the discount period is 40 years and that the annual probabilities of theft remain constant over this period.

The evidence from the sample of 124 contested proposed deficiencies based on disallowance of a casualty or theft loss deduction is that taxpayers who contest a proposed disallowance of the deduction at the Appellate Division level are in the higher income brackets and have sustained a loss with respect to uninsured or underinsured personal assets. Two-thirds of the taxpayers in the sample of contested cases had adjusted gross income of $15,000 and over. The average adjusted gross income for all of the taxpayers in the sample was $33,054. (See Table 3-13 below.) 1/

Table 3-13
Adjusted Gross Income (AGI) Levels
(sample cases)

AGI Levels	Number of cases	Percent of cases
Under $10,000 a/	25	20.3
10,000-14,999	16	13.0
15,000-24,999	34	27.6
25,000-49,999	35	28.5
50,000-99,999	5	4.1
100,000 and above	8	6.5
Total	123 b/	100.0

a/Includes one deficit return.

b/The income level of one sample case is unknown.

Sixty-nine percent of the items of property in our sample of 124 proposed deficiencies were uninsured. Table 3-14 on page 45 shows by type of property the number and percent of property items for which insurance or other reimbursement was received. The fact is, in 69 percent of the contested cases, taxpayer looked either to Federal subsidies in the form of direct relief or to the tax system for recovery of loss. There is no way to determine from facts in the administrative files for these cases

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1/The data reported in Table 3-1 show that three-fourths of all taxpayers who claim a casualty or theft loss deduction had adjusted gross income of over $14,000. Without an audit, there is no way to determine the kind of property claimed as a loss or the amount of insurance coverage.

the reason for the failure to insure. There are several possibilities: the risk involved was not insurable (e.g., weather damage to ornamental trees and shrubs), or taxpayer assigned a low probability to the occurrence of loss, or the cost of insurance in excess of reimbursement for possible loss was greater than the tax-saving value of the deduction in the event of actual loss.

The remaining 31 percent of the items of insured property included in the sample consist of partially insured property (37 percent) and fully insured property (63 percent). With respect to partially insured property, the taxpayer looks to the tax system for reimbursement of the amount of his loss in excess of insurance coverage or in excess of the estimate of loss of value determined by his own insurance adjustor. With respect to property which is fully insured, the taxpayer looks to the tax system to recover the difference between the amount of his claim presented to the insurer and the amount allowed. While the fully insured taxpayer does not, in the first instance, look to the tax system as coinsurer, if the taxpayer sustains his burden of proof of loss, the result is the same as in the case of casualty loss to partially insured property. 1/

1/The problem of the taxpayer who protests his insurance claim before the IRS rather than to the insurer is a familiar one to IRS examiners. It was described by an appellate conferee in one of the sample cases involving fire damage to a personal residence fully covered by insurance as follows "* * * the government cannot be placed in the position of acting as a reinsurer for the insurance company where the taxpayer does not fully recover the entire amount of the coverage from the insurance company for some personal reasons."

Table 3-14
INSURANCE OR OTHER REIMBURSEMENT

Type of property	Total		Insurance received		No insurance but other reimbursement received		No insurance or other reimbursement received	
	#	%	#	%	#	%	#	%
Personal dwelling	58	100	21	36	17	29	20	35
Contents of personal dwelling	23	100	14	61	1	4	8	35
§1231 property	15	100	2	13	4	27	9	60
Automobile	12	100	3	25	0	0	9	75
Trees and shrubbery	11	100	2	18	0	0	9	82
Other	33	100	5	15	0	0	28	85
Total all types	a/152	100	47	31	22	14	83	55

a/Totals to 152 because it is not known whether insurance or other reimbursement was received for 9 of the 161 items of property in the sample of contested proposed deficiencies.

In Table 3-15 on page 46 we summarize the cases where the taxpayer looked to the tax system as coinsurer either because he was underinsured or because he disputed the amount of loss reimbursed by his insurer.

Table 3-15

Summary by Type of Property of Loss Deductions Claimed in Sample Cases for Which Amount of Insurance Received is Known

Type of property	Amount of insurance reimbursement received	Loss claimed by taxpayers	Loss allowed by revenue agents	Loss allowed by Appellate Division
Personal dwelling	$295,471	$208,335	$(17,933)	$76,336
Contents of personal dwelling	137,253	243,400	40,623	55,841
Trees and shrubbery	6,752	58,500	250	29,365
Automobile	7,127	2,967	1,546	1,546
§1231 property	8,000	4,600	0	0
Other	32,480	20,692	2,130	6,849
Total	$487,083	$538,494	$26,616	$169,937

In addition to the 124 sample contested cases, we examined six of the 22 nontaxable returns filed for 1976 which reported adjusted gross income of $200,000 or more. These six returns were nontaxable because taxpayers claimed casualty or theft loss deductions in excess of before-loss taxable income. In every case the assets subject to loss were uninsured. Two of the six cases involved loss to personal assets arising out of storm damage to a boat, a pier, a sunken garden and ornamental trees and shrubbery. Three of the six cases involved business or investment assets (embezzlement loss, losses on loan guarantees). In one case the property lost was not specified and the cause of loss was not described--the deduction claimed was over $1 million. The six returns had not yet been audited at the time of our examination.

CONCLUSION

While the underlying policy justification for the personal casualty and theft loss deduction is a consideration of ability-to-pay, the evidence is ambiguous. Three-fourths of the taxpayers claiming the deduction are in an adjusted gross income class of $14,000 and above and two-thirds of the taxpayers contesting a proposed disallowance of a loss deduction are in an adjusted gross income class of $15,000 and above. A comparison of the dollar value of casualty or theft loss claimed to adjusted gross income reported for 1976 shows that the total loss claimed was more than 400 percent of total adjusted gross income reported for the income class under $2,000. The per return loss claimed by this income class was nearly $5,000.

The bearing of unaudited statistics of income figures on the ability-to-pay aspect of the deduction cannot be evaluated apart from consideration of the compliance problems created by this provision. As set forth in greater detail in chapter 4, the error rate for taxpayers in the adjusted gross income class under $10,000 is 78.2 percent. The overall error rate is 64.4 percent. With respect to contested cases, the principal reason for disallowance of the deduction claimed is failure to substantiate. And, if the casualty or theft loss deduction provision were repealed, only 10 percent of the total revenue loss would be recouped from taxpayers in the adjusted gross income classes of less than $15,000. 1/ Even where taxpayers were involved in a casualty which qualified as a disaster within the meaning of section 165(h), the tax relief aspect of the deduction provision was abused. For example, the sample of 124 contested cases included 22 taxpayers who suffered loss in the 1972 flood in Elmira, New York. Of these 22, 16 received a Small Business Administration loan forgiveness. Of the 16, 13 did not reduce the loss claimed by the forgiveness of indebtedness income received.

Apart from problems of compliance, the tax relief afforded by the personal casualty and theft loss deduction is significantly reduced for the low income taxpayer who otherwise would not itemize by the fact that the tax value of the zero bracket amount (standard deduction) foregone reduces the tax saving value of the loss deduction claimed.

1/See table 5-1, chapter 5.

The ability-to-pay aspect of the casualty loss deduction is ambiguous for a reason quite apart from the income level of the taxpayers who are the principal claimants of the deduction. The loss offset not only is a reimbursement for loss of personal assets which affects taxable capacity, e.g., personal residence, it also is a loss offset for luxury items such as jewelry, ornamental shrubs and trees, pleasure vehicles, and artifacts which do not affect taxable capacity. For taxpayers in the higher income levels the deduction is a positive incentive to self-insure or to underinsure such luxury articles. With respect to insured property of any kind, the deduction is an inducement for taxpayers in all income classes to try to recover through the tax system alleged losses in excess of the amount reimbursed by a private claims adjustor.

CHAPTER 4

COMPLIANCE AND ENFORCEMENT PROBLEMS

INTRODUCTION

Taxpayers and tax administrators, alike, have considerable difficulty in applying the casualty and theft loss deduction provision despite the clear and consistent legal rules set forth in administrative rulings and regulations and in the decided cases. Whether the issue is a dispute over an ultimate fact question or over substantiation (an evidentiary question), settlement of the contested proposed deficiency is reached by negotiation between IRS and taxpayer and the result rationalized by both sides on the basis of litigating hazards. It is rare that a disputed fact case is ever conceded in full by either taxpayer or IRS.

In this chapter, we examine the compliance and enforcement problems created by the personal casualty and theft loss deduction. For this purpose, we use data from the cases covered by our sample of contested proposed deficiencies, and data collected by the IRS pursuant to its Taxpayer Compliance Measurement Program (TCMP) based on returns filed in 1973.

REASONS FOR PROPOSED ADJUSTMENTS

The different reasons cited for asserting a proposed deficiency in the cases covered by the sample of 124 contested deficiencies are summarized in Table 4-1 on page 50.

Table 4-1

Reasons for Proposed Adjustments: By Type of Property

	Personal dwelling		Contents of personal dwelling		§1231 property		Automobile		Trees and Shrubbery	
Number of proposed adjustments:	55		23		15		11		11	
Reasons for proposed adjustments: (note b)	#	%	#	%	#	%	#	%	#	%
Error in determining fair market value	17	31	12	52	5	33	4	36	7	64
Error in computation	3	5	0	0	1	7	2	18	0	0
Failure to take into account insurance or other reimbursement	15	27	1	4	2	13	0	0	1	9
Loss does not qualify as a casualty	12	22	2	9	3	20	3	27	4	36
Failure to substantiate	32	58	13	57	7	47	5	45	5	45
Other	9	16	2	9	5	33	0	0	2	18

a/There was no adjustment for 6 and the reasons for adjustment are unknown for 7 of the property.

b/Does not add to 100 percent because there was more than one reason for proposed adju casualty loss deduction claimed for some items of property.

Failure to substantiate

For all kinds of property, failure to substantiate the amount of the loss claimed was the reason most frequently cited for asserting a proposed deficiency. In a few instances taxpayers offered no substantiation to the revenue agent, but they later substantiated the claimed loss at the appellate conference level. In many of the substantiation cases examined, taxpayers continued to protest disallowance of a loss deduction through the entire administrative appeals process without offering any credible evidence to support their claims.

Errors in determining fair market value

Error in determining the fair market value of damaged or destroyed property was the second most frequent reason for asserting a proposed deficiency. It was cited in one-third of the total of sample cases and was the basis for the proposed adjustments made in two-thirds of the cases involving loss to trees and shrubbery. In many instances it appeared from a reading of the administrative file that taxpayers had intentionally inflated the dollar value of property subject to loss with a view to recovering a percentage of this inflated value by settlement in the event of audit. 1/ In some cases the taxpayer was successful. In others he was not.

For example, one taxpayer, a clothing contractor, reporting adjusted gross income of $206,646, claimed a fire and theft loss of $64,321 in excess of insurance received for the contents of a house which had a cost basis of $50,450. The loss was disallowed in full by the revenue agent for lack of substantiation and was finally conceded in full by taxpayer at the appellate conference level. In another case, the taxpayer, a model and television actress reporting adjusted gross income of $12,295, claimed a loss of $42,180 in excess of insurance for fire loss to the contents of her home. The case was settled at the Tax Court level for a loss deduction of $6,117.

1/In one instance an appellate conferee was moved to remark: "* * * it stretches credulity to accept the proposition that taxpayers had personalty in the house of a value approaching that of the house."

The regulations provide for proof of loss by the opinion of a competent appraiser; however, obtaining a professional appraisal is seldom dispositive of a case. Typically, the taxpayer appraisal is higher than the IRS appraisal and, if the taxpayer obtains two or more appraisals it is likely that each of these will be different.

The regulations allow proof of cost of repairs as an alternative to appraised loss of value as a measure of the casualty loss. However, the cost of repairs rule provides no greater certainty than the loss of value rule. 1/ Consensus on the amount of repairs to be regarded as restoration expenses as distinguished from the amount to be regarded as capital improvement is as difficult to arrive at as agreement on appraisal value.

Failure of loss to qualify as a casualty

Failure of the loss to qualify as a casualty was the third most frequent reason for asserting a proposed deficiency, accounting for 26 percent of the proposed adjustments in the sample of cases. In most instances the issue was whether the loss of value was due to progressive deterioration or to a "sudden" event. There is no way that a taxpayer and an examining agent can reach a consensus on an ultimate fact question of this kind except by negotiation. While in theory the difference between loss of value through use and loss of value through unforeseen catastrophe is clear, actual loss events not caused by natural hazards are inherently ambiguous. For example, no yes or no answer is possible in the case of the taxpayer who contends that his tree was destroyed by a "sudden" infestation of insects and the IRS examiner who contends that the tree toppled over because it was weakened by dry rot. The ambiguity of the fact situations which typically underlie the category of "other" loss events, combined with the propensity of taxpayers to regard any loss as occurring "suddenly" because it is suddenly discovered, makes this issue area, also, unadministrable except by negotiation.

Failure to report insurance received

For 11 percent of the items of property for which some insurance reimbursement was received, the casualty loss

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1/Cost of repairs was used to measure the loss for 16 percent of the items of property in our sample of 124 contested proposal deficiencies.

claimed was not reduced by the amount received. With respect to losses to 14 percent of the items of property in the sample, reimbursement was received from such noninsurance sources as the Small Business Administration, the Red Cross, or the state or local government. For 68 percent of the items of property for which such noninsurance reimbursement was received, the casualty loss deduction claimed was not reduced by the cancellation of indebtedness income received. Over one-fourth of the proposed adjustments to losses claimed for damage to personal dwellings were based on the failure of taxpayers to reduce the amount of loss claimed by insurance or other reimbursement received.

Strictly speaking, failure to offset a loss by reimbursement income is an issue area in which there should be no controversy, given that there is agreement on the amount of the loss. Either through design or inadvertence, taxpayer has failed to declare the amount of reimbursement received for the loss claimed; he has been audited and must now pay the tax due. However, by carrying his case through the administrative appeals process, he can postpone the day of payment of the proposed deficiency. In effect, by stalling through the administrative settlement process, he can secure a loan of tax dollars for the period of the appeal at an interest rate which is less than the market rate. 1/ Since failure to disclose the receipt of insurance is not an issue susceptible to settlement by negotiation and compromise, the tax deferral aspect of the appeals process would appear to be the only plausible explanation of why this issue is a source of controversy.

1/The interest rate was 6 percent per annum for all underpayments of income taxes through June 30, 1975. Thereafter, the interest rate was increased to 9 percent. Under the adjustment provisions of section 6621, added to the Internal Revenue Code by Public Law 93-625, the rate declined to 7 percent on February 1, 1976, and to 6 percent on February 1, 1978.

LOSS COMPUTATION FORMULAS APPLIED TO SETTLE CASES REFLECT LITIGATING HAZARDS

Taxpayers, revenue agents, and appellate conferees used a wide range of formulas to compute the amount deductible as a casualty loss for the different items of property covered by the sample of cases. 1/

There is a decreasing level of compliance with the tax computation rules of the regulations at successive stages of the appeals process. Whereas two-thirds of the taxpayers' computation formulas conformed to the regulations rules, less than one-half of the revenue agents and only one-third of the appellate conferees followed the regulations rules. Because one-fourth of the appellate conferees' formulas are unknown, the compliance level at the appellate stage may be either lower or higher than indicated. The decreasing rate of compliance at successive stages of the appeals process reflects an increased use of computation-of-loss formulas which reflect the "hazards of litigation." For example, 19 out of 161 formulas, or 11.8 percent of formulas used by appellate conferees involved taking a percentage, ranging from 20 to 78 percent, of the claimed decrease in fair market value resulting from the casualty. Less than 1 percent of the revenue agents' formulas used such a percentage method since revenue agents have limited authority to settle cases on the basis of litigating hazards. Twenty (20) of the 322 2/ taxpayers' formulas, or 6.2 percent, involved settlement at the appellate conference level based upon a percentage of the claimed loss of fair market value. The percentage formulas applied by taxpayers were similar to the 19 appellate conferees' formulas based upon a percentage of the claimed loss of fair market value.

Thirteen percent of the formulas used by both taxpayers and appellate conferees, but only 3 percent of those applied by revenue agents, were clearly not authorized by the regulations.

1/In the sample of 124 cases there were 161 items of property for which detailed information concerning the casualty was available.

2/For each of the 161 items of property, there are two possible taxpayer computation formulas, one used in preparing the tax return and one used in the appeals process.

At the revenue agent level, no formula was applied in the case of losses claimed with respect to 37 percent of the items of property; 19 percent because the loss did not qualify as a casualty loss and 18 percent because the loss was not substantiated.

Table 4-2 on page 56 summarizes the different formulas used. It shows each formula as a percent of the total of different formulas used by taxpayers, revenue agents, and appellate conferees.

Table 4-2
Computation Formulas Used for Each Item of Property in the Sample of Cases

	Taxpayers No.	Taxpayers Percent	Revenue Agents No.	Revenue Agents Percent	Appellate Conferees No.	Appellate Conferees Percent
I. Per Regulations [(FMV BEFORE - FMV AFTER) ≤ ADJUSTED BASIS] - INSURANCE (note a)	206	64.0	74	46.0	57	35.4
II. Contra Regulations						
A. Based on [(FMV BEFORE - FMV AFTER) ≤ ADJUSTED BASIS] - INSURANCE Except						
1. Increased by REPAIRS and/or OTHER AMOUNT	10	3.1	4	2.5	3	1.9
2. NOT reduced by INSURANCE	18	5.6	0	-	0	-
3. Percentage of (FMV BEFORE - FMV AFTER) (Percentages range from 20 percent to 78 percent)	20	6.2	1	0.7	19	11.8
Total	48	14.9	5	3.2	22	13.7
B. ADJUSTED BASIS - INSURANCE	29	9.0	14	8.7	14	8.7
C. ADJUSTED BASIS - INSURANCE Except						
1. Increased by REPAIRS and/or Reduced by SALVAGE	5	1.6	0	-	1	0.6
2. NOT Reduced by INSURANCE	2	0.6	0	-	0	-
3. Percentage of ADJUSTED BASIS (Percentages range from 30 percent to 56 percent)	2	0.6	1	0.6	3	1.9
Total	9	2.8	1	0.6		
D. Based on REPLACEMENT COST	13	4.0	0	-	0	-
E. Miscellaneous						
1. 50% [(LAWSUIT - COURT JUDGMENT) - (EXPENSES TO RECOVER INSURANCE + INSURANCE)]	1	0.3	0	-	1	0.6
2. LOSS OF EARNINGS because of casualty OR	2	0.6	0	-	0	-
3. REPAIRS + FMV AFTER - INSURANCE OR	0	-	1	0.6	0	-
4. SALE PRICE + INSURANCE = GAIN	0	-	1	0.6	0	-
Total	3	0.9	2	1.2	1	0.6
TOTAL	102	31.6	22	13.7	41	25.5
III. No formula applied						
A. Not qualified (note c)	9	2.8	30	18.6	15	9.3
B. Not substantiated (note c)	5	1.6	29	18.0	5	3.1
Total	14	4.4	59	36.6	20	12.4
IV. Unknown	0	-	6	3.7	43	26.7
TOTAL	b/322	100.0	161	100.0	161	100.0

a/Of these, about one-fourth used cost of repairs less capital expenditures as evidence of loss of value, as permitted by the regulations.

b/Based on 2 computation formulas used by each taxpayer for each of the 161 items of property, 1 used on the tax return and 1 used in the appeals process.

c/Includes only those items of property for which no loss computation formula was applied. In other cases, formulas were used even though one or both of these were cited as a reason for proposed adjustment.

KEY: FMV = Fair Market Value BEFORE = Before Casualty AFTER = After Casualty

TAXPAYER COMPLIANCE MEASUREMENT PROGRAM

Not only is the casualty and theft loss deduction provision a significant source of taxpayer-IRS contorversy, it also is a frequent source of taxpayer error.

A study prepared under TCMP, which estimated the frequency and amount of error for each line item on individual returns filed for tax year 1973, indicates that taxpayer compliance is lower for the casualty and theft loss deduction than for any other line item except the medical expense deduction. Over 64 percent of taxpayers covered by the TCMP sample deducted the wrong amount of casualty and theft loss. Table 4-3 below shows the frequency of error by filing status and adjusted gross income (AGI) class.

Table 4-3

Estimated Frequency of Error in Casualty and Theft Loss Deductions on 1973 Individual Returns by Filing Status and AGI Class

Filing status and AGI class	Number reported (note a)	Number in error (note a)	Percent in error
	-----(000	omitted)----	
1040A (note b) plus nonbusiness and Schedules C & F - under $10,000	441	345	78.2
Nonbusiness $10,000 - $50,000	1,259	815	64.7
Schedules C & F - $10,000 - $30,000	214	95	44.4
Schedules C & F $30,000 and over	48	20	41.7
Nonbusiness - $50,000 and over	41	15	36.6
Total	2,003	1,290	64.4

a/Includes number not reported but established per IRS examination.

b/1040A returns not claiming the casualty and theft loss deduction for which the deduction was established upon IRS examination.

In general, the higher the adjusted gross income, the higher the level of taxpayer compliance with respect to the casualty and theft loss deduction. This higher level of compliance does not appear to be attributable to paid assistance, however. Over half of all taxpayers claiming the deduction received IRS or paid assistance, but the compliance level for these taxpayers was the same as the average compliance rate for all taxpayers claiming the deduction. (See Table 4-4 below.)

Table 4-4

Estimated Frequency of Error in Casualty and Theft Loss Deductions on 1973 Individual Returns for Taxpayers Receiving IRS or Paid Assistance

	Percent of all taxpayers who claimed the deduction	Number reported (note a)	Number in error (note a)	Percent in error
		---(000 omitted)---		
IRS assistance (note b)	2	34	22	65
Paid assistance	55	1,102	702	64
Total	57	1,136	724	64

a/Includes number not reported but established per IRS examination.

b/IRS walk-in or telephone assistance received as indicated by a stamp on the return.

Table 4-5 on page 59 shows the average dollar amount of the casualty and theft loss deduction claimed in error by filing status and AGI class.

Table 4-5

Estimated Average Dollar Amount of The Casualty and Theft Loss Deductions Claimed in Error on 1973 Individual Returns by Filing Status and AGI Class

Filing status and AGI class	Number in error (note a)	Amount in error (note a)	Average amount in error
	----(000	omitted)----	
1040A (note b) plus nonbusiness and Schedules C & F - under $10,000	345	$168,452	$ 488
Nonbusiness $10,000 - $50,000	815	330,287	405
Schedules C & F - $10,000 - $30,000	95	43,779	461
Schedules C & F $30,000 and over	20	27,672	1,384
Nonbusiness $50,000 and over	15	16,357	1,090
Total	1,290	$586,547	$ 455

a/Includes number/amount not reported but established per IRS examination.

b/1040A returns not claiming the casualty and theft loss deduction for which the deduction was established upon IRS examination.

The higher the adjusted gross income level, the larger the average dollar amount of the casualty and theft loss deduction claimed in error. 1/

1/Such averages were computed using statistics provided in Statistics of Income 1974, Individual Income Tax Returns, IRS Publication 79 (10-77), p. 96.

The average dollar amount of the casualty and theft loss deduction claimed in error on returns prepared with paid assistance was $606, which is higher than the average error of $455 for all returns in which a casualty and theft loss deduction was claimed. The average dollar amount of the deduction claimed in error on returns prepared with IRS assistance was $143.

USE OF CASUALTY AND THEFT LOSS TAX FORMS

Our examination of the 124 sample cases showed a low level of use of the casualty and theft loss Forms 4684 and 4797. Form 4684 is applicable to losses of multiple items of property in a single casualty, to losses from multiple casualties, and to losses of income-producing property. Form 4797, Supplemental Schedule of Gains and Losses, is applicable to losses of section 1231 property. If taxpayer sustains a casualty or theft loss to a single item of property in a single event, the instructions to the Form 1040 direct him to enter his "loss before insurance reimbursement" directly on line 25 of the Schedule A, itemized deductions. The instructions state the lower-of-basis-or-fair market-value rule of the regulations but offer no computational example. The Form 4684, on the other hand, contains an example and, in addition, provides a separate line for each computational step of the regulations rule. Use of this Form is not mandatory for loss of more than one item and does not apply to loss of a single item.

Not surprisingly, we found a low level of use of Form 4684 in the 124 sample cases. Of the 124 cases, 56, or 45.2 percent, involved multiple losses or losses of income-producing property. Only 12, or 21.4 percent of the 56 cases in fact used the form. On the other hand, 6 of the 124 sample cases (4.8 percent) used the Form 4684 to compute the loss of a single item.

We had only 19 cases in the sample which involved loss to business property. Of these 19, only 4 correctly used the schedule 4797 which tracks the netting rules of section 1231. In one case, a taxpayer used the Form 4797 to report as a business casualty loss the payment of legal fees in an employment dispute.

We cannot say, based upon our examination of the 124 sample cases, that any one controversy would not have arisen or that the claimed loss would have been correctly computed had it been reported on a Form 4684 or 4797. However, use

of the appropriate form might have been helpful in some cases to alert taxpayers to the fact that "loss before insurance reimbursement" does not mean "loss of value."

CONCLUSION

The evidence is that the personal casualty and theft loss deduction provision is inherently unadministrable in an evenhanded manner. Whatever tax relief is afforded by the loss deduction is erratic and unrelated to financial capacity to pay an income tax. The provision lends itself to fraud by those taxpayers who claim the deduction with no substantiation. It lends itself to abuse by all taxpayers who claim the deduction for loss of value unrelated to the occurrence of a casualty or theft loss event. The administrative difficulties involved in enforcing the provision far exceed whatever small tax relief may be afforded in particular hardship cases.

CHAPTER 5

CONCLUSIONS, RECOMMENDATIONS AND TREASURY COMMENTS

CONCLUSIONS

The statutory provision allowing a personal casualty or theft loss deduction is deceptively simple. Loss from fire, storm, shipwreck, or theft is certainly a familiar phenomenon. However, on closer inspection it is apparent that the casualty and theft loss deduction provision involves so many complex problems of definition, valuation, and computation that it cannot be administered in an even-handed manner. Enforcement of the provision imposes heavy costs both on taxpayers and on the IRS.

It is no criticism of IRS administrative and compliance effort that enforcement is erratic. Indeed, the loss computation rules of the regulations insure that inequitable results will occur because in any one case, the lower the percentage loss of value, the higher the percentage recovery through the tax system.

Unavoidably, the provision is a significant source of IRS-taxpayer controversy. The regulations rules require some of the most difficult factual determinations known to the income tax: "sudden loss" versus "progressive deterioration," fair market value, capital versus noncapital repair costs. In fact, these kinds of questions constitute 40 percent of the issues raised in the sample of contested proposed deficiencies examined.

Moreover, far from being a tax relief measure the deduction is a tax incentive for taxpayers in the higher income classes not to insure or to underinsure.

--First, the tax-saving value of the deduction increases as a function of the increase in marginal tax rates for taxpayers in successively higher income classes.

--Second, if, in the year of the casualty or theft, the amount of loss sustained exceeds taxable income computed without allowance of the loss, the excess is treated as a net operating loss. 1/ This means that the net operating loss carryback and

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1/Section 172(d)(4)(c).

carryforward rules applicable to excess business losses, and not the carryforward rules applicable to excess capital losses, apply. 1/ Treating the excess casualty loss as a business loss and not as a capital or personal loss allows the loss as an offset against gross income to reach adjusted gross income in each of the three taxable years preceding the year of the casualty or theft and in each of the seven taxable years following the taxable year of loss. Further, while the tax saving generated by the casualty and theft loss deduction is reduced by the tax value of the zero bracket amount (standard deduction) in the year of loss, it is not reduced by the tax value of the zero bracket amount (standard deduction) in the carryback and carryforward years. This quirk in the rules tends to make the deduction more valuable to high income taxpayers who typically would itemize whether or not they have sustained a personal casualty or theft loss.

--Third, the deduction covers nondepreciable personal property such as precious jewelry and fine arts, loss of which does not significantly affect the financial capacity of a taxpayer to pay an income tax.

The available data neither clearly support nor counter the contention that the deduction significantly affects the ability of low-income taxpayers to pay a tax out of current income. However, in view of the inherent inadministrability of the provision, the possible ability to pay aspect is not sufficiently persuasive to justify retaining the provision in its present form.

One other problem with administration of the personal casualty and theft loss provision in the failure of most taxpayers claiming such a loss to use IRS casualty and theft loss Forms 4684 and 4797. Given the low level of use of these forms, IRS should reevaluate the effectiveness of the forms as an aid to taxpayers and IRS.

1/Regulations §1.172-3(a)(3)(iii).

RECOMMENDATIONS
TO THE CONGRESS

We recommend that the Congress reassess the need to retain the personal casualty and theft loss provision Section 165(c)(3) of the Internal Revenue Code) in its present form.

In making such a reassessment the Congress could consider several alternatives.

- --Repeal the personal casualty and theft loss deduction on the ground that it is inherently inadministrable.

- --Repeal the personal casualty and theft loss deduction and allow a deduction for all or a percentage of the cost of premiums for casualty insurance covering real property and personal effects.

- --Amend the statutory personal casualty and theft loss deduction provision to limit the allowable loss to an amount in excess of a stated percentage of adjusted gross income, restrict the category of loss events and loss property, repeal the netting rules of section 1231, and treat an excess casualty or theft loss as a net long-term capital loss carryforward.

- --Amend the Treasury Regulations to limit the recognized loss to the amount of realized loss attributable solely to the casualty or theft.

Below we examine each of these options and their revenue effects which were estimated using the Treasury Department's Individual Income Tax Simulation Model.

Repeal Section 165(c)(3)

Were the personal casualty and theft loss deduction repealed and no personal loss deduction substituted, the estimated revenue gain to the Treasury would be $425.2 million. This revenue figure is based upon the amount by which the casualty and theft loss deduction claimed on the sample of returns underlying the Treasury Department tax model exceeds the zero bracket amount (standard deduction). Table 5-1 on page 65 shows the distribution by expanded income class of the increased tax payments which would result from repeal of the personal casualty and theft loss deduction.

Table 5-1
Increased Tax Payments
Resulting from Repeal of the
Personal Casualty and Theft Loss Deduction
(1978)

Expanded income class	Amount ($ millions)	Percent	Cumulative percent
less than $ 5,000	0.0	0.0	0.0
5,000 < 10,000	10.4	2.4	2.4
10,000 < 15,000	32.8	7.7	10.1
15,000 < 20,000	61.3	14.4	24.5
20,000 < 30,000	106.3	25.0	49.5
30,000 < 50,000	122.2	28.7	78.2
50,000 < 100,000	41.5	9.8	88.0
100,000 < 200,000	35.9	8.5	96.5
200,000 and over	14.8	3.5	100.0
Total	425.2	100.0	

It is significant that only 10 percent of the revenue loss would be recouped from the low income taxpayers for whom the deduction may operate as a tax relief measure.

The estimate assumes that taxpayer behavior would not change in response to the hypothetical repeal of the deduction. Since the likely behavioral response to repeal of the personal casualty and theft loss deduction would be to increase insurance coverage, and since the cost of insurance premiums to cover loss of nonbusiness property is not deductible the failure to take into account likely behavioral response does not distort the estimated revenue-loss figure.

The option of repeal is in line with the recommendation of the Treasury Department in Blueprints for Basic Tax Reform (1977) and of the American Bar Association, the Special Committee on Simplification, Section on Taxation, in "Evaluation of the Proposed Model Comprehensive Income Tax," 32 Tax Lawyer 563, 649-50 (1979), that the personal casualty and theft loss deduction be eliminated entirely. Outright repeal of the personal casualty and theft loss deduction is the preferred option from the standpoint both of tax theory and ease of administration. 1/

1/See Appendix IV.

Deduct insurance premiums

An alternative to outright repeal of the personal casualty and theft loss deduction would be repeal plus allowance of a deduction for all or a percentage of the cost of premiums for casualty and theft loss insurance covering real property and personal effects. This alternative has the advantage that it not only removes the government from the role of involuntary co-insurer but it also provides a positive incentive to purchase casualty and theft loss insurance. This alternative has the disadvantage common to all deductions from income taxable under progressive rate schedules: the taxsaving value of the relief increases as a function of progression. This result could be avoided if the deduction were reduced by taxpayer's top marginal tax rate. That is, the deduction would be computed as

$$D = P(1 - tx)$$

where D = deduction
P = dollar costs of insurance premiums
tx = applicable marginal tax rate taken from the tax tables in section 1 of the Code

For example, assume that a taxpayer, married, filing jointly has net taxable income without allowance of a deduction for the cost of casualty insurance, of $12,000. Under present law if he incurs premium costs of $1,000, the tax-saving value of his deduction is $220 (.22 x 1,000). If his net taxable income before deduction of premium costs is $100,000, the tax-saving value of his deduction is $600 (.60 x $1,000). Under the proposed change, the tax-saving value of a deduction for $1,000 of premiums would be $780 for the taxpayer in the 22 percent marginal bracket ($1,000 x [1 - .22]); it would be $400 for the taxpayer in the 60 percent marginal bracket ($1,000 x [1 - .60]).

The effect of reducing the amount of the deduction by the applicable marginal rate applied to the dollar value of the premium cost is to vary the tax-saving value of the deduction inversely with income level and thus to preserve the ability-to-pay aspect of the deduction.

It is estimated that if the personal casualty and theft loss deduction were repealed and replaced by the deduction for the entire cost of premiums, computed as D = P(tx), for casualty and theft loss insurance covering real property and personal effects only, the annual estimated revenue loss would be $1.25 billion. If the deduction were limited

to a percentage of the annual premium cost and a ceiling imposed, the revenue loss could be reduced to approximately the revenue loss of the present personal casualty and theft loss deduction.

Amend section 165(c)(3) and related statutory provisions

An alternative to outright repeal of the casualty and theft loss deduction is to amend the provision.

(a) Limit the allowable loss

Under this alternative the personal casualty and theft loss deduction would be retained in some form, but the allowable deduction would be limited to an amount in excess of a stated percentage of adjusted gross income. While this alternative would solve none of the definitional and computational problems of the existing law, it would so markedly reduce the number of taxpayers eligible for the loss deduction, that the audit and compliance problems would be made manageable.

The Administration's 1978 Tax Program recommended that the personal casualty and theft loss and medical care expense deductions be combined into a single hardship deduction and be allowable only to the extent that, in the aggregate, the expenses and losses exceed 10 percent of adjusted gross income. For purposes of calculating the amount of the loss sustained, the $100 floor of existing law would be retained.

An alternative would be to retain the separate deduction provisions for medical expenses and casualty and theft losses and to limit the allowable loss deduction to the amount of loss sustained in excess of 10 percent of adjusted gross income. Our study of the 124 contested cases covered by the sample does not show that taxpayers who claimed high casualty or theft losses also claimed extraordinary medical expenses. While both deductions are, in theory, ability-to-pay or hardship deductions, so also are most of the other itemized deductions. In principle, allowance for the aggregate of consumption expenses which affect taxpaying ability is taken into account by the zero bracket amount. When in excess of the zero bracket amount, there are sound reasons for maintaining the separate identity of the different extraordinary consumption expenditures which may affect taxpaying ability. There is a further consideration: maintaining the separate identity of the medical expense and

personal casualty and theft loss deductions makes it easier to assign a dollar value to the financial assistance given through the tax system to health care and to reimbursement for personal loss.

It is estimated that if the personal casualty loss deduction were limited to the amount of loss sustained in excess of 10 percent of adjusted gross income, the revenue loss would be $311.2 million. This is $114 million less than the estimated revenue loss of the present casualty and theft loss deduction.

Were this alternative proposal preferred, we also suggest that the loss category "other casualty" be eliminated and that the loss deduction be limited to loss caused by fire, storm, volcano, earthquake, flood, shipwreck, theft, and automobile accident. In addition, we suggest that the loss property be limited to a building or structure which is the taxpayer's principal residence and to motor vehicles and ships. 1/

(b) Repeal the netting rules of section 1231

If the decision is made to retain the personal casualty or theft loss deduction in some form, we suggest that loss of personal property by casualty or theft not be netted with capital losses and gains from investment assets nor with ordinary losses and capital gains from depreciable business assets under any circumstances. As an ability-to-pay deduction, the casualty and theft loss deduction should stand alone as an offset against ordinary income in the year of loss in the same manner as the other ability-to-pay deductions. There is no policy reason to treat a casualty or theft loss of personal property differently depending on the fortuitous and unrelated circumstance that the taxpayer also has net gains and losses from the sale or other disposition of depreciable business assets and that net "section 1231" gains exceed net "section 1231" losses.

Separation of section 165(c)(3) losses from section 1231 gains would not have a significant revenue effect. It would, however, greatly simplify computation of the personal casualty and theft loss deduction by taxpayers

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1/See Appendix V for suggested statutory language.

who suffer a loss of both business and personal assets in the same tax year. It also would remove the difference in tax treatment between taxpayers who suffer a personal casualty and have no section 1231 gains or losses in the same year and persons who have both personal casualty losses and section 1231 gains and losses in the same year.

(c) Treat an excess personal casualty or theft loss as a net long-term capital loss carryforward

If the decision is made to retain the personal casualty and theft loss deduction in some form, we suggest that excess loss, if any, be treated as a net long-term capital loss carryforward under the rules of section 1212(b).

This change would require repeal of section 172(d)(4)(C) and Regulation §1.172-3(a)(3)(iii) and amendment of section 1212(b)(2)(B) by adding a new subparagraph (iii) to paragraph (2)(B). 1/ This change would not have a significant revenue effect.

Amend the computation of loss rules of Regulations §1.165-7(b)(1)

Regardless of whether any statutory change is made Treasury regulations section 1.165-7(b)(1) could be amended to limit recognition of the loss realized to the amount of loss attributable solely to the casualty. This means that the loss recognized would be limited to adjusted cost basis reduced by the absolute value of the change in market value of the property occurring before the casualty. The amount of recognized loss would be reduced by the fair market value of the loss property remaining after the casualty plus insurance or other reimbursement received for purposes of determining the loss allowable as a deduction under section 165(a). 2/

While it is not possible to estimate the likely revenue effect of this change, it probably would not have an appreciable revenue effect. It also would not significantly reduce the difficult interpretative and definitional problems of the present regulations rules. It would, however, improve tax equity by preventing double recovery of capital invested in personal property and recovery of appreciation in value not taken into income.

1/See Appendix V for the suggested statutory language.

2/See Appendix V for the suggested regulations language.

RECOMMENDATIONS TO THE
COMMISSIONER OF INTERNAL REVENUE

We recommend that IRS reevaluate the utility of IRS Forms 4684 and 4797 as aids to voluntary compliance and enforcement of the personal casualty and theft loss deduction.

In doing such an evaluation IRS should consider whether (1) to eliminate the forms with respect to the personal casualty and theft loss deduction, (2) expand their use to single casualty or theft losses, or (3) require their mandatory use by all taxpayers claiming a personal casualty and theft loss deduction.

TREASURY COMMENTS

The Assistant Secretary of the Treasury for Tax Policy and Commissioner of Internal Revenue, by joint letter dated September 19, 1979, advised us of Treasury's views on the recommendations in the report. (See Appendix I.)

In the draft report provided Treasury we discussed all of these alternatives, but recommended that the Congress repeal the personal casualty and theft loss deduction. In response to our draft recommendation, Treasury stated that "[It] * * * would not oppose repeal of the personal casualty loss deduction." It also stated that:

> "The personal casualty loss deduction stands in contravention to the general principle in the Internal Revenue Code that losses and expenses of a primarily personal nature are not deductible."

Treasury stated further that:

> "If it is felt that the deduction should be retained so as to effect some redistribution of losses, the deduction should be restructured so that loss redistribution is more effective for those least able to insure privately against loss."

Treasury noted that in 1978 the President proposed that no deduction be allowed unless the medical expense and casualty and theft loss exceeded 10 percent of a taxpayer's income. This would have limited the deductibility to extraordinary losses which may affect a taxpayer's ability to pay taxes.

We continue to believe that from the standpoint of tax theory and of ease of administration, repeal of the personal casualty loss deduction is the preferred alternative. But, recognizing the practical issues that the Congress must consider when reviewing the need for the provision, we also believe it appropriate and necessary to provide other alternatives. We have therefore modified our recommendations in the final report to recommend all of the alternatives to the Congress for its consideration. Any one would limit the scope of the deduction and serve the goals of tax equity and simplification.

As set forth above, it appears that Treasury agrees that the time has come for the Congress to reexamine the need to retain the personal casualty and theft loss deduction in its present form and that among the alternatives to be considered are outright repeal and a floor-type limit on the deductibility of the loss realized.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

SEP 1 1979

Dear Mr. Voss:

The General Accounting Office has prepared a draft report on section 165 (c) of the Internal Revenue Code and regulations section 1.165-7, the provision allowing for the deduction of personal casualty losses. In that report you have recommended repeal of the personal casualty loss deduction. Your recommendation is based upon your conclusions that the casualty loss deduction is inherently unadministrable and that the policy justifications for it are unclear. The report also discusses, without recommendation, alternatives to outright repeal.

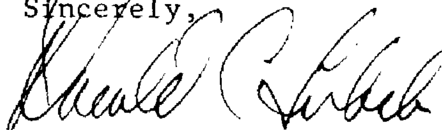
The personal casualty loss deduction stands in contravention to the general principle in the Internal Revenue Code that losses and expenses of a primarily personal nature are not deductible. The rationale for the existence of the deduction is that a sudden and unexpected loss can affect one's ability to pay taxes. It is not clear, however, that an individual who has suffered such a loss and now wishes to replace the lost asset is any less able to pay taxes than an individual who now desires to acquire such an asset. The Treasury Department would not oppose repeal of the personal casualty loss deduction.

A corollary of existence of the deduction is that the Federal Government offers to become co-insurer of a taxpayer's property. There is consequently a loss distribution function to the deduction. Given the progressivity of the tax rates, the loss distribution is most effective at higher income levels, less effective at lower income levels, and completely ineffective for those whose income is so low that no tax is paid. This result is questionable from a tax policy standpoint. If it is felt that the deduction should be retained so as to effect some redistribution of losses, the deduction should be restructured so that loss redistribution is most effective for those least able to insure privately against loss. The President's 1978 proposal suggested that a higher floor be placed upon the casualty loss deduction. No deduction would have been allowed unless the medical expense and casualty loss

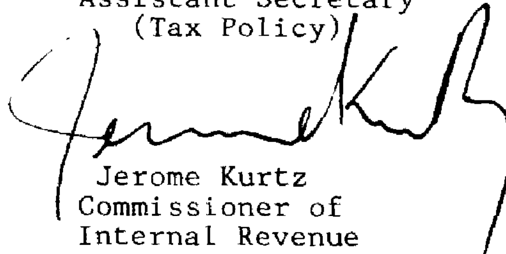
exceeded 10 percent of a taxpayer's income. This would have limited the deductibility of incidental losses which have no effect on the taxpayer's ability to pay taxes. It would also have made the decision to self-insure substantially less attractive.

Since GAO is not recommending any amendment to the Code or the regulations as an alternative to the repeal of section 165 (c) (3), we have no comment to make at this time on the other courses of action discussed in the draft report.

Sincerely,



Donald C. Lubick
Assistant Secretary
(Tax Policy)



Jerome Kurtz
Commissioner of
Internal Revenue

Mr. Allen R. Voss
U. S. General Accounting Office
General Government Division
Washington, D.C. 20548

DERIVATION OF ANNUAL INSURANCE PREMIUM EQUATION

The hypothesis that we wish to address asks if there exists a set of financial circumstances that makes it economical for an individual to insure himself using the tax-saving value of the casualty and theft loss deduction for reimbursement of loss. To test this hypothesis, we used four steps

--we constructed an equation that calculates the present value of taxpayer's costs and benefits when he chooses to purchase insurance (the insurance premium option);

--we constructed an equation that calculates the present value of a taxpayer's costs and benefits when he chooses to use the casualty and theft loss provisions and to act as his own insurer (the tax write-off option);

--we compared the above two equations and solved for that level of annual insurance premium that equates the present values of the two options to the taxpayer;

--we repeated the preceeding steps for each year in the discount period and attached a yearly probability to them.

After listing the notational symbols used in the formulas, each of these four steps will be discussed in turn.

Notation

Y_d = disposable after-tax income (no casualty or theft loss)

Y_{dct} = income before taxes but after deductions (with casualty or theft loss)

Y_{dc} = disposable after tax income (with casualty or theft loss)

Y = gross income

DI = itemized deductions (except casualty or theft loss and state income tax)

DO = standard deductions or the zero bracket amount (assumed to be less than or equal to DI)

INS = amount of the insurance reimbursement

C = amount of the casualty and/or theft loss (this analysis ignores the fact that the first $100 of a casualty and theft loss is not deductible)

N = number of years before the loss is expected to occur

A = average state income tax rate

I = personal discount rate

TX = tax table rate on taxable income

P = annual insurance premium

T = number of years in the discount period

PRt = probability of casualty or theft loss in year t

<u>The insurance premium option</u>

If a taxpayer elects to insure his property with a commercial firm, he pays an annual premium P every year until he incurs a casualty or theft loss in year N. At that time, he receives a reimbursement for his loss, INS. To compare this option with the tax write-off option we also need to calculate his disposable after-tax income YD in year N. Summing these together and taking into account present values, gives us:

(A-1) The net present value of the insurance premium option =

$$- \sum_{t=1}^{N} \frac{P_t}{(1 + I)^t} + \frac{INS}{(1 + I)^N} + \frac{Y_d}{(1 + I)^N}$$

Since we can assume all insurance premiums are equal, we can rewrite (A-1) as:

(A-2) The net present value of the insurance premium option=

$$- \frac{P(1 + I)^N - P}{I(1 + I)^N} + \frac{INS}{(1 + I)^N} + \frac{Y_d}{(1 + I)^N}$$

The after-tax income is calculated from the following equation which takes into account the taxpayer's gross income, deductions, state tax rate, zero bracket amount, and effective Federal tax rate:

(A-3)

$$YD = YG - [YG - (DI + A\ (YG - DI) - DO)]TX - A(YG - DI)$$

The tax write-off option

If a taxpayer elects to insure his property himself, his only relative benefit is the greater amount of after-tax income, YDC, he will have in the year of his casualty loss. This is calculated in the same manner as YD above except that the amount of the casualty or theft loss is added.

(A-4) The net present value of the tax write-off option =

$$\frac{YDC}{(1 + I)^{N}}$$

(A-5)

$$YDC = YG - [YG - (OI + C + A(BC - DI - C) - DO)]\ TXC - A(YG - DI - C)$$

Annual insurance premium equation

If we assume some premium amount exists such that the present values of the two options are equal, then we can equate equations (A-2) and (A-4).

(A-6)

$$\frac{P(1 + I)^{N} - P}{I(1 + I)^{N}} + \frac{INS}{(1 + I)^{N}} + \frac{BD}{(1 + I)^{N}} = \frac{BDC}{(1 + I)^{N}}$$

Solving for P in (A-6) gives us:

(A-7)

$$P - [INS + BD - BDC][I/((1 + I)^{N} - 1)],\ \text{or}$$

(A-8)

$$P = [INS + Y_{d} - Y_{dc}][I^*], \text{ where } I^* = (1 + I)^{\frac{I}{N}} - 1$$

Equation (A-8) now permits us to determine at what level of annual insurance premiums the taxpayer is indifferent to the insurance premium option or the tax write-off option.

<u>Annual insurance premium equation with probabilities attached</u>

To take into account the fact that the casualty or theft could occur in any year with probability PRt, we can solve for the level of P where the taxpayer is indifferent by multiplying the right hand side of equation (A-8) for each year by its probability of occuring in the discount period and summing over all the years.

(A-9)

$$P = \sum_{t=1}^{T} (PRt)(INSt + Y_{dt} - Y_{dct})(I^*t)$$

TABLE 01 PAGE 0001

TABLE 1--RETS. WITH NET CASUALTY OR THEFT LOSS DEDUCTION: RATIO OF CASUALTY LOSS TO AGI & TO TOTAL DEDS. BY SIZE OF AGI, 1976

(ALL FIGURES ARE ESTIMATES BASED ON SAMPLES--MONEY AMOUNTS ARE IN THOUSANDS OF DOLLARS)

SIZE OF AGI	ADJUSTED GROSS INCOME RETURNS	ADJUSTED GROSS INCOME AMOUNT	TOTAL ITEMIZED DEDS. RETURNS	TOTAL ITEMIZED DEDS. AMOUNT	NET CAS. OR THEFT LOSS RETURNS	NET CAS. OR THEFT LOSS AMOUNT	CAS./AGI PERCENT	CAS./DEDS. PERCENT
TOTAL	1998333	48472248	1998333	12727603	1998333	1570410	3	12
$1 < $1,000...........	278	136	278	1827	278	193	142	11
$1,000 < $2,000.......	572	809	572	5195	572	3967	490	76
$2,000 < $3,000.......	3373	9772	3373	14147	3373	227	2	2
$3,000 < $4,000.......	2330	8159	2330	11638	2330	2050	25	18
$4,000 < $5,000.......	11686	54880	11686	37819	11686	16338	30	43
$5,000 < $6,000.......	16264	86414	16264	54123	16264	13904	16	26
$6,000 < $7,000.......	36842	239103	36842	115133	36842	22770	10	20
$7,000 < $8,000.......	40021	300940	40021	138263	40021	19258	6	14
$8,000 < $9,000.......	55743	474820	55743	233114	55743	98235	21	42
$9,000 < $10,000......	53776	513628	53776	184033	53776	29863	6	16
$10,000 < $11,000	71374	752254	71374	273430	71374	57115	8	21
$11,000 < $12,000.....	60010	689565	60010	245555	60010	41930	6	17
$12,000 < $13,000.....	65330	817457	65330	275614	65330	72383	9	26
$13,000 < $14,000.....	73848	999543	73848	324107	73848	60142	6	19
$14,000 < $15,000.....	89294	1300640	89294	382467	89294	40898	3	11
$15,000 < $20,000.....	403001	7044556	403001	2076866	403001	282993	4	14
$20,000 < $25,000.....	337939	7608161	337939	1908797	337939	242686	3	13
$25,000 < $30,000.....	279910	7634820	279910	1758049	279910	152082	2	9
$30,000 < $50,000.....	299999	10883617	299999	2475146	299999	229126	2	9
$50,000 < $100,000....	76264	5048954	76264	1164944	76264	108321	2	9

APPENDIX III

TABLE 01 PAGE 0002

TABLE 1--RETS. WITH NET CASUALTY OR THEFT LOSS DEDUCTION: RATIO OF CASUALTY LOSS TO AGI & TO TOTAL DEDS. BY SIZE OF AGI, 1976

(ALL FIGURES ARE ESTIMATES BASED ON SAMPLES--MONEY AMOUNTS ARE IN THOUSANDS OF DOLLARS)

SIZE OF AGI	ADJUSTED GROSS INCOME		TOTAL ITEMIZED DEDS.		NET CAS. OR THEFT LOSS		CAS./AGI	CAS./DEDS.
	RETURNS	AMOUNT	RETURNS	AMOUNT	RETURNS	AMOUNT	PERCENT	PERCENT
$100,000 < $200,000...	15921	2087043	15921	499143	15921	53440	3	11
$200,000 < $500,000...	3839	1077435	3839	281126	3839	17055	2	6
$500,000 < $1,000,000.	503	344401	503	109264	503	3336	1	3
$1,000,000 OR MORE....	216	495141	216	157803	216	2098	(1)	1

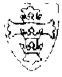
Less than .5%

Internal Revenue Service
Statistics Division

Tax Model of Individual
Income Tax Returns
October 3, 1979

APPENDIX III

 APPENDIX IV



Boston University

School of Law
765 Commonwealth Avenue
Boston, Massachusetts 02215

July 11, 1979

Reka P. Hoff, Attorney
Senior Tax Law Specialist
U.S. General Accounting Office
Washington, D.C. 20548

Dear Reka:

I have read with interest the draft report you sent me in May concerning the personal casualty loss tax deduction. You have done a good job of combining empirical investigation of income tax administration with theoretical analysis of the area.

The report shows that the casualty loss deduction suffers from difficulties in practical enforcement and consumes an inordinately large percentage of audit and appeal resources. The most important problems derive from the need to value loss property before and after the casualty in order to determine the amount of loss. Both appraisals necessarily will involve differing judgments as to value and invite disagreement between the taxpayer and the IRS. Further, the high percentage of cases in your sample in which the taxpayer provided no substantiation of the claimed loss, or failed to reduce the loss by reimbursement from insurers and other sources, reflects an abuse of the deduction which requires correction. The draft report correctly identifies the ambiguity in the statute's phrase "other casualty" as contributing to the number of dubious deductions.

Without addressing the conclusions of the draft report directly, I would like to comment on some of the points in the analysis.

The draft report evaluates the measure of loss provided under the existing regulations by contrast with its own formula for determining the reduction in taxpayer net worth. This formula tries to correct for problems of unrealized appreciation and imputed rent.

A. Unrealized appreciation. The statute limits the deduction to adjusted basis. But it does not specify how to carry out the same policy of matching the deduction to prior investment when the property is partially destroyed. Suppose a property with an adjusted basis of $10,000 and a fair market value before the casualty of $30,000 that suffers a loss of $6,000 and a reduction in value to $24,000; the regulations allow a full $6,000 loss.* The regulations apply

----

*Following the draft report, for simplicity/ignore the $100 limitation of section 165(c)(3) throughout this discussion.

the loss in full against the taxpayer's $10,000 investment and treat none of the loss as applicable to the $20,000 of unrealized appreciation. The draft report in essence reverses this "stacking" rule and treats the loss as applicable first against the unrealized appreciation, the increase in value in the property on which the taxpayer has paid no income tax. Under that rule, the taxpayer deducts nothing in the hypothetical case.

The regulation formula may be unduly generous to the taxpayer; the approach of the draft report, however, may be unduly harsh. I understand the deduction to allow tax recognition under some circumstances of the taxpayer's reduction in capital or previously taxed income. I see no more reason to view the loss as having fallen entirely on previously taxed than on untaxed income. I propose a middle way: treat the loss as attributable proportionately to taxpayer's investment and to unrealized appreciation. In operation, this means the deduction would be reduced when the fair market value before the casualty exceeds adjusted basis, as follows: multiply the tentative loss (the difference in value before and after the casualty) by a fraction whose numerator is adjusted basis and whose denominator is fair market value before the casualty. In the example, the deductible loss would be $2,000. This approach incidentally would reduce the advantage to the taxpayer of inflating his appraisal of before-casualty value in order to enlarge the loss, by simultaneously enlarging the denominator of the limiting fraction. If the taxpayer in my hypothetical inflated the value of the property before casualty to $32,000, he would report a $8,000 loss under current rules, an increase of $2,000 in his deductions. Under my proposal the amount of deduction is $2,500, an inflation of $500 over the proper amount.

B. Imputed rent. The draft report addresses a second problem, that present rules do not reduce the deductible loss so as to take account of the taxpayer's pre-casualty use of the property. The draft proposes an adjustment which aims at this imputed rent. Although such an adjustment may reflect an economic view of the taxpayer's income from the property, I believe it is inconsistent with the Code's failure to tax imputed income in many other contexts. Accordingly, I would ignore imputed rent altogether.

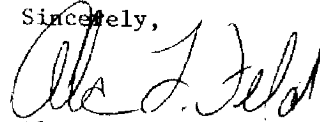
The practical difficulties of enforcement turn in part on the need to determine loss through a comparison of values before and after the casualty. The regulations allow cost of repair to substitute for this comparison. The draft report emphasizes the difficulty sometimes encountered in distinguishing the cost of restoring property from that of improving it; the latter may not be a repair. Yet the regulation provides an attractive substitute for appraisal in many instances. The draft report apparently did not find sufficient data in its sample to deal with it at length. Further study of this question may be appropriate.

APPENDIX IV

Reka P. Hoff -3- July 11, 1979

In conclusion, I congratulate you on the draft and I look forward to the other studies planned in this series. I am enclosing a separate memorandum of specific comments on the draft.

Sincerely,



Alan L. Feld
Professor of Law

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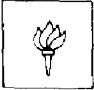
Enclosure



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July 12, 1979

Ms. Reka P. Hoff
Senior Tax Law Specialist
GAO
441 G St., N.W.
Washington, D.C. 20548

Dear Ms. Hoff:

Thank you for sending me a copy of draft report on the personal casualty loss deduction, which I found most interesting.

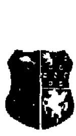
I would endorse the conclusion that this deduction should be repealed. And I do not think merely tinkering with the present provisions would accomplish anything worthwhile.

Sincerely yours,

Charles S. Lyon

Charles S. Lyon
Professor of Law

CSL:cm



YORK UNIVERSITY

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4700 KEELE STREET, DOWNSVIEW, ONTARIO M3J 2R5

July 11, 1979

Reka P. Hoff
Senior Tax Law Specialist
United States General Accounting Office
General Government Division
Washinton, D.C. 20548
U.S.A.

Dear Ms. Hoff:

Thank you very much for sending me a draft of a proposed report on the "The Personal Casuality Loss Tax Deduction". I found it a most thorough discussion and agree with your conclusion.

As you point out in your paper the deduction has little to commend for it either as part of the structural aspect of the income tax act or as a tax expenditure. In virtually all cases a tax deductible loss is suffered because the taxpayer chose to purchase an additional consumption item rather than to increase the cost of previously purchased consumption items by insuring them. The loss might also be viewed as a consumption loss in the sense that many of those who suffer casualty losses chose to bear an increased risk by not taking precaution to protect their property. For both of these reasons, and others that you mention, I doubt if a tax technician would suggest that the deduction should be part of a tax act based solely on ability to pay. Indeed, although I have not thoroughly researched the point, I believe the U.S. is one of the few countries in the world where such a deduction is allowed.

As a spending program, again as you point out, the provision is bazarre: it discriminates against those who insure (since insurance premiums are not deductible); it reimburses taxpayers according to their marginal rates; and, as an insurance program it raises almost insurmountable "moral hazard" problems.

 APPENDIX IV

Ms. Hoff
July 11, 1979

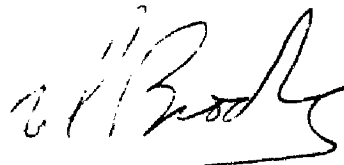
- 2 -

In determining whether administrative and compliance costs justify repealing a spending program or normative tax deduction the strength of the policy basis of the provision should be considered. In the case of the casualty loss deduction these costs seem over-whelming when weighed against the policy goals.

Incidentally, in all of the recent tax reform history we have had in Canada, not once has anyone suggested that we should have a casualty loss deduction.

While I am afraid that I agree so whole-heartedly with your conclusion in this report that my comments have been of little value to you, I would very much like receiving your next draft report.

Yours truly



Neil Brooks
Associate Professor

kjd

Suggested Alternatives;
Proposed Statutory and
Regulation Language

Amend section 165(c)(3) to limit the kinds of
loss events and loss property covered.

SECTION 165 LOSSES

* * * * * * * *

(c) LIMITATION ON LOSSES OF INDIVIDUALS.

* * * * * * * *

(3) losses of depreciable property not connected with a trade or business, if such losses arise from fire, storm, volcano, earthquake, flood, automobile accident, or theft. A loss described in this paragraph shall be allowed as a deduction only to the extent that the amount of such loss not compensated for by insurance or otherwise exceeds 10 percent of adjusted gross income. No loss described in this paragraph shall be allowed, if at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

 APPENDIX V

Amend Section 1231 to remove the netting provisions

SECTION 1231 PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS

(a) General Rule - If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business or held for the production of income for more than 9 months [1 year for taxable years beginning after December 31, 1977] into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 9 months. [1 year for taxable years beginning after December 31, 1977]. If such gains do not exceed such losses, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection -

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

APPENDIX V

(2) losses (including losses not compensated for by insurance or otherwise) upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of (A) property used in the trade or business or (B) property held for the production of income for more than 9 months [1 year for taxable years beginning after December 31, 1977] shall be considered losses from a compulsory or involuntary conversion.

Amend sections 172 and 1212 and related regulations to treat an excess personal casualty or theft loss as a net long-term capital loss carryforward.

This change would require repeal of section 172(d)(4)(C) and regulation §1.172-3(a)(3)(iii) and amendment of section 1212(b)(2)(B) by adding a new subparagraph (iii) to paragraph (2)(B), as follows.

Section 1212 Capital Loss Carrybacks and Carryovers

* * * * * *

(b) Other taxpayers

* * * * * *

(2) Special rules

* * * * * *

(B) For purposes of determining the excess referred to in paragraph (1)(B), an amount equal to the sum of - -

* * * * * *

(iii) any amount allowable under section 165(c)(3) (relating to casualty losses).

Amend Regulations §1.165-7(b)(1) to limit the loss deduction to the amount of the loss attributable solely to the casualty.

§1.165-7 Casualty losses - (a) In general -

* * * * *

(b) Amount deductible -

In the case of any casualty loss of property not connected with a trade or business and not incurred in any transaction entered into for profit, the amount of the loss to be taken into account for purposes of section 165(c)(3) shall be 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 reduced by --

(1) The amount which is equal to the fair market value of the property immediately after the casualty; plus

(2) The absolute value of the amount which is equal to the difference between the fair market value of the property immediately before the casualty and the adjusted basis prescribed in §1.1011-1.

For purposes of determining the fair market value of property immediately after the casualty under subparagraph (1) of this paragraph, cost of repairs shall not be taken into account.

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