

JOHNSTON v. COMMISSIONER 51 AFTR2d 83-313
Affirming 17 TTJ 107 41 T.C.M. 258
Tax Ct. Mem. Dec. (CCH) 37,361(M), (P-H) ¶80,477
(Timber issue only)

Editor's Summary

Key Topics

CASUALTY LOSSES

- Logging roads

Facts

A 200 foot portion of taxpayer's logging road was washed out by a flooded river in 1974. The road cost approximately \$23 per foot to build. The taxpayer sought a casualty loss deduction of \$25,000, the estimated cost of driving piles for a retaining wall needed to hold the road fill adjacent to the river. There was no retaining wall in place at the time of the flood. The Commissioner of Internal Revenue allowed a casualty loss of \$3,400.

Tax Court

HELD: For the Government. The amount allowable as a casualty loss is limited to the lesser of (1) the adjusted basis or (2) fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty. The regulations provide two acceptable methods for calculating the amount of the deductible loss---a competent appraisal of the before-and after-casualty fair market value, or evidence of the cost of repairs. To use repair costs as such a measure, the taxpayer must show that (1) the repairs are necessary to restore the property to its previous condition, (2) the cost is not excessive, (3) the repairs do not go beyond the damage, and (4) the value of the property after repairs does not exceed the value before the casualty.

Taxpayer did not offer any appraisals and it appeared to the court that the proposed repair would increase the value of the property over its pre-casualty value. Also, the court interpreted the regulations to require actual repairs, rather than estimated costs, to avoid potential abuses. Since the taxpayer failed to meet the necessary prerequisites for using repair costs, the Government's determination of the value of the casualty loss was sustained.

Court of Appeals

HELD: Affirmed. Taxpayers failed to sustain their burden of proving the amounts claimed as a casualty loss deduction. They did not offer any appraisal of the fair market value of the road immediately before and after the flood. The only evidence submitted, an estimate of the cost to repair the road, did not meet the requirements of the regulations for use of costs of repairs as evidence of value. In addition, the court rejected the use of the repair estimate on the grounds that no repairs had actually been made.

Case Text
Memorandum

ART AND VEDA JOHNSTON (taxpayers) appeal the tax court's finding of deficiencies in their income-tax payments. Their principal contentions on appeal are that the tax court improperly denied portions of their claimed deductions for casualty loss and travel and transportation expenses. Because we find that taxpayers failed to sustain their burden of proving the amounts claimed as deductions, we affirm the tax court's judgment with respect to these deductions. We also find the other contentions raised by taxpayers on appeal to be without merit.

I. Casualty Loss

A. Facts

In 1974, the Nehalem River flooded and completely washed out 200 feet of taxpayers' logging road. Although simple gravel fills had previously been used to repair the road, taxpayers were advised that the only legal way to replace the washed-out road would be to drive piling and attach a retaining wall to hold the required fill. The lowest estimate received by the taxpayers for repairing the washed-out road in this fashion was \$25,000 by the Western Pile driving and Construction Company. Relying solely on this estimate to substantiate the amount of their loss, taxpayers claimed a casualty loss of \$25,000 on their 1974 tax return for the damage done to their road. The Commissioner of the Internal Revenue Service disallowed the amount claimed and limited the casualty loss to \$3,440.¹

B. Discussion

[1] A taxpayer bears the burden of proving the existence and the amount of a claimed casualty loss. *Clapp v. Commissioner*, 321 F.2d 12, 14 (9th Cir. 1963). It is undisputed that taxpayers in the present case suffered a casualty loss under § 165(a) and (c)(1) of the Internal Revenue Code of 1954. Only the amount of the loss is at issue.

Treasury Regulation § 1.165-7(b)(1) limits casualty losses deductible under § 165(a) and (c)(1) to the *lesser* of either (1) the difference between the fair market value of the property immediately before and immediately after the casualty, or (2) the adjusted basis of the property. The regulations further define the acceptable methods of calculating the amount of a deductible casualty loss. The first method requires that a competent appraisal generally be used to ascertain the fair market value of the property immediately before and immediately after the casualty. Treas. Reg. §1.165-7(a)(2)(i). The second method allows the use of the cost of repairs to the damaged property as evidence of the amount of the casualty loss. Treas. Reg. §1.165-7(a)(2)(ii).

Taxpayers did not offer any appraisal of the fair market value of the road immediately before and after the flood to establish the amount of their casualty loss. They relied solely on the \$25,000 estimate they received for the cost of repairing the road by means of piling and a retaining wall to establish their loss. This estimate, however, cannot be used to establish the amount of taxpayers' casualty loss because taxpayers did not meet the prerequisites imposed by the regulation for use

of the cost of repairs.

Treas. Reg. § 1.165-7(a)(2)(ii) requires that before the cost of repairs can be used to establish the amount of a casualty loss, the taxpayer must show that "(a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amount spent on such repairs is not excessive, (c) the repairs do not care for more than the damage suffered, and (d) *the value of the property, after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.*" (Emphasis added.) Taxpayers in the present case failed to satisfy condition (d) because they did not show that repairing the road by use of piling and a retaining wall would not increase the value of the road beyond its pre-casualty level. It seems clear that the use of piling and a retaining wall would in fact increase the value of the road by protecting it against damage from future floods.

Moreover, the language of the regulation strongly suggests that the cost of repairs cannot be used as evidence of the amount of a casualty loss unless the repairs are actually made. *Lamphere v. Commissioner*, 70 T.C. 391,396 (1978); *Farber v. Commissioner*, 57 T.C. 714,719 (1972). Reading the regulation to require actual repairs and not merely estimates is reasonable in light of the possible abuses that could result from the use of flexible or inflated estimates. *Lamphere v. Commissioner*, 70 T.C. at 396. Taxpayers in the present case have not yet repaired the road. Their failure to repair the road provides an alternate ground for rejecting their use of the \$25,000 estimate² as evidence of the amount of their casualty loss.

Having failed to meet the prerequisites imposed by the regulation, taxpayers were precluded from using the repair estimate to establish the amount of their casualty loss. Since this unacceptable estimate was the only evidence offered by taxpayers, they clearly failed to satisfy their burden of proving the amount of their casualty loss. The tax court thus properly found that it had no basis for calculating a casualty loss greater in amount than the \$3,440 allowed by the Commissioner.

The decision of the tax court is Affirmed.

¹ This figure apparently represents the Commissioner's estimate of the cost of repairing the washed-out road by means of a gravel fill.

² Taxpayers argue that the \$25,000 quote they received was not an estimate but a firm bid. Even if taxpayers' characterization of the quoted price were accepted, however, our analysis would remain unchanged. Firm bids would raise the same potential for abuse as estimates.