Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **AM 2006-006**

Release Date: 10/20/06
CC:ITA:B02:ASWei/AMIrving
POSTS-119766-06

UILC: 161.00-00, 162.16-00, 165.04-02, 263.00-00, 1016.07-00

date: October 11, 2006

to: Keith M. Jones
Industry Director
(Natural Resources and Construction) LM:NRC

from: Lewis J. Fernandez
Associate Chief Counsel
(Income Tax & Accounting) CC:ITA

---

subject: Cost of restoring property after casualty loss deduction

This memorandum addresses the tax treatment of costs of restoring property when the taxpayer has claimed a casualty loss under section 165. [1]

ISSUE

Whether, as a result of the same casualty affecting the same property, a taxpayer may both deduct the casualty as a loss under § 165 of the Internal Revenue Code and also deduct the cost of restoring the property as a repair cost under § 162; or whether, instead, the cost of restoring the property must be added to the basis of the property restored under § 263.

CONCLUSION

We conclude that a taxpayer cannot take both a loss deduction and a business expense deduction as a result of one casualty. Rather, as provided in Rev. Rul. 71-161, 1971-1 C.B. 76, if the loss is deductible under § 165, the cost of restoring the property to its pre-

---

[1] This advice may not be used or cited as precedent.

casualty condition must be capitalized under § 263. This is true regardless of the method used to determine the amount of the loss deduction.[2]

FACTS

The taxpayer owns various assets that were damaged as a result of a casualty. Some of the assets were nearly destroyed whereas others required less substantial repairs. The taxpayer incurred repair costs to rebuild the assets that were nearly destroyed and to repair the assets that were less damaged. The taxpayer would like to use its repair costs for all assets as an estimate of its loss under § 165. The taxpayer also would like to deduct those same repair costs under § 162(a).[3]

LAW AND ANALYSIS

Section 165(a) allows taxpayers to deduct any loss sustained during the taxable year and not compensated for by insurance or otherwise. Generally, any loss arising from fire, storm, shipwreck or other casualty is allowable as a deduction under § 165(a) in the taxable year in which the loss is sustained. See § 1.165-7(a)(1) of the Income Tax Regulations. A "casualty" is the complete or partial destruction or loss of property resulting from an identifiable event of a sudden, unusual, and unexpected nature. See Rev. Rul. 72-592, 1972-2 C.B. 101.

Generally, the amount of a casualty loss deduction is the lesser of the property's adjusted basis or the difference between the fair market value of the property immediately before and immediately after the casualty. However, if business or investment property is totally destroyed, and the property's pre-casualty fair market value is less than its basis, the deductible loss is its adjusted basis. See § 1.165-7(b)(1).

The regulations provide two methods of determining the loss in value resulting from a casualty. Generally, it should be determined by competent appraisal. § 1.165-7(a)(2)(i). However, the cost of repairs is acceptable as evidence of the loss in value if (1) the repairs are necessary to restore the property to its condition immediately before the casualty, (2) the amount spent for the repairs is not excessive, (3) the repairs do not care for more than the damage suffered, and (4) the value of the property after

[2] On August 21, 2006, a notice of proposed rulemaking, *Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property*, REG-168745-03; 71 Fed. Reg. 48590-48623, was issued. Proposed regulation § 1.263(a)-3(f)(iv), "Restoration after a casualty loss," contains a rule consistent with the conclusion of this memorandum. Although the regulations, when finalized, will apply prospectively, we view proposed § 1.263(a)-3(f)(iv) as essentially reflective of current law.

[3] We do not address whether the taxpayer is entitled to a casualty loss deduction for any particular asset in any specific amount; for purposes of this discussion, it is assumed that the losses in question are properly deductible under § 165.

the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty. § 1.165-7(a)(2)(ii). A taxpayer deducting a casualty loss *measured by* repair costs is not deducting the repair costs themselves under § 165. A loss deduction under § 165(a) results in a decrease in the taxpayer's basis in the property. § 1016(a)(1).

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. In particular, § 1.162-4 provides that taxpayers may deduct the costs of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition. Unlike a loss deduction under § 165, if repair costs are deducted under § 162, basis is not adjusted downwards.

Section 263 prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or estate. Capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. § 1.263(a)-1(b).

Section 161 provides that, in computing taxable income, there are allowed as deductions the items specified in part IV, subject to exceptions. Section 1.161-1 provides that double deductions are not permitted; amounts deducted under one provision of the Code cannot again be deducted under another provision.

Section 1.162-1(a) prohibits deductions under § 162 for items which are used as the basis for a deduction or a credit under provisions of law other than § 162. It also provides that an item cannot be deducted as a business expense to the extent that it is used by the taxpayer in determining the basis of its plant, equipment, or other property.

Section 1016(a) provides that proper adjustments to basis must be made for expenditures, receipts, losses, or other items, properly chargeable to capital account. Section 1.1016-6(a) provides that adjustments must always be made to eliminate double deductions or their equivalent.

In the present situation, the taxpayer claims a § 165 deduction based upon the diminution in fair market value caused by the casualty. The taxpayer also seeks to deduct the costs of restoring the property to its pre-casualty condition under § 162 as ordinary and necessary business expenses. After reviewing the relevant regulations, administrative rulings, and case law, we conclude that the Code does not contemplate the taking of two current deductions with respect to the same casualty event, and that to the extent damage or destruction of property qualifies for a loss deduction under § 165, the costs of restoring that property must be capitalized, to reflect the fact that the property has been restored to its pre-casualty condition. Our conclusion is based on the following points.

1. The regulations.

As noted above, damage such as the damage that occurred in the present case is properly deductible as a loss under § 165 and the corresponding regulations, and the regulations under § 162 prohibit a deduction for an item which is the basis for a deduction under another Code provision, or which, like a § 165 deduction, is used in determining basis. See § 1.162-1(a); see also § 1.1016-6(a).[4]

2. The published position of the Service.

Rev. Rul. 71-161, 1971-1 C.B. 76, specifically applies these principles to the case of property damaged by a casualty. In that revenue ruling, the taxpayer sustained business property damage as a result of a hurricane and paid for the removal of debris and repair of the damaged property. The debris and damage to the property resulted in a decrease in the fair market value of the property immediately after the casualty. The cost of the debris removal and property repair was used as evidence of the amount of the casualty loss sustained. The revenue ruling holds that the debris removal and repair costs themselves are "in the nature of replacement of the part of the property that was damaged." Id. at 77. Accordingly, the costs are capitalized and added to the property's basis pursuant to § 1016(a)(1).

It has been argued that this holding in Rev. Rul. 71-161 does not stand for the proposition that post-casualty repair costs must be added to basis; rather, the argument runs, the holding is premised on a factual assumption that the costs in question happen to be capital expenditures in this particular case. We disagree. Costs of removing debris or repairing damage are not the types of expenditures that would normally be capitalized if there were no casualty loss deduction. The holding of the revenue ruling, which cites § 1016(a)(1), is based on the reasoning that the expenditures should be treated as a replacement of what was lost and was deducted under § 165, not an unrelated business expense resulting in a second deduction under § 162.[5]

---

[4] See generally Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 (1934); United States v. Skelly Oil Co., 394 U.S. 678, 684 (1969); Transco Exploration Co. v. Commissioner, 949 F.2d 837, 840-841 (5th Cir. 1992) (unless specifically provided otherwise, tax provisions should be interpreted to avoid the "practical equivalent of double deductions").

[5] See, e.g., B. Bittker, M. McMahon, Jr., L. Zelenak, Federal Income Taxation of Individuals, 2d Ed., ¶ 24.04, n.40 (2005):

> When a loss deduction is allowed for repaired property, no deduction may be taken for the cost of repair as such. See Reg. § 1.161-1 ("[d]ouble deductions are not permitted"). In that case, the cost of the repair is added to the basis of the asset. See Rev. Rul. 71-161, 1971-1 CB 76 (applying this rule in the case of hurricane damage to business property).

3. Case law.

With respect to the case law, a number of cases have considered whether, in a given situation, a loss deduction or a business expense deduction is appropriate.[6] However, we have found no case holding that a taxpayer may take *both* a loss and an expense deduction with respect to the same property and the same casualty event, and to the extent the issue has been addressed incidentally, the opinions tend to support the rationale and holding of Rev. Rul. 71-161. For example, in Trinity Meadows Raceway, Inc. v. Commissioner, 187 F.3d 638, 99-2 USTC ¶ 50,754; 84 AFTR2d 5356 (6th Cir. 1999) (unpublished opinion), the court, agreeing that the taxpayer had failed to establish the amount of its claimed casualty loss deduction, cited the double deduction issue and § 1.162-1(a) as a factor in its determination:

> As an example of the problems in sorting out Trinity's claimed loss in this case, Trinity spent approximately $ 300,000 paying its own employees to clean up and make repairs after the flood. … Trinity conceded that "there was no way . . . to sort that out" from other maintenance undertaken by the workers during the same timeframe. As a business, section 162 allows Trinity to deduct all its "ordinary and necessary expenses" associated with running the business, including the expense of performing repairs. However, Trinity may deduct the repairs as "ordinary and necessary expenses" under § 162 *or* take the loss in value under § 165—it cannot take both deductions. The Treasury regulations expressly provide that a taxpayer may not deduct the item as a business expense "to the extent that it is used by the taxpayer ... in determining the gain or loss basis of its ... property." Treasury Reg. § 1.162-1(a). Therefore, if Trinity deducted the $ 300,000 as "ordinary and necessary" expenses …, and Trinity concedes it had no way to sort out the $ 300,000, it took a double deduction for that $ 300,000.

See also Atlantic Greyhound, 111 F. Supp. at 955 ("the provisions for deductions of 'ordinary and necessary expenses' and 'casualty losses' would seem to be mutually exclusive, for the normal connotation of one negates, at least by implication, the idea of the other").[7]

---

[6] See, e.g., Jones v. Smith, 193 F.2d 381 (10th Cir. 1951), cert. den., 343 U. S. 952 (1952); Buffalo Union Furnace Co. v. Helvering, 72 F.2d 399 (2d Cir. 1934); Hubinger v. Commissioner, 36 F.2d 724 (2d Cir. 1929), aff'g 13 B.T.A. 960 (1928); Atlantic Greyhound Corp. v. United States, 111 F. Supp. 953 (Ct. Cl. 1953); R.R. Hensler, Inc. v. Commissioner, 73 T.C. 168 (1979), acq. in result, 1980-2 C.B. 1; J. F. Wilcox & Sons v. Commissioner, 28 B.T.A. 878 (1933), nonacq., 1933-2 C.B. 27. Which deduction to take is not elective, despite the implication in the Trinity Meadows opinion, quoted in the text.

[7] In Louisville and Nashville Railroad Co. v. Commissioner, T.C. Memo. 1987-61, the judge noted: "We do not intend to imply that someone who is entitled to a deduction under sec. 165 due to a casualty loss is precluded from deductions for ordinary and necessary business expenses in connection with the particular assets subject to the casualty." This precautionary *caveat* on a point not before the court does not affect our analysis.

The conclusion in Rev. Rul. 71-161 and this memorandum is consistent with Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq. on other grounds, 1964-2 C.B. 8. In that influential opinion, allowing the cost of relining water pipes as a § 162 expense, the court observed that "any properly performed repair adds value as compared with the situation existing immediately prior to that repair. The proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure." 39 T.C. at 338. However, in Plainfield-Union the condition necessitating the restoration operation was not a casualty event, no loss deduction had already been taken to reflect the "condition necessitating the expenditure," and there was thus no double benefit in allowing a business expense deduction.

Accordingly, our conclusion is supported by the holding of Rev. Rul. 71-161, which is a correct interpretation of the relevant Code provisions and regulations, and is consistent with the case law.

Additional observations.

First, it could be argued that technically there is no double deduction in this situation because the capitalized costs that are reflected in basis and are, in effect, deducted as a casualty loss are not the same as the repair costs. It is true that over the life of the property, the total cost recovery under the taxpayer's approach would not exceed the taxpayer's actual expenditures. The problem here, however, is with timing, principles of capitalization, and the clear reflection of income. Generally, the cost of a business or investment asset is matched to the income it produces by capitalizing the cost and recovering that cost through depreciation, amortization, depletion, or disposition. A casualty loss is an exception to this general treatment, reflecting the fact that an unusual event has occurred which reduced the value of the property and should be taken into account currently. But *one* casualty event should not be the occasion for *two* current expense deductions. Rather, as in Rev. Rul. 71-161, a loss deduction should be allowed, and the costs of restoring the property to its pre-casualty condition reflected in a restored basis.

Second, our conclusion does not depend on whether the amount of the casualty loss is determined by appraisal or the alternative cost-of-repairs method. It is the allowance of two current deductions occasioned by the same loss event that is problematic. The incongruity is perhaps more obvious when the cost-of-repairs method is used, and the same repair or replacement costs are used to support both deductions, but the anomaly is equally present if the amount of the loss deduction is determined by appraisal.

Finally, the same underlying principle—that costs of restoration after a casualty loss should be capitalized—applies in situations in which the loss is partially or totally compensated and the tax benefit related to the casualty is exclusion or deferral of the compensation. Suppose, for example, an otherwise deductible $100x loss is fully compensated by insurance, and the proceeds used to restore the damaged property,

placing the taxpayer in the same economic position as before the casualty. There is no § 165 deduction, because of the compensation. However, the $100x is not includible in current gross income—instead, it is applied in reduction of the taxpayer's basis in the property. See Rev. Rul. 71-161. As in Rev. Rul. 71-161, where there was partial compensation, the restoration costs should be capitalized in this situation, offsetting the $100x basis reduction with a matching $100x basis increase, and effectively restoring the taxpayer to its tax position before the casualty. If the restoration costs were deductible under § 162, the taxpayer would obtain the double benefit of avoiding or deferring taxation on the insurance proceeds while deducting the restoration costs made with those proceeds.

Please call Andrew Irving at (202) 622-5020 or me if you have any further questions.

CC: Rebecca Wolfe
Deputy Area Counsel (IP) CC:LM:NR