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The Misconstruction of the Deductions for Business and Personal Casualty Losses

by

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Abstract

Losses suffered on an individual's personally used property generally are not deductible. Even after the changes made by the 2017 Tax Cuts and Jobs Act, in two circumstances an exception to this rule applies when "such losses arise from fire, storm, shipwreck, or other casualty, or from theft." The principal issue that arises is determining the meaning of the term "other casualty." Taking what they deemed to be the common elements in the three explicitly identified casualties, the courts and the Internal Revenue Service determined that an event will qualify as an "other casualty" only if it is "sudden," "unusual," and "unexpected."

This current definition of "other casualty" does not support the appropriate purpose of that provision. Applying this incorrect standard leads to unfair results in that the courts and the Service disallow deductions for some losses that should be deductible. Instead, courts and the Service should look to the purpose of allowing a casualty and theft loss deduction. The key issues are whether a loss of property as a result of an outside force constitutes a personal consumption and whether the event causing the loss is one that is part of the ordinary vicissitudes of life. If not, allowing a deduction complies with the congressional purposes for allowing one in the two circumstances in which the deduction is currently allowed.

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While most scholarship concerning the casualty and theft loss deduction is on personal losses, the definition of "other casualty" can be important to business and investment losses as well. The determination that a business or investment loss did or did not occur as a result of a casualty can affect the timing and characterization of the deduction of that loss. Whatever definition is adopted for personal losses purpose should not be used to determine the timing and realization of a business or investment loss because the role of the casualty characterization in applying the realization requirement is very different. There has been little, if any, commentary on those issues and a major contribution of this piece is to shed light on them.

I. Introduction

Section 165(a) of the Internal Revenue Code (the "Code") states that "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."[1] This broad rule is severely limited, especially for individual taxpayers, by restrictions contained in that Code section. For example, an individual taxpayer may deduct a loss only if it was sustained in connection with (1) the trade or business of the taxpayer,[2] (2) a transaction entered into

1. I.R.C. § 165(a).
2. I.R.C. § 165(c)(1).

for profit that is not connected to a trade or business,[3] or (3) a casualty or a theft of the taxpayer's personal-use property (i.e., property not connected to a trade or business or a transaction entered into for a profit).[4]

For individuals, the Code divides property into three separate categories—business, investment, and personal. As noted above, taxpayers typically can deduct losses involving either business or investment property regardless of the cause of the loss.[5] However, losses suffered by an individual's personally used property generally are not deductible. The exception to that latter rule applies when "such losses arise from fire, storm, shipwreck, or other casualty, or from theft."[6]

The principal issue that arises in applying section 165(c)(3) is determining the meaning of the term "other casualty." The other items listed in section 165(c)(3) are specific, and so there is no issue in determining when an event that causes a property loss qualifies for one of those explicitly listed examples. "Other casualty" is a broader and less

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3. I.R.C. § 165(c)(2).

4. I.R.C. § 165(c)(3). The provision provides that losses of personal-use property will be allowed to be deducted if "such losses arise from fire, storm, shipwreck, or other casualty, or from theft." *Id.* Those losses are referred to as "personal casualty losses." I.R.C. § 165(h)(3). The term "casualty" is frequently used to refer to both casualties and thefts. The legislation popularly known as the 2017 Tax Cuts and Jobs Act, Pub. L. No. 115–97, 131 Stat. 2054 (2017) [hereinafter 2017 Act], further limited the deductibility of personal casualty losses. *See infra* Part II.

5. I.R.C. § 165(c)(1)–(2). As to investment losses, some are itemized deductions and some are nonitemized. The itemized deductions for casualty or theft losses of investment properties are not miscellaneous itemized deductions and so were not repealed by the 2017 Act. *See* I.R.C. §§ 67(b)(3), 68(c)(3).

6. I.R.C. § 165(c)(3). The 2017 Act further limited the deductibility of personal casualty losses. *See infra* Part II. While certain casualty "losses" are deductible, personal expenses that arise from a personal casualty are not deductible by a taxpayer. Superficially, this treatment seems inconsistent with the exclusion from income generally applied to reimbursements of those expenses through insurance proceeds or otherwise. *See, e.g.*, I.R.C. § 123. However, it is not unusual in tax law for there to be a lack of parallel treatment; and there are numerous examples of denying a deduction for an expense or loss whose reimbursement is not taxable. *See* Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 Hastings L.J. 645 (2006).

specific term and requires clarification to determine what events fit within it. The term "other casualty" was not included in the original version of the statute; the term was added to the statute in 1916.[7]

The Internal Revenue Service[8] and the courts, applying the maxim of *ejusdem generis*, used the three expressly identified casualties in section 165(c)(3) for guidance in establishing the meaning of the broader term "other casualty." Taking what they deemed to be the common elements in the three explicitly identified casualties, they determined that an event will qualify as an "other casualty" only if it is "sudden," "unusual," and "unexpected."[9] The presence of those three elements has been adopted by both the Service and the courts as the requirements for constituting a casualty.[10] In addition, the event must be the proximate cause of the loss.[11] In this Article, the author disputes the appropriateness of making the presence of those three elements a condition for qualifying for the casualty deduction in light of the apparent congressional purpose for allowing that deduction. Moreover, two of those three elements are not always present in the three named casualties and so cannot be said to be common to them.

One common element that is shared by the three listed casualties is that they cause physical damage to property. A number of courts have held that the casualty loss deduction applies only to a loss incurred because of physical damage to the taxpayer's property.[12] The author agrees that that limitation is proper.

7. Revenue Act of 1916, ch. 463, § 5(a), 39 Stat. 756, 759.

8. Unless otherwise noted, any reference to "the Service" in this Article refers to the Internal Revenue Service.

9. *See, e.g.*, Matheson v. Comm'r, 54 F.2d 537, 539 (2d Cir. 1931) ("[T]he word 'casualty' . . . is an event due to some sudden, unexpected, or unusual cause."); Rev. Rul. 76–134, 1976–1 C.B. 54 (also using phrase "sudden, unexpected, or unusual cause").

10. *E.g.*, Fay v. Helvering, 120 F.2d 253 (2d Cir. 1941); Clem v. Comm'r, T.C. Memo 1991-414, 62 T.C.M. (CCH) 586; Rev. Rul. 72–592, 1972–2 C.B. 101.

11. *See, e.g.*, White v. Comm'r, 48 T.C. 430, 434 (1967).

12. *E.g.*, Kamanski v. Comm'r, 477 F.2d 452 (9th Cir. 1973). *But see* Finkbohner v. United States, 788 F.2d 723 (11th Cir. 1986) (allowing a casualty loss deduction for a decline in value to taxpayer's residence caused by market resistance when there was no physical damage to taxpayer's residence).

This Article will review the casualty and theft loss deduction including a review of the significance of that deduction in light of the 2017 Tax Cut and Jobs Act (the "2017 Act").[13] It will set forth the most likely theoretical justifications for allowing a deduction. It will also explore the historical treatment of the provision and how the three factors noted above have been applied. In light of the congressional purpose for allowing the deduction, the current definition does not properly distinguish between events that should qualify for the deduction and those that should not. The currently existing standard is too restrictive. I will show that because the current standard excludes from deductibility events that should be covered, there are inconsistencies in the judicial decisions applying the Code provision. It appears that courts have struggled with trying to reconcile the results invited by the currently applied standard with the results that seem proper.

While most of the focus concerning the casualty and theft loss deduction is on personal losses, the definition of "other casualty" can be important to business and investment losses as well. Of course, businesses do not have personal losses and so generally all losses of a business are deductible. Nevertheless, the determination that a business or investment loss did or did not occur as a result of a casualty can affect the timing and characterization of the deduction of that loss.[14]

Regardless of whether the courts' definition of "other casualty" is appropriate for a loss of personally used property, it is my contention that whatever definition is adopted for that purpose should not be used to determine the timing and realization of a business or investment loss because the role of the casualty characterization in applying the realization requirement is very different from the role it plays in section 165(c)(3). On the other hand, it is proper to use the section 165(c)(3) definition of casualty in determining the *character* of a business or investment loss. There has been little, if any, commentary on those issues and a major contribution of this piece is to shed light on them.

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13. 2017 Act, *supra* note 4. The Senate parliamentarian formally required that the name "Tax Cuts and Jobs Act" be struck from the bill, but this remains its popular name. *See Parliamentarian: 3 Provisions in GOP Tax Bill Violate Byrd Rule*, 2017 Tax Notes Today 243-29 (Dec. 20, 2017).

14. As discussed later, whether the cause of a loss of business or investment was a casualty can determine whether the deduction will be a capital or ordinary loss. *See infra* Part IV.B.

II. Significance of Issues in Light of New Tax Law

As briefly set out in the introduction, this Article sets forth two major contentions. One is that the standard currently used by the courts and the Service to determine what constitutes a personal casualty (resulting in a gain or loss) is too narrow and should be expanded. The second contention is that the standard for determining what constitutes a casualty for a loss due to damage to property used in a trade or business or in a profit activity should be different from and of a broader scope than the standard that is applied to personal casualties. As to the first issue concerning personal casualties, while the recent adoption of the 2017 Act,[15] reduces the importance of that question, it continues to be a significant issue. As to the second contention that a different and broader standard should be used for determining what is a casualty for a loss incurred by property used in a trade or business or profit activity, the 2017 Act has no effect whatsoever on the importance of that issue.

Section 11044 of the 2017 Act adds section 165(h)(5) to the Code. Section 165(h)(5)(A) provides that no deduction will be allowed for a personal casualty loss except to the extent that it is attributable to a "Federally declared disaster" area.[16] Section 165(h)(5)(B)(i) creates an exception to that denial of a deduction and allows the deduction of a personal casualty loss to the extent of the taxpayer's personal casualty gains for that period. Thus, it is still important to determine what constitutes a personal casualty gain and personal casualty loss. In addition, section 165(h)(2)(B) provides that if a taxpayer's personal casualty gains exceed his personal casualty losses for a taxable year, they are treated as long-term capital gains and losses respectively. That provision was left intact by the 2017 Act and also makes it important to determine what constitutes a personal casualty gain or loss. The characterization as a casualty can qualify a loss for a deduction and can qualify a gain for capital gain treatment. Consequently, except for a loss incurred in a Federally declared disaster area, the standard for determining what constitutes a personal casualty arises whenever a taxpayer has a personal casualty gain. An example of a personal casualty gain is a receipt of an insurance payment for an item damaged in a personal casualty in which the amount of the payment is greater than the taxpayer's basis in the damaged item.

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15. 2017 Act, *supra* note 4.

16. Section 165(h)(5) applies to tax years beginning after December 31, 2017, and before January 1, 2026.

As noted previously, the 2017 Act deals only with the deduction of personal casualty losses which otherwise would be deductible under section 165(c)(3). The 2017 Act has no application to casualty losses of business property or property used in a profit activity, which are allowable under section 165(c)(1) and (2).

Section 11045 of the 2017 Act adds section 67(g) to the Code, which provision denies a deduction for all Miscellaneous Itemized Deductions. Miscellaneous Itemized Deductions are itemized deductions not listed in section 67(b). None of the casualty loss deductions are Miscellaneous Itemized Deductions, and therefore none of them is affected by section 67(g). The casualty losses incurred in a trade or business are nonitemized deductions and so are not affected by section 67(g). Personal casualty losses and losses incurred in a profit activity are expressly excluded from Miscellaneous Itemized Deductions by section 67(b)(3).

III. Theoretical Justifications for the Deduction

A. Haig-Simons Definition of Income

An initial question to consider is what are the theoretical justifications of and purpose for allowing a casualty and theft loss deduction. While the identification of the purpose of a provision is not dispositive of the issue of how it should be construed (and it is not a purpose of this Article either to defend or repudiate the appropriateness of the deduction), the construction of a statutory provision is greatly aided by viewing it in light of the most likely purpose for its adoption.

To understand the theoretical justification of the casualty and theft loss deduction, we need to step back and consider the theoretical structure of the federal tax system as a whole. It is helpful in construing a Code provision to place the provision in the context of the role it plays in the overall tax scheme.

The Haig-Simons definition of income is the one that is most commonly adopted, and it is often used as a starting point to describe an ideal income tax. That definition states that a person's income for a specific period equals the increase in wealth accumulated by that person during that period plus the market value of the person's personal consumption during that period.[17] To take a very simple example, if a

17. Henry C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy 50 (1938).

person begins the period with nothing, earns $1,000 from work, and spends nothing, then they will have $1,000 in accumulation of wealth and thus $1,000 of income under the Haig-Simons definition.

To flip the example, if the same person spends the $1,000 that she earned on food, which she consumes, then she will still have $1,000 of income for the period. Although she did not accumulate any wealth (she began the period with zero and ended it with zero), she had $1,000 worth of a personal consumption during that period; and the second half of the Haig-Simons definition treats that consumption as income.

In truth, consumption is the key to what constitutes income under the Haig-Simons definition. Although consumption appears to be only one-half of the formula, the inclusion of accumulation of wealth is merely the means of taxing the present value of future consumption.[18]

So, a justification for allowing a deduction for an expenditure is that the expenditure does not constitute a personal consumption. If an expenditure is viewed as not being a personal consumption, it should not be considered income under the Haig-Simons definition—in other words, the expenditure eliminated that amount from the taxpayer's accumulation of wealth and did not constitute a personal consumption.

This approach provides a theoretical justification for several personal-type tax deductions such as the one for charitable contributions.[19] If our hypothetical taxpayer above, who earned $1,000 in one year, gave the entire $1,000 to charity, a charitable deduction's prevention of an income tax on $1,000 of the taxpayer's income can be seen as taking into account the fact that the taxpayer did not consume anything when he gave that $1,000 to the charity.[20]

The fact that an expenditure or loss is not a personal consumption is not sufficient to warrant allowing a deduction for it. Only those

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18. Douglas A. Kahn & Jeffrey H. Kahn, *"Gifts, Gafts, and Gefts"—The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 Notre Dame L. Rev. 441, 453–54 (2003).

19. Douglas A. Kahn, *A Proposed Replacement of the Tax Expenditure Concept and a Different Perspective on Accelerated Depreciation*, 41 Fla. St. U. L. Rev. 143, 145 (2013).

20. *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 349 (1972). Note that there is a ceiling on the amount of deduction that a taxpayer may take. I.R.C. § 170(b), (d). The charitable deduction is also classified as an itemized deduction (although not a miscellaneous itemized deduction). I.R.C. § 67(b)(4).

expenditures and losses that Congress has designated for a deduction will qualify. The absence of a personal consumption is the driving force behind the Code's allowance of a number of deductions, but only those that Congress selects are deductible. The casualty loss is one that Congress has chosen, albeit with certain limitations.

B. Casualty and Theft Deductions

Thus, we see that, according to Haig-Simons, personal consumption should not provide any deduction for a taxpayer.[21] So how should we consider a casualty and theft loss provision with the Haig-Simons definition of income in mind? If a taxpayer purchases an item for personal consumption, absent special circumstances, no deduction is available either when she purchases it or when she consumes it. In effect, the taxpayer is taxed on the income that was expended to purchase the item on the assumption that the item will be consumed over time. This treatment is grounded on an assumption that the taxpayer will enjoy the full use or consumption of the item. If an event such as a casualty or theft occurs that prematurely terminates that taxpayer's ability to enjoy the full consumption of an item, a deduction may be appropriate. Another way to frame that position is that the taxation of the entirety of the income that was used to purchase the damaged item is discovered to have been based on a false assumption, and the deduction of the loss constitutes a reversal of that taxation. This principle can be seen as the converse of the tax benefit rule where a tax is imposed to reverse a deduction that was previously allowed on the basis of an erroneous assumption.[22] Albeit the allowance of a deduction is not without controversy.[23]

For example, suppose our hypothetical taxpayer (the first taxpayer) purchases a car for $1,000. If the first taxpayer used the car for personal reasons for several years and thereby consumed a portion of

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21. In addition to the charitable deduction, the Code provides deductions for some other personal items such as medical expenses. I.R.C. § 213. The allowance of deductions for such items, including the charitable deduction, have been controversial, having both defenders and opponents.

22. *See* I.R.C. § 111.

23. *See* Andrews, *supra* note 20; Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 Stan. L. Rev. 831 (1979).

the car by exhausting some of its useful life each year of its use, that would be a personal consumption for which no deduction is appropriate and none is allowed. However, if the car were stolen, a deduction for the remaining unconsumed cost of the car may be justified to recognize the fact that the first taxpayer did not actually consume the full $1,000 of cost for the car.[24] Contrast the circumstance of this first taxpayer with one (the second taxpayer) who bought a car that was not subsequently stolen. The first taxpayer will be taxed on the cost of the car even though he used only part of that cost. The second taxpayer will be taxed an equal amount, but the second taxpayer did in fact use the car and enjoyed the full consumption of it. It could be said to be unfair to tax those two taxpayers the same when they occupy very different circumstances. A casualty and theft deduction makes an allowance for the difference in their actual consumptions. Similarly, if the car was destroyed by a storm, the resulting loss of value can be seen as not being consumption.

The fairness of allowing a deduction for such losses can be better understood by considering a commonly used illustration. A taxpayer is paid her wages at the end of each work week. At the end of a week, she is paid $1,000 in cash. She puts the cash in her purse and leaves the building. Just as she exits, she is accosted by a robber who takes her $1,000. Surely, it would be unfair to tax her on the entire $1,000 merely because she possessed it for such a short period of time.

Of course, this justification does not preclude the discussion of whether a casualty and theft deduction belongs in our tax system or, if allowed, should be subject to significant limitations, as it is under the 2017 Act.[25] A practical tax system does not and should not conform completely with a theoretically ideal system. First, an effective tax system must work in practice; and so even if an item should be included in income (or a deduction should be allowed) under the Haig-Simons definition, other policy concerns (for example, administrability or revenue raising concerns) may trump Haig-Simons.

Second, not everyone agrees that such deductions are appropriate under the Haig-Simons definition. For example, the recent *Tax*

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24. However, a deduction could not exceed the value of the car at the time of the theft. Under the 2017 Act, the taxpayer would also be required to have personal casualty gains or have the casualty occur in a Federally declared disaster area. I.R.C. § 165(h)(5); 2017 Act, *supra* note 4, § 11044.

25. *See supra* Part II.

Expenditure Budget promulgated by the Treasury Department[26] lists the "deductibility of casualty losses" as a tax expenditure.[27] "Tax expenditures" are defined by law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[28]

In order to determine what is a special preference for purposes of a tax expenditure budget, one must have a baseline to compare. That is, there must be some ideal model of the income tax system to use in order to determine that a provision deviates from that ideal.[29] Treasury's *Tax Expenditure Budget* states that it uses the Haig-Simons definition of income as its measurement stick.[30] Any provision listed in Treasury's *Tax Expenditure Budget* has been determined by the authors of that budget to be a departure from the Haig-Simons ideal. Although no one has seriously argued that the United States should adopt an income tax system based on the Haig-Simons definition of income without any deviations, there is a pejorative connotation of inappropriateness when an item is listed in a budget. At the very least, it may add a burden on those who desire the continuation of such a provision since, according to the authors of the *Tax Expenditure Budget*, it does not truly belong.[31]

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26. There are several tax expenditure budgets promulgated by several agencies, and Treasury's is only one of them.

27. Office of Tax Analysis, U.S. Treas. Dep't, Tax Expenditure Budget 19 (Sept. 28, 2016) [hereinafter Treas. Expenditure Budget].

28. 2 U.S.C. § 622(3) (Westlaw, Mar. 2018).

29. The Treasury's *Tax Expenditure Budget* states, "Identification and measurement of tax expenditures depends crucially on the baseline tax system against which the actual tax system is compared." Treas. Expenditure Budget, *supra* note 27, at 1; *see* Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 Tax Notes 1661 (Mar. 30, 1992).

30. "The tax expenditure estimates presented in this document are patterned on a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time." Treas. Expenditure Budget, *supra* note 27, at 1. The tax expenditure budgets promulgated by other government agencies use a slightly different baseline.

31. Stanley Surrey was a major proponent of the tax expenditure budget concept and his goal was to have people consider these provisions in the same way that they would consider direct outlays from the government. As such, it seems clear that his view was that those provisions listed in a tax expenditure budget should at least be subject to special scrutiny since they do

C. Utility

In addition to conforming to the Haig-Simons definition of income, a deduction for casualty and theft losses may serve another purpose as well. The tax rates applicable to income are graduated—that is, the more income one earns, the higher the rate of tax imposed on that additional income. This system is referred to as progressive taxation. The rationale for having a progressive tax system has been debated,[32] and there is not a consensus as to what it is. In the author's view, the justification for and purpose of a progressive system is to take into account the diminishing utility of dollars.[33] The more one has of an item, the less valuable each additional item is to that person. This is likely true of dollars just as it is for other items. The first dollars that one earns are especially precious because they are needed to obtain the necessities of life such as food and shelter. The utility of those dollars is very high. Additional dollars earned above that amount become of decreasingly less utility because they are available to purchase items that, while desirable, are less essential. The graduated tax rates reflect a kind of standardized utility curve for the taxpaying population. The allowance of personal tax exemptions reflects the high utility of those first dollars of income by applying a zero rate of tax on them. Tax rates increase as more dollars are earned to reflect the fact that less utility is lost from the payment of those taxes.

The standardized utility curve reflected in the rate schedule is far from perfect, but it serves the function of taking declining utility into account. It does not reflect each individual's unique utility curve, but rather embodies a somewhat arbitrary curve for a mythical average person.

Some persons will suffer an event that has a significant financial impact on them and that is not contemplated in the standardized

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not conform with the ideal income tax system. Jeffrey H. Kahn, *Personal Deductions–A Tax "Ideal" or Just Another "Deal"?*, 2002 L. Rev. Mich. St. U. Det. C.L. 1, 12 (2012).

32. *E.g.*, Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 Cal. L. Rev. 1905 (1987); Walter J. Blum & Harry Kalven Jr., *The Uneasy Case for Progressive Taxation*, 19 U. Chi. L. Rev. 417 (1952); Donna M. Byrne, *Progressive Taxation Revisited*, 37 Ariz. L. Rev. 739 (1995); Nancy C. Staudt, *The Hidden Costs of the Progressivity Debate*, 50 Vand. L. Rev. 919 (1997).

33. *See* Kahn, *supra* note 31.

utility curve underlying the tax rate schedule. Ordinary illness is a part of life and should be treated as included in the standardized curve. But, some persons will suffer a serious illness that requires a large expenditure. The medical expense deduction provides an adjustment to the standardized utility curve applied to that individual by taking into account the necessity of satisfying the large expenses caused by that illness. It is a kind of rough adjustment to the utility curve.[34] Medical expenses are deductible only to the extent that they exceed 10% of the individual's adjusted gross income.[35] The medical expenses within that floor are deemed to be part of life's ordinary expenses that are deemed addressed in the normal tax rates.[36]

Similarly, a large loss from a theft or casualty is outside of the ordinary vicissitudes of life. A deduction for personal casualty and theft losses provides a rough adjustment to the standardized utility curve applied to the victims of those events. Under the law prior to the 2017 Act, the deduction was subject to two floors. Only the amount of each personal casualty or theft that exceeded $100 could be taken into account.[37] So, there was $100 floor for each such casualty. In addition, an individual's personal casualty gains and personal casualty losses were netted. If the personal casualty losses exceeded the personal casualty gains, the excess (referred to as the "net casualty loss") was deductible only to the extent it exceeded 10% of the taxpayer's adjusted gross income.[38] Those two floors were applied to reflect that a certain amount of such losses is deemed normal and accommodated by the tax rate schedule, and the adjustment to the rate schedule was to be made only for excessively large amounts of such losses.

When adopting a floor to the casualty and theft loss deduction as part of the Revenue Act of 1964, the Senate Report explained the purpose of the deduction and the floor as follows:

> [The] committee agrees with the House that in the case of nonbusiness casualty and theft losses, it is appropriate in computing taxable income to allow the deduction

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34. *Id.* at 28.
35. I.R.C. § 213(a).
36. Kahn, *supra* note 31, at 28.
37. I.R.C. § 165(h)(1).
38. I.R.C. § 165(h)(2).

> 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.[39]

As noted above, these policy justifications do not support the contention that the income tax system must include an unrestricted casualty and loss deduction. The 2017 Act has significantly restricted the use of the casualty loss deduction. The $100 floor still applies. However, taxpayers may not deduct any personal casualty loss in excess of their personal casualty gains unless the casualty occurred in a Federally declared disaster area. The justifications mentioned above support the treatment of losses occurring in Federally declared disaster areas. Outside of such areas, the ceiling on casualty loss deductions equal to the amount of the taxpayer's casualty loss gains was likely to counter the "unfairness" of taxing casualty gains while disallowing casualty losses.

D. Significance of Purpose

Even if one believes that the allowance of a deduction for casualty losses is improper and conflicts with tax policy, the provision exists in the Code and must be construed. The identification of the purpose of that provision (whether or not that purpose is deemed to be ill-advised) is essential to construing it correctly to carry out the function for which it was designed.

IV. Losses of Business and Investment Property

A. Deductibility

As noted previously, the reference to a "casualty" in section 165(c)(3) applies only to personally used property. The provisions for deducting a loss of business or investment property in section 165(c)(1) and (2) make no mention of casualties or thefts. Nevertheless, the regulations dealing with casualty losses include provisions for the deduction of casualty losses of business and investment property.[40] In one important

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39. S. Rep. No. 88-830, at 57 (1964).
40. Reg. § 1.165–7(a), (b).

respect, the method used in the regulations to determine the amount of a deduction for a casualty loss of business and investment property is different from the method used for personal-use property.[41] These provisions were not affected by the 2017 Act.

The significance of and purpose for providing a deduction for casualty losses of business and investment property is different from the significance of and purpose for allowing a deduction for personal casualties. The general rule is that no deduction is allowable for the purchase and use of personal-use property. Section 165(c)(3) creates an exception to that general rule and allows a deduction in two circumstances: when the loss is incurred from a casualty or a theft. So, the significance of the casualty characterization for personal-use property is to allow a deduction that otherwise would not be available. Obviously, that is the purpose for the adoption of section 165(c)(3). While in the case of partially damaged personal-use property there is also a realization issue, the qualification for a deduction is the principal function of that provision.[42]

The situation is quite different for business and investment property. All business and investment losses are deductible under section 165(a), (c)(1), and (c)(2). What significance then does it have to separate casualty losses of such property from other business losses?

The answer is that a casualty loss can be deducted when the loss occurs.[43] The doctrine of realization prevents the taking of a deduction merely because the value of property has declined.[44] The realization doctrine typically requires that there be a severance of the loss (often by a disposition of the property) for the decline in value to be taken into account. The well-established realization doctrine is reflected in a Treasury Regulation which reads in part, "To be allowed as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained

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41. Reg. § 1.165–7(b). The difference in treatment is described later in the text.

42. Another significance of lesser importance is that a casualty loss of personal-use property can qualify to be included in a net operating loss. Reg. § 1.172–3(a)(3)(iii).

43. That assumes that there does not exist a reasonable prospect for the taxpayer to be reimbursed for the loss. Reg. § 1.165–1(d)(2).

44. *See, e.g.*, Chamales v. Comm'r, T.C. Memo 2000-33, 79 T.C.M. (CCH) 1428.

during the taxable year."[45] If business property is destroyed or becomes useless in the business, its adjusted basis is deductible regardless of the cause of the destruction or obsolescence.[46] So in the case of destroyed or useless property, a characterization of the cause as a casualty has no consequence.[47] As shown below, this is reflected in the regulations dealing with the determination of the amount of a casualty loss.

If property damaged by a casualty is not destroyed, then the method for determining the amount of the deduction is the same for business and personal-use property. The amount deductible is the *lesser* of (1) the difference in fair market values of the item before and after the casualty, or (2) the taxpayer's adjusted basis in the item.[48] If a personal item is destroyed by a casualty, the valuation method for determining the amount of casualty deduction is the same as the one that is used for measuring the amount deductible for a partial damage.[49] But, if the item destroyed is business property, the amount deductible is the taxpayer's adjusted basis in the item regardless of its value before the injury occurred.[50] Why the difference? When business property is destroyed, the only loss caused by the casualty is the decline in the property's fair market value to zero. If the taxpayer's adjusted basis is greater than the value of the item immediately before the casualty occurred, why does the regulation allow a deduction for the excess basis? The answer is that while only the loss of value is due to a casualty, the excess basis is deductible because the item is no longer useful in the business. In essence, the regulations have conflated two separate allowances into a single deduction. That conflation is convenient since neither of the two allowances is treated differently by the tax law, and it simplifies administration to combine them. This demonstrates that the

45. Reg. § 1.165–1(b).

46. Reg. § 1.165–2; Reg. § 1.167(a)–9.

47. *E.g.*, Rev. Rul. 90–61, 1990–2 C.B. 39. In that ruling, a deduction was allowed for business seedlings that were destroyed by a drought that was not deemed a casualty because it lacked suddenness. The Service said that because the loss arose in a trade or business, it need not be caused by a casualty to be deductible. As noted previously, however, casualty characterization can affect the character of a loss in some circumstances. In that ruling, the Service held that because the loss was not due to a casualty, it would be characterized under I.R.C. § 1231.

48. Reg. § 1.165–7(b)(1).

49. *Id.*

50. *Id.*

inclusion of business property in the regulations on casualties was not needed to make the loss deductible. The reason for its inclusion in the regulation was to clarify that the loss was realized and therefore deductible.

The significance of including business and investment property in the regulation on casualties arises when the property is damaged but not destroyed. If the taxpayer continues to use the property, a strict application of the doctrine of realization would prevent a deduction until there is a disposition of the item. The regulation allows the resulting loss of value to be deducted in the year in which the damage was sustained.[51] The inclusion of business property in the regulations is based on a determination that the event causing the decline in value is one in which it is appropriate to permit the taxpayer to deduct the item—in other words, the event is sufficiently significant to constitute realization.

There is no Code provision that addresses the treatment of damage to business property from a casualty. Unlike the circumstance for a personal casualty, the regulation's allowance of a deduction for a business casualty is not based on a specific statutory provision. Rather, the regulation and its determination is based on Treasury's construction of the realization doctrine and its conclusion that a casualty constitutes a realization event. The question of what constitutes a "casualty" for that purpose rests on very different considerations than those that induced Congress to permit a deduction for a personal casualty loss. The purpose of the deduction for personal casualty losses is to identify and allow a deduction for losses that do not constitute a personal consumption, whereas the purpose of the deduction for a business casualty is to recognize an event that constitutes a realization of the loss. To conform with the purposes of those two provisions, the standards for determining what constitutes a "casualty" should not be the same for both. The determination that an event causes realization should face a much lower hurdle than to determine that a loss is not a personal consumption.

The inappropriateness of applying the section 165(c)(3) definition of "casualty" to a business loss is illustrated in a Chief Counsel Advice that was promulgated in 2015.[52] That advisory involved a company that rented vehicles. From time to time, while being operated by its customers, some of the vehicles would suffer damage from collisions.

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51. Of course, a deduction cannot exceed the taxpayer's adjusted basis in the item. I.R.C. § 165(b).

52. C.C.A. 2015-29-008 (July 17, 2015).

In some such cases, the customer had purchased a waiver from the company that prevented the company from being reimbursed by the customer for the damage. In such cases, it was the company that suffered the loss (less the amount that the company had received from the customer for granting the waiver). In some cases where the damaged vehicle could still be rented in its current condition, the company did not repair it, but continued to rent it in that condition. The company sought to deduct the loss of value it sustained for the damaged vehicles that were not repaired but still usable.

The Chief Counsel concluded that the loss was not deductible. In doing so, the Chief Counsel applied the definition of a "casualty" that has been applied to section 165(c)(3). The Chief Counsel said that a casualty loss under section 165 must result from an event that is (1) identifiable, (2) damaging to property, and (3) sudden, unexpected, and unusual in nature. The Chief Counsel held that all of those requirements but one were satisfied. The one requirement that the Chief Counsel held that the taxpayer failed to satisfy was that the collisions be unusual in nature. The Chief Counsel noted that collisions were a frequent occurrence in the taxpayer's business and so were not unusual.[53] As a consequence, the Chief Counsel determined that no deduction was allowable.

In the author's view, the Chief Counsel's conclusion is wrong. The issue was whether the collisions were sufficiently significant events to constitute a realization of the loss that resulted from them. When the question is correctly framed in that manner, the answer seems clear that a deduction should be allowable.

Moreover, even if the Chief Counsel were correct in applying the section 165(c)(3) definition of a casualty, the conclusion he reached would nevertheless be questionable. The regulations expressly treat automobile collisions as a casualty for both personally used and business vehicles even when the taxpayer's negligence caused the accident.[54] While collision damage to rental vehicles is not unusual, neither is collision damage to personally used vehicles or vehicles used in a business. Yet, the regulations acknowledge that losses from such collisions are deductible as casualties. The current regulations concerning automobile accidents were adopted in response to a 1927 decision of the Second Circuit. An earlier regulation provided that an automobile accident

53. *Id.; see also* Atl. Greyhound Corp. v. United States, 111 F. Supp. 953 (Ct. Cl. 1953).

54. Reg. § 1.165–7(a)(3).

resulting from negligence was not deductible. In *Shearer v. Anderson*,[55] the court rejected that view and held that a deduction was allowable for a car that was damaged when it turned over regardless of whether the accident was caused by the negligence of the driver. The government then amended its regulation to provide as it now reads.

What then should be the standard for determining whether a casualty-type business or investment loss should be deductible? The standard should be whether the event causing the loss is of such significance that it warrants realization of the loss. The regulations' allowance of a deduction for an event that constitutes a casualty within the meaning of section 165(c)(3) as one that qualifies as a realization event does not prevent other events from qualifying as realization events. The problem with the current position of the government is that it makes the satisfaction of the casualty standard the exclusive path to a deduction. Instead, the qualification as a casualty, as the term is used in section 165(c)(3), should be one means of satisfying the realization requirement, but it should not be the exclusive means of doing so. In other words, satisfying the standards of section 165(c)(3) is sufficient but not necessary. The Service's view that a business loss will not be recognized as a casualty unless it conforms to the standard applied to section 165(c)(3) is too restrictive.

Note that there is no problem with finding realization for a loss resulting from a theft or a destruction of the property. It is only when the property is damaged but still usable that this issue will arise.

B. Section 1231 Characterization

Gains or losses from the involuntary conversion of property used in a trade or business[56] are characterized according to the terms of section 1231. All of the section 1231 gains and losses for a taxable year are netted, and if the net result is a gain, all of the gains and losses are treated

55. 16 F.2d 995 (2d Cir. 1927).

56. The properties to be included in this provision include depreciable property and realty used in a trade or business and held for more than one year. The provision also applies to the involuntary conversion of capital assets held for more than one year in connection with a trade or business or a transaction entered into for a profit. Section 1231 does not apply to that amount of a gain that constitutes a recapture of depreciation under section 1245. Reg. § 1.1245–6(a).

as long-term capital gains and losses.[57] If the gains do not exceed the losses, all of them are treated as ordinary income and losses.[58] This netting process is sometimes referred to as the "first hotchpot."[59]

Section 1231(a)(4)(C) excludes the gains and losses from certain properties from characterization by section 1231, and so those gains and losses are not included in the first hotchpot. The excluded properties are certain business and investment properties that were involuntarily converted as a result of "fire, storm, shipwreck, or other casualty, or from theft."[60] The gains and losses from those properties that fit this description are then netted in what is sometimes called the "second hotchpot." If the recognized losses in the second hotchpot exceed the recognized gains, all of those gains and losses are excluded from section 1231(a) and so are characterized without regard to that section. Typically, those gains and losses will be treated as ordinary since there will not have been a sale or exchange.[61] If the losses in the second hotchpot do not exceed the gains, then all of them are included in the first hotchpot for characterization.

The Service has consistently applied the section 165(c)(3) definition of "casualty" in determining whether an event falls within the second hotchpot of section 1231(a)(4)(C).[62] While it is proper to use that definition for this purpose, as discussed in the next part of this Article, the author contends that the definition currently applied to the term casualty should be changed. Whatever definition is utilized should be applied to section 1231.

The purpose of creating the second hotchpot exception to the application of section 1231(a) is to permit a taxpayer who has a net loss from such involuntary conversion to treat the net loss as an ordinary deduction. If left in section 1231(a), the loss might or might not be treated as ordinary depending upon the outcome of the first hotchpot.

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57. I.R.C. § 1231(a)(1).

58. I.R.C. § 1231(a)(2).

59. Douglas A. Kahn & Jeffrey H. Kahn, Federal Income Tax: A Guide to the Internal Revenue Code 664 (7th ed. 2016).

60. Gains that are characterized as a recapture of depreciation also are excluded from the first hotchpot. Reg. § 1.1245–6(a); Kahn & Kahn, *supra* note 59, at 664.

61. *See* I.R.C. § 1222.

62. *See* Rev. Rul. 90–61, 1990–2 C.B. 39; Rev. Rul. 87–59, 1987–2 C.B. 59; Rev. Rul. 61–216, 1961–2 C.B. 134.

Involuntary conversions were included in section 1231(a) primarily as relief for taxpayers who otherwise might have ordinary income from the gains on such conversions because of the sale or exchange requirement to qualify as a capital gain. But, if the taxpayer's losses from such involuntary conversions were greater than her gains, placing them in section 1231(a) would be disadvantageous. The taxpayer would be better off if all such gains and losses were excluded from section 1231(a) and so treated as ordinary. The statute makes clear that Congress wanted the scope of the conversions that are to be included in the second hotchpot to be the same as is applied by section 165(c)(3) to personally used property. The language used in section 1231(a)(4)(C) is identical to the language used in section 165(c)(3). That identity of language cannot be coincidental. Congress clearly intended the section 165(c)(3) meaning of "casualty" to be applicable to section 1231(a)(4)(C) as well. One purpose of adopting that definition is to exclude gains and losses from condemnations from the second hotchpot.

The situation of section 1231 is quite different from the situation dealing with the deductibility of damages to business property. The latter case raises a question of realization, and there is no congressional language adopting the terms used in section 165(c)(3). In contrast, in the case of section 1231, Congress signaled that it wanted only the same types of transactions that are described in section 165(c)(3) to be excluded from section 1231(a).

V. The Meaning of "Other Casualty" and "Theft"

Personal losses generally are not deductible. As explained above, one exception is for casualty and theft losses.[63] As noted, subject to significant limitations under the 2017 Act, section 165(c)(3) provides that individuals may deduct losses to personally used property that are caused by "fire, storm, shipwreck, or other casualty, or from theft." Although the 2017 Act restricted the use of personal casualty losses to situations where the taxpayer has personal casualty gains or the loss occurs in a Federally declared disaster area, the 2017 Act did not change the standard for determining what constitutes a casualty. Thus, the cases that define what qualifies as a casualty, whether resulting in a gain or a loss, are still applicable under the current law. All but one of the items on the list are easily identifiable, and it is settled that losses from a fire, storm,

63. I.R.C. § 165(c)(3).

or shipwreck qualify as a casualty. There have been a few cases dealing with the meaning of "theft," and I will discuss some of them later in this Article.

There has been significant litigation over the meaning and scope of the term "other casualty." If an event does not qualify as a fire, storm, shipwreck, or theft, the taxpayer must determine whether it qualifies under the more open-ended term of "other casualty." The Code and Regulations provide only a little guidance as to what that term means, so the courts and the Service have stepped in to provide further information.[64] The regulations state that even if the event is caused by the taxpayer's own negligence, it can still qualify for a casualty deduction unless the taxpayer's action (or one acting in his behalf) amounted to "willful negligence."[65]

Revenue Ruling 76–134[66] is one example of the guidance the Service has provided. In that ruling, there was an abnormal rise in water level that caused flood damage to the taxpayer's home. The Service ruled that the damage was not deductible under section 165(c)(3) because the event was not sudden. The Service noted that property losses due to floods will be deductible as a casualty loss if the flood damage was "directly attributable to a storm or other casualty and not caused by gradual erosion or inundation from normal seasonal variations in water levels."[67] The ruling also held that expenses incurred by homeowners in constructing protection against future floods are not deductible. Section 165(c)(3) provides a deduction for the loss of property; it does not provide a deduction for expenses incurred as a consequence of the event.

The Service notes in that Ruling that both court decisions and prior revenue rulings defining the term "casualty" for purposes of section 165(c)(3) have required that the event be "sudden, unexpected, or

64. The regulations provide one example of an event to which that term applies—i.e., automobile accidents are casualties. Reg. §§ 1.165–7(a)(3), –7(b)(3), Ex. 1.

65. Reg. § 1.165–7(a)(3). The acknowledgment in the regulation that ordinary negligence of the taxpayer does not prevent the qualification for a casualty deduction was adopted in response to a 1927 decision of the Second Circuit invalidating a prior version of the regulation. *See supra* text accompanying note 55.

66. 1976–1 C.B. 54.

67. *Id.* at 1.

unusual." The failure to satisfy any one of those three elements, especially the sudden requirement, has caused the failure of many claims.[68]

A. Inadequacy of Current Standards

The standard that the Service and the courts have contrived for construing the term "other casualty" has not worked well and has resulted in confusion and inconsistency in the application of the provision. As noted, the maxim of *ejusdem generis* has been applied to require that the event causing the damage be sudden, unexpected, and unusual to qualify as "other casualty." The Tax Court has explicitly noted that the meaning of the term has been expanded over the years. In *Popa v. Commissioner*,[69] quoting from an earlier case of *White v. Commissioner*,[70] a majority of the court said that the principle of *ejusdem generis* in section 165(c)(3) "has been consistently broadened." The reason for that expansion is that the constricted standard derived from utilizing some elements of the explicitly named events creates distinctions that do not appear reasonable to many observers and so has motivated some courts to expand the scope of the term. This results in there being inconsistencies among the courts' decisions. In *White v. Commissioner,*[71] the Tax Court said: "there are 'numerous cases involving casualty losses, some of them difficult to reconcile with others either in result, theory, or language.'"[72]

Consider several examples below of decisions arriving at different results on facts that do not differ in ways that would justify treating them differently given the congressional purpose for allowing a deduction.

The most striking examples involve the injury to property caused by an attack of insects. In Revenue Ruling 57–599,[73] the deaths of trees caused by an attack of insects or by disease were held not to be casualties and so not deductible. The deaths were the consequence of a steadily operating cause and so were not sudden. The failure to meet

68. *E.g.*, Buist v. United States, 164 F. Supp. 218 (E.D.S.C. 1958); Rev. Rul. 90–61, 1990–2 C.B. 39; Rev. Rul. 87–59, 1987–2 C.B. 59.

69. 73 T.C. 130, 132 (1979).

70. 48 T.C. 430 (1967).

71. *Id.*

72. *Id.* at 434 (quoting Heyn v. Comm'r, 46 T.C. 302, 309 (1966)).

73. 1957–2 C.B. 142.

the "sudden" requirement prevented the deduction.[74] On the other hand, in Revenue Ruling 79–174,[75] the death of ornamental trees that were killed by a massive attack of beetles was held to be a deductible casualty. The trees died within five to ten days after the attack began, and so the event was deemed to be sudden. In contrast, a casualty deduction was disallowed for clothes that were destroyed in a single winter by larvae of carpet beetles.[76]

The arbitrariness in applying the current standards is shown from the distinctions made involving the death of trees. As noted above, if the death of a tree is caused by an attack of insects that takes effect in a short period of time, a deduction will be allowed. On the other hand, if a tree is killed by a disease, however short a time that takes, no deduction is allowed.[77] In one case, no deduction was allowed even though the disease was brought to the tree by beetles because it was the disease and not the carrier that caused the death.[78]

Similarly, the treatment of damages caused by termites has depended on how long it took for the termites to do serious injury. Two district courts and the Court of Appeals for the Eighth Circuit allowed a deduction for termite damage when the damage occurred over a period of up to 15 months.[79] To the contrary, two courts of appeals and the Board of Tax Appeals have held that the damage caused by termites over a period of years is not deductible because it took place gradually.[80] The Service subsequently ruled that there is scientific evidence that termite damage takes place over a number of years, and so the Service ruled that termite damage is never deductible.[81] In a 1996 decision, while finding that termite damage was not a casualty, the Tax Court expressed the view that it is appropriate to use the length of time over which the

74. *See* Rev. Rul. 87–59, 1987–2 C.B. 59.

75. 1979–1 C.B. 99.

76. Meersman v. United States, 244 F. Supp. 278 (M.D. Tenn. 1965), *aff'd*, 370 F.2d 109 (6th Cir. 1966).

77. *See* Burns v. United States, 174 F. Supp. 203 (N.D. Ohio 1959), *aff'd*, 284 F.2d 436 (6th Cir. 1960).

78. *Id.*

79. Rosenburg v. Comm'r, 198 F.2d 46 (8th Cir. 1952); Buist v. United States, 164 F. Supp. 218 (E.D.S.C. 1958); Shopmaker v. United States, 119 F. Supp. 705 (E.D. Mo. 1953).

80. Fay v. Helvering, 120 F.2d 253 (2d Cir. 1941), *aff'g* 42 B.T.A. 206 (1940); United States v. Rogers, 120 F.2d 244 (9th Cir. 1941).

81. Rev. Rul. 63–232, 1963–2 C.B. 97.

infestation took place as the crucial element in deciding whether the loss is deductible.[82]

The speed at which termites or other insects operate should not be the controlling factor for determining whether the resulting damage is deductible. Either termite and other insect damage is a personal consumption or it is not. Should such damage be considered part of the ordinary contingencies of life that are taken into account in the tax rate schedule, or should they be regarded as extraordinary events that should be deductible to accommodate the resulting increase in the taxpayer's utility curve? That should be the determinative question. The current reliance on suddenness as a crucial element has led the courts to treat differently the same damage caused by the same source depending only upon how quickly the insects can accomplish their work. The speed of their destruction is given conclusive weight only because of an arbitrary standard derived from the fact that suddenness is present in the specifically listed items in section 165(c)(3). Instead, deductibility should rest on whether the type of loss that occurred is deemed a personal consumption; the length of time in which the damage took place should be irrelevant.

Droughts are another area where there are inconsistent results because of the suddenness requirement. The loss of seedlings destroyed by a drought that was unexpected and unusual were held by the Commissioner not to be a casualty because it lacked suddenness.[83] The Commissioner has ruled that losses due to droughts are not deductible casualties because droughts typically kill gradually over a long period of time.[84] The Commissioner subsequently modified his position and suggested that a drought can constitute a casualty in certain circumstances, but he did not explain what they are.[85] In a 1981 case, the Tax Court allowed a casualty loss deduction for a loss of ornamental plants and shrubs caused by a severe drought that took place over a three- to four-month period.[86]

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82. Joseph v. Comm'r, T.C. Memo 1996-65, 71 T.C.M. (CCH) 2103, *aff'd*, 111 F.3d 892 (5th Cir. 1997).

83. Rev. Rul. 90–61, 1990–2 C.B. 39.

84. *See* Rev. Rul. 76–521, 1976–2 C.B. 44; Rev. Rul. 66–303, 1966–2 C.B. 55.

85. Rev. Rul. 77–490, 1977–2 C.B. 64.

86. Ruecker v. Comm'r, T.C. Memo 1981-257, 41 T.C.M. (CCH) 1587.

One criterion that might possibly be used to determine the deductibility of a loss from a drought or other event is whether the event is unusual in that area. For example, if droughts occur regularly, the taxpayer can be deemed to have taken that into account when she purchased the items that subsequently were destroyed. The destruction can then be seen to be part of her consumption of the items and so not a deductible loss. The taxpayer can be seen as having accepted the loss when purchasing the item as part of the cost of her enjoyment of the item during the period prior to the time when it was injured or destroyed. That does not mean that foreseeability always prevents a deduction, but only that in certain unusual cases where the loss was part of the taxpayer's expectations when purchasing the item should no deduction be allowed. If there is no reason to find that the taxpayer had an expectation of suffering the loss, the test for the deduction should rest on whether the loss is a personal consumption.

The loss of rings is another area where consequences have turned on the manner in which the loss occurred. In *White v. Commissioner*,[87] a husband accidentally slammed a car door on his wife's hand. The force of the blow loosened the fastening of the diamond ring that the wife was wearing, and the diamond fell out shortly afterwards when the wife shook her hand in pain. The diamond was never recovered. The Tax Court allowed a casualty deduction for the loss. Similarly, in *Carpenter v. Commissioner*,[88] the Tax Court allowed a casualty loss deduction for a diamond ring that was accidentally dropped into a garbage disposal and damaged by the blades of the disposal. The ring was found to be a total loss.

In two other cases, however, the loss of rings was held not to be the result of a casualty and so not deductible. In *Keenan v. Bowers*,[89] a husband and wife stopped for the night at a hotel. The husband put some tissue papers on the bedside for use during the night. The wife put two diamond rings into a tissue paper which she folded. The husband, unaware of the wife's action, subsequently picked up all of the tissue papers, including the one with the rings in it, and flushed them down the toilet. The rings were never recovered. The court held that the event was not a casualty and no deduction was allowed.

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87. 48 T.C. 430 (1967), *acq.*, 1969–1 C.B. 20, 21.
88. T.C. Memo 1966-228, 25 T.C.M. (CCH) 1186.
89. 91 F. Supp. 771 (E.D.S.C. 1950).

In *Stevens v. Commissioner*,[90] the taxpayer was duck hunting when his ring slipped from his finger, fell into muddy water, and was never recovered. Even though the Tax Court accepted for purposes of the decision that the event causing the loss was sudden, unexpected, and unusual, the court ruled that the event was not a casualty and so no deduction was allowed.

These ring cases can be explained on the basis that there must be an outside imposition of force for an event to be a casualty. As the Second Circuit expressed it, a casualty "denotes an accident, a mishap, some sudden invasion by a hostile agency."[91]

Another issue that has arisen is the question of deductibility where an event did little or no physical damage to a taxpayer's residence but caused the neighborhood to seem less desirable and so triggered a decline in the market value of the taxpayer's home.

In *Chamales v. Commissioner*,[92] the taxpayers purchased an expensive home that was located near the home of O.J. Simpson. Subsequently, the arrest and trial of Mr. Simpson for the murder of Nicole Simpson and Ronald Goldman created a sensation that drew numerous sight seekers to the neighborhood. This resulted in a significant decline in the value of the taxpayer's property because of market resistance to living in that area. The Tax Court held that a decline in value due to market changes is not a deductible casualty. No deduction was allowed.

Contrast the result in *Chamales* with the decision in *Finkbohner v. United States*.[93] In *Finkbohner*, there was flooding damage to homes near that of the taxpayer, but the taxpayer's house was not damaged. The municipality required that some nearby homes be demolished because of the danger of flooding. As a result of market resistance caused by the flood and the required demolition of homes, the value of the taxpayer's home fell. The court held that the taxpayer suffered a casualty and was allowed to deduct the loss in value of his home.

A result similar to *Chamales* was reached by the Tax Court and the Ninth Circuit in *Kamanski v. Commissioner*.[94] A landslide near the

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90. 6 T.C.M. (CCH) 805.

91. Fay v. Helvering, 120 F.2d 253, 253 (2d Cir. 1941); *see also* Rev. Rul. 59–102, 1959–1 C.B. 200.

92. T.C. Memo 2000-33, 79 T.C.M. (CCH) 1428.

93. 788 F.2d 723 (11th Cir. 1986).

94. 477 F.2d 452 (9th Cir. 1973), *aff'g* T.C. Memo 1970-352, 29 T.C.M. (CCH) 1702.

taxpayer's residence caused some minor damage to the taxpayer's residence. As a result of the event, the market value of the taxpayer's residence fell due to market resistance. The Commissioner allowed a deduction for the decline in value attributable to the physical damage to taxpayer's home, but the Commissioner denied the claim for a deduction for the decline in value attributable to market resistance. The Tax Court and the Ninth Circuit sustained the Commissioner's determination.

It would seem that the decisions of the Tax Court and the Ninth Circuit are correct, and the decision of the Eleventh Circuit is wrong. Only actual damage to the taxpayer's property is deductible. Yet, when there is physical damage, the value of the property could decline both because of that damage and also because of market resistance arising from that event. It may be difficult to determine how much of the property's decline in value is attributable to the physical damage and how much to market resistance. Nevertheless, that distinction needs to be made.

Another example involves the treatment of a loss of property that may have been due to a confiscation by a foreign government. In *Popa v. Commissioner*,[95] the taxpayer was residing in an apartment in Saigon, Vietnam. The taxpayer left the city on a business trip. While he was away, the United States withdrew its forces from Vietnam, and hostile forces took over the city. The taxpayer could not return and never recovered his personal belongings that were housed in his apartment. The taxpayer was unable to show what happened to his belongings. They may have been confiscated by the new government, or they may have been destroyed in a fire or some other casualty. A majority of the Tax Court (four judges dissented) allowed the deduction. The court noted that the law is settled that the confiscation of property by a foreign power under its lawful authority is neither a casualty nor a theft. Nevertheless, the majority allowed a deduction because the property may have been destroyed by a casualty, and it was not the taxpayer's fault that he could not prove how it was lost to him.

The Tax Court reached the same result in an earlier case similar to *Popa*. In *Clem v. Commissioner,*[96] the taxpayer and his family moved to Teheran, Iran, where he was assigned by his employer. The taxpayer had the family's personal belongings shipped to Iran. The goods arrived in Iran, but were not delivered to the taxpayer's home. Due to

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95. 73 T.C. 130 (1971) *acq. in result*, 1981–2 C.B. 1, 2.

96. T.C. Memo 1991-414, 62 T.C.M. (CCH) 586.

civil unrest in the country, the taxpayer's employer assigned him to move to Dubai, and he did so. He instructed the carrier to move his belongings to Dubai. The carrier could not locate the belongings, and they were never recovered. The Tax Court allowed the taxpayer a casualty loss deduction. The court held that the taxpayer is not required to show that his property was damaged by a casualty; he only needs to show that it is more likely than not that his property was so damaged. The court held that it was more likely than not that a casualty had caused the loss of taxpayer's property.

Those two cases were extremely generous to the taxpayers. Perhaps, the explanation is that the courts did not like the view that the confiscation of property by a foreign power is not a deductible loss. The courts did not wish to directly confront that rule, and so they may have been willing to hold that the most likely event was one that, in fact, is the least likely to have occurred. It is surprising that the Commissioner acquiesced in the *Popa* decision.

There are numerous holdings that the confiscation or nationalization of a taxpayer's property under color of law is not a casualty or a theft.

In *Farcasanu v. Commissioner,*[97] the taxpayer's personal belongings were confiscated by the communist government of Romania. The Tax Court and the Circuit Court of Appeals for the District of Columbia denied the taxpayer a deduction. The taxpayer claimed that the taking constituted a theft, but the courts held that a theft must be an illegal taking and there must be criminal intent. In two other cases, the Tax Court and the Second Circuit Court of Appeals held that nationalization or confiscation of property does not constitute a casualty or a theft.[98]

There does not appear any good reason to treat a government's confiscation or nationalization of property any differently from a theft for purposes of applying the casualty and theft deduction. In both cases, the taxpayer is denied the opportunity to use and consume the property before its time. The property was taken from the taxpayer without his consent. From the vantage point of the taxpayer, his position is the same whether the property was taken from him unlawfully or under the color of law. The word "theft" in the statute should be read broadly to include

97. 50 T.C. 881 (1968), *aff'd*, 436 F.2d 146 (D.C. Cir. 1970).

98. Weinmann v. United States, 278 F.2d 474 (2d Cir. 1960); Powers v. Comm'r, 36 T.C. 1191 (1961).

similar circumstances even when they do not constitute a theft in the normal use of that word.

The current standard for "other casualty" is based on what has been deemed to be a common denominator in the three specifically listed casualties—"fire, storm, and shipwreck." Suddenness is a common factor in those three items, but unexpected and unusual are not always present. Storms are common in some parts of the country and can be expected to occur. Fires are not unusual in some parts of the country, especially in the summer months. The regulations treat automobile accidents as casualties because they are similar to shipwrecks. But automobile accidents are a common occurrence, and a driver can reasonably expect to have some during her lifetime. Moreover, even if those items were found in all three listed events, they are not useful in distinguishing events that do not constitute personal consumption from those that do. In other words, those standards are arbitrary in that they bear little relationship to the purpose of allowing the deduction—i.e., to exclude from income large losses due to events that are not part of the ordinary vicissitudes of life.

Some common elements of the listed events are appropriate to use as standards for allowing a casualty loss deduction. All of the listed events involve physical damage to property of the taxpayer. It is proper to limit the deduction to the loss of value of the taxpayer's property that is due to physical damage, and current law does so. The three listed items involve the imposition of force on the taxpayer's property, and it is proper to require that as well. As previously noted, the courts have required that a physical force be the cause of the loss.[99]

B. A Change of Meaning

If the current definition of "other casualty" is incorrect, what should be the definition? The virtue of requiring the three elements of sudden, unexpected, and unusual is that it was hoped to provide clarity and precision to the broad term, "other casualty." Unfortunately, it failed to do so, and the adopted standard has proved to be too narrow.[100] A strict

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99. *See supra* text accompanying notes 92–94.

100. Other commentators have also criticized the current standard and proposed a new test for the courts and Service to apply. *See* Brian Lester, *The "Casualty" to Taxpayers from a Misapplied Application of Internal Revenue Code Section 165(c)(3): The Need for an Objective Approach*, 48 S.D. L.

application of those three factors will deny deductions for losses that fall within the purposes for allowing the deduction and so should be allowed. The three requirements have not provided the precision and certainty of application that might have been expected of them. We have seen, and the courts have noted, that the cases reach irreconcilable results. Since the current test does not provide an easily administrable bright line, the courts and the Service should be willing to adopt a more flexible standard even though it requires greater discretion and judgment.

I propose that the determination of deductibility be made by referring to the two purposes for allowing a deduction. The Service and the courts would determine whether the loss constitutes a personal consumption and whether it represents a significant and unusual change in the taxpayer's financial circumstances to warrant making an adjustment to her utility curve. Concededly, those are difficult criteria to apply, and there would almost certainly be inconsistent results in the early years of their application. Over time, however, the decisions of the courts and the Service will establish a better understanding of the standards, and there will be greater certainty as to how they will be applied. That is the genius of the common law tradition. Even with some inconsistencies in the early years, the purposes of the provision will be better served than the current standard provides.

The satisfaction of the three elements that are currently used can be treated as evidence that the event does not constitute a personal consumption, but they would merely be factors and would not be decisive.

In addition to being too narrow, the current standard is inadequate in that there are two elements that should be required that are not reflected in the three elements that are usually cited. One is that the deduction will be allowed only for physical damage to the taxpayer's property. The second is that the damage have been caused by an invasion

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Rev. 52 (2003). Lester contended that the error in the current construction is that it focuses on the event and the loss rather than on the taxpayer. He proposes that the test for the deduction should rest on foreseeability and whether the taxpayer could have taken steps to protect against the event. One issue with Lester's test is that foreseeability is already part of the current standard since a casualty must be "unusual" and "unexpected" in order to qualify. However, the main issue is Lester's test would further remove the provision from the principled policy justification for the provision under Haig-Simons and adjustments to a taxpayer's utility curve.

of some hostile force. As noted earlier in this Article, current law has added those two elements as requirements for obtaining the deduction. They should be retained and continue to be a limitation on the allowance of the deduction.

Congress did not intend that every expenditure that could affect a taxpayer's utility should be deductible. They limited the deductions to certain circumstances—e.g., medical expenses and casualty losses. So, there are limits to what can be classified as a casualty. Two of those limitations are that (1) there must be a loss in the value of property (2) that is caused by a physical force. In addition, whether such a loss is not to be treated as a personal consumption and so deductible should be restricted to events that are not considered to be one of the ordinary occurrences of life that are deemed to be incorporated in the standardized utility curve reflected in tax rate schedule. Thus, both the non-personal consumption and the standardized utility curve are factors to be used in construing what constitutes a casualty.

VI. Conclusion

The current definition of "other casualty" used by both the courts and the Service for purposes of both the personal casualty loss deduction and determining personal casualty gains does not support the appropriate purpose of that provision. Applying this incorrect standard leads to unfair results in that the courts and the Service disallow deductions for some losses that should be deductible. The courts and the Service should discard the current test that attempts to search for common elements among all the events listed in the personal casualty provision. Moreover, the stated justification for the current standard does not hold up well since two of the three "common" denominators do not apply to all the listed events. Instead, the courts and the Service should look to the purpose of allowing a casualty and theft loss deduction. The key issues are whether a loss of property as a result of an outside force constitutes a personal consumption and whether the event causing the loss is one that is part of the ordinary vicissitudes of life. If not, allowing a deduction complies with the congressional purposes for allowing one. This is still true even under the further deduction limitations applied in the 2017 Act. While the elements the courts and the Service currently use to determine deductibility would have some bearing on this question, they should not be dispositive. The courts and the Service should use the principles of both non-personal consumption and the need to adjust the standardized utility curve in construing what constitutes a casualty. Over time, such usage would likely produce a general standard that would lead to more justifiable and consistent results.

However, whether one agrees with the need for change in the current personal casualty deduction standard, it is clear that the use of the same standard for determining a business casualty loss makes little sense. As Ralph Waldo Emerson stated, "[a] foolish consistency is the hobgoblin of little minds."[101] Although the term "casualty" is applied to both personal and business casualty losses, it serves significantly different purposes. On the personal side, we are determining whether the loss will be deductible. On the business side, we are merely determining timing—there is no issue that a business loss will be deductible at some point. On account of that major difference in application, using the same definition of other casualty for both situations is misguided. The Service should repudiate its conclusion in the 2015 Chief Counsel Advice[102] and instead apply a test that looks at whether the event is significant enough to warrant the realization of the loss.

101. Ralph Waldo Emerson, *Self-Reliance*, *in* Essays: First and Second Series 45, 58 (Oxford Univ. Press 1936) (1883).

102. C.C.A. 2015-29-008 (July 17, 2015).