

TAX UPDATE

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Housing Fiasco Of a Different Sort—Casualty Loss Issues

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The Contractor, the Septic System and the Shifting Ground

This week we look at the case of a taxpayer who attempted to get a tax deduction for issues arising from a botched attempted to build the taxpayer's dream home. In the cases of *Greif v. Commissioner* and *Bui v. Commissioner*, TC Summary Opinion 2009-18 the taxpayers hired a contractor to build them a home—but what happened was a Keystone Cops set of miscues in building the property, for which the taxpayers attempted to claim a casualty loss. Unfortunately their choice of positions on their return turned out to be about as faulty as the construction of their home, at least in the view of the IRS and, eventually, the Tax Court.

I. Casualty Losses

IRC §163 governs taxpayer's right to claim a deduction for losses incurred. And it starts out very broadly, providing in §163(a) that:

(a) General rule

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction

For purposes of subsection (a), the basis for determining the amount of the

deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

IRC §163(c) provides bad news for individuals, though—their losses are limited:

(c) Limitation on losses of individuals

In the case of an individual, the deduction under subsection (a) shall be limited to--

- (1) losses incurred in a trade or business;
- (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- (3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

Our issue today is going to deal with §163(c), specifically the “other casualty” aspect of the deduction.

Note that even if a deduction is allowed, there are limitations that reduce the value of the casualty deduction found at §163(h), but since those aren't a key aspect of today's case, we won't worry about that here.

However, the definition of what is a casualty is what's at play here—and that has been defined generally by the courts. As the Tax Court notes in today's opinion:

The term "casualty" is not clearly defined in the Code or the regulations. Section 165(c)(3) mentions losses arising from "fire, storm, shipwreck, or other casualty". In defining the term "other casualty", courts apply the rule of ejusdem generis and look for characteristics similar to those of a fire, storm, or shipwreck. *Maher v. Commissioner*, 76 T.C. 593, 596 (1981), affd. 680 F.2d 91 (11th Cir. 1982). Courts have interpreted "other casualty" to require an undesigned, sudden and unexpected event, or a sudden, cataclysmic, and devastating loss. *Torre v. Commissioner*, T.C. Memo. 2001-218, affd. 52 Fed. Appx. 965 (9th Cir. 2002).

Now we'll take a look at applying this treatment to the facts in the case involving the house and the many challenges this property faced as the construction went awry.

II. House Problems

In this case, each of the taxpayers were claiming over \$160,000 in casualty losses on their 2003 individual federal income tax returns related to the fiasco that was the construction of a house on property they owned.

A. Building the House

The Court begins by describing the history of this cursed piece of property and the building that went up on it. The story begins in 1999, as the Court notes:

On May 4, 1999, petitioners purchased, for \$57,100, unimproved real property (parcel) in SeaTac, Washington, with the intent of placing a personal residence on the property. The parcel was roughly square with boundaries from approximately 208 to 224 feet. The parcel had a relatively steep grade, dropping 60 feet from one side to the other. The improved real property had been appraised on April 13, 1999, at a projected value of \$320,000 upon completion of the planned improvements.

Their dream lot, as noted above, had a steep grade that would turn out to present a challenge. As well, there were no public sewer services available to the property at this time, and that would also serve to create problems, as we shall see.

Petitioners secured a \$236,848 construction loan and on or about March 28, 1999, hired Gifford Olson (Mr. Olson) as a general contractor to build the residence at that price. Construction began in June 1999. Later that year it was discovered that Mr. Olson had built the driveway on a portion of the area intended for the septic system drain field. Because this deviated from the plans approved by the city and violated the King County Health Department's setback requirement, petitioners were denied an occupancy permit. Other problems included the removal of vegetation on the slopes of the property and the negligent construction of the road leading to the house. These errors created instability in the soil.

Having a house you can't occupy is a bit of a problem, but they initially tried to correct the problems. But it turned out their contractor wasn't quite up to getting this fixed:

The costs to correct the various problems mounted, and after drawing \$182,500 from the \$236,848 construction loan, Mr. Olson abandoned the project in June 2000. At that point, the home building project was 70 percent complete. At petitioners' request, the King County Board of Equalization reduced the assessed value of the improved real property to \$23,000 on the

basis that the parcel was considered "unbuildable" for lack of a sewer connection.

As you might expect, the parties on each side of this transaction weren't terribly happy at this point—and their unhappiness spilled over into Superior Court in Washington with a judge who decided that there was plenty of blame to go around for all parties in this case:

On September 29, 2000, Mr. Olson sued petitioners alleging that he was still owed \$35,000 for materials and labor. Petitioners answered Mr. Olson's complaint, denying they owed any amount. Without setting forth a specific amount of relief, petitioners counterclaimed for breach of contract, negligence, and violation of the Washington State Consumer Protection Act. In addition to a few other complaints about Mr. Olson's performance, petitioners sought relief for the denial of the occupancy permit due to the misplacement of the road and the damage to the slope and drain field.

On March 13, 2002, Judge Michael J. Heavey, Superior Court for King County, State of Washington, issued a memorandum opinion in which he generally described the contractual dealings between Mr. Olson and petitioners as follows:

The plaintiff [Olson] and defendant [petitioners] were both greedy. The plaintiff saw an opportunity to break into full-scale home building and the defendant saw an opportunity to get a custom home as opposed to a modular home. They ignored problems and cut corners. The contract and specifications they entered into were deficient. There was no survey of the lot corners. They both ignored that it was a difficult lot; with a challenging access, septic, and site location issues. No persons (contractor, owner, sanitarian, engineer) located the drain field and reserve drainfield areas and flagged them off. They needed serious legal, engineering, architectural and licensed sanitarian professional help. Their collective ignorance and greed blinded them to these realities. Both were reluctant to fully discuss and resolve overruns. They continually danced around these issues without fully addressing them. There was no schedule, no change order process, no definitions of "allowance" or "default allowance", no clear statement of work, and no real specifications: i.e., a prescription for disaster.

On the basis of those and other found facts, Judge Heavey held that Mr. Olson did not commit a deceptive trade practice but that he did default on the contract and negligently damaged the septic drain field. Petitioners were awarded costs of obtaining a new septic field design and approval and the costs of "rockery", or a retaining wall to preserve the drain field. Petitioners were also awarded a

\$38,150 judgment to supplement the \$40,000 remaining in the construction loan in order to finish the home.

That seems to a case where everyone (judge and both parties) left the courtroom not very happy—the judge seemed to believe the parties deserved each other, and neither party ended up with a result anything like they wanted.

The taxpayers, however, kept trying to recover, now turning to the contractor's insurance company.

Petitioners also filed a claim with Mr. Olson's insurance carrier seeking to recoup \$280,000 of alleged damage to petitioners' parcel by Mr. Olson. After discussions with the carrier, petitioners' attorney advised them that Mr. Olson's policy did not cover the type of damage caused to petitioners' property. Petitioners, during 2003, filed a claim under their own homeowner's policy but were denied on the basis that it covered only damage to the improvements and not the realty. Petitioners, however, did not concede that the insurance companies were without liability.

The saga, however, continued with the issue of converting the property into something that could be occupied—but this time the taxpayers dropped the ball after getting what could have been a reprieve:

On March 9, 2001, the King County Health Department granted Mr. Greif a waiver on the setback requirement. Petitioners were required only to submit the new plans for approval and to construct the septic system in order to obtain the occupancy permit. Neither was done, and later surface erosion invalidated the waiver. Petitioners' later requests for a new waiver were denied.

But more bad news was to come—this time from the steep incline and what had been done to the property:

During April 2002 the city of Kent hired a geotechnical engineer to inspect petitioners' parcel of land. The engineer concluded that there was instability in the slope and roadway alignment which, if uncorrected, could result in a landslide and cause damage to the real property improvements. Petitioners subsequently hired a geotechnical engineering firm, Krazan & Associates, Inc. (Krazan), to examine the property. Krazan's report made findings similar to the city engineer's. Petitioners contend some earth movement occurred sometime between May 2002 and June 2003, resulting in the accumulation of soil along the eastern edge of the property and causing some damage to vegetation and a gate.

The taxpayers were back to the original issue of the judgement they weren't happy with, looking to have the judge reconsider matters—but it turned out that Mr. Olsen was going to take another step that would thwart this option before the matter could be decided:

On November 25, 2002, petitioners filed a motion for reconsideration and clarification of Judge Heavey's March 13, 2002, memorandum opinion. In their motion petitioners pointed out that there was evidence that it would cost \$153,000 to correct the problems with the road that cut across the drain field. During a period of cross-motions in the superior court proceeding (petitioners' motion for reconsideration and Mr. Olson's motion to dismiss) Mr. Olson voluntarily entered into a liquidating bankruptcy on May 1, 2003. In the bankruptcy proceeding Mr. Greif filed a motion, that was granted, seeking to lift the stay as it related to his pursuit of Mr. Olson in the superior court proceeding. Petitioners also filed an adversary proceeding complaint objecting to the discharge of Mr. Olson's debt. Mr. Olson moved to dismiss petitioners' complaint, and on December 12, 2003, petitioners' response indicated they would not oppose the motion but would proceed with their action in Superior Court for King County. On January 8, 2004, the bankruptcy trustee filed a report of no distribution, and on May 11, 2004, Mr. Olson's claimed debt to petitioners was discharged.

Eventually in 2004 events finally occurred that allowed them, about three years after that date, to finally move into this residence:

During 2004 development of the surrounding area made the municipal sewer system accessible to petitioners' property. Petitioners were granted an occupancy permit, and they moved into the residence in the latter part of 2006 or early 2007. On January 25, 2007, petitioners' improved realty was assessed on the local tax rolls at \$496,000, comprised of \$69,000 for land and \$427,000 for improvements.

On October 26, 2006, petitioners stipulated to the superior court's dismissal of their suit against Mr. Olson. In 2007 petitioners accepted \$7,500 from Mr. Olson's insurance carrier in settlement of their claims.

And thus ended the long, arduous process of constructing their dream home. But they would now end up having to deal with the little matter of their tax reporting of this whole adventure

B. Is There a Casualty in Here?

Figuring they had been damaged here, they reported as noted by the Tax Court on their income tax returns:

Mr. Greif claimed casualty or theft losses with respect to the subject property on his 2001 and 2002 income tax returns of \$23,000 and \$48,000, respectively. Petitioners claimed a casualty loss for 2003 on the basis of their belief that Mr. Olson's bankruptcy rendered any relief in the superior court proceeding uncollectable and also because of their inability to recover from insurance companies. On their respective 2003 income tax returns, petitioners each claimed a \$171,163 basis in the improved real property, no insurance recovery, and a fair market value of \$250,000 before and \$78,837 after the casualty.

As all facts in the case were stipulated by the IRS and the taxpayer before trial, the only question was how the law applied in this case.

The Tax Court outlined the claimed losses:

Petitioners claim two losses. First, petitioners contend they were denied an occupancy permit because damage to the septic system drain field made the septic area unusable and significantly decreased the value of the property. Second, petitioners contend the land was rendered unstable when Mr. Olson removed vegetation along the slopes of the property and cut the road too steep into the hillside.

As noted above, the loss needs to be a sudden, unexpected event—and the taxpayers argued that it was.

Petitioners argue that the damage to the drain field and slope was sudden because it was not caused by gradual deterioration and happened over a relatively short period. Petitioners argue that the damage was unexpected because such damage does not usually occur during the construction of homes on similarly situated properties. Petitioners correctly observe that negligence is not an automatic bar to a casualty loss deduction. See *White v. Commissioner*, 48 T.C. 430, 435 (1967). The foreseeability of an event or the presence of negligence does not preclude the finding that the event was a casualty. *Heyn v. Commissioner*, 46 T.C. 302, 308 (1966). Both are merely factors in making such a determination. *Id.*

The Court noted, however, that faulty construction itself wasn't sufficient to get a casualty loss—rather it needed to lead to the casualty:

Casualty losses have been allowed in faulty construction cases typically where there has been a subsequent, unexpected event apart from the contractor's negligence. See *Marx v. Commissioner*, T.C. Memo. 1991-598 (subsequent leaks in taxpayer's roof arising from its negligent repair were a casualty loss, but the original leak from its faulty construction was not); *Hayutin v. Commissioner*, T.C. Memo. 1972-127 (flood damage proximately caused not by

faulty construction of taxpayer's home, but by plumber stepping on unprotected pipe), affd. 508 F.2d 462 (10th Cir. 1974).

The Court found that their particular fact pattern wasn't going to qualify:

Nevertheless, we hold that petitioners' losses were not casualties because neither was the result of sudden or unexpected events. Damage caused by faulty construction methods has long been held not to constitute a casualty loss. *Matheson v. Commissioner*, 18 B.T.A. 674 (1930), affd. 54 F.2d 537 (2d Cir. 1931). In petitioners' litigation against Mr. Olson, the court found that Mr. Olson mistakenly encroached onto the area of the septic system drain field while excavating for the driveway. Petitioners contend that the damage to the drain field site occurred instead when a subcontractor negligently drove a bulldozer over the area. Regardless of how the drain field was damaged, the end result was the placement of the driveway over a portion of the intended drain field site. When this occurred, the location of the driveway no longer conformed with the approved plans and violated the setback requirement. For that reason, petitioners were denied an occupancy permit, and the property lost most of its value.

...Whether the encroachment onto the drain field site was the result of negligent excavation or a bulldozer running over the area is irrelevant. Denial of the occupancy permit was based on the driveway being too close to the drain field. The improper placement of the driveway is simply a matter of faulty construction. Once the driveway had been constructed, there was no later event that caused further harm to the property.

But there was the issue of the landslide—and the taxpayers argued that, at the very least, that was a casualty loss.

Petitioners cite the *Heyn* case as an example of the allowance of a casualty loss based on a contractor's negligence. In *Heyn v. Commissioner*, supra at 305, the contractor unilaterally deviated from the prescribed excavation method and was warned of the likelihood of a landslide occurring. Nevertheless, the Court allowed the casualty loss because the physical characteristics of the landslide were those normally associated with a casualty, and the landslide involved a sudden and violent movement or a large mass of earth that was cataclysmic in character. *Id.* at 307-308.

However the Court didn't accept their assertion that a “sudden” landslide took place between May 2002 and June 2003:

We have held that the magnitude of the taxpayer's loss is another factor to consider in the casualty loss analysis. See *White v. Commissioner*, supra at

434. It was the physical characteristics and magnitude of the taxpayer's loss which the Court in *Heyn* found akin to the sudden and devastating loss suffered during a fire, storm, or shipwreck.

Petitioners contend the soil instability culminated in a landslide sometime between May 2002 and June 2003. However, the record does not adequately support this contention. The geotechnical engineer's report from Krazan merely notes instability created by the removal of vegetation from the slopes and the steep angle of the driveway. The report stated that if those conditions were not mitigated, there would be an adverse effect on the property; but it made no mention of a landslide.

Similarly, a letter from the Department of the Army notes that the city's engineering manager made the same observations about the instability on the property. This letter is dated June 11, 2003 (after the purported landslide), and also fails to mention that such an event occurred. In the absence of such an event petitioners have experienced only instability in the slopes of their property. This is not the type of loss that can be considered sudden, cataclysmic, and devastating or the result of an undesigned, sudden, and unexpected event.

The Court also noted that the taxpayers' own negligence caused them to lose the ability to have obtained an occupancy permit earlier.

Furthermore, a taxpayer may not knowingly allow his property to be damaged or willfully damage the property himself. See *White v. Commissioner*, supra at 435; *Pryor v. Commissioner*, T.C. Memo. 1987-80. Petitioners were granted a waiver on the setback requirement and could have thus obtained an occupancy permit, thereby mitigating the loss they suffered. By failing to pursue the variance, petitioners knowingly perpetuated the impediment to completion of the real property improvements.

In the end the Court found:

Petitioners' loss was the product of Mr. Olson's negligent construction and not some unexpected event. There was no devastating or cataclysmic damage to the property, such as a landslide. Petitioners could have remedied the occupancy permit problem, but they neglected to take the necessary steps to do so. We accordingly hold that petitioners' loss was not a casualty.

C. Other Problem—What Was the Loss?

The Court decided to continue on and note there are other issues—in this case the lack of showing what the loss was. In a footnote, the Court justifies looking at this because “We consider whether petitioners have established the amount of a loss because petitioners have made the generalized alternative contention that their loss was a theft loss.”

The Court notes a deduction is limited as follows:

The amount of a particular casualty loss deduction is limited to the lesser of (1) the difference between the fair market value of the property before and after the loss, or (2) the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of the property. Sec. 165(b); secs. 1.165-7(b)(1), 1.165-8(c), Income Tax Regs.

The first problem the taxpayers have is establishing that difference between the fair value before or after the loss:

Petitioners have not met their burden of establishing the amount of their loss. They have not demonstrated the value of the property before their loss. Petitioners purchased the parcel on May 4, 1999, for \$57,100. No appraisal was made at that time. Petitioners did submit an appraisal performed before the purchase (dated April 13, 1999) as proof that the property was valued at \$320,000. However, the report was marked "subject to completion per plans and specifications." Construction of the home began in June. The encroachment of the driveway into the septic system drain field was discovered later that year, and construction had not yet been completed at that time. Therefore, the property could not have been worth as much as the full estimated value in that appraisal report. The next valuation of the property was not made until after petitioners' loss, when it was assessed at \$23,000 for the 2000 tax year.

The Court also had issues with the proof of basis in this case, noting they didn't deal with the timing of when basis was created vs. when the loss took place. It noted:

Petitioners have also failed to establish their adjusted bases in the property at the time of the loss. Petitioners now contend that they each had an adjusted basis of \$119,725. They arrived at this number by adding the \$57,100 purchase price of the parcel to the \$182,500 already paid to Mr. Olson at the time he stopped work on the home in June 2000. These calculations are imprecise, and the measure of their loss has more to do with the construction of the driveway over the drain field site. Petitioners have not documented how

much of the \$182,500 paid to Mr. Olson was for work done afterwards. Such amounts are not properly includable in petitioners' adjusted basis at the time of the loss.

D. One More Way to Kill the Deduction

And in case this wasn't enough, the Tax Court found another theory in which the taxpayers position was deficient—they hadn't established the lack of prospect for recovery when they claimed the loss.

The taxpayers claimed they had no reasonable prospect of recovery once the insurance company denied the claim:

Petitioners contend that the denial of coverage by Mr. Olson's insurance carrier proves they had no reasonable prospect of recovery. Petitioners note that their attorney advised them on January 21, 2007, that Mr. Olson's insurance policy did not, in fact, cover their claim.

However the Court found the taxpayers actions were inconsistent with that position:

Petitioners litigated the denial of coverage, and we accordingly hold that they have not met their burden of proving a reasonable prospect of recovery did not exist at the end of 2003. In Mr. Olson's 2003 bankruptcy proceeding petitioners stated that Mr. Olson's insurance carrier was liable for many of Mr. Greif's claims against him. Petitioners requested that the stay to be lifted so that they could proceed against the insurance carrier. As of December 12, 2003, petitioners indicated their intent to continue with the litigation against Mr. Olson. While petitioners' decision to litigate does not decide the issue, it does demonstrate that they had not yet abandoned their claim for reimbursement. With the ongoing litigation, it could not be ascertained with reasonable certainty that petitioners would not prevail in their suit against Mr. Olson and recover the judgment from his insurance carrier. The continuation of the litigation until 2006 and the fact that a settlement was reached in 2007 suggest that a reasonable prospect of recovery did exist.

The fact that petitioners maintained their claim for insurance reimbursement and had a reasonable prospect of recovery at the end of 2003 also militates against allowing them a casualty loss deduction.

E. And Negligent Too...

And to add insult to injury, the taxpayer is determined to have been negligent due to the big problem with basis (which may explain why we have the Court deal with that basis issue).

Petitioners' underpayments are also attributable to negligence. Petitioners declared a total adjusted basis of \$342,326 in their 2003 returns, but they provided no documentation as to how they arrived at this figure. Petitioners have since claimed the adjusted basis was \$239,450 without explaining this discrepancy. Both petitioners claimed casualty loss deductions of \$171,163. The deductions far exceed the \$239,450 petitioners now claim to be the property's total adjusted basis. Even if we assume the \$239,450 figure is correct and ignore the property's preloss value, petitioners' claimed casualty losses plainly exceeded the \$239,450 adjusted basis limitation on their casualty loss deductions.