**Office of Chief Counsel**
**Internal Revenue Service**
# Memorandum

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subject: Deductibility of Claimed Casualty Loss of

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =
A =
County =
State =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
N1 =
N2 =
N3 =

## ISSUES

Whether Taxpayers may be denied a casualty loss deduction under section 165(c)(3) of the Internal Revenue Code based on public policy considerations for two uninsured structures which were built without the requisite permits and were destroyed in a fire.

## CONCLUSIONS

Based on the facts provided, there are not sufficient grounds to deny Taxpayers a casualty loss deduction based on public policy considerations.

Further, Taxpayers have not provided sufficient evidence to substantiate the amount of their casualty loss. We recommend that Exam further develop the issue of whether Taxpayers properly computed and adequately substantiated the casualty loss claimed on the two structures.

## FACTS AND BACKGROUND

The facts provided are summarized below. A full statement of the facts is set forth in the incoming request.

In Year1, Taxpayers purchased a N1-acre parcel of property jointly with another couple, the A. The property is located in the mountains of County.

Taxpayers built a home themselves on the property and lived in the home since the early Year2. Based on statements from Taxpayers' representative, Taxpayers knowingly built the home without the necessary permits because they wanted to live without Government interference. The State Building Code requires building, plumbing, electrical, and mechanical permits to be obtained in order to build a home. There are various remedies available to the State and County to enforce the building code, such as recording a notice of violation on the property, as well as imposing penalties and fines.

A also built their own home on the property in the early Year2 and lived in it. In Year 3, Taxpayers bought the A's share of the property including the A's home. Taxpayers claim that they converted the A's home into a timber mill. Taxpayers did not file a Schedule C regarding the sale of timber and did not report income or expenses from the sale of timber on their Year4 return.

In Year4, a large fire burned N2 acres of forested land in the County. Both of Taxpayers' structures were totally destroyed in the fire. According to press reports N3 other structures and homes in the area were destroyed, a number of which were built without the required permits. Taxpayers claimed a casualty loss deduction on their Year4 amended return.

Taxpayers computed their adjusted basis in the two structures using statistical data for the cost of building comparable structures in an adjacent county in Year5, which included the cost of labor. Taxpayers did not provide any substantiation of the expenses they incurred in building the home or for converting the purchased home into a timber mill.

Exam and field counsel believe that Taxpayers are not entitled to a casualty loss deduction because allowing the deduction would severely and completely frustrate the State policy of obtaining permits before building a home. Field counsel states that the policy reflected in the State and County laws is to protect public safety by ensuring the safety and integrity of the houses and the public. In support of this position, they assert that: first, allowing the deduction would cause the Federal Government to be the insurer of last resort for unpermitted, and thus illegal, homes; second, Taxpayers would have no financial incentive to comply with the State and County statutes if the Federal government effectively insured their loss; third, the loss does not need to be related to the illegal activity; and fourth because Taxpayers knowingly did not get the required permits, they were not legally entitled to incur the costs for building their home, buying the A's home, and making improvements to that home, and they should not get the benefit of a casualty loss deduction.

LAW

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(c) limits a deduction for losses under section 165(a) for individuals 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 section 165(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.

Section 1.165-7(a)(1) of the Income Tax Regulations provides that any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained.

Section 1.165-7(b)(1) provides that the amount of the loss to be taken into account for purposes of section 165(a) is the lesser of either—(i) The amount which is equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or (ii) The amount of the adjusted basis prescribed in section 1.1011-1 for determining the loss from the sale or other disposition of the property involved. However, if business or income-producing property is totally destroyed by casualty, and the fair market value of the property immediately before the casualty was less than the adjusted basis of the property, the adjusted basis is treated as the amount of the loss. A casualty loss deduction for

business or income-producing property must be computed based on each single identifiable property damaged or destroyed pursuant to section 1.165-7(b)(2)(i). Therefore, a casualty loss must be computed separately for each improvement (e.g., a building, landscaping) to the property.

Section 1.165-7(a)(2)(i) provides, in part, that in determining the amount of the deductible loss, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal. However, section 1.165-7(a)(2)(ii) provides that the cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that (a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amount spent for the repairs is not excessive, (c) the repairs do not care for more than the damage suffered, and (d) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.

Section 1.165-7(a)(5) provides, in part, that in the case of property which originally was not used in a trade or business or for income-producing purposes and which is thereafter converted to either of such uses, the fair market value of the property on the date of conversion, if less than the adjusted basis of the property at such time, shall be used, after making proper adjustments in respect of basis, as the basis for determining the amount of loss.

Courts have imposed a limitation on various deductions, including section 165 loss deductions, where allowance of the deduction would severely and immediately frustrate a sharply defined national or state policy. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35 (1958) (the Supreme Court affirmed disallowance of business deductions of fines imposed on truck owners for violations of state maximum truck weight laws based on public policy considerations; case decided before the enactment of section 162(f)); Richey v. Commissioner, 33 T.C. 272, 276 (1959) (theft loss disallowed for money stolen from the taxpayer during his participation in a counterfeiting scheme based on public policy against counterfeiting). "[T]he question of illegality to frustrate public policy is . . . one of degree, to be determined from the peculiar facts of each case." Fuller v. Commissioner, 213 F.2d 102, 106 (10th Cir. 1954) (disallowed the taxpayer's loss for cost of confiscated whiskey as deduction would frustrate state law). The mere fact that an expenditure bears a remote relationship to an illegal act does not make it nondeductible. Commissioner v. Heininger, 320 U.S. 467, 474 (1943).

In analyzing whether the allowance of a deduction would severely and immediately frustrate a sharply defined national or state policy, courts have looked at several factors. One factor is whether the taxpayer's activity directly caused the loss. In Blackman v. Commissioner, 88 T.C. 677 (1987), the taxpayer claimed a casualty loss deduction for his home that was destroyed by a fire the taxpayer started when he intentionally set his wife's clothes on fire. The Tax Court disallowed the loss deduction on the grounds of his grossly negligent conduct and because allowing the deduction would severely and

immediately frustrate the public policy of the Maryland statutes against arson and burning and domestic violence. See also Madsen v. Commissioner, T.C. Memo. 1989-431 (citing Blackman, the court noted that if public policy would be frustrated by permitting the deduction, such as for a casualty loss attributable to arson, the loss is not deductible); Rev. Rul. 81-24, 1981-1 C.B. 79 (loss on destruction of taxpayer's building by fire would not qualify as a casualty due to taxpayer's knowing and willful act of arson). But see Hossbach v. Commissioner, T.C. Memo. 1981-291 (the Tax Court allowed the taxpayer a casualty loss deduction for a fire resulting from the taxpayer's illegal drug manufacturing that destroyed taxpayer's building because the taxpayer did not recklessly create a risk of catastrophe in violation of the state statute).

Even if the taxpayer's activity did not directly cause the loss, courts have examined whether a direct relationship exists between the claimed loss and the violation of the public policy. In Mazzei v. Commissioner, 61 T.C. 497 (1974), the Tax Court held that a taxpayer who entered into a conspiracy to counterfeit U.S. currency could not take a theft loss deduction when genuine currency the taxpayer provided for use in the counterfeiting process was stolen by co-conspirators. The Tax Court found that "the loss claimed by the petitioner here had a direct relationship to the purported illegal act which the petitioner conspired to commit" and therefore, the loss should be denied based on a clearly defined public policy against counterfeiting. Mazzei, 61 T.C. at 502. Similarly, in Lincoln v. Commissioner, T.C. Memo. 1985-300, the Tax Court disallowed the taxpayer a theft loss for money that was stolen by co-conspirators during a scheme to purchase stolen currency at a discount because the loss had a direct relationship to the taxpayer's active participation in the scheme. In reaching this conclusion, the Tax Court noted that the "[t]he frustration of policy resulting from the allowance of the deduction must be severe and immediate. The expenditure must be directly related to the violation of the public policy; the fact that the expenditure bears a remote relationship to an illegal act does not make it nondeductible."

The Supreme Court also emphasized the importance of the direct relationship between the deduction and the frustration of public policy in Tank Truck Rentals:

> Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. . . . If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, as in the present case, the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance. Deduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature.

356 U.S. at 35. See also Hossbach, T.C. Memo. 1981-291 ("where a loss is directly related to conduct proscribed by a legislative body, it would obviously be inconsistent with articulated public policy to permit a tax deduction for that loss").

Another factor is whether allowing the loss would defeat the purpose of the laws that the taxpayer violated and would encourage others to violate those laws. Courts have disallowed deductions for fines, penalties, and forfeitures specifically imposed by the state for the violation of various laws. Courts have held that to allow a deduction for the fines and penalties, and for the value of the goods forfeited, would encourage continued violations of the stated laws by increasing the odds in favor of non-compliance, and would tend to destroy the effectiveness of those laws. See, e.g., Tank Truck Rentals, 356 U.S. at 35 (allowing business expense deduction of fines for violations of state maximum truck weight restrictions would frustrate the purpose of the restrictions); Holt, 69 T.C. 75, 80 (1977), aff'd 611 F.2d 1160 (2d Cir. 1980) (the Tax Court disallowed the taxpayer a loss deduction for assets seized in an illegal drug trafficking business because allowing the deductions would frustrate a sharply defined national policy against illegal drug trafficking). See also Murillo v. Commissioner, T.C. Memo. 1998-13 (denial of a loss deduction for forfeited money that was used in a bank deposit structuring scheme; allowing the deduction would frustrate the clearly defined Federal policy against structuring); Farris v. Commissioner, T.C. Memo. 1985-346 (disallowed loss deduction for cash and gambling equipment was that was seized; allowing the deduction arising out of the illegal activities would undermine the public policy prohibiting certain gambling activities).

Finally, courts have examined whether allowing the loss would alleviate the sting of any punishment imposed on the taxpayer for violation of a statute. See Murillo, T.C. Memo. 1998-13 (allowing loss deduction for forfeited money arising from illegal activities would take the sting out of the forfeiture); Revenue Ruling 77-126, 1977-1 C.B. 47 (deduction denied for losses incurred for the forfeiture of coin-operated gambling devices; deduction would soften the sting of, and thus frustrate, the sanction of the seizure and forfeiture). See also Rohrs v. Commissioner, T.C. Summ. Op. 2009-190 (casualty loss deduction allowed for a truck the taxpayer damaged while driving intoxicated; allowing the loss would not in any way alleviate the sting of the punishment of imprisonment and fines imposed by the state for a DUI offense).

ANALYSIS

Although we recognize that based on the information you provided Taxpayers' failure to obtain permits for the two structures is in violation of State law, we believe that allowing Taxpayers a casualty loss deduction would not severely and immediately frustrate the policy (i.e. promoting public safety) behind the State law requiring building permits. Applying the various factors courts have used to determine whether allowing the taxpayer a deduction would severely and immediately frustrate State's policy of obtaining permits, we do not see a sufficiently direct link between the casualty loss Taxpayers suffered and their failure to obtain permits to deny the loss based on public policy considerations.

The incoming memo cites cases such as Holt and Mazzei to support a finding that the Government should not bear the cost incurred by Taxpayers resulting from Taxpayers' failure to obtain permits. Taxpayers' facts are distinguishable from the cases described above where courts have used the public policy doctrine to deny a deduction. In those cases, such as Tank Truck Rentals, Holt, Lincoln, and Mazzei, the loss claimed by the taxpayers bore a more direct relationship to the purported illegal act which the taxpayer either conspired to commit or actually committed, and based on the language cited above the courts have acknowledged that relationship in deciding to deny the taxpayers a deduction those cases. The Tax Court in Holt stated that "public policy is directly offended by Holt's actions. Holt had no right, constitutional or otherwise, to transport marijuana. He did so at his own risk, and losses inflicted on him by the Government must be borne solely by him, not in part by the Government through a tax benefit." Holt, 69 T.C. at 81. In Holt, however, there is more a direct relationship between the loss incurred by the taxpayer and the taxpayer's illegal activity because the Government seized the taxpayer's money and property that was directly used in or obtained by engaging in the illegal activity. Similarly, in Mazzei, because the taxpayer's money was stolen while the taxpayer was engaged in a conspiracy to counterfeit currency, there was a direct relationship between the theft loss and the illegal act of counterfeiting that the taxpayer conspired to commit. Mazzei, 61 T.C. at 502. Likewise in Lincoln, the taxpayer's money was stolen while the taxpayer was engaged in a conspiracy to purchase stolen money at a discount, and the Tax Court held that allowing a theft loss that was directly related to the taxpayer's active participation in the scheme would severely and immediately frustrate the public policy against purchasing stolen money. Lincoln, T.C. Memo. 1985-300. Here, in contrast, the casualty loss was not directly related to Taxpayers' failure to obtain permits, and the loss would have occurred regardless of whether Taxpayers had obtained the required permits.

We believe that allowing the casualty loss would neither severely frustrate nor defeat the purpose of the State laws requiring permits or lessen the sting of the various punitive measures prescribed by State and County law for failure to obtain proper permits. Additionally, allowing the casualty loss deduction would not necessarily increase the odds in favor of non-compliance and encourage others to build without obtaining the proper permits. State has specific punitive measures for property owners who do not obtain the required permits (e.g. placing a notice of violation on the property, imposing penalties and fines). Allowing Taxpayers' casualty loss deduction here would have no impact on these punitive measures.

## CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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