Casualty Loss Rule in Capitalization Regulations Continue to Attract Criticism

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Although favorably received overall, the temporary regulations issued late last year on deduction versus capitalization of tangible property costs continue to attract critical comments. The latest salvo, issued by the Edison Electric Institute (EEI), an association of electric utilities, concentrates on the temporary regulations' controversial casualty loss rule and claims that if retained when the regulations are finalized, the rule will face significant challenges when scrutinized by the courts.

Background

Under Code Sec. 165, taxpayers may claim a casualty loss deduction for any damage to property caused by fire, shipwreck, storm or other casualty and which is not compensated by insurance. The loss deduction equals the diminishment in the property's fair market value (FMV) but is limited to the taxpayer's tax basis in the property. Expenses to repair property are not part of the casualty loss deduction, but under Reg. § 1.165-7(a)(2)(ii) may be used as the measure to estimate the diminution in the property's FMV. Basis in the damaged property is reduced by the amount of the casualty loss deduction.

For tax years beginning before 2012, Reg. § 1.263(a)-1(b), before its amendment by T.D. 9564, 12/23/2011, provided that capital expenses included amounts paid or incurred to: (a) add to a property's value or substantially prolong its useful life, or (b) adapt property to a new or different use. Amounts paid or incurred for repairs, that is, for expenses that don't do either (a) or (b), above, were currently deductible under Code Sec. 162.

The temporary regulations issued in December of 2011, continue to provide that repair (as well as maintenance) expenses are treated as deductible if they are not otherwise required to be capitalized. (Reg. § 1.162-4T(a)) Capitalized expenses generally are those that better or improve a unit of property, restore it, or adapt it to a new and different use. Under Reg. § 1.263(a)-3T(i)(1), expenses are treated as capitalized restoration costs only if one of five conditions are met. The third condition is that the expense repairs damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss or casualty event under Code Sec. 165. Reg. § 1.263(a)-3T(i)(1)(iii)) A parallel rule under Reg. § 1.263(a)-3T(g)(3), provides that deductible routine maintenance does not include amounts paid to repair damage to a unit of property for which the taxpayer has taken a basis adjustment as a result of a casualty loss or casualty event under Code Sec. 165.

The temporary regulations' casualty loss rule also had been in proposed regulations that IRS issued in 2008, and had attracted a considerable volume of negative comments. In T.D. 9564, IRS acknowledged the criticisms, notably that the casualty loss and the repair expense do not create a double deduction for the same item because they arise out of separate tax events, but nonetheless retained the casualty loss rule which again attracted criticism.

Latest Criticisms

In a comment letter released last week under the Freedom of Information Act (FOIA), the Edison Electric Institute (EEI), an association of electric utilities, once again raised its "deep concern" about the casualty loss rule and raised the argument that the casualty loss rule in the temporary regulations would not stand judicial scrutiny under the Supreme Court's two-step analysis in *Chevron* (Sup Ct 1984) 467 U.S. 837. In that case, the Supreme Court set out a two-step analysis for a court to apply in reviewing an agency's construction of a statute that it administers: (1) if the intent of Congress is clear, IRS and the courts must give effect to the unambiguously expressed intent of Congress; (2) if the statute is silent or ambiguous as to a specific issue, the question for a court is whether the agency's answer is based on a permissible construction of the statute. An agency's regulations are given controlling weight unless they are "arbitrary, capricious, and manifestly contrary to the statute." *Chevron* was held to apply "in full force in the tax context." (*Mayo Foundation for Medical Education and Research, et al v. U.S.*, (Sup Ct 1/11/2011) 107 AFTR 2d 2011-341).

The EEI argues that under the first step of *Chevron,* with respect to casualty losses and repair deductions, as in the regulation declared invalid in *Home Concrete* (Sup Ct 4/25/2012) 109 AFTR 2d 2012-1692, there is no "gap" for Treasury and IRS to fill with the 2011 regulations. The EEI reasons that "Congress has explicitly allowed a deduction for a loss resulting from a

casualty. Separately, Congress has allowed a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business, which includes expenses for repairs that do not increase the value of the property or extend its useful life. These are two specific deductions based upon two independent events. We are not aware of, and the preambles to the various iterations of the regulations have not referred to, any indication that Congress was concerned about the interrelationship between these two separate deductions."

The casualty loss rule in the temporary regulations would be similarly vulnerable under the second *Chevron* step, EEI says, because "the linkage created by the 2011 Regulations that would require the capitalization of an otherwise deductible repair as a consequence of claiming a casualty loss deduction would frustrate rather than further Congressional intent. As embraced by numerous courts, the Congressional purpose in allowing a casualty loss deduction is clear—provide a tax (financial) benefit for those who have suffered economically as a result of the casualty event."

EEI's position is that rather than provide a benefit, the temporary regulations' casualty loss rule places business taxpayers in an economically worse position than they would be had Congress never allowed a casualty loss deduction. Without Code Sec. 165, businesses whose property was damaged by a storm would be entitled to a deduction under Code Sec. 162 for repairs that returned the property to its normal operating condition without increasing the property's FMV or extending its useful life. Such a taxpayer would receive the tax benefit of an immediate deduction for the repair while the basis in the property would continue to be recovered over its recovery period. With Code Sec. 165 in the picture, "this same taxpayer will still be entitled to an immediate deduction for the 'repair,' but now that deduction is in the guise of a Section 165 casualty loss with the accompanying reduction to basis. This taxpayer simultaneously capitalizes the 'repair' expense with a restart to the useful life and extended deprecation period. For the utilities that are EEI members, the damaged property is typically long-life property with useful lives of 15 or more years."

EEI raises a number of other arguments against the casualty loss rule, including that it violates the Administrative Procedure Act because Treasury and IRS don't offer a reasoned explanation for its position. It concludes by saying that the casualty loss rule in the temporary regulations "directly conflicts with the Code and Congressional intent, has no support in the caselaw, and is not sound tax policy. For these reasons, EEI believes that the Casualty Loss Rule, if retained will face significant challenges when scrutinized by the courts." Accordingly, EEI urges IRS to reconsider whether to continue to include the Casualty Loss Rule in the finalized regulations.

We will continue to follow the capitalization regulations and their impact on our clients as they arise. Please consult your Keiter tax professional to find out how the regulations may affect your specific situation.

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