Casualty Loss Deduction Under IRC § 165 Compared to Casualty Loss Deduction claimed under IRC § 162

By: Professor John H. Skarbnik**

** John H. Skarbnik is a professor of taxation at Fairleigh Dickinson University in Madison, N.J., and is tax counsel to the Florham Park, N.J. law firm of McCusker, Anselmi, Rosen & Carvelli, P. C.

A taxpayer who uses property in a trade or business or a transaction entered into for profit can claim a expenses relating to repairing or restoring property damaged by a casualty under Internal Revenue Code § 162(a) rather than the casualty loss rules under Internal Revenue Code § 165. Internal Revenue Code § 162(a) provides, "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." A taxpayer can also deduct casualty losses which are incurred (1) in a trade or business; (2) in a transaction entered into for profit, though not connected with a trade or business; and (3) except as limited, not connected with a trade or business or a transaction entered into for profit, if such loss arises from fire, storm, shipwreck, or other casualty, or from theft.[1]

As will be discussed in this article, where a taxpayer has a choice under which section should apply to a casualty loss of property used in a trade or business or a transaction entered into profit, assuming the taxpayer would prefer to accelerate when the deductions are claimed, the taxpayer would probably elect to treat the expenses as a deduction under Internal Revenue Code § 162(a).

Section I of this article discusses the casualty loss rules under Internal Revenue Code § 165. Due to certain limitations on claiming casualty losses, a taxpayer may not be able to claim any loss until all claims for loss reimbursement are extinguished.

In Section II, rules relating to the deduction of ordinary and necessary expenses incurred in a trade or business, or a transaction entered into for profit, under Internal Revenue Code § 162(a) are reviewed.

In Section III, the issue of whether a taxpayer's are required to apply the casualty deduction rules of Internal Revenue Code for damage incurred for property which is used in a trade or business or a transaction entered into for profit. As discussed within this section, the Internal Revenue Service took this position in R.R. Hensler, Inc. v. Commissioner.[2]

Section IV discusses tax rules which disallow casualty loss deduction where damaged property was restored and a deduction is taken for repairs.

Section V explores whether expenditures to restore casualty loss property should be expensed or capitalized.

Section VI discusses two elective provisions. Subsection A discusses the safe harbor election for qualifying taxpayers by which they can elect to expense certain improvements,

[1] Internal Revenue Code § 165 (c).

[2] 73 T.C. 168 (1979).

maintenance expenses, repairs on eligible property which do not exceed a limited dollar amount. Subsection B discusses an option by which the taxpayer may elect to capitalize repair and maintenance costs.

Section VII, discusses rules relating to a taxpayer's burden of proof and the taxpayer's duty to substantiate deductions. A list of commonly need items that taxpayers should substantiate are listed.

Final comments and conclusions are set forth in Section VIII.

I. Casualty Loss Rules

The Internal Revenue Code allows a taxpayer to deduct casualty losses or property used in a trade or business or a transaction entered into for profit.[3] An individual may also claim a casualty loss for a personal loss.[4] A personal casualty loss is defined as a loss arising from the involuntary conversion of property which does not arise from a trade or business or transaction entered into for profit, arising from fire, storm, shipwreck, or other casualty or theft.[5]

The amount of the casualty loss is determined in the same manner whether the property is (i) used by the taxpayer in a trade or business, (ii) used in a transactions entered into for profit by the taxpayer though not connected with a trade or business, or (iii) personal loss property, such as a taxpayer's car or home. The treasury regulations[6] provide:

> The manner of determining the amount of a casualty loss allowable as a deduction in computing taxable income under section 63 is the same whether the loss has been incurred in a trade or business or in any transaction entered into for profit, or whether it has been a loss of property not connected with a trade or business and not incurred in any transaction entered into for profit.

Notwithstanding the fact that the amount of the casualty loss is determined in the same manner for property used in a trade or business or for a transaction entered into for profit or a personal casualty. However, notwithstanding the regulation, a personal casualty loss is reduced by ten percent of the taxpayer's adjusted gross income and $100 per casualty occurrence.[7]

A taxpayer must establish the casualty loss by obtaining an appraisal that measures the difference between the fair market value of the damaged property immediately before and immediately after the occurrence of the casualty. The treasury regulations[8] state:

> In determining the amount of loss deductible under this section, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any

[3] Internal Revenue Code § 162(a).
[4] Internal Revenue Code § 165(c)(3).
[5] Internal Revenue Code § 165 (h)(3).
[6] Treas. Reg. § 1.165-7(a)(1).
[7] Internal Revenue Code § 165 (h).
[8] Treas. Reg. § 1.165-7(a)(2).

deduction under this section shall be limited to the actual loss resulting from damage to the property.

In lieu of establishing the loss by appraisal of the fair market value immediately before and immediately after, the treasury regulations permit the taxpayer to establish the loss by the cost of the repairs subject to several limitations. The treasury regulations[9] provide:

> 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 such 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.

The total amount of a claimed casualty loss cannot exceed a taxpayer's adjusted tax basis in the property damaged. The treasury regulations[10] provide

> The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by §1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by §1.1011-1 for such items as expenditures, receipts, or losses, properly chargeable to capital account, and for such items as depreciation, obsolescence, amortization, and depletion, in order to determine the amount of loss allowable as a deduction."

The treasury regulations provide that a taxpayer's casualty loss is the lesser of (i) the decrease in the value of the property measured by the difference between the fair market value of the property immediately before and immediately after the casualty; and (ii) the taxpayer's basis in the property damaged.[11]

A casualty loss deduction under IRC § 165 casualty may only be claimed to the extent that there is no prospect that the loss or a portion of the loss will be compensated by insurance or other reimbursement. The treasury regulations[12] provide:

> If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists

[9] Treas. Reg. § 1.165-7(a)(2)(ii).
[10] Treas. Reg. § 1.165-1(c)(1).
[11] Treas. Reg. § 1.165-7(b).
[12] Treas. Reg. § 1.165-1(d)(2)(i).

with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances.

This limitation applies only to losses sustained under I.R.C. § 165. As such, the limitation does not apply to casualty losses of property used in a trade or business or transactions entered into for profit by the taxpayer, though not connected with a trade or business, which are deductible under I.R.C. § 162(a).

Example # 1[13]

Assume a taxpayer's residence, which has a basis of $200,000, is severely damaged by a fire in 2017. The taxpayer spends $100,000 in 2017 repairing the damaged to his home. The moneys spent by the taxpayer is not considered a betterment to the unit of property.[14] Additionally, the expenditures will not change the use of the property.[15]

The insurance company and the taxpayer in November 2017 enter into a settlement agreement by which the insurance company agrees to pay the $80,000 in full payment of the damages suffered by the taxpayer from the fire. The $80,000 insurance payment is made on March 15, 2018. In 2017, the taxpayer may claim a $ 20,000 loss since the taxpayer does not have any other claims for reimbursement. Since this loss is consider a personal casualty, the loss will be decreased by 10% of the taxpayer's adjusted gross income and $100 per occurrence.[16]

Example # 2[17]

Assume the same facts in Example 1 except the taxpayer has a claim against a neighbor who accidentally started the fire. Since the taxpayer has an outstanding claim at the close of 2017, he may be able to recover the amount of the loss. Therefore, no deduction is allowed for the loss in 2017 since the taxpayer may receive compensation for damages. If the taxpayer's claim against the neighbor is dismissed in 2019, the taxpayer may claim a casualty loss of $20,000 ($100,000 minus $80,000 repair cost). Since this is a personal casualty the amount of the loss will be decreased by 10% of the taxpayer's adjusted gross income and $100 per occurrence.

A taxpayer who claims a casualty loss deduction under I.R.C. § 165, must capitalize the expenditures made to restore the property to the extent the casualty loss resulted in a basis adjustment of to the damaged property.[18]

If a taxpayer claimed a loss in accordance with the rules set forth within the regulations and in a subsequent year receives reimbursement for the loss, the regulations provide the

[13] Based upon Treas. Reg. § 1.165-1(d)(2)(ii)
[14] Treas. Reg. § 1.263(a)-3(j).
[15] Treas. Reg. § 1.263(a)-3(l).
[16] Based upon example within Treas. Reg. § 1.165-1(d)(2)(ii).
[17] See Treas. Reg. § 1.165-1(d)(2)(ii).
[18] Treas. Reg. § 1.263(a)-3(k)(iii).

payment should be reported in the taxpayer's income in the year the payment is received. The taxpayer is also directed that he, she or it should not file an amended return for the year that the loss was claimed.[19]

II. Ordinary and Necessary Business Expenses.

I.R.C. § 162(a) provides, "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

If the taxpayer repairs property that was damaged in a casualty, the issue becomes whether he or she can claim an ordinary income tax deduction. The treasury repair regulations[20] provide, "A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized."

If the expenditure results in an improvement to the property, the cost must be capitalized. The treasury regulations[21] provide:

> Requirement to capitalize amounts paid for improvements. Except as provided in paragraph (h) or paragraph (n) of this section or under §1.263(a)-1(f), a taxpayer generally must capitalize the related amounts (as defined in paragraph (g)(3) of this section) paid to improve a unit of property owned by the taxpayer. . . Section 1016 provides for the addition of capitalized amounts to the basis of the property, and section 168 governs the treatment of additions or improvements for depreciation purposes. For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer
>
> (1) Are for a betterment to the unit of property (see paragraph (j) of this section);
>
> (2) Restore the unit of property (see paragraph (k) of this section); or
>
> (3) Adapt the unit of property to a new or different use (see paragraph (l) of this section).[22]

Betterments must be capitalized. The treasury regulations[23] state:

> (1) In general. A taxpayer must capitalize as an improvement an amount paid for a betterment to a unit of property. An amount is paid for a betterment to a unit of property only if it—
>
> (i) Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;

---

[19] Treas. Reg. § 1.165-1(d)(2)(iii).
[20] Treas. Reg. § 1.162-4(a).
[21] Treas. Reg. § 1.263(a)-3(d).
[22] Treas. Reg. § 1.263(a)-3(d). See Chief Counsel Advice 201213023 where the IRS held that a conversion kit for casino slot machines did not result in an improvement because its purpose was to enhance its revenue but did not extend the machines useful life or adapt it for a new purpose.
[23] Treas. Reg. § 1.263(a)-3(j).

(ii) Is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component (as defined in paragraph (k)(6) of this section) to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property[24]; or

(iii) Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property.

In a private letter ruling,[25] the Internal Revenue Service held that a building owner's mold remediation expenses qualified as ordinary and necessary expenses under I.R.C. § 162 (a). At the time the taxpayer purchased the building, to the best of the taxpayer's knowledge, there was no mold in the building. The building was later leased to a skilled nursing facility. The taxpayer after he became aware of the problem undertook a mold remediation project which included removing the old drywall, installing new drywall, and replacing a portion of the electrical and plumbing fixtures. The IRS found that the effect of the program "was to restore the Building to the same physical condition that existed prior to the onset of mold. The new materials used were of substantially similar quality as the materials that were replaced." The IRS further stated:

> Section 162 of the Internal Revenue Code allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on its trade or business. Section 162-4 of the Income Tax Regulations provide that the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in ordinarily efficient operating condition may be deducted as an expense.

Example # 3[26]

> Y owns a building in which it conducts its retail business. The building is covered with shingles. Over time, the shingles begin to wear and Y begins to experience leaks into its retail premises. However, the building still functions in Y's business. To eliminate the problems, a contractor recommends that Y remove the original shingles and replace them with new shingles. Accordingly, Y pays the contractor to replace the old shingles. The new shingles are comparable to original shingles but correct the leakage problems. Assume that replacement of old shingles with new shingles to correct the leakage is not a betterment or a restoration of the building structure or systems under paragraph (j) or (k) of this section and does not adapt the building structure or systems to a new or different use under paragraph (l) of this section. Thus, the amounts paid by Y to replace the shingles are not improvements to the building unit of property under paragraph (d) of this section. Under paragraph (g)(2)(i) of this section, the amounts paid to remove the shingles

[24] See Hotel Sulgrave, Inc. v. Commissioner, 21 T.C. 619 (1954), where the court held that the taxpayer should capitalize sprinkler system installed into a building to comply with city order.
[25] PLR 200607003
[26] Treas. Reg. § 1.263(a)-3(g)(2)(ii), Example 3.

are not required to be capitalized because they directly benefit and are incurred by reason of repair or maintenance to the building structure.

As the following example highlights, if the taxpayer claims a loss for a capital component that is replaced, the taxpayer will capitalize the cost of the replacement component. However, notwithstanding the foregoing, the amount paid to replace the component is not required to be capitalized.

Example # 4[27]

> Assume the same facts as Example 3, immediately above, except Y disposes of the original shingles, and Y elects to treat the disposal of these components as a partial disposition of the building under §1.168(i)-8(d), and deducts the adjusted basis of the shingle as a loss on the disposition. Under paragraph (k)(1)(i)[28] of this section, amounts paid for replacement of the shingles constitute a restoration of the building structure because the amounts are paid for the replacement of a component of the structure and the taxpayer has properly deducted a loss for that component. Thus, under paragraphs (d)(2) and (k) of this section, Y is required to capitalize the amounts paid for the replacement of the shingles as an improvement to the building unit of property. However, under paragraph (g)(2)(i) of this section, the amounts paid by Y to remove the original shingles are not required to be capitalized as part of the costs of the improvement, regardless of their relation to the improvement.

Issues may arise as to whether an expense is deductible as an ordinary and necessary business expense. In Welch v. Helvering,[29] a United States Supreme Court case, the taxpayer was discharged from its debts in bankruptcy. Notwithstanding the discharge, the taxpayer decided to pay its creditors so that it could re-establish relationships with its customers and to improve its credit. The Supreme Court in holding that the amounts paid to the company's creditors were an ordinary and necessary expense stated:

> We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. McCulloch v. Maryland, 4 Wheat. 316, 4 L. Ed. 579. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is

[27] Based upon Treas. Reg. § 1.263(a)-3(g)(2)(ii), Example 4.
[28] See Treas. Reg. § 1.263(a)-3(k)(1)(i), which is set forth in V. of this article.
[29] 290 U.S. 111, 54 S. Ct. 8 (1933).

unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. Kornhauser v. United States, 276 U. S. 145, 48 S. Ct. 219, 72 L. Ed. 505. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

Similarly, the Tax Court in Vaksman v. Commissioner,[30] stated:

In order for an expense to be deductible as a business expense, the expense must be ordinary and necessary. See sec. 162(a). An expense is "ordinary" if it is "normal, usual, or customary" in the taxpayer's trade or business. Deputy v. du Pont, 308 U.S. 488, 495 [23 AFTR 808] (1940) (citing Welch v. Helvering, 290 U.S. 111, 114 [12 AFTR 1456] (1933)). An expense is "necessary" if it is "appropriate and helpful". Welch v. Helvering, supra at 113. In deciding whether an expense is ordinary and necessary, we generally focus on whether there is a reasonably proximate relationship between the expense and the taxpayer's trade or business. See Henry v. Commissioner, 36 T.C. 879, 884 (1961). Conclusory statements by a taxpayer that the expense was incurred in pursuit of the taxpayer's trade or business are not sufficient to establish that the expense had a reasonably proximate relationship to that trade or business. See Ferrer v. Commissioner, 50 T.C. 177, 185 (1968), affd. per curiam 409 F.2d 1359 (2d Cir. 1969); see also Tokarski v. Commissioner, 87 T.C. 74, 77 (1986) ("we are not required to accept the self-serving testimony of petitioner).

III. Does the Casualty Loss Statute, I.R.C. § 165, take Priority over I.R.C. § 162(a)?

In a Tax Court case, R.R. Hensler, Inc. v. Commissioner,[31] the taxpayer, a California corporation, entered into a contract with the Los Angeles County Flood Control District to remove 10 tons of dirt and debris that had accumulated in the San Gabriel Canyon. The taxpayer created an excavation system of 162 separate units. The taxpayer at a cost of approximately, $2,360,000, installed the excavation system and brought in additional machinery and equipment.

Several years after the contract was entered into, there were severe rainstorms over a period of approximately one month. The extraction system and machinery and equipment were severely damaged. The taxpayer decided to uncover its buried equipment and extraction systems units as it preceded with the contract. The buried equipment and uncovered extraction units were repaired or replaced.

[30] TC Memo 2001-165; see also R.R. Hensler, Inc. v. Commissioner, 73 T.C. 168 (1979).
[31] 73 T.C. 168 (1979)

A dispute arose between the taxpayer and its insurance company. The insurance company argued that its liability under the contract was limited to $500,000. The taxpayer argued that the insurance company liability was limited to $500,000 per occurrence and there were several occurrences.

Prior to June 30, 1969, the taxpayer spent approximately $620,000 in repairing and replacing damaged property, and received approximately, $315,000 from the insurance company.

The taxpayer formed a joint venture which commenced on July 1, 1969 with a construction company which acquired a 10% interest in the joint venture. In the tax years that were being challenged, the taxpayer and the joint venture spent a total of approximately $1,380,000, while the amount paid by the insurer was $500,000.

The taxpayer timely filed a suit against the insurance carrier in 1969 which was settled in 1972. The carrier agreed to pay an additional $850,000 to the joint venture.

The IRS asserted in its notice of deficiency that the repair and replacement expenses were not deductible either by the taxpayer or the joint venture prior to 1972, the year in which the taxpayer's suit with the insurance carrier was resolved. The Court was confronted with 4 issues:

Issue 1. Could the taxpayer claim an ordinary and necessary business deduction for the cost of the repairs?

Issue 2. Were the expenditures capital or ordinary?

Issues 3 and 4. Were the deductions allowable under I.R.C. § 162(a) or I.R.C. § 165? In what year is the deduction allowed?

A. Issue 1. May the taxpayer claim an ordinary and necessary business expense for the cost of the repairs?

The Tax Court reviewed the rules as to what constitutes an ordinary and necessary expense. As stated in Welch v. [pg. 177] Helvering, supra, with reference to the words "ordinary and necessary expense" the court stated "One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in its fullness must supply the answer to the riddle. [290 U.S. 114, 115.]" [32]

The court stated that there was no dispute that the repairs were necessary. The Court stated that expenses were ordinary and necessary.[33] Recovering and repairing equipment buried by the flood were directly related to the taxpayer's business. The issue was whether they were ordinary. The Tax Court citing Welch v. Helvering[34] held the payments were ordinary and necessary. [35]

B. Issue 2. Should the expenditures be capitalized or deducted as ordinary expenses?

---

[32] Welch v. Helvering, 290 U.S. 111, 115 (1933); Deputy v. DuPont, 308 U.S. 488 (1940).

[33] The Tax Court sited Illinois Merchants Trust Co., Executor v. Commissioner, 4 B.T.A. 103 (1926); Midland Empire Packing Co. v. Commissioner, 14 T.C. 635 (1950); American Bemberg Corp. v. Commissioner, 10 T.C. 361 (1948), affd. per curiam 177 F.2d 200 (6th Cir. 1949).

[34] 290 U.S. 111, 115 (1933)

[35] Welch v. Helvering, 290 U.S. 111, 115 (1933); Deputy v. DuPont, 308 U.S. 488 (1940).

The Tax Court concluded that the expenses incurred by the taxpayer were ordinary and necessary expenses that the taxpayer incurred in carrying on its business. The Court however recognized that the expenditures may have to be capitalized. The Tax Court stated:

> On the other hand, if the expenditures improve or better the property, or prolong its useful life, they should be added to the basis of the property and amortized over its useful life. And, if the expenditures are to replace the destroyed property, they should be capitalized and the loss on the destroyed property would be deductible as a loss. Buffalo Union Furnace Co. v. Commissioner, supra.

C. Issue 3 Were the deductions allowable under I.R.C. § 162(a) or I.R.C. § 165?
Issue 4. In what year is the deduction allowed?

The IRS argued that if the expenses were incurred as a result of casualty, the casualty loss rules of I.R.C. § 165 applied. As such, no deduction should be allowed prior to 1972 when the taxpayer's claim with the insurance company was resolved. Under I.R.C. § 165, the amount of the loss is determined by appraisal measured by the difference between the fair market value of the property immediately before and immediately after the casualty. The loss could not be determined until all claims for reimbursement were resolved, 1972.

The Tax Court held that under I.R.C. § 162(a) the taxpayer was allowed to claim an ordinary loss based upon the cost of the repairs. The Tax Court noted that if I.R.C. § 162(a) applied, a taxpayer may claim an ordinary and necessary business expenses in the taxable year in which the repair expenses were paid or incurred, depending upon a taxpayer's accounting method.

D. Chief Counsel Advice Memorandum 199903030- The Measure of Damages

The I.R.S. Chief Counsel adopted the Tax Court's decision in R.R. Hensler, Inc. v. Commissioner, 73 T.C. 168 (1979). The IRS held in CCA 19903030 the cost of restoring uninsured business property were currently deductible. The IRS stated:

> While the costs of restoring flood damaged business property are not deductible as part of a casualty loss, these costs may be deducted under section 162 or they may be treated as capital expenditures under section 263. Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. In particular, section 1.162-4 provides that taxpayers may deduct the costs of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in ordinary efficient operating condition. In general, the courts have permitted taxpayers to deduct the costs of repairing property damaged in a casualty if they meet the requirements of section 162. . .
>
> However, section 263 prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase to the value of any property or estate. Moreover, section 263(a)(2) provides that any amount expended

in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. Capital expenditures include amounts paid or incurred:

(1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or

(2) to adapt property to a new or different use. Section 1.263(a)-1(b).

IV. Casualty loss deduction is not allowed where damaged property was restored and a deduction was taken for repairs.[36] The 9th Circuit Court of Appeals in affirming a decision of the Tax Court in Boswell v. Commissioner,[37] stated:

The Tax Court, however, found that these injuries had been repaired and that the land had been rehabilitated for farming use. It found that the out-of-pocket costs incurred to make these repairs were deducted by petitioner as ordinary and necessary business expenses. These deductions were stipulated by the parties to have been properly deducted. By now claiming these expenses as a loss, petitioner seeks to reinforce its allegations as to the other, more speculative, elements of loss sustained. We agree with the Tax Court's conclusion that "petitioner's claim for the loss is not advanced by this contention. 34 T.C. 539, 545."

V. Expenditures to restore property which suffered casualty loss. Should the expenses be capitalized?

The treasury regulations[38] on capitalization of restorations provides:

- (1) In general. A taxpayer must capitalize as an improvement an amount paid to restore a unit of property, including an amount paid to make good the exhaustion for which an allowance is or has been made. An amount restores a unit of property only if it—
- (i) Is for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss for that component, other than a casualty loss under §1.165-7;
- (ii) Is for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- (iii) Is for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment[39] as a result of a casualty loss under

[36] If a deduction was claimed for the loss of the component and it is replaced, the cost of the replaced component must be capitalized. See Treas. Reg. § 1.263(a)-3(k)(1)(i). If a casualty loss deduction has been claimed for which the taxpayer is required to make a basis adjustment, is required to capitalize the expenditure to the extent of the basis adjustment. Treas. Reg. § 1.263(a)-3(k)(1)(iii).

[37] 302 F. 2d 682, 9 AFTR 2d 1343, 1346 (CA9 1962), affirming 34 T.C. 539 (1960).

[38] Treas. Reg. § 1.263(a)-3(k)(1).

[39] See Treas. Reg. § 1.263(a)-3(k)(1)(iii).

section 165, or relating to a casualty event described in section 165, subject to the limitation in paragraph (k)(4) of this section;

- (iv) Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;
- (v) Results in the rebuilding of the unit of property to a like-new condition as determined under paragraph (k)(5) of this section after the end of its class life as defined in paragraph (i)(4) of this section; or
- (vi) Is for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property as determined under paragraph (k)(6) of this section.

If taxpayer claims a casualty loss, the taxpayer must reduce the basis of the property by the amount of the casualty loss.[40] A taxpayer must also reduce its basis by the amount of the insurance reimbursement, even though no deduction is claimed for a casualty loss.[41] Where a taxpayer recovers insurance proceeds which exceeds the taxpayer's basis in the property, no loss is incurred even if the taxpayer spends more money on the repairs than the insurance proceeds received by the taxpayer.[42]

Example # 5[43]

B owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of $500,000. B deducts, under IRC § 165, a casualty loss in the amount of $50,000, and properly reduces its basis in the office building to $450,000. B hires a contractor to repair the damage to the building, including the repair of the building roof and the removal of debris from the building premises. B pays the contractor $50,000 for the work. Under paragraph (k)(1)(iii) of this section, B must treat the $50,000 amount paid to the contractor as a restoration of the building structure because B properly adjusted its basis in that amount as a result of a casualty loss under section 165, and the amount does not exceed the limit in paragraph (k)(4) of this section. Therefore, B must treat the amount paid as an improvement to the building unit of property and, under paragraph (d)(2) of this section, must capitalize the amount paid.

Example # 6[44]

Assume the same facts as in Example 5, above, except that B receives insurance proceeds of $50,000 after the casualty to compensate for its loss. B cannot deduct a casualty loss under section 165 because its loss was compensated by insurance. However, B properly reduces its basis in the property by the amount of the insurance proceeds. Under paragraph

[40] Treas. Reg. § 1.263(a)-3(k)(1)(iii).
[41] Treas. Reg. § 1.165-1(c)(4).
[42] Lafavre v. Commissioner, TC Memo 2000-297; Eliston, Jr. v. Commissioner, T.C. Memo 1973-4.
[43] Treas. Reg. §1.263(a)-3(k)(7), Example 3
[44] Treas. Reg. §1.263(a)-3(k)(7), Example 4

(k)(1)(iii) of this section, B must treat the $50,000 amount paid to the contractor as a restoration of the building structure because B has properly taken a basis adjustment relating to a casualty event described in section 165, and the amount does not exceed the limit in paragraph (k)(4) of this section. Therefore, B must treat the amount paid as an improvement to the building unit of property and, under paragraph (d)(2) of this section, must capitalize the amount paid. The taxpayer's basis in the property after the receipt of the insurance payment of $50,000 and the amount paid to the contractor, remains at $500,000.

The casualty loss deduction cannot exceed the taxpayer's basis in the property.[45] If the amount paid for a restoration exceeds the amount of the casualty loss deduction, the excess amount "must be treated in accordance with the provisions of the Internal Revenue Code and regulations that are otherwise applicable. See, for example, §1.162-4 (repairs and maintenance); §1.263(a)-2 (costs to acquire and produce units of property); and §1.263(a)-3 (costs to improve units of property)."[46] Thus, based upon the nature of the improvement, it may be deductible as an ordinary and necessary expense or it may be capitalized if it is an improvement.[47]

Example # 7[48]

- (i) C owns a building that it uses in its trade or business. A storm damages the building at a time when the building has an adjusted basis of $500,000. C determines that the cost of restoring its property is $750,000, deducts a casualty loss under section 165 in the amount of $500,000, and properly reduces its basis in the building to $0. C hires a contractor to repair the damage to the building and pays the contractor $750,000 for the work. The work involves replacing the entire roof structure of the building at a cost of $350,000 and pumping water from the building, cleaning debris from the interior and exterior, and replacing areas of damaged dry wall and flooring at a cost of $400,000. Although resulting from the casualty event, the pumping, cleaning, and replacing damaged drywall and flooring, does not directly benefit and is not incurred by reason of the roof replacement.

- (ii) Under paragraph (k)(1)(vi) of this section, C must capitalize as an improvement the $350,000 amount paid to the contractor to replace the roof structure because the roof structure constitutes a major component and a substantial structural part of the building unit of property. In addition, under paragraphs (k)(1)(iii) and (k)(4)(i), C must treat as a restoration the remaining costs, limited to the excess of the adjusted basis of the building over the amounts paid for the improvement under paragraph (k)(1)(vi). Accordingly, C must treat as a restoration $150,000 ($500,000—$350,000) of the $400,000 paid for the portion of the costs related to repairing and cleaning the building structure under paragraph (k)(1)(iii) of this section. Thus, in addition to the $350,000 to replace the roof structure, C must also capitalize the $150,000 as an improvement to the building unit of property under paragraph (d)(2)

[45] Treas. Reg. § 1.263(a)-3(k)(4)(i).
[46] Treas. Reg. § 1.263(a)-3(k)(4)(ii).
[47] Treas. Reg. § 1.263(a)-3(d).
[48] Treas. Reg. § 1.263(a)-3(k)(7), example 5.

of this section. C is not required to capitalize the remaining $250,000 repair and cleaning costs under paragraph (k)(1)(iii) of this section.

Example 8[49]

With respect to personal-use property, the taxpayer generally may claim as a casualty loss deduction the lesser of (1) the difference between the fair market value of the property immediately before and after the casualty; or (2) the adjusted basis of the property.[50] The amount of the deduction is reduced by any insurance proceeds or other payments the taxpayer receives or reasonably expects to receive. An individual taxpayer must reduce the amount claimed for each casualty loss deduction for personal-use property by $100, and reduce the total amount of casualty loss deductions claimed for personal-use property for one taxable year by 10 percent of the taxpayer's adjusted gross income.

With respect to business or income-producing property that is partially destroyed, the taxpayer generally may claim as a casualty loss deduction the lesser of (1) the difference between the fair market value of the property immediately before and after the casualty; or (2) the adjusted basis of the property. The amount of the deduction is reduced by any insurance proceeds or other payments the taxpayer receives or reasonably expects to receive. However, if business or income-producing property is completely destroyed and its adjusted basis exceeds its fair market value, the taxpayer may claim a casualty loss deduction equal to the adjusted basis of the property, reduced by payments the taxpayer receives or reasonably expects to receive for the property (including insurance proceeds or payments for damages).

VI. Elective Provisions

A. Safe harbor for small taxpayers. The treasury regulations[51] provide:

1. In general. A qualifying taxpayer (as defined in paragraph (h)(3) of this section) may elect to not apply paragraph (d) or paragraph (f) of this section to an eligible building property (as defined in paragraph (h)(4) of this section) if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building property does not exceed the lesser of—

a. 2 percent of the unadjusted basis (as defined under paragraph (h)(5) of this section) of the eligible building property; or

b. $10,000.

2. If the taxpayer qualifies under the safe harbor, the amounts expended for repairs, maintenance, improvements, and similar activities will qualify for ordinary income tax deductions.[52]

[49] IRS Gulf Oil Spills: Question and Answers, question and answer to question 5.
[50] Treas. Reg. § 1.165-7(b).
[51] Treas. Reg. § 1.263(a)-3(h), Safe harbor for small taxpayers.
[52] Treas. Reg. § 1.263(a)-3(h)(7).

3. To qualify for the safe harbor the taxpayer must meet the following tests

a. Taxpayer must be a "qualifying taxpayer". The treasury regulations provide, "the term qualifying taxpayer means a taxpayer whose average annual gross receipts as determined under this paragraph (h)(3) for the three preceding taxable years is less than or equal to $10,000,000."[53]

b. Expenses paid for "eligible building property." The property is a building, condominium, cooperative, or a leased building that has an "unadjusted basis" of $1,000,000 or less."[54]

c. The taxpayer makes an election by filing a statement titled "Safe Harbor Election for Small Taxpayers" on a timely filed Federal tax return, including extensions, for the taxable year in which the repairs, maintenance, improvements are performed on the eligible building.[55]

Example # 9[56]

> A is a qualifying taxpayer under paragraph (h)(3) of this section, A, owns an office building in which A provides consulting services. In Year 1, A's building has an unadjusted basis of $750,000 as determined under paragraph (h)(5)(i) of this section. In Year 1, A pays $5,500 for repairs, maintenance, improvements and similar activities to the office building. Because A's building unit of property has an unadjusted basis of $1,000,000 or less, A's building constitutes eligible building property under paragraph (h)(4) of this section. The aggregate amount paid by A during Year 1 for repairs, maintenance, improvements and similar activities on this eligible building property does not exceed the lesser of $15,000 (2 percent of the building's unadjusted basis of $750,000) or $10,000. Therefore, under paragraph (h)(1) of this section, A may elect to not apply the capitalization rule of paragraph (d) of this section to the amounts paid for repair, maintenance, improvements, or similar activities on the office building in Year 1. If A properly makes the election under paragraph (h)(6) of this section for the office building and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business, A may deduct these amounts under §1.162-1 in Year 1.

Exhibit # 10[57]

> Assume the same facts as in Example 9, above, except that A pays $10,500 for repairs, maintenance, improvements, and similar activities performed on its office building in Year 1. Because this amount exceeds $10,000, the lesser of the two limitations provided in paragraph (h)(1) of this section, A may not apply the safe harbor for small taxpayers under paragraph (h)(1) of this section to the total amounts paid for repairs, maintenance, improvements, and similar activities

[53] Treas. Reg. § 1.263(a)-3(h)(3).
[54] Treas. Reg. § 1.263(a)-3(h)(4). Unadjusted basis is defined as the cost of the property without adjustments for depreciation. See Treas. Reg. § 1.263(a)-3(h)(5).
[55] Treas. Reg. § 1.263(a)-3(h)(6).
[56] Treas. Reg. § 1.263(a)-3(h)(10), Example 1.
[57] Treas. Reg. § 1.263(a)-3(h)(10), Example 2.

performed on the building. Therefore, A must apply the general improvement rules under this section to determine which of the aggregate amounts paid are for improvements and must be capitalized under paragraph (d) of this section and which of the amounts are for repair and maintenance under §1.162-4.

B. Taxpayer's Election to capitalize repair and maintenance costs.

1. The treasury regulations[58] provide:

> In general. A taxpayer may elect to treat amounts paid during the taxable year for repair and maintenance (as defined under §1.162-4) to tangible property as amounts paid to improve that property under this section and as an asset subject to the allowance for depreciation if the taxpayer incurs these amounts in carrying on the taxpayer's trade or business and if the taxpayer treats these amounts as capital expenditures on its books and records regularly used in computing income ("books and records"). A taxpayer that elects to apply this paragraph (n) in a taxable year must apply this paragraph to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year. Any amounts for which this election is made shall not be treated as amounts paid for repair or maintenance under §1.162-4.

2. The taxpayer must make a timely election on its timely filed Federal return, including extension, by attaching a statement for the taxable year in which the taxpayer paid the amounts referred to in paragraph 1. "The statement must be titled 'Section 1.263(a)-3(n) Election' and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under §1.263(a)-3(n). A taxpayer making this election for a taxable year must treat any amounts paid for repairs and maintenance during the taxable year that are capitalized on the taxpayer's books and records as improvements to tangible property. The taxpayer must begin to depreciate the cost of such improvements amounts when they are placed in service by the taxpayer under the applicable provisions of the Code and regulations."[59]

Example # 11[60]

> Election to capitalize routine maintenance on non-rotable part.
> (i) Q is a towboat operator that owns a fleet of towboats that it uses in its trade or business. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. Assume the towboat engines are not rotable spare parts under §1.162-3(c)(2). In Year 1, Q acquired a new towboat, including its two engines, and placed the towboat into service. In Year 4, Q pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the scheduled

[58] Treas. Reg. § 1.263(a)-3(n)(1).
[59] Treas. Reg. § 1.263(a)-3(n)(2).
[60] Treas. Reg. § 1.263(a)-3(n)(4), Example 1

maintenance costs and that the scheduled maintenance on Q's towboat is within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 4 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

(ii) On its books and records, Q treats amounts paid for scheduled maintenance on its towboat engines as capital expenditures. For administrative convenience, Q decides to account for these costs in the same way for Federal income tax purposes. Under paragraph (n) of this section, in Year 4, Q may elect to capitalize the amounts paid for the scheduled maintenance on its towboat engines. If Q elects to capitalize such amounts, Q must capitalize all amounts paid for repair and maintenance to tangible property that Q treats as capital expenditures on its books and records in Year 4.

VII. Burden of Proof and Substantiation of Deductions

In Hershberger v. Commissioner,[61] the United States Tax Court reviewed the taxpayer's residential rental property tax deductions arising from repairs. As noted by the Tax Court, the burden to proof is placed upon the taxpayers who must maintain adequate records to establish the deductions.

A. With respect to the Burden of Proof, the Tax Court stated:

> Generally, the Commissioner's determinations in a notice of deficiency are presumed correct, and a taxpayer bears the burden of proving those determinations are erroneous. Rule 142(a)(1); Welch v. Helvering, 290 U.S. 111, 115 [12 AFTR 1456] (1933). Petitioner has not claimed or shown that he meets the requirements of section 7491(a) to shift the burden of proof to respondent on any relevant factual issues.
>
> [*5] Taxpayers must maintain records adequate to substantiate their income and deductions. Sec. 6001. These records should be sufficient to establish the amount of the gross income or other items shown on the tax return. Sec. 1.6001-1(a), Income Tax Regs. The taxpayer shall retain these records as long as they may become material in the administration of the Internal Revenue Code. Sec. 1.6001-1(e), Income Tax Regs.

B. With respect to Rental Repair Deductions, the Tax Court stated:

> Deductions are a matter of legislative grace, and the taxpayer must prove his or her entitlement to a deduction. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992). Section 212(2) allows for a deduction of all the ordinary and necessary expenses paid or incurred during the taxable year for the management, conservation, or maintenance of

[61] TC Memo 2014-63.

> property held for the production of income. A taxpayer may deduct properly substantiated repair expenses for properties held out for rent under section 212.
>
> A taxpayer claiming a deduction on a Federal income tax return must demonstrate that the deduction is allowable pursuant to a statutory provision and must further substantiate that the expense to which the deduction relates has been [*8] paid or incurred. Sec. 6001; Hradesky v. Commissioner, 65 T.C. 87, 89-90 (1975), aff'd per curiam, 540 F.2d 821 [38 AFTR 2d 76-5935] (5th Cir. 1976).
>
> Petitioner produced receipts for 2006 and 2007 that he contends substantiate his repair expenses. These receipts are vague and do not include the nature and date of the repairs, the name of the individual or company that performed the repairs, the details concerning what work was performed, or the type of materials used in the repairs. The receipts were printed on blank paper rather than on the official letterhead of a business. Petitioner testified that a man named Juan Rodriguez made the repairs and prepared the receipts in [pg. 486] 2006 and that a man named Jose Martinez made the repairs and prepared the receipts in 2007. Petitioner did not call either Mr. Rodriguez or Mr. Martinez as a witness to verify the cost of the repairs or to authenticate the receipts, and therefore respondent did not have an opportunity to cross-examine them. Petitioner's uncorroborated and vague receipts are not credible. We sustain respondent's disallowance of petitioner's repair expense deductions.

C. Issues that Taxpayers Should Substantiate

1. Documentation substantiating that the taxpayer's property suffered a casualty loss.

2. A taxpayer who uses property in a trade or business or a transaction entered into for profit, although not within a trade or business, incurs a casualty and the taxpayer claims the restoration expenses as ordinary and necessary deductions, will need to establish the amount paid to restore the property and the date the expenditures were paid or incurred, depending upon the taxpayer's accounting method.

3. Did the taxpayer have any insurance? Did the taxpayer receive a payment from the insurance company? Are there any claims for insurance reimbursement which have not yet been resolved?

4. For any damages incurred, did the taxpayer replace the damage property with property that was similar in kind to the property replaced? If not, was the amount expended a betterment to the property?

5. Following the restoration of the property damaged by the casualty, was the taxpayer using the property for a different purpose than it was used for prior to the casualty?

6. If a taxpayer is claiming a casualty loss deduction for the amount paid to restore the property under IRC § 165(c), the taxpayer will need to establish by appraisal the fair market value of the property immediately before and after the casualty, or substantiate the amount paid to restore the property.

7. If the taxpayer is claiming a personal casualty loss, does the taxpayer have any outstanding claims for reimbursement for damage to the property?

8. What was the taxpayer's basis in the properties which incurred a casualty?

VIII. Final Comments and Conclusions

A taxpayer deducting a personal casualty loss pursuant to I.R.C. § 165 must establish by appraisal the difference between the fair market value of the damaged property immediately before and immediately after the occurrence of the casualty.[62] Notwithstanding the foregoing, a taxpayer's casualty loss cannot exceed the lesser of (i) the decrease in the value of the property immediately before and immediately after the casualty; and (ii) the taxpayer's basis in the property damaged.[63]

Although the amount of a personal casualty loss is determined in the same manner for casualties arising in a trade or business, or a transaction entered into for profit, the computation of the losses will not be the same. The amount of a personal casualty loss is reduced by ten percent of the taxpayer's adjusted gross income and $100 per casualty occurrence.[64]

A taxpayer who incurs a casualty loss of property which is either used in a trade or business, or a transaction entered into for profit, probably would prefer to claim the loss under Internal Revenue Code § 162(a) as an ordinary and necessary business expense, rather than claiming a casualty loss deduction under Internal Revenue Code § 165. A taxpayer, claiming a loss under I.R.C. § 162(a), may be able to claim an ordinary loss at the time the taxpayer pays or accrues an expense relating to the repair or restoration of the damaging arising from the casualty, provided that such expenditure is not considered an improvement to the property. Whereas, if the casualty is deducted under I.R.C. § 165, the taxpayer will not be able to claim a loss to the extent the taxpayer has outstanding claims for reimbursements for the loss from insurance companies, individuals or entities which may be responsible for the loss. To the extent there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. [65]

If property is used in a trade or business or in a transaction that is entered into for profit suffers a casualty, a taxpayer may claim the cost of repairs and maintenance of the property as ordinary and necessary expense. [66]

Notwithstanding the foregoing, if the expenditure results in an improvement or betterment of the property, the expenditure should be capitalized. A betterment will deemed to occur if the expenditure (i) ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, (ii) is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component (as defined in paragraph (k)(6) of this section) to the unit of

[62] Treas. Reg. § 1.165-7(a)(2).
[63] Treas. Reg. § 1.165-7(b).
[64] Internal Revenue Code § 165 (h).
[65] Treas. Reg. § 1.165-1(d)(2)(i).
[66] Treas. Reg. § 1.162-4(a).

property or a material increase in the capacity, including additional cubic or linear space, of the unit of property; or (iii) is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property. [67]

A unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer, and therefore such expenses should be capitalized if it:

(1) For a betterment to the unit of property (see paragraph (j) of this section);
(2) Restores the unit of property (see paragraph (k) of this section); or
(3) Adapts the unit of property to a new or different use.[68]

If taxpayer claims a casualty loss pursuant to IRC § 165(a), the taxpayer must reduce the basis of the property by the amount of the casualty loss.[69] A taxpayer, who restores damage to a unit of property for which the taxpayer reduces the basis of the property as a result of a casualty loss deduction under section 165, is required to capitalize the restoration expenses to the extent of the loss. Expenditures in excess of the loss may be deducted as an ordinary and necessary expense provided that the excess expenditure are not an improvement or betterment.[70]

Taxpayer's have the option of making certain elections. A qualified taxpayer can elect to expense repairs, maintenance, improvements, and similar activities performed on the eligible building property does not exceed the lesser of (i) 2 percent of the unadjusted basis of the eligible building property; or (ii) $10,000. [71] A qualifying taxpayer means a taxpayer whose average annual gross receipts for the three preceding taxable years is less than or equal to $10,000,000."[72] An "eligible building property" is a building, condominium, cooperative, or a leased building that has an "unadjusted basis" of $1,000,000 or less.[73]

Taxpayer's also have the option of electing to capitalize repair and maintenance costs.[74] Taxpayer's who cannot currently utilize the benefit of claiming deductions may want to make the election to defer when the deduction will be claimed for the repair and maintenance expenses.

[67] Treas. Reg. § 1.263(a)-3(j).
[68] Treas. Reg. § 1.263(a)-3(d).
[69] Treas. Reg. § 1.263(a)-3(k)(1)(iii).
[70] Treas. Reg. § 1.263(a)-3(k)(4)(ii).
[71] Treas. Reg. § 1.263(a)-3(h)(7).
[72] Treas. Reg. § 1.263(a)-3(h)(3).
[73] Treas. Reg. § 1.263(a)-3(h)(4). Unadjusted basis is defined as the cost of the property without adjustments for depreciation. See Treas. Reg. § 1.263(a)-3(h)(5).
[74] Treas. Reg. § 1.263(a)-3(n).