Casualty losses and expenditures under Sec. 162 or 165

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PREVIEW

- Know the rules for deducting casualty damages to property as casualty losses under Sec. 165 and the repair of such damages as ordinary and necessary business expenses under Sec. 162.
- Recent legislation restricts personal casualty losses to "qualified disaster losses."
- A safe harbor to elect not to apply capitalization rules to certain property may benefit qualifying small taxpayers that suffer casualty losses.

Two Code provisions, Sec. 162 and Sec. 165, offer a potential deduction for a taxpayer who has property that has been damaged by a casualty. A taxpayer who uses property in a trade or business may be able to deduct expenses of repairing or restoring property damaged by a casualty under Sec. 162(a), which 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."

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Sec. 165 provides a deduction for casualty losses that 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] However, as discussed below, for tax years 2018 to 2025, deductions for personal casualty losses are generally limited to losses of property within certain federally declared disaster areas.

Whether a deduction is taken under Sec. 162 or Sec. 165 is important because a business expense is deductible when paid or incurred, while a casualty loss is deductible only when sustained and if not compensated for by insurance or otherwise. Also, a loss generally is measured by the difference between the value of the property before and after the casualty, limited to adjusted basis, and reduced by any insurance recovery, rather than the cost of repairs or replacements.

Casualty loss rules

The Internal Revenue Code allows all taxpayers to deduct losses arising from fire, storm, shipwreck, or other casualty for property used in a trade or business or a transaction entered into for profit.[2] Until 2018, an individual could claim a personal casualty loss for property not used in a trade or business or a transaction entered into for a profit (personal-use property) if the loss arose from fire, storm, shipwreck, or other casualty.[3] However, the deduction for personal casualty losses was greatly limited by the passage of P.L. 115-97, known as the Tax Cuts and Jobs Act of 2017. Under the act, no deduction is allowed for a personal casualty loss arising after Dec. 31, 2017, and before Jan. 1, 2026, with several exceptions. Between 2018 and 2025, a personal casualty loss may only be deducted (1) to the extent of personal casualty gains, or (2) where the property loss was attributable to a "qualified disaster loss," i.e., one attributable to a "federally declared disaster" determined by the U.S. president to warrant assistance under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.[4]

The amount of the casualty loss is determined in the same manner whether the property is used by the taxpayer in a trade or business or a transaction entered into for profit or is personal-use property, such as a taxpayer's car or home.[5] However, a taxpayer's casualty losses from personal-use property are reduced by $100 per casualty and 10% of the taxpayer's adjusted gross income (AGI).[6]

For all three categories of casualty loss, a taxpayer must establish the amount of the loss by obtaining an appraisal that measures the difference between the fair market value (FMV) of the damaged property immediately before and immediately after the occurrence of the casualty. The appraisal must take into account the effects of any simultaneous general market decline affecting the property's value.[7]

In lieu of establishing the loss by appraisal of the FMV immediately before and immediately after the casualty, the regulations permit the taxpayer to establish the amount of the loss by the cost of the repairs, if the taxpayer shows (1) the repairs are necessary to restore the property to its condition immediately before the casualty; (2) the amount spent for the repairs is not excessive; (3) the repairs do not repair more than the damage suffered; and (4) the repairs do not increase the property's value to above its value immediately before the casualty.[8]

The total amount of a claimed casualty loss cannot exceed a taxpayer's adjusted tax basis in the property damaged.[9] The regulations provide that a taxpayer's casualty loss is the lesser of (1) the decrease in the value of the property, measured by the difference between the FMV of the property immediately before and immediately after the casualty, and (2) the taxpayer's adjusted basis in the property damaged.[10]

In addition, a casualty loss deduction under Sec. 165 may be claimed only to the extent that there is no prospect that the loss or a portion of the loss will be compensated for by insurance or other reimbursement. The regulations[11] 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 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.

1. Sec. 165(c).
2. Secs. 165(c)(1) and (2).
3. Sec. 165(c)(3).
4. Secs. 165(h)(5)(B) and (i)(5), as added and amended by Section 11044(a) of P.L. 115-97.
5. Regs. Sec. 1.165-7(a)(1).
6. Sec. 165(h).
7. Regs. Sec. 1.165-7(a)(2).
8. Regs. Sec. 1.165-7(a)(2)(ii).
9. Sec. 165(b) and Regs. Sec. 1.165-1(c)(1).
10. Regs. Sec. 1.165-7(b).
11. Regs. Sec. 1.165-1(d)(2)(i).

This limitation applies only to losses sustained under Sec. 165. As such, this 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, that are deductible under Sec. 162(a).

Example 1:[12] 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 damage to his home. The money spent by the taxpayer is not considered a betterment to the unit of property.[13]

The insurance company and the taxpayer in November 2017 enter into a settlement agreement by which the insurance company agrees to pay $80,000 in full payment for the damage 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 ($100,000 repair cost minus $80,000 insurance settlement), since the taxpayer does not have any other claims for reimbursement. Since this loss is considered a personal casualty, it will be decreased by 10% of the taxpayer's AGI and $100. Also, note that if the fire had occurred after Dec. 31, 2017, under the change made by P.L. 115-97, the loss (to the extent greater than any casualty gains) would not be deductible at all, pursuant to new Sec. 165(h)(5), unless it was attributable to a federally declared disaster.

Example 2: Assume the same facts in Example 1, except the taxpayer also files a lawsuit in 2017 against a neighbor who negligently started the fire. There is a reasonable prospect that the taxpayer will be able to recover the remaining $20,000 in damages from the neighbor.

Since the taxpayer has an outstanding claim at the close of 2017, he has a reasonable prospect of recovering the remaining amount of the loss. Therefore, no deduction is allowed for this portion of the loss in 2017 since the taxpayer may receive compensation for the damage to the residence. If the taxpayer's suit against the neighbor is dismissed in 2019, the taxpayer may claim the casualty loss of $20,000 in the 2019 tax year (decreased by 10% of the taxpayer's AGI and $100).

A taxpayer who claims a casualty loss deduction under Sec. 165 must capitalize the expenditures made to restore the property, to the extent the casualty loss results in a basis adjustment to the damaged property.[14]

If a taxpayer claimed a loss in accordance with the rules set forth in the regulations and in a subsequent year receives reimbursement for the loss, the payment should be reported in the taxpayer's income in the year it is received. The taxpayer should not file an amended return for the year that the loss was claimed.[15]

Ordinary and necessary business expenses

If the taxpayer repairs capital property that was damaged in a casualty, the issue becomes whether the taxpayer can claim an ordinary deduction under Sec. 162(a). The tangible property, or "repair," regulations[16] 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.[17] Improvements are activities performed to a unit of property

12. Based upon Regs. Sec. 1.165-1(d)(2)(ii).
13. Regs. Sec. 1.263(a)-3(j).
14. Regs. Sec. 1.263(a)-3(k)(1)(iii).
15. Regs. Sec. 1.165-1(d)(2)(iii).
16. Regs. Sec. 1.162-4(a).
17. Regs. Sec. 1.263(a)-3(d).

EXECUTIVE SUMMARY

- The deduction for an individual's personal casualty loss of property not connected with (1) a trade or business or (2) a transaction entered into for profit arising after Dec. 31, 2017, and before Jan. 1, 2026, has been eliminated, with several exceptions.
- Business taxpayers may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized. However, expenditures that result in an improvement to the property must be capitalized.
- Amounts paid for certain restorations of tangible property, including restoration of damage for which the taxpayer is required to adjust the property's basis, must be capitalized.
- Under a safe harbor, a qualifying small taxpayer may elect not to apply capitalization rules to eligible building property for amounts paid to repair, maintain, or improve the property.
- Taxpayers must take care to properly substantiate amounts connected with a casualty and its repair and restoration.

after the property is placed in service if the amounts paid for the activities are for a betterment of the property, restore the property, or adapt the unit of property to a new or different use.[18] According to regulations, an expense is a betterment 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;
> (ii) Is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component . . . to the unit of 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.[19]

Issues may arise as to whether an expense is deductible as an ordinary and necessary business expense. In *Welch v. Helvering*,[20] the Supreme Court explored what constitutes an "ordinary" expense:

> 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 unlikely. [Nonetheless], 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. . . . 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.

Generally, taxpayers bear the burden of proof to properly substantiate their claimed deductions, including for repairs.

Similarly, the Tax Court in *Vaksman*[21] stated:

> An expense is "ordinary" if it is "normal, usual, or customary" in the taxpayer's trade or business. . . . An expense is "necessary" if it is "appropriate and helpful". . . . 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. . . . 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.

Does Sec. 165 take priority over Sec. 162(a)?

In a Tax Court case, *R.R. Hensler, Inc.*,[22] 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. Several years after the contract was entered into, there were severe rainstorms over a period of approximately one month. The taxpayer's extraction system and machinery and equipment were severely damaged.

A dispute arose between the taxpayer and its insurance company. The taxpayer filed a suit against the insurance carrier in 1969 that was settled in 1972. The IRS asserted in its notice of deficiency that the taxpayer's repair and replacement expenses were not deductible prior to 1972, the year in which the taxpayer's suit with the insurance carrier was resolved. The court was asked to decide whether a deduction was allowable under Sec. 162(a) or Sec. 165.

In determining whether a deduction was allowable under Sec. 162(a), the court analyzed whether the expenses were ordinary and necessary in the taxpayer's business and determined they were. The expenses were necessary, the court found, as recovering and repairing equipment buried by the flood was directly related to the taxpayer's business and performing its contract. They also were ordinary, even though large, in the sense that the flooding that occasioned them was not unique or unanticipated, the decision to recover and repair the equipment was not unsound, and the repair work was not performed in an unusual or abnormal manner. Whether the expenses were capital or deductible in nature was not before the court, although, in *dicta*, the court recognized

18. Id.
19. Regs. Sec. 1.263(a)-3(j).
20. *Welch v. Helvering*, 290 U.S. 111 (1933).
21. *Vaksman*, T.C. Memo. 2001-165; see also *R.R. Hensler, Inc.*, 73 T.C. 168 (1979).
22. *R.R. Hensler, Inc.*, 73 T.C. 168 (1979).

that expenditures of restoring damaged property may in some cases have to be capitalized:

> [I]f 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.

The IRS argued that the expenses were incurred as the result of a casualty and, therefore, the casualty loss rules of Sec. 165 applied. As such, the IRS argued no deduction should be allowed prior to 1972, when the taxpayer's claim with the insurance company was resolved, and a year not before the court. Rejecting the IRS's argument that the taxpayer was bound by Sec. 165, the Tax Court held that under Sec. 162(a), the taxpayer was allowed to claim an ordinary loss in the tax year of the expenditure for repairs, based upon their cost.

CCA 199903030: The measure of damage

The IRS Chief Counsel adopted the Tax Court's decision in *R.R. Hensler, Inc.*, holding in Chief Counsel Advice (CCA) 199903030 that the costs of restoring uninsured business property damaged by flooding could be currently deductible under Sec. 162. The CCA explained that although repair costs can serve as evidence for the amount of reduction in the property's FMV for claiming a casualty loss deduction under the method of Regs. Sec. 1.165-7(a)(2)(ii) (described above), the loss is based on this change in FMV. The CCA then 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 [Sec.] 162 or they may be treated as capital expenditures under [Sec.] 263. . . . [Regs. Sec.] 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 [Sec.] 162. . . .
>
> However, [Sec.] 263 prohibits deductions for capital expenditures. [Sec.] 263(a)(1) provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase . . . the value of any property or estate. Moreover, [Sec.] 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.[23]

No double deduction

Once a taxpayer deducts casualty repair costs under Sec. 162(a), it cannot then also claim a casualty loss under Sec. 165 with respect to damage to the same property. In *J.G. Boswell Co.*, a casualty loss deduction was disallowed where, among other reasons, flooded cropland had been restored and a deduction under Sec. 162 claimed for costs of the restoration.[24]

Should expenditures to restore property that suffered casualty loss be capitalized?

The regulations[25] on capitalization of restorations provide:

> (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 [Regs. Sec.] 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 as a result of a casualty loss under [Sec.] 165, or relating to a casualty event described in [Sec.] 165, subject to the limitation in [Regs. Sec. 1.263(a)-3(k)(4)]. . . ;
>
> (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;

23. Quoting Regs. Sec. 1.263(a)-1(b).
24. *J.G. Boswell Co.*, 302 F.2d 682 (9th Cir. 1962), aff'g 34 T.C. 539 (1960). See also Regs. Sec. 1.161-1 and *Gras*, T.C. Memo. 1974-230.
25. Regs. Sec. 1.263(a)-3(k)(1).

(v) Results in the rebuilding of the unit of property to a like-new condition as determined under [Regs. Sec. 1.263(a)-3(k)(5)] . . . after the end of its class life as defined in [Regs. Sec. 1.263(a)-3(i)(4)] . . . ; 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 [Regs. Sec. 1.263(a)-3(k)(6)].

A taxpayer who incurs a casualty loss of property that is used in a trade or business probably would prefer to claim the loss under Sec. 162(a) as an ordinary and necessary business expense, rather than claiming a casualty loss deduction under Sec. 165.

If a taxpayer claims a casualty loss, the taxpayer must reduce the basis of the property by the amount of the casualty loss.[26] A taxpayer must also reduce its basis by the amount of any insurance reimbursement, even if no deduction is claimed for the casualty loss.[27] Where a taxpayer recovers insurance proceeds that exceed 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.[28]

Example 3:[29] *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 Sec. 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 repairing the building's roof and removing debris from the building premises, for which *B* pays the contractor $50,000.

B must treat the $50,000 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 Sec. 165, and the amount does not exceed the limit in Regs. Sec. 1.263(a)-3(k)(4) (generally, the adjusted basis of the property over the amount paid for its restoration that also constitutes an improvement). Therefore, *B* must treat the amount paid as an improvement to the building unit of property and capitalize the amount paid.

Example 4:[30] Assume the same facts as in Example 3, except that *B* receives insurance proceeds of $50,000 after the casualty to compensate for its loss.

B cannot deduct a casualty loss under Sec. 165 because its loss was compensated by insurance. However, *B* properly reduces its basis in the property by the amount of the insurance proceeds. *B*'s basis in the property after the receipt of the insurance payment of $50,000 and the amount paid to the contractor remains $500,000.

The casualty loss deduction cannot exceed the taxpayer's basis in the property.[31] 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 Code and regulations that are otherwise applicable. See, for example, Regs. Sec. 1.162-4 (repairs and maintenance); Regs. Sec. 1.263(a)-2 (costs to acquire and produce units of property); and Regs. Sec. 1.263(a)-3 (costs to improve units of property).[32] Thus, based upon the nature of the expenditure, it may be deductible as an ordinary and necessary expense, or it may be capitalized if it is an improvement.

Example 5:[33] *C* owns a building that it uses in its trade or business. A storm damages the building at a time when it has an adjusted basis of $500,000. *C* determines that the cost of restoring its property is $750,000, deducts a casualty loss under Sec. 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, for which it pays the contractor $750,000. 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 drywall and flooring at a

26. Regs. Sec. 1.263(a)-3(k)(1)(iii).
27. Regs. Sec. 1.165-1(c)(4).
28. *Lafavre*, T.C. Memo. 2000-297; *Elliston*, T.C. Memo. 1973-4.
29. Based on Regs. Sec. 1.263(a)-3(k)(7), Example (3).
30. Based on Regs. Sec. 1.263(a)-3(k)(7), Example (4).
31. Regs. Sec. 1.165-1(c)(1).
32. Regs. Sec. 1.263(a)-3(k)(4)(ii).
33. Based on Regs. Sec. 1.263(a)-3(k)(7), Example (5).

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.

Under Regs. Sec. 1.263(a)-3(k)(1)(vi), *C* must capitalize as an improvement the $350,000 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 Regs. Secs. 1.263(a)-3(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. 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. 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. *C* is not required to capitalize the remaining $250,000 repair and cleaning costs.

Elective provisions

Safe harbor for small taxpayers

The regulations[34] provide that a qualifying taxpayer (defined below) may elect to not apply the capitalization rule under Regs. Sec. 1.263(a)-3(d) or (f) to an eligible building property (defined below) if the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the eligible building property does not exceed the lesser of (1) 2% of the unadjusted basis of the eligible building property; or (2) $10,000. If the taxpayer qualifies under this safe harbor, the amounts expended for repairs, maintenance, improvements, and similar activities will qualify for ordinary income tax deductions.[35] To qualify for the safe harbor, the taxpayer must meet the following tests:

- The taxpayer must be a "qualifying taxpayer," a taxpayer whose average annual gross receipts for the three preceding tax years is less than or equal to $10 million.[36]
- The expenses are paid for "eligible building property," a building, condominium, cooperative, or a leased building or portion of building that has an unadjusted basis of $1 million or less.[37]
- The taxpayer makes an election by filing a statement titled "Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers" on a timely filed federal tax return, including extensions, for the tax year in which the repairs, maintenance, and improvements are performed on the eligible building.[38]

Example 6:[39] *A* is a qualifying small taxpayer that owns an office building in which it provides consulting services. In year 1, *A*'s building has an unadjusted basis of $750,000. 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 million or less, *A*'s building constitutes eligible building property. 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% of the building's unadjusted basis of $750,000) or $10,000. Therefore, *A* may elect to not apply the capitalization rule of Regs. Sec. 1.263(a)-3(d) to the amounts paid for repair, maintenance, improvements, or similar activities on the office building in year 1. If *A* properly makes the small taxpayer election 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 Regs. Sec. 1.162-1 in year 1.

Example 7:[40] Assume the same facts as in Example 6, 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 Regs. Sec. 1.263(a)-3(h)(1), *A* may not apply the safe harbor for small taxpayers to the total amounts paid for repairs, maintenance, improvements, and similar activities performed on the building. Therefore, *A* must apply the general improvement rules under Regs. Sec. 1.263(a)-3 to determine which of the aggregate amounts paid are for improvements and must be capitalized, and which of the amounts are for repair and maintenance under Regs. Sec. 1.162-4.

Taxpayer's election to capitalize repair and maintenance costs

The regulations[41] provide:

34. Regs. Sec. 1.263(a)-3(h).
35. Regs. Sec. 1.263(a)-3(h)(7).
36. Regs. Sec. 1.263(a)-3(h)(3).
37. Regs. Sec. 1.263(a)-3(h)(4). Unadjusted basis is defined as the cost of the property without regard to adjustments for depreciation, amortization, obsolescence, depletion, or to amounts for which the taxpayer has elected to treat as an expense (e.g., amounts elected to be expensed under Sec. 179). See Regs. Sec. 1.263(a)-3(h)(5).
38. Regs. Sec. 1.263(a)-3(h)(6).
39. Based on Regs. Sec. 1.263(a)-3(h)(10), Example (1).
40. Based on Regs. Sec. 1.263(a)-3(h)(10), Example (2).
41. Regs. Sec. 1.263(a)-3(n)(1).

The deduction for personal casualty losses was greatly limited by the passage of P.L. 115-97, known as the Tax Cuts and Jobs Act of 2017.

> In general. A taxpayer may elect to treat amounts paid during the taxable year for repair and maintenance (as defined under [Regs. Sec.] 1.162-4) to tangible property as amounts paid to improve that property under [Regs. Sec. 1.263(a)-3] 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. . . . A taxpayer that elects to apply this [Regs. Sec. 1.263(a)-3(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 [Regs. Sec.] 1.162-4.

The taxpayer must make this election on its timely filed federal return, including extensions, by attaching a statement for the tax year in which the taxpayer paid the amounts for repair and maintenance. 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 Regs. Sec. 1.263(a)-3(n). A taxpayer making this election for a tax year must treat any amounts paid for repairs and maintenance during the tax 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 these improvements when the taxpayer places them in service, under applicable Code and regulations provisions.[42]

> ***Example 8:***[43] *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 Regs. Sec. 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 to treatment as routine maintenance under Regs. Sec. 1.263(a)-3(i)(3) apply to the scheduled maintenance costs and that the scheduled maintenance on *Q*'s towboat is within the routine maintenance safe harbor under Regs. Sec. 1.263(a)-3(i)(1)(ii).

42. Regs. Sec. 1.263(a)-3(n)(2).
43. Based on Regs. Sec. 1.263(a)-3(n)(4), Example (1).

Accordingly, the amounts paid for the scheduled maintenance to the towboat engines in year 4 are deemed not to improve the towboat and are not required to be capitalized.

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 the election to capitalize repair and maintenance costs, in year 4, *Q* may elect to capitalize the amounts paid for the scheduled maintenance on its towboat engines. If *Q* elects to capitalize these amounts, it must capitalize all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in year 4.

Issues that taxpayers should substantiate

Generally, taxpayers bear the burden of proof to properly substantiate their claimed deductions, including for repairs.[44] The types of issues and situations for which taxpayers should determine the proper treatment of property and retain substantiating records include:

- Documentation substantiating that the taxpayer's property suffered a casualty loss.
- A taxpayer who uses property in a trade or business or a transaction entered into for profit, incurred a casualty, and 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.
- Did the taxpayer have any insurance? Did the taxpayer receive a payment from the insurance company? Are there any claims for insurance reimbursement that have not yet been resolved? Are there any claims against anyone for the damage suffered by the taxpayer?
- For any damage incurred, did the taxpayer replace the damaged property with property that was similar in kind to the property replaced? If not, was the amount expended a betterment to the property?
- Following the restoration of property damaged by the casualty, was the taxpayer using the property for a different purpose than it was used for prior to the casualty?
- If a taxpayer is claiming a casualty loss deduction for the amount paid to restore the property under Sec. 165(c), the taxpayer will need to establish by appraisal the FMV of the property immediately before and after the casualty or substantiate the amount paid to restore the property.
- What was the taxpayer's basis in the properties that incurred a casualty?

Issues may arise as to whether an expense is deductible as an ordinary and necessary business expense.

Final comments and conclusions

A taxpayer who incurs a casualty loss of property that is used in a trade or business probably would prefer to claim the loss under Sec. 162(a) as an ordinary and necessary business expense, rather than claiming a casualty loss deduction under Sec. 165. A taxpayer claiming a loss under Sec. 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 damage arising from the casualty, provided that the expenditure is not considered an improvement to the property.

If the casualty is deducted under Sec. 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, or claims against individuals or entities who 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.[45]

If property used in a trade or business suffers a casualty, a taxpayer may claim the cost of repairs and maintenance of the property as ordinary and necessary expenses.[46] However, if the expenditure results in an improvement or betterment of the property, the expenditure should be capitalized. ■

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44. See, e.g., *Hershberger*, T.C. Memo. 2014-63.
45. Regs. Sec. 1.165-1(d)(2)(i).
46. Regs. Sec. 1.162-4(a).