Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Susan Canavello
Associate Area Counsel (New Orleans)
(Small Business/Self-Employed)

from: Thomas D. Moffitt
Chief, Branch 2
(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your request for assistance dated May 23, 2008. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =

Year 1 =

Year 2 =

Month 1 =

Date 1 =

ISSUES

1. If the taxpayers use the cost indexes safe harbor method provided in Revenue Procedure 2006-32 to compute the decrease in fair market value of their personal-use residential real property, may the taxpayers also add to the

casualty loss an additional amount reflecting the decrease in fair market value of a wharf located on the same parcel of land that the taxpayers computed using one of the methods in § 1.165-7(a)(2)?

2. May the taxpayers amend the tax return on which they claimed a casualty loss for their personal-use residential real property using the cost indexes safe harbor method in Revenue Procedure 2006-32 to re-compute their casualty loss using either another safe harbor method or a method in § 1.165-7(a)(2) to determine the decrease in fair market value of their property?

CONCLUSIONS

1. If the taxpayers use the cost indexes safe harbor method provided in Revenue Procedure 2006-32 to compute the decrease in fair market value of their personal-use residential real property, they may not add to the casualty loss an additional amount computed using one of the methods in § 1.165-7(a)(2) reflecting the decrease in fair market value of a wharf located on the same parcel of land.

2. The taxpayers may amend the tax return on which they claimed a casualty loss for their personal-use residential real property using the cost indexes safe harbor method in Revenue Procedure 2006-32 to re-compute their casualty loss using either another safe harbor method or one of the methods in § 1.165-7(a)(2) to determine the decrease in fair market value of their property.

FACTS

The taxpayers contend that they sustained damage to the following improvements on their personal-use real property as a result of hurricane Rita: a residence, a camp, and a wharf. The taxpayers claimed a casualty loss deduction on their Year 1 tax return for the damage to their residence. The taxpayers computed the decrease in fair market value of their residence by comparing the fair market value of the residence immediately before the casualty with the fair market value immediately after the casualty. The taxpayers did not obtain an appraisal to determine the decrease in value.

In Month 1 of Year 2, the taxpayers filed an amended return for the Year 1 tax year to include as part of their casualty loss damage to the camp and wharf located on their property. The taxpayers re-computed the casualty loss on their amended return by using the cost indexes safe harbor method provided in Revenue Procedure 2006-32 to determine the decrease in fair market value of their residence, camp, and wharf. The casualty loss was limited to the taxpayer's basis in the residence, camp, and wharf.

The taxpayers' Year 1 return was selected for examination. On Date 1, while the examination was still open, the taxpayers filed a second amended return for the Year 1

tax year. On the second amended return, the taxpayers used tables 4 and 5 of the cost indexes safe harbor method to calculate the decrease in fair market value of their personal residence. The taxpayers calculated the decrease in fair market value of their wharf using the cost of repairs method. The amended return did not reflect a loss for damage to the camp.
The revenue agent disallowed the portion of the taxpayers' casualty loss deduction for the wharf. The taxpayers' representative asserts that the casualty loss should include both the damage to the residence (computed using the cost indexes safe harbor method) and the damage to the wharf (computed using the cost of repairs method). The taxpayer's representative contends that the wharf does not constitute personal-use residential real property, as defined in Revenue Procedure 2006-32, and thus the loss to the wharf should be calculated separately using the cost of repairs method and added to the loss calculated using the cost indexes safe harbor method. As the taxpayers are no longer claiming a casualty loss for damage to the camp, the casualty loss to the camp is not discussed in the analysis below.

LAW

Section 165(c)(3) of the Internal Revenue Code provides that individuals may deduct losses of property arising from fire, storm, shipwreck, or other casualty, or from theft. To compute a deductible casualty loss, taxpayers must determine: (1) the difference between the fair market value of the property immediately before and immediately after the casualty and (2) the adjusted basis of the property. Taxpayers may deduct the lesser of these two amounts minus insurance or other form of compensation they receive or reasonably expect to receive. *See* §§ 1.165-1(a), 1.165-1(d), 1.165-7(b)(1).

Section 1.165-7(a)(2) of the Income Tax Regulations provides two methods for taxpayers to determine the decrease in fair market value of property affected by a casualty. The first method is an appraisal. An appraisal must reflect only the physical damage to the property and not a general decline in the property's fair market value. *See* § 1.165-7(a)(2)(i). The second method is the cost to repair the property. *See* § 1.165-7(a)(2)(ii). The cost to repair the damaged property may be used as evidence of the decrease in value if the taxpayer makes the repairs and shows that the repairs: a. are necessary to bring the property back to its condition before the casualty; b. the amount spent for 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.

In determining a casualty loss involving real property and improvements thereon not used in a trade or business or in any transaction entered into for profit, the improvements (such as buildings and ornamental trees and shrubbery) to the property damaged or destroyed shall be considered an integral part of the property. No separate basis need be apportioned to such improvements. Section 1.165-7(b)(2)(ii).

Revenue Procedure 2006-32 provides three safe harbor methods that individuals who suffered property damage from hurricanes Katrina, Rita, or Wilma may use as alternatives to the methods set forth in § 1.165-7(a)(2)(i) and (ii) to determine the decrease in the fair market value of their personal-use residential real property that was damaged or destroyed by these hurricanes. These methods are the insurance safe harbor method, the contractor safe harbor method, and the cost indexes safe harbor method. Section 3.02 of the revenue procedure defines personal-use residential real property as real property, including improvements (such as buildings and ornamental trees and shrubbery) that is owned by the individual who suffered a casualty loss, that contains at least one personal residence and that is not used in a trade or business or in a transaction entered into for profit.

Under the insurance safe harbor method, an individual may use the estimated loss determined in reports prepared by the individual's homeowners' or flood insurance company setting forth the estimated loss the individual sustained as a result of the damage to or destruction of the individual's personal-use residential real property from hurricanes Katrina, Rita, or Wilma to determine the decrease in fair market value of the property.

Under the contractor safe harbor method, an individual may use the contract price for the repairs specified in an itemized contract prepared by a contractor, licensed or registered in accordance with state or local regulations, and signed by the individual and the contractor, setting forth the costs to restore the individual's personal-use residential real property to its pre-hurricane condition to determine the decrease in the fair market value of the individual's personal-use residential real property.

Under the cost indexes safe harbor method, an individual may use one or more cost indexes to determine the decrease in fair market value of the individual’s personal-use residential real property. Section 4.04 provides that the cost indexes method applies only to the following types of improvements to the personal-use residential real property: the personal residence, detached structures, and pressure-treated wood decking. If there is any other type of improvement to the property, an individual may use the cost indexes safe harbor method to determine the decrease in fair market value of the personal-use residential real property, but may not add on any amount for any other type of improvement. As one example, the revenue procedure provides that an individual may not use the cost indexes safe harbor method for a deck made of synthetic material or hardwood that is not pressure treated. Therefore, if an individual chooses to utilize the cost indexes safe harbor method, then the amount determined represents the total decrease in fair market value of the personal-use residential real property.

ANALYSIS

Issue 1

In the present case, the taxpayers contend that they sustained damage to their residence, as well as to a wharf, on their personal-use real property that was attributable to hurricane Rita. On their first amended return for tax year Year 1, the taxpayers used the cost indexes safe harbor method to compute the decrease in fair market value of their personal residence, and added to the casualty loss an amount reflecting the decrease in fair market value of the wharf that was situated on the same parcel of land. Section 3.02 of the revenue procedure defines personal-use residential real property as real property, including improvements (such as buildings and ornamental trees and shrubbery) that is owned by the individual who suffered a casualty loss, that contains at least one personal residence and that is not used in a trade or business or in a transaction entered into for profit. Both the personal residence and the wharf situated on the taxpayers' real property would constitute improvements to the property. As indicated above, however, section 4.04 of Revenue Procedure 2006-32 expressly provides that the cost indexes safe harbor method encompasses only three types of improvements, namely a personal residence, a detached structure, and a pressure-treated wood deck. If there is any other type of improvement on an individual's personal-use residential real property, the individual may not add any amount for the other type of improvement. The decrease in fair market value computed using the cost indexes safe harbor method represents the decrease in fair market value of the entire property, including all other types of improvements to the property. Therefore, if the taxpayers used the cost indexes safe harbor method in determining the casualty loss for their personal-use residential real property, they may not add on any amounts to the loss for the damage to the wharf.

Issue 2

The taxpayers may amend their return to use one of the methods for determining the decrease in fair market value in § 1.165-7(a)(2), namely an appraisal or the cost of repairs. Alternatively, the taxpayers may amend their return to use one of the other safe harbor methods provided by Revenue Procedure 2006-32, namely the insurance or contractor safe harbor method, assuming the taxpayers comply with the requirements to use these methods. The taxpayers may apply only one of the safe harbor methods to a single parcel of personal-use residential real property. The taxpayers may use any one of these methods to compute the decrease in fair market value of their entire parcel of personal-use residential real property. Because the taxpayers' property is personal-use property, the improvements to the property (such as the residence and wharf) must be considered an integral part of the property. No separate basis is apportioned to the improvements and no separate computation is made for the decrease in fair market value of each improvement to the property.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-7900 if you have any further questions.

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