

STATE OF ALABAMA  
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

v.

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DOCKET NO. INC. 87-163

JAMES L. & MARY BUTLER  
2608 Belle Meade Drive, N.E.  
Huntsville, AL 35811,

§  
§

Taxpayers.

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#### ORDER

The Department assessed income tax against James L. and Mary Butler ("Taxpayer(s)") for the year 1983. A hearing was conducted in the matter on October 15, 1987. Mr. James L. Butler, Jr. was present and represented the Taxpayers. Assistant counsel mark Griffin appeared for the Department. Based on the evidence submitted at said hearing, the following findings of fact and conclusions of law are hereby made and entered.

#### FINDINGS OF FACT

In January, 1983, a severe freeze caused a waterpipe to burst in a cement block wall in the basement of the Taxpayers' residence. Water saturated the wall and subsequently froze and expanded, causing a single 1/4 inch vertical crack between the cement blocks in the wall. The crack zigzags almost from top to bottom of the approximately eight foot high wall. Over the last four and one-half years, the crack has expanded to approximately 5/16ths of an inch in width. The wall is loadbearing, but there is no apparent structural damage.

The Taxpayers have not filed an insurance claim for the damage. Rather, they contacted their insurance agent, the wife's brother, and he informally reported that the damage would probably not be covered. No further action has been taken. However, the Taxpayers have indicated that a claim may be filed in the future.

The Taxpayers claimed a \$14,900.00 casualty loss on their 1983 Alabama return. The Taxpayers calculated the pre-freeze value of the house by adjusting the 1978 purchase price for inflation. The post-freeze value, again as estimated by the Taxpayers, was then subtracted to arrive at the \$14,900.00 loss amount.

In January 27, 1987, the Taxpayers obtained an independent estimate of \$18,954.00 for replacement of the entire block wall. However, to date only minor cosmetic work has been performed. No evidence was introduced as to existing or possible future structural damage or whether the wall must be repaired or replaced in the future.

The Department initially disallowed the deduction on two grounds: (1) The amount of the loss was unsubstantiated, and (2) The damage was caused by a leaking pipe and thus did not meet the "suddenness" test of Code of Ala. 1975, §40-18-15(a)(6) and Reg. 810-3-15-.07. The Department now adds that the deduction should be disallowed because there is still a reasonable expectation of full or partial recovery through insurance.

CONCLUSIONS OF LAW

Code of Ala. 1975, §40-18-15(a)(6) allows a "casualty loss" deduction for losses arising from storms, fires, shipwrecks and like-kind sudden and unforeseen destructive events. To claim a deduction, a taxpayer is required to (1) establish that the destructive event was of a sudden and unforeseen nature, (2) adequately substantiate the existence and the amount of the loss, and (3) prove that the loss was from a closed and completed transaction in the year claimed.

The destructive event in the instant case was the severe freeze which caused a waterpipe to burst in the Taxpayers' basement wall. The escaping water saturated the wall and refroze the next night, causing the wall to crack. Clearly the freeze constituted a sudden and unexpected event within the purview of the casualty loss statute. Freeze damage has been recognized as a sudden and unexpected occurrence under 26 U.S.C., §165, the federal equivalent of §40-18-15(a)(6), see The Squirt Company v. C.I.R., 423 F.2d 710; Carloat Indust., Inc. v. U.S., 354 F.2d 814; Fiona Corp. v. U.S., 218 F.Supp. 354 .

The existence and extent of damage and the amount of the loss must also be proved. Westvaco v. U.S., 639 F.2d 700; Rosenthal v. C.I.R., 416 F.2d 491. The freeze directly caused the crack in the wall. But the crack is significant only if there is underlying foundation damage. No such structural damage has been established.

The Taxpayers argue that the crack threatens the foundation and

must be repaired. However, no evidence was introduced that the foundation has been substantially or even moderately weakened by the 1/4 inch crack. To the contrary, the crack has existed for almost five years with no apparent damage to the structure.

The purpose of the casualty loss deduction is to compensate for economic loss due to actual damage. Carloat Indust., Inc., supra. A loss must be disallowed if based on a prediction or future expectation of damage. Kamanski v. C.I.R., 477 F.2d 452; Pulvers v. C.I.R., 407 F.2d 838. Thus, while the wall may substantially deteriorate in the future, there is insufficient evidence that it is at present structurally unsound.

Also, the Taxpayers failed to provide adequate evidence as to the dollar amount of any damage. A casualty loss is measured by the difference between the fair market value immediately before the destructive event and the fair market value immediately afterward. Helvering v. Owens, 59 S.Ct. 26, 305 U.S. 468; U.S. v. Koshland, 208 F.2d 636. The Taxpayers used their own inflation adjusted estimates of pre-freeze and post-freeze value in computing the loss. Those self-serving estimates, without independent verification, are insufficient to establish the amount of the loss, especially without evidence that major structural damage has in fact occurred. The repair estimate obtained by the Taxpayers in 1987 was too far removed in time from the actual destructive event to provide an accurate measure of damages, again especially

without. evidence that the repairs are necessary and that a loss has occurred.

The deduction in question must be denied because the Taxpayers failed to prove the extent of damage and the amount of loss. However, the insurance coverage issue should be addressed for the benefit of the parties.

A casualty loss deduction will be allowed notwithstanding a taxpayer's failure to file a valid insurance claim. Miller v. C.I.R., 733 F.2d 399.<sup>1</sup> However, if insurance reimbursement is reasonably anticipated, and the scope and amount of coverage is uncertain, the deduction should not be taken until the uncertainties are finally settled. C.I.R. v. Harwick, 184 F.2d 835; Boston & M.R.R. v. C.I.R., 206 F.2d 617; Miller v. C.I.R., supra.

On the other hand, Department Reg. 810-3-15-.07(3) provides that if the amount of compensation cannot be anticipated in the loss year, the entire loss should be claimed in that year and any subsequent reimbursement reported as income in the year received. The regulation conflicts with the above cited case law. However,

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<sup>1</sup>Miller overruled Kentucky Utilities Co. v. Glenn, 394 F.2d 631 and Bartlett v. U.S., 397 F.Supp. 216, which held that a deduction could not be claimed if a taxpayer voluntarily elected not to file an insurance claim for reimbursement of the loss. However, effective in 1987, Congress has itself effectively overruled Miller and reinstated by legislation the Kentucky Utilities and Bartlett rationale by passage of 26 U.S.C., §165(h)(4). That section requires that a casualty loss cannot be claimed unless a person covered by insurance actually files a claim for reimbursement.

under the circumstances, the Taxpayers properly attempted to claim a loss in 1983, as allowed by the regulation. The Taxpayer's testimony that an insurance claim may be filed does not constitute a reasonable expectation of insurance reimbursement. Recovery of insurance is unlikely due to the lack of evidence confirming structural damage.

The above considered, the Revenue Department is hereby directed to make the preliminary assessment in issue final, with applicable interest as required by statute.

Done this 24th day of November, 1987.

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BILL THOMPSON  
Chief Administrative Law Judge