

Recommendations for Published Guidance under IRC § 165(c): Issue Published Guidance To Provide a Safe Harbor That Treats Certain Damage Resulting From Crumbling Concrete Foundations As a Casualty Loss And Provide a Formula For Determining the Amount of the Loss

Recommendation

Issue a Revenue Procedure that provides guidance to individuals on the federal income tax treatment of amounts paid to repair damage to their personal residences resulting from deteriorating concrete foundations, addressing what constitutes a deductible casualty loss, the tax year in which the loss is deductible, and how to compute the amount of the loss.

Reasons for Change

Pursuant to the Governor's request in August 2015, the Connecticut Office of the Attorney General and Department of Consumer Protection ("DCP") conducted an investigation into numerous complaints (450+) of failing concrete foundations. Their inquiry evaluated whether, based on scientific knowledge and industry standards at the time foundations were installed, any party misled or used improper business practices and if so, whether viable legal remedies exist to remedy any harms. The investigation found insufficient basis to support claims that the Joseph J. Mottes ("Mottes") Company or others in the concrete production or home construction industries violated Connecticut consumer protection laws. Additionally, investigators concluded there was insufficient evidence to bring an action against the State under the Connecticut Unfair Trade Practices Act. However, the investigation found sufficient evidence that significant levels of the mineral pyrrhotite in stone aggregate used in the production of concrete was a substantial contributing factor to the crumbling foundations in eastern Connecticut. Additionally, the report revealed that no foundations poured outside of 1983 to 2010 had been reported to DCP as having deteriorating concrete, and that given the uncertainty in predicting the time for the condition to manifest itself, it is possible that the affected date range will expand. The minimum amount of pyrrhotite needed to trigger deterioration is not yet known.

Section 165(a) of the Internal Revenue Code (IRC) generally permits taxpayers to deduct losses sustained during the taxable year that are not compensated by insurance or otherwise. For personal-use property (such as a taxpayer's personal residence and household appliances), IRC § 165(c)(3) limits an individual's deduction to losses arising from fire, storm, shipwreck, *or other casualty*, or from theft.

The original income tax statute passed in 1913 allowed deduction only for losses arising from 'fires, storms, or shipwreck.'¹ In 1916, the statute was amended to add the words 'or other casualty, and from theft.'² There appears to be no additional legislative history

¹ 38 Stat. 114, 167.

² 39 Stat. 756, 759.

on how the words ‘or other casualty’ were defined. As such, courts have had to determine whether the facts in each case come within the scope of the statute, and consequently have produced varying results. Generally, an “other casualty” has been defined by the courts to mean a loss proximately caused by a sudden, unexpected, or unusual event, excluding progressive deterioration.³

The IRS has defined “other casualty” similarly: A casualty is damage, destruction, or loss of property that results from an identifiable event that is sudden, unexpected, and unusual.⁴ However, damage or loss resulting from progressive deterioration of property through a steadily operating cause is not a casualty loss.⁵ Section 165(h)(1)-(2) furthermore imposes two limitations on casualty loss deductions for personal use property. First, a casualty loss deduction is allowable only for the amount of the loss that exceeds \$100 per casualty (\$500 for taxable years beginning in 2009 only). Second, the net amount of all of a taxpayer’s casualty losses (in excess of casualty gains, if any) is allowable only for the amount of the losses that exceed ten percent of the taxpayer’s adjusted gross income (AGI) for the year.

Additionally, a casualty loss is allowed as a deduction only for the taxable year in which the loss is sustained. If the taxpayer has a claim for reimbursement of the loss (from insurance or otherwise) for which there is a reasonable prospect of recovery however, no portion of the loss is deductible until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.⁶

Although negligent or faulty construction may not be cause for a casualty deduction, there is precedent for allowing tax relief due to damage from corrosive drywall that deteriorated over time.⁷ In early 2009, the U.S. Consumer Product Safety Commission (CPSC) launched an investigation into problem drywall installed in homes between 2001 and 2008 to determine if there was a health and safety hazard. The agency joined forces with the U.S. Department of Housing and Urban Development (HUD), the U.S. Centers for Disease Control and Prevention (CDC), and the U.S. Environmental Protection Agency (EPA) to form the Federal Interagency Task Force on Problem Drywall. Investigators determined a strong association between problem drywall, hydrogen sulfide and corrosion, leading to the development of identification and remediation guidance for homeowners with problem drywall. CPSC received 3,905 reports from residents of 42 states and the District of Columbia, American Samoa, and Puerto Rico, who believed their health symptoms or the corrosion of certain metal components in their homes were related to problem drywall. For purposes of this special procedure, “corrosive drywall” means drywall that is identified as problem

³ See, e.g., *Matheson v. Comm’r*, 54 F.2d 537 (2d Cir. 1931); *White v. Comm’r*, 48 T.C. 430 (1967).

⁴ Rev. Rul. 72-592, 1972-2 C.B. 101.

⁵ See *Matheson*, 54 F.2d 537 (taxpayer suffered losses as a result of rusting and corrosion of reinforcing steel used in cement floor beams of a residence; loss was found to be due to the ordinary action of the elements upon a poorly constructed building, not a casualty event due to a sudden, unexpected, or unusual causes).

⁶ See Treas. Reg. § 1.165-1(c)(4).

⁷ Rev. Proc. 2010-36, 2010-42 I.R.B. 439.

drywall under the two-step identification method published by the Consumer Product Safety Commission (CPSC) and the Department of Housing and Urban Development (HUD) in their interim guidance dated January 28, 2010, as revised by the CPSC and HUD.

Based on information provided by CPSC, the IRS allows certain impacted taxpayers whose homes meet the CPSC's problem drywall identification criteria to treat damages from corrosive drywall as a casualty loss, and provides a "safe harbor" formula for determining the amount of the loss. The amount of a taxpayer's casualty loss generally is the decrease in the fair market value of the property as a result of the casualty, limited to the taxpayer's adjusted basis in the property.⁸ To simplify the computation of a casualty loss deduction, existing regulations permit taxpayers to use the cost to repair the damaged property as evidence of the decrease in value of the property.⁹

Similarly, homeowners experiencing crumbling foundations have seen the fair market value of their homes decrease dramatically since discovering the damage. If there is not an accurate appraisal of the property prior to any damage to the concrete foundations, it could be extremely difficult to determine just how much of the loss is attributable to the presence of the mineral pyrrhotite versus an overall decline in residential housing prices.

Connecticut legislature passed Public Act 16-45¹⁰ during the 2016 legislative session to provide state residents with deteriorating foundations an avenue for having their home value reassessed, assuring that information of complainants will be protected for seven years, and making it mandatory to record a concrete supplier and installer in the application process for new building permits. Under the state law affected homeowners are required to use the following two step process in order to reduce their property assessment values and associated real property taxes:

- 1) To provide a written evaluation from a licensed engineer indicating that the foundation was made with defective concrete; and
- 2) To provide a reassessment report from the county assessor's office, which reassessed the value of the residential property based on the written evaluation from the engineer and an inspection as required by state law.¹¹

The IRS may adopt use this bright line test in its guidance to avoid (or limit) the risk of unsubstantiated casualty loss deductions. Using this method would also provide the amount of the casualty loss which would be the assessment value prior to reassessment in accordance with the Pub. Act 16-45 minus the reassessment value (current value – after the adjustment for defective concrete).

⁸ See Treas. Reg. § 1.165-7(b).

⁹ See Treas. Reg. § 1.165-7(a)(2)(ii).

¹⁰ 2016 Conn. Legis. Serv. P.A. No. 16-45 (H.B. No. 5180) (West).

¹¹ *Id.*

This approach would not create additional compliance burden for affected taxpayers who are currently required to use the process under the state law to reduce their property assessment values and associated real property taxes.

In order to reduce taxpayer burden, promote compliance and in furtherance of the taxpayer *right to a fair and just tax system*, the National Taxpayer Advocate recommends that the IRS issues published guidance in a form of a Revenue Procedure that provides guidance to individuals on the federal income tax treatment of amounts paid to repair damage to their personal residences resulting from deteriorating concrete foundations, addressing what constitutes a deductible casualty loss, the tax year in which the loss is deductible, and how to compute the amount of the loss. By issuing a revenue procedure analogous to the corrosive drywall revenue procedure taxpayers have a clear method to claim a deduction for the cost of repairs due to deteriorating concrete foundations, which will improve compliance and fairness of tax administration in accordance with the Taxpayer Bill of Rights.¹²

¹² See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR that was adopted by the IRS are now listed in the Internal Revenue Code. See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).