BEFORE THE STATE BOARD OF 'EQUALIZATION

OF THE STATE OF CALIFORNIA

In, the Matter of the Appeal of)
)
FELIX AND ANNABELLE CHAPPELLET)

Appearances:

For Appellants: Thomas E. O'Sullivan
Attorney at Law

For Respondent: Jack E. Gordon
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Felix and Annabelle Chappellet against a proposed assessment of additional personal income tax in the amount of $864.23 for the year 1962,

The question for decision is whether respondent properly disallowed a portion of the casualty loss deduction claimed by appellants in their 1962 income tax return.

In 1956 appellants purchased approximately three acres of real estate near Beverly Hills, California. The property consisted of a naturally flattened hilltop which sloped off at about a forty-five degree angle into a canyon. In late 1957, under the supervision of an architect, appellants built a large home on the hilltop site. All necessary building permits were obtained and inspections made by the City of Los Angeles in connection with the improvement of this property.

Appellants landscaped the grounds around the house with trees, shrubberies, and lawn. Decorative outdoor fountains and planters were installed and concrete.

patio areas were laid. At the rear of the house where the property began to slope down into the canyon a concrete garden wall was erected. That wall was some 150 feet long, 3 feet high and extended about one foot into the ground. A drainage system was installed which diverted drain water away from this rear slope. Appellants' total investment in the property to date is in excess of $350,000.

During February of 1962 heavy rains occurred in the area of appellants* residence. Eight inches of rain fell during a six-day storm which commenced on or about February 8 Water collected on the patio area surrounding the house and the drainage system became clogged. As a result the water seeped under the concrete laid at the rear of the house, and on February 11, 1962, a portion of the back garden wall slid down the hillside. Parts of the driveway, lawn, sprinkler system, and several trees were also washed away, although the house Itself was not damaged by the storm. Appellants received no insurance or other recovery for this loss.

Thereafter appellants consulted three engineering firms for advice as to the best way to repair the storm damage which their property had sustained. Upon the recommendation of the Donald R. Warren Co., a firm of consulting engineers, appellants decided to construct a slope-stabilizing wall along the slide area. The design and specifications for that retaining wall were prepared by the Warren Company for a fee of $660.00. Thereafter appellants obtained bids from several contractors for the construction of the wall. The contract was awarded to the lowest bidder, the Edward R. Siple Company, which agreed to build the wall according to the Warren Company's specifications for a total price of $22,436.65.

The wall as designed consisted of a series of interlocking steel bins. Each bin was to be set into place and filled with dirt. The dirt would then be tamped down and topsoil placed in the top portion of the bins. The specified bins were some 10 feet wide and extended from 15 to 20 feet down, their height depending on variations in the contour of the slope. By interlocking the bins a structure of the desired size and shape could be formed.

Construction of this retaining wall was begun in August or September of 1962 and was completed and fully paid, for in October 1962. Heavy equipment was

used and crews of from three to ten men worked on it at various times. The completed wall was some 125 feet long. Appellants expended additional amounts to replace the washed out portions of the driveway, lawn, trees and shrubs, sprinkler system, and soil.

On their tax return for 1962 appellants deducted $31,342.92 for "Damage and loss to personal residence due to rain storm and floods in February, 1962." Upon examination of appellants' return respondent's auditor treated this figure as consisting of

Cost of retaining wall under Siple Company contract	$22,436.65
Additional expenditures for repair and replacement of damaged driveway, lawns, trees, etc.	8,906.27
Total	$31,342.92

Respondent disallowed $484.91 of the total deduction claimed for lack of substantiation. Of the remainder ($30,858.01), respondent allowed a casualty loss deduction of $10,858.01, consisting of $8,906.27 in repair expenditures and $2,436.65 of the cost of the retaining wall. Deduction of the rest of the cost of the wall, $20,000, was disallowed on the ground that it constituted a capital expenditure rather than an expenditure for repairs. Respondent's disallowance of $20,484.91 of the total casualty loss deduction claimed by appellants in their 1962 return gave rise to this appeal.

With respect to the $484.91 disallowed for lack of substantiation, respondent's disallowance of $376.69 of that amount was based on the fact that the cancelled checks offered by appellants to substantiate that portion of the deduction were dated prior to the casualty date. Respondent's disallowance of the remaining $108.22 was made on the ground that there was no proof of the alleged expenditures. It is well settled that deductions are a matter of legislative grace and the burden of proof is upon the taxpayer to show that he is entitled to the deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348].) Since appellants have presented no additional proof that the $484.91 was properly deductible, we must sustain respondent's disallowance of that

part of the total casualty loss deduction. The remainder of this opinion therefore relates to the $20,000 disallowed on the ground that it was a capital investment.

Section 17206 of the Revenue and Taxation Code provides:

> (a) There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
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> (c) In the case of an individual, the deduction under subsection (a) shall be limited to -
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> * * *
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> (3) Losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft,

Respondent's regulations (Cal. Admin. Code tit. 18, reg.. 17206(g) subdivision (l)(B)) provide that the amount of a casualty loss shall be determined as follows:

> (i) In determining the amount of loss deductible under this regulation, 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 deduction under this regulation shall be limited to the actual loss resulting from damage to the, property.
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> (ii) 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.

Both the statutory section and the regulation quoted above are substantially similar to their federal counterparts. (Int. Rev. Code of 1954, § 165; Treas. Reg. § 1.165-7(a)(2).)

Appellants concede that they have no competent appraisal evidence of the value of their residential property immediately before and after the 1962 storms. However, they contend that their erection of the steel retaining wall, on the advice of a firm of construction engineers, constituted a repair or restoration of what the property had been prior to the wash-out, and the cost of that structure should therefore be accepted as proof of the amount of the loss. They argue that the value of the property was not increased in any way by the construction of the new wall; if anything, they urge, the property value was diminished, since the completed wall was not particularly attractive and it made it obvious to any observer that the property had at one time been subjected to storm damage and resulting land slippage. Furthermore, appellants urge, it was by no means certain that the erection of the new steel wall had entirely cured the damage which had occurred, or that it would prevent further slippage in the future.

Respondent concedes that appellant sustained a casualty loss as a result of the heavy rains in February, 1962. Respondent argues, however, that the entire cost of the steel retaining wall was not an accurate measure of the loss in value of appellants' property. In support of this argument respondent contends that, in order for repair costs to be acceptable as the measure of the amount of a casualty loss, the repairs must merely restore the property to its condition before the casualty, even if that condition is defective. In the instant case respondent urges that after the new wall was completed appellants' property had something which it had not had before i. e., the prospect of increased slope stability and

strength in the face of similar storm conditions. That being so, respondent concluded that $2,436.65 of the total cost of the wall was a deductible casualty loss, and the remainder constituted a capital improvement to appellants' property.

The general rule is that the measure of a casualty loss on nonbusiness property is the difference between the fair market value of the property immediately before and immediately after the casualty, but not in excess of the adjusted basis of the property. (Helvering v. Owens, 305 U.S. 468 [83 L. Ed. 292]; W. F. Harmon, 13 T.C. 373; Graham M. Brush, T.C. Memo., May 23, 1962.) Furthermore, the loss of value must be the direct result of the actual physical damage to the property which was caused by the casualty. (Citizens Bank of Weston v. Commissioner, 28 T.C. 717, aff'd, 252 F.2d 425.) A deductible loss is not incurred where the property decreases in value merely because it is apparent that a casualty once occurred (Leonard J. Jenard, T.C. Memo., Mar., 15, 1961), or where the loss of value is due to fear on the part of prospective buyers that future casualty damage might occur (Frank P. Kendall, T.C. Memo., Aug. 29, 1958).

The taxpayer claiming a casualty loss deduction bears the burden of showing that the fair market value of his property decreased as a result of the casualty damage. Where a taxpayer is unable to produce competent appraisals, repair costs may be considered as evidence of loss of value, provided such expenditures were necessitated by the casualty, were reasonable in amount, and did not improve the property beyond its condition prior to the casualty. (Raymond Tank, 29 T.C. 677, 692; W. F. Harmon, 13 T.C. 373.)

Expenditures which improve the property beyond its condition immediately prior to the casualty are not a proper measure of the loss sustained, even though those expenditures may have been deemed advisable as a result of the casualty. (The Wellston Company, T.C. Memo., Mar. 18, 1965.) Such expenditures which do more than merely restore the property to its pre-casualty state are in the nature of nondeductible capital expenditures. (Richard A. Dow, 16 T.C. 1230; George B. Friend, 8 B.T.A. 712.) The Internal Revenue Service has taken the position that expenditures for protection against future casualties, such as the construction of a dike to prevent future flooding, are not deductible but should be capitalized as permanent improvements.

(Rev. Rul. 60-386, 1960-2 Cum. Bull. 107; Rev. Rul. 79 1953-1 Cum. Bull. 41; Internal Revenue Service Publication 547 (10-68).)

In our opinion appellants have failed to establish that the entire cost of constructing the steel retaining wall at the rear of their property in late 1962 constituted a reasonable measure of the casualty loss which they sustained. It may well be that the construction of that wall was deemed both necessary and wise after the severe storms which occurred in February 1962. However, we believe that upon completion of that wall appellants had something more than they had before the casualty, i.e., a hilltop lot which would withstand heavy rainfall; The fact that they may not have known prior to February 1962 that their land was subject to slippage does not alter the fact that, in truth, it was. By building the retaining wall appellants were not only restoring the property. to its condition before the storm but were protecting it against similar damage in the future. To that extent the cost of the wall constituted a nondeductible capital expenditure,

Appellants also contend that respondent acted arbitrarily when it allowed $2,436.65 of the cost of the new retaining wall under the Siple Company contract and disallowed $20,000 of that cost, However, the federal courts have upheld the application of the so-called "Cohan rule" (Cohan v. Commissioner, 39 F.2d 540) in cases of this type, where the taxing authority concedes that a casualty loss was sustained, but the taxpayer has failed to prove the exact amount of that loss. (Harry M. Leet, T.C. Memo., Jan. 24, 1955, aff'd, 230 F.2d 845; Herbert H. Nelson, T.C. Memo., Feb. 27, 1968; Andrew A. Maduza, T.C. Memo., Aug. 31, 1961.) On the record before us we find no basis for altering or overturning the determination of respondent in this regard.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue *and* Taxation Code, that the action of the Franchise Tax Board on the protest of Felix and Annabelle Chappellet against a proposed assessment of additional personal income tax in the amount of $864.23 for the year 1962, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of June, 1969, by the State Board of Equalization.

John W. Lynch, Chairman

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: J. F. Freeman, Secretary