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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **LARRY G. DIGHERA**) Case No. 515547

13
14 Year Proposed
15 2004 Assessment
16 \$148,177¹

16 Representing the Parties:

17 For Appellant: Joseph A. Vinatieri, Attorney at Law
18 For Franchise Tax Board: Raul A. Escatel, Tax Counsel

19
20 **QUESTION:** Whether appellant has shown that he is entitled to a claimed casualty loss deduction
21 under Internal Revenue Code (IRC) section 165 for 2004.

22 HEARING SUMMARY

23 Introduction

24 IRC section 165(c) provides that a casualty loss can be claimed for (1) a loss incurred in
25 a trade or business (IRC section 165(c)(1)), (2) a loss incurred from a transaction entered into for profit
26 (IRC section 165(c)(2)), or (3) a loss from a personal use asset (IRC section 165(c)(3)). The Franchise
27

28 ¹ This proposed assessment includes additions to appellant's income for the disallowance of a claimed like-kind exchange and the disallowance of the claimed casualty loss. Appellant has conceded the like-kind exchange issue.

1 Tax Board (respondent or the FTB) has conceded that appellant would be entitled to a casualty loss in
2 the amount of \$55,250, for physical damages, for the portion of his Santa Barbara property that
3 suddenly fell into the ocean in 2004 as a result of a storm in December of that year.² The issue in this
4 matter is whether appellant would also be entitled to a casualty loss deduction for the portion of that
5 property that did not suddenly fall into the ocean in December of 2004. With regard to this issue,
6 appellant relies upon *Finkbohner v. U.S. (Finkbohner)* (11th Cir. 1986) 788 F.2d 723 and upon an
7 appraisal prepared for him. In general, the *Finkbohner* court allowed a casualty loss under IRC section
8 165 for a “permanent impairment” suffered by the taxpayer’s property in that matter.

9 Respondent argues that *Finkbohner* was wrongly decided and instead contends that
10 casualty losses require, at a minimum, physical damage to property and that it is appropriate to allow
11 casualty losses claimed for such damage to property, and likewise inappropriate to allow casualty loss
12 deductions claimed for mere fluctuations in the value of property. Respondent relies upon *Kamanski v.*
13 *Commissioner (Kamanski)* (9th Cir. 1973) 477 F.2d 452 which provides that IRC section 165 was not
14 intended to address mere fluctuations in value arising from changes in the market demand for real
15 property, even when the change is due to fear of a repetition of a particular casualty and that such losses
16 are not covered even when incurred upon the disposition of the property.

17 Background

18 Appellant filed a timely California resident tax return for 2004. On that return, appellant
19 reported an overpayment of tax of \$226 but did not claim a refund of any amount. (Resp. Op. Br.,
20 Exhibit C.) On Form 8824 (Like-Kind Exchanges) of his federal return, appellant reported a like-kind
21 exchange under IRC section 1031. Appellant stated on that form that he gave up a home in
22 Newport Beach, California, in exchange for receiving like-kind property located in Santa Barbara,
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25 ² In a memorandum dated October 10, 2014, respondent concedes that appellant’s Santa Barbara property was not a personal
26 use asset, such that IRC section 165(c)(3) does not apply to this appeal. It further appears that respondent concedes that the
27 physical damage to appellant’s property would qualify as a casualty loss under IRC section 165(c)(2). In its memorandum,
28 respondent states that it will allow a loss of \$55,250 for the physical damage to the property. However, from the facts in the
appeal record, Board staff is interpreting this concession to be \$55,250.

As a result of respondent’s concession, the parties’ arguments as to whether appellant was holding the Santa Barbara
property for use in a trade or business (under IRC section 165(c)(1)) or for profit (under IRC section 165(c)(2)) are no
longer germane to the disposition of this appeal. As such, these contentions and arguments have been removed from this
hearing summary.

1 California. Appellant asserted that the fair market value (FMV) of the property he received was
2 \$2,100,000 and that he had a deferred gain of \$1,498,500. He also asserted that he transferred the
3 property in Newport Beach on February 3, 2004, and received the property in Santa Barbara on July 30,
4 2004. (Resp. Op. Br., Exhibit A.) On Form 4684 of his federal return, appellant also reported a
5 casualty loss of \$224,070 resulting from a storm-induced landslide on the Santa Barbara property. In
6 calculating the amount of the casualty loss, appellant stated that the FMV of the property before the
7 casualty was \$2,100,000 and that the FMV of the property after the casualty was \$1,875,930. (Resp.
8 Op. Br., Exhibit B.)

9 To determine whether appellant properly reported the deferral of the gain from the
10 like-kind exchange and the casualty loss, respondent sent appellant several information documents
11 requests (IDR's) to his most recent address contained in respondent's records. Respondent states that
12 appellant did not reply to any of the IDR's. Respondent also mailed appellant a formal demand for the
13 requested information, warning him that a penalty would be imposed under Revenue and Taxation Code
14 (R&TC) section 19133 if he did not comply. Respondent states that the demand letter was returned as
15 unclaimed even though the United States Postal Service (USPS) confirmed that appellant was receiving
16 mail at the address listed in respondent's records. (Resp. Op. Br., p. 2.)

17 In a Notice of Proposed Assessment (NPA) dated May 1, 2008, respondent disallowed
18 the deferral of gain of \$1,498,500 and the casualty loss of \$224,070. Respondent stated that the
19 deferred gain with regard to the Newport Beach residence was disallowed because compliance with the
20 requirements of IRC section 1031 was not documented and public records indicated that the acquisition
21 of the Santa Barbara property occurred in excess of 180 days after the disposition of the Newport Beach
22 residence. Further, respondent stated that the casualty loss was disallowed because neither the casualty
23 event nor the amount of the loss was documented. After making other adjustments, respondent
24 proposed the assessment of additional tax of \$148,177.00 and imposed a penalty of \$37,044.25 for the
25 failure to furnish information. (Resp. Op. Br., Exhibit D.)

26 Appellant protested the NPA in a letter dated July 18, 2008. (Resp. Op. Br., Exhibit E.)
27 In a second letter dated May 15, 2009, appellant conceded that the purported like-kind exchange did not
28 meet the requirements of IRC section 1031. However, appellant requested that respondent remove the

1 penalty for the failure to furnish information in view of the technical flaws that rendered the USPS
2 unable to deliver specific FTB Notices and the lack of language in respondent's formal demands, that
3 were required by its Manual of Audit Procedure, which resulted in appellant not receiving adequate
4 notice for due process purposes. (Resp. Op. Br., Exhibit F.) Appellant attached to the second letter an
5 amended Form 4684 that increased the claimed casualty loss from \$224,070 to \$1,300,000 as a result of
6 restating the FMV of the Santa Barbara property before the casualty as \$3,400,000 and the FMV of the
7 property after the casualty as \$2,100,000. (Resp. Op. Br., Exhibit G.) Appellant also attached a
8 supporting appraisal by Mr. Michael Arnold dated May 5, 2009 (the Arnold appraisal) (Resp. Br.,
9 Exhibit H; Declaration of Larry G. Dighera (the Dighera Declaration or sometimes the Declaration),
10 Exhibit 25, accompanying App. Op. Br.), as well as other documents.

11 The Arnold appraisal describes the Santa Barbara property as a home on a beachfront
12 bluff on two adjacent parcels with a gross area in excess of an acre. The appraisal states that, because
13 of public beaches, the bluffs, and the private road easement, the usable area of the site is no more than
14 20,000 square feet. In addition, the appraisal states that the improvements on the site are a recently-
15 constructed home with a total of 3,021 square feet. (Resp. Op. Br., Exhibit H, p. 2.)

16 The Arnold appraisal indicates that, immediately before the sale of the Santa Barbara
17 property to appellant on August 31, 2004, the property was appraised by Mr. Greg Wood (the Wood
18 appraisal) (The Dighera Declaration, Exhibit 15) to have an estimated market value of \$3,148,000 "as
19 is".³ The Arnold appraisal asserts that the Wood appraisal was reasonable and appropriate as of the
20 date of the sale. The Arnold appraisal also asserts that, as of December 28, 2004, the property was
21 structurally complete but in need of \$250,000 of exterior site work. (Resp. Op. Br., Exhibit H, p. 2.)

22 The Arnold appraisal states that, in addition to the Wood appraisal, it considered
23 information of market activity between August and December of 2004 from a listing service of local
24 realtors. Taking the foregoing information into account, the appraisal concluded that the market value
25 of the property, subject to the completion of all improvements, had increased to approximately
26 \$3,650,000. The Arnold appraisal also states that, subsequent to the valuation date of the
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28 ³ Board staff notes that this value does not include approximately \$360,000 in expenditures which remained to complete all of the construction.

1 Wood appraisal, appellant spent approximately \$250,000 to complete the site work. The Arnold
2 appraisal concludes that, as a result, the value of the property “as is” on that valuation date was
3 approximately \$3,400,000. (Resp. Op. Br., Exhibit H, p. 2.)

4 The Arnold appraisal states that, on December 28, 2004, the bluff on the Santa Barbara
5 property lost an area of approximately 850 square feet (approximately 10 feet deep and a width of
6 85 feet), as a result of heavy storms. The appraisal states that the lost area was approximately 4.25
7 percent of the property’s total usable area. (Resp. Op. Br., Exhibit H, pp. 2-3.)

8 The Arnold appraisal asserts that, in addition to the physical loss, there were damages to
9 the remaining portions of the property. The appraisal asserts that the utility of the site was significantly
10 diminished as a result of the 10 foot loss in the site area. The Arnold Appraisal states that the building
11 envelope⁴ for the property is effectively established by set-back requirements. It asserts that, on the
12 south portion of the property, the required setback was equivalent to a minimum of 50 years of erosion.
13 The Arnold Appraisal states that the maximum bluff erosion averages were established to be 18 inches
14 per year and, as a result, the minimum setback from the bluff would be 75 feet. (Resp. Op. Br., Exhibit
15 H, p. 3.)

16 The Arnold appraisal indicates that surveys and descriptions provided by the owner
17 appear to provide that the placement of the recently-constructed residence was almost exactly 75 feet
18 back from the top of the bluff. The appraisal concluded that the loss of 10 feet of bluff top moved the
19 setback into the middle of the existing structure. The Arnold appraisal asserts that, as a result of
20 Mr. Arnold’s conversation with a Santa Barbara County government planner, if the structure were to be
21 destroyed for any reason, it could not legally be replaced and any proposed improvements allowed
22 would have to be extremely modest in size and irregular in shape. The appraisal further asserts that
23 subsequent bluff top loss has essentially eliminated any potential to rebuild on the property. (Resp. Op.
24 Br., Exhibit H, p. 3.)

25 The Arnold appraisal states that the bluff top cannot be replaced and that the impact on
26 the remaining property cannot be reversed, asserting that there is no “cure.” The Arnold appraisal states
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⁴ Board staff notes that a “building envelope” is generally described as including all of the components that make up the shell or skin of a building.

1 that California law requires the full disclosure of any adverse conditions which affect a residential
2 property that is being sold. It asserts that the remaining property was negatively impacted because of
3 having improvements that could not be replaced (not to mention fears--since borne out--of extraordinary
4 bluff loss). The Arnold appraisal also states that conventional financing would not be available until
5 after all of the facts had been revealed. (Resp. Op. Br., Exhibit H, p. 3.)

6 The Arnold appraisal asserts that the loss in value to the site is a fairly straight-forward
7 calculation: 4.25 percent of the usable area was lost. It then states that the damage to the remaining
8 property required more judgment. The Arnold appraisal asserts that it would be possible to structure a
9 hypothetical value analysis from the perspective of the present value of future net earnings. The Arnold
10 appraisal states that the elements required in such an analysis would be a projection period, net incomes,
11 a reversion value, and a discount rate. (Resp. Op. Br., Exhibit H, p. 3.)

12 The Arnold appraisal asserts that the projection period would be the remaining economic
13 life. It states that, using the geologist-established erosion rate of 18 inches a year, it would be
14 approximately 35 years until the bluff top was too close (within 10 to 15 feet) to the house for
15 habitation. (Resp. Br., Exhibit H, p. 3.) The Arnold appraisal then calculates the other elements in the
16 analysis and concludes that the indicated present value would be between \$568,325 and \$615,684.
17 (Resp. Br., Exhibit H, p. 4.) It then states that, while theoretically sound, such an analysis does not
18 reflect the perspective or decision making process for a typical market participant for this type of
19 property but does demonstrate the potential for a significant discount in value. (Resp. Op. Br.,
20 Exhibit H, p. 5.)

21 The Arnold appraisal then states that market-generated discounts for detrimental
22 conditions in residential properties reflect the nature of the conditions. It states that the property bluff
23 loss was irreversible and, after the damages sustained on December 28, 2004, the property would be
24 viewed as having a remaining economic life of up to 35 years. The Arnold appraisal states that such an
25 economic life is 30 percent less than what could have been expected the day before. The Arnold
26 appraisal asserts that, when the permanent constraints associated with the impaired utility and financing
27 difficulties are added to the property's reduced economic life, a total discount to the remaining property
28 in the range of 35 percent to 40 percent is reasonable and appropriate. (Resp. Op. Br., Exhibit H, p. 5.)

1 The Arnold appraisal concludes with the opinion that the total loss in value to the
2 property as the result of the described sustained damages is approximately \$1,300,000. The Arnold
3 appraisal calculates the total loss by multiplying \$1,300,000 by 4.25 percent to reach a site loss of
4 \$55,250. It then calculates the impact to the remaining property to be \$1,254,281. The Arnold
5 appraisal calculates the total impact by multiplying \$3,344,750 by 37.5 percent. It calculates the
6 \$3,344,750 amount by subtracting from the market value of \$3,650,000 an allowance for the \$250,000
7 completion of construction and the site loss allowance of \$55,250. The Arnold appraisal adds \$55,250
8 to \$1,254,281 to determine total impacts of \$1,309,531. The appraisal then asserts that an approximate
9 loss of \$1,300,000 seems reasonable and appropriate, as the market value of the property was
10 approximately \$2,100,000, as of December 28, 2004, after the damage occurred. (Resp. Op. Br.,
11 Exhibit H, p. 5.)

12 After a review of appellant's letter dated May 15, 2009, including the attached
13 Arnold appraisal, and other documentation, the Hearing Officer Report (the Report) stated in its
14 conclusion that appellant had conceded the like-kind exchange issue. The Report also stated that a
15 casualty did occur because a percentage of the Santa Barbara property was physically lost due to a
16 natural disaster. However, the Report stated that the present value for the loss in future income
17 potential could not be deducted and, therefore, the allowable loss was limited to a percentage of the
18 property. The Report also stated that the failure to furnish information penalty should be reversed
19 because proper notification was not given to appellant. The Report recommended a Notice of Action
20 (NOA) revising the NPA in order to reverse the penalty. (The Dighera Declaration, Exhibit 26.)

21 The NOA, dated October 23, 2009, stated that the reported deferred gain was taxable
22 because the provisions of IRC section 1031 were not met. The NOA also stated that the reported
23 casualty loss was disallowed because the requirements of IRC section 165 were not met.⁵ (The Dighera
24 Declaration, Exhibit 27.) Appellant timely appealed the NOA.

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28 ⁵ Consistent with the Report, the NOA did not include the failure to furnish information penalty.

1 Contentions

2 Appellant's Appeal Letter

3 Appellant argues that the amount of the deductible casualty loss should include the
4 permanent drop in value for the property remaining after the cave-in. Appellant also argues that the
5 casualty loss should be recognized as property held in connection with a profit-making activity. (App.
6 Ltr., p. 4.)

7 With regard to the amount of the casualty loss, appellant states that Revenue Ruling
8 66-242, 1966-2 C.B. 56, holds that a loss measured by the difference between the FMV before and after
9 a casualty cannot support a tax deduction when the difference represents a mere fluctuation in value
10 attributable to temporarily-adverse buyer resistance. However, appellant argues that respondent's
11 examining agent failed to recognize that appellant's loss in value of the remaining property is
12 permanent. (App. Ltr., p. 2.)

13 Appellant asserts that the permanent loss in value occurred because of building set-back
14 requirements. Appellant states that the ocean-front setback of structures is governed by the County of
15 Santa Barbara and the California Coastal Commission. Appellant states that most ocean-front property
16 is subject to erosion rates computed by geological engineers and that the amount of the required setback
17 for such properties is based on the retreat rate determined for that particular section of coastline.
18 Appellant alleges that his constructed building was built at the appropriate setback line, as designated in
19 the reports of CFD Engineering Geology, dated January 7, 1999, and of the Santa Barbara County
20 Zoning Administrator Hearing, dated February 11, 2002. (App. Ltr., p. 2.)

21 However, appellant also alleges that, after the cave-in, his structure was 10 feet inside the
22 required setback zone. Appellant asserts that the result is a buyer would be unable to rebuild if it
23 became necessary because of a fire or other hazards. Appellant states that the disclosure of such issues
24 to prospective buyers is mandated and argues that, as a result, the value of the property was permanently
25 impacted. (App. Ltr., p. 2.)

26 Appellant states that, on September 1, 2009, he sent a letter to the examining agent
27 advising him that his summary of the case law failed to note *Finkbohner*. Appellant argues that, under
28 *Finkbohner*, a loss of FMV attributed to the permanent resistance of buyers may be included in the

1 amount of the casualty loss deduction. Appellant alleges that no objection or response was received to
2 that communication. (App. Ltr., p. 2.)

3 Appellant states that, in *Finkbohner*, floodwaters entered and damaged several dozen
4 homes fronting on the taxpayer's cul-de-sac. Appellant states that the taxpayer's physical property
5 damage was limited to the driveway and grounds. Appellant asserts that the Eleventh Circuit Court of
6 Appeals (the Eleventh Circuit) in *Finkbohner* also allowed losses based on buyer resistance to the
7 remaining property because the facts demonstrated that such resistance was likely to be permanent.
8 Appellant states that those facts involved the municipal authorities' decision after the flood to eliminate,
9 for safety reasons, seven of the twelve houses on the cul-de-sac (not including the taxpayer's residence).
10 Appellant states that those houses were demolished and that the lots were acquired by the city to be
11 maintained as permanent open space. Appellant states that the taxpayers in *Finkbohner* introduced
12 evidence that this change markedly and permanently diminished the amenities and attractiveness of their
13 home by placing it in a lonesome neighborhood that was more exposed to crime, and with much
14 diminished privacy, in view of the home's proximity to heavily-traveled streets and bridges. (App. Ltr.,
15 pp. 2-3.)

16 Appellant argues that this case is analogous to the taxpayer's situation in *Finkbohner*
17 because the cave-in of the bluff permanently precludes further construction on the site. Therefore,
18 argues appellant, the examining agent should have considered as deductible the loss attributable to the
19 loss in value of the remaining property. (App. Ltr., p. 3.)

20 Appellant alleges that his intent was to continue with construction plans initiated by the
21 seller of the Santa Barbara property and to hold the property for investment and eventual sale.
22 Appellant contends that he began construction upon acquisition and that construction was about
23 75 percent complete when the cave-in occurred in December 2004. Appellant states that this
24 percentage was based on costs of \$823,842 that were incurred before the casualty and \$255,978 after
25 the casualty. Appellant states that the cave-in at the end of 2004 further reduced the rental value and
26 that 2005 brought another cave-in. (App. Ltr., pp. 3-4.)

27 Appellant's Opening Brief

28 Appellant asserts that the facts are stated, and the exhibits are presented, in the

1 Dighera Declaration which accompany his opening brief. (App. Op. Br., p. 2.)

2 The Dighera Declaration

3 In the Declaration, appellant alleges that he inherited the property in Newport Beach
4 from his father in 1992. Appellant alleges that the Newport Beach property consisted of a single family
5 home that his father used as a rental property. Appellant alleges that, after inheriting the property, he
6 continued to rent it and received approximately \$60,000 a year in rental income until the property was
7 exchanged. (The Dighera Declaration, p. 1.)

8 Appellant alleges that, after entering into an exchange agreement with an IRC section
9 1031 exchange intermediary (the Intermediary) which facilitated tax-deferred real property exchanges,
10 he assigned all of his right, title, and interest in the Newport Beach property (as well as his obligation to
11 sell the property to the purchaser for \$2,100,000) to the Intermediary. (The Dighera Declaration, p. 2.)

12 Appellant alleges that he learned of the availability of the Santa Barbara property, which
13 consisted of two parcels of ocean front bluff top property (parcel numbers 065-310-023 and 065-310-
14 025), that had a combined gross area of over an acre and came with approved blueprints and permits, to
15 construct a single family dwelling. (The Dighera Declaration, p. 2, Exhibit 2 (photo of the property).)

16 Appellant asserts that his intent was (1) to purchase the Santa Barbara property for \$1,150,000, (2) to
17 build improvements on the property such that the value of that property would approximately equal the
18 value of the Newport Beach property, and (3) to sell the developed property for a quick profit.

19 Appellant alleges that he thought, perhaps naively, that he could have the Santa Barbara property
20 developed within six months and could then sell it for double what he had received for the Newport
21 Beach property or, alternatively, he could lease the Santa Barbara property for significantly more rent
22 than he had received for the Newport Beach property. (The Dighera Declaration, p. 2.)

23 Appellant alleges that, despite the size of the Santa Barbara property, County setback
24 requirements established a smaller usable area as the building envelope. Appellant asserts that the
25 Santa Barbara property was subject to various conditions established by County ordinance as well as by
26 the Coastal Development Permit. Appellant alleges that the following are some examples:

- 27 a. Section 35-67(1) of the County of Santa Barbara Coastal Zoning ordinance, [the Dighera
28 Declaration, Exhibit 4 (copy of ordinance section)] requires a 75 year setback from the

1 bluff edge unless such standard would make the lot unbuildable, in which case a 50 year
2 set back is required. Consistent with that requirement, the Coastal Development Permit
3 issued for the construction of the structures contained the following condition:

4 All above ground structures shall meet the required fifty (50) year retreat rate as
5 determined in the January 7, 1999 report from CFS Engineering Geology Inc.
6 The structures on APN 065-310-023 shall be placed at a minimum of 75 feet from
7 the bluff edge at the start of construction. The structures on APN 065-310-025
8 shall be placed at a minimum of 69 feet from the bluff edge at the start of
9 construction. [The Dighera Declaration, Exhibit 5, paragraph 10.]

10 Exhibit 6 is the Plot Plan for the Santa Barbara property. The 50 year setback line is
11 highlighted in red. The County also required a 50 foot setback from Austin Road. This
12 setback line is depicted on the Plot Plan in blue.

13 b. The Coastal Development Permit contains a condition “requiring removal of the structure
14 at the time when the bluff retreats to the point that renders the structure uninhabitable.”

15 [The Dighera Declaration, Exhibit 7, paragraph 16.] In fact, the County recorded an
16 Agreement for Structural Hazard Abatement against the Subject Property on November
17 19, 2002, which obligates the owners, their heirs, representatives, successors and assigns
18 to remove all structural development in accordance with the permit conditions when the
19 structures are uninhabitable, the determination of which rests solely with the County.

20 [The Dighera Declaration, Exhibit 8.]

21 c. The permit also forbids the construction of “bluff or shoreline protective device(s) . . . to
22 protect development, including but not limited to the residences, garages, patio areas and
23 any future development. (The Dighera Declaration, Exhibit 9, paragraph 20.) This is
24 consistent with § 35-67(5) of the Coastal Zoning Ordinance. [The Dighera Declaration,
25 Exhibit 8.]

26 (The Dighera Declaration, pp. 2-3.)

27 Appellant alleges that the construction of the home began in February 2004. Appellant
28 contends that, by July 29, 2004, the County deemed that construction was sufficiently complete and it
issued a temporary certificate of occupancy. (The Dighera Declaration, p. 3.)

Appellant asserts that Condition 15 of the Coastal Development Permit prohibits any

1 structural elements from being placed within 10 feet of the bluff. (The Dighera Declaration, Exhibit 9,
2 paragraph 15.) Citing Exhibit 18 of the Declaration, appellant also asserts that, as a result of the bluff
3 collapse, and as a condition of obtaining the Permanent Certificate of Occupancy, he was required to
4 relocate the fence at the rear of the Santa Barbara property and he did so in March 2005. (The Dighera
5 Declaration, p. 5.)

6 Appellant states that, on January 15, 2005, Governor Schwarzenegger declared that a
7 State of Emergency existed in Santa Barbara and other counties as a result of the series of rainstorms
8 that commenced on December 28, 2004. (The Dighera Declaration, p. 5, Exhibit 19.) Appellant states
9 that, on February 4, 2005, President Bush determined that the damage caused by severe storms,
10 flooding, debris flows, and mudslides on December 27, 2004, through January 11, 2005, were of
11 sufficient severity and magnitude to warrant a major disaster declaration under the Robert T. Stafford
12 Disaster Relief and Emergency Assistance Act (the Stafford Act). (The Dighera Declaration, p. 5,
13 Exhibit 20.)

14 Appellant asserts that, subsequently, additional bluff damage occurred because of winter
15 storms in December 2005 (the Dighera Declaration, Exhibit 21) and in February and March of 2010
16 (the Dighera Declaration, Exhibit 22). Appellant alleges that Exhibit 2 of the Dighera Declaration
17 shows the Santa Barbara property before construction. Appellant alleges that Exhibit 23 shows how the
18 bluff looked in 2006. Appellant alleges that the red line along the edge of the bluff shows the current
19 location of the bluff after the 2010 storms. (The Dighera Declaration, pp. 5-6.)

20 Appellant attached, as Exhibit 29 of the Declaration, photographs from the California
21 Coastal Records project, a non-profit organization, that he alleges is establishing a photographic
22 database which documents the California coast. Appellant alleges that those photographs show how
23 the Santa Barbara property has changed since 2002. Appellant alleges that page one is a photograph
24 taken September 23, 2002, showing the bluff before development. Appellant alleges that the
25 Santa Barbara property is located next to the home at the far left of the photograph. Appellant alleges
26 that page two is a photograph taken October 23, 2004, showing the Santa Barbara property still under
27 construction. Appellant alleges that page three is a photograph taken on September 16, 2006, showing
28 the damage to the bluff as a result of bluff losses that occurred in December 2004 and December 2005.

1 Appellant alleges that page four is a photograph taken on September 18, 2008. Appellant alleges that
2 the property to the left of his Santa Barbara property in the photograph, which is located on
3 Austin Road, was required to be demolished because it was too close to the bluff edge. Appellant
4 alleges that, in fact, one can see on page three how portions of the foundation had slipped over the cliff.
5 Appellant alleges that a new home on Austin Road recently had been rebuilt on the property and was
6 completed earlier this year. Citing Exhibit 30 of the Declaration, including Exhibit B and paragraph 1
7 of Attachment A of Exhibit 30, appellant states that the Coastal Development Permit, which was
8 approved for the Austin Road property on December 17, 2007, provides that “[t]he required setback
9 from the bluff edge shall be measured [by the] 50-year bluff retreat rate, plus an additional ten feet to
10 allow for increased bluff stability.” (The Dighera Declaration, pp. 8-9.)

11 Appellant alleges that, at the conclusion of the lease, he listed the Santa Barbara property
12 for sale for \$4.5 million with Richard Mann, a real estate agent at Coldwell Banker. Appellant alleges
13 that he thought the listing price was high but wanted to get whatever he could for the property and
14 accepted the real estate agent’s advice, because appellant was new to the Santa Barbara market.
15 Appellant alleges that, after having listed the property for nearly two years, he took the property off of
16 the market and never received any offers on the property. Appellant alleges that one realtor who had
17 shown the property told him that his client quipped “[t]hat property is falling into the ocean,” as they
18 rode away. (The Dighera Declaration, p. 9.)

19 Appellant attached as Exhibit 31 of the Declaration a copy of the April 14, 2008 article
20 entitled “the Hottie and the Nottie” from the Santa Barbara Housing Bubble Blog. Appellant alleges
21 that the article discusses the Santa Barbara property by comparing it to a house two doors down on
22 Austin Road which was listed for sale at the same time as the Santa Barbara property. Appellant
23 alleges that the other Austin Road property was listed for sale at \$15 million and was considered to be
24 “the hottie” of the two properties. Appellant alleges that the article suggested reasons why the other
25 Austin Road property was “hot” but his property was “not.” Appellant states that, at the conclusion of
26 the article, the blog cautioned that “should you wish to pursue either of the two properties featured
27 here, please consult a qualified realty-transactions professional *and* a reputable soil geologist.”
28 Appellant alleges that the other property located on Austin Road did not sell either. (The Dighera

1 Declaration, pp. 9-10.)

2 Appellant alleges that a posting at www.trulia.com refers to the Santa Barbara property
3 as follows: “[a]s a side note, this property was on the market for almost two years asking \$4.5 million.
4 It did not sell. I’ve been in the property on multiple occasions and have opinions as to why. In this
5 situation, as in many others in the Santa Barbara/Montecito areas, knowledge from a local professional
6 is essential to completely understand what you’re buying.” (The Dighera Declaration, p. 10, Exhibit
7 32.)

8 Appellant asserts that the inability to sell the Santa Barbara property and the online
9 comments reflect market recognition that the property is impaired as the result of the substantial loss of
10 its previous 50-year economic life. Appellant argues that the comments merely confirm the validity of
11 the conclusion drawn by the Arnold appraisal. (The Dighera Declaration, p. 10.)

12 Appellant’s Legal Arguments

13 Appellant states that neither party disputes that a casualty occurred with regard to the
14 Santa Barbara property. Appellant states that, as the pictures in Exhibits 16 and 17 make clear, the
15 severe winter storm that occurred on December 28, 2004, claimed an 85 by 10 foot swath of the
16 Santa Barbara property (850 square foot area) that was irreversibly lost to the sea. Appellant states that
17 the storms occurring between December 27, 2004, and January 11, 2005, were of such a magnitude that
18 President Bush declared counties impacted by the storm to be federal disaster areas under the
19 Stafford Act and Governor Schwarzenegger declared the counties to be in a State of Emergency. (App.
20 Op. Br., p. 5.)

21 Appellant asserts that the Santa Barbara property has been permanently damaged as a
22 result of the loss and that the damage is measured by the Arnold appraisal. Appellant states that
23 respondent asserts that the Santa Barbara property only sustained a temporary, hypothetical paper loss
24 that is not entitled to a deduction. Appellant states that respondent relied on Revenue Ruling 66-242 in

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1 denying the deduction.⁶ Appellant argues that, while Revenue Ruling 66-242 addresses a “short lived”
2 loss, cases establish that, when the damage results in a permanent change in condition to the land or to
3 the land’s surrounding area, the loss is entitled to a deduction. As examples, appellant quotes language
4 from *Philmon v. U.S.* (*Philmon*) 1999 U.S. Dist. (MD Fla.) LEXIS 14258 and *Radding v.*
5 *Commissioner* (*Radding*) T.C. Memo 1988-250.⁷ First, appellant quotes the court in *Philmon* as stating
6 that “[w]hen a taxpayer suffers a casualty loss to property, the proper computation of a deduction under
7 section 165 is based on the fair market value of the property just before the loss less the value of the
8 property after the disaster. . . .” Then appellant quotes the court as stating that “[i]f a taxpayer’s
9 property is not physically damaged during a disaster, but is no less damaged due to a permanent
10 impairment of value caused by the event, the taxpayer may claim a section 165 deduction.” Appellant
11 quotes the court in *Radding* as stating that a “loss of value due to permanent buyer resistance after a
12 flood could be claimed as a casualty loss.” Citing *Chamales v. Commissioner* (*Chamales*) T.C. Memo
13 2000-33, appellant also states that irreversible changes in the neighborhood that affect a permanent
14 devaluation in property constitute a casualty for purposes of IRC section 165. (App. Op. Br., pp. 5-6.)

15 With regard to *Finkbohner*, appellant states that the federal appellate court observed that
16 the government semantically allows the loss of FMV as the regulation requires, but actually views IRC
17 section 165(c)(3), in the circumstances of that case at least, as allowing nothing but physical damage.
18 Appellant states that the court viewed this position as untenable. Appellant quotes the court as stating
19 that “[i]n effect, [the government] gives lip service to the [FMV] test, while in reality, requiring that
20 everything except the cost of repairs be adjusted out of the case as ‘buyer resistance.’ We think that the
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22 ⁶ Appellant quotes Revenue Ruling 66-242 as follows:

23 “A loss sustained to a personal residence resulting from a casualty must be real and actual in order to be deductible under
24 section 165 of the Internal Revenue Code of 1954. The loss cannot be (1) a hypothetical loss, or (2) a mere fluctuation in
25 value. Standing alone an appraisal of real property which demonstrates economic obsolescence attributable to adverse buyer
26 resistance, as the basis for a decline in value, is inadequate to prove a deductible casualty loss where it represents a
hypothetically calculated loss. Similarly, an appraisal of real property which demonstrates a decline in market value caused
by adverse buyer resistance which arises shortly after a casualty, and which is short lived, cannot establish a deductible
casualty loss where it represents a mere fluctuation in value.”

27 ⁷ Appellant argues that the consistent thread running through *Philmon*, *Radding*, and *Lund v. United States* 2000 U.S. Dist.
28 (CD Utah) LEXIS 2099, is that the permanence of the damage is determinative. Appellant asserts that, contrary to
respondent’s position, courts have relied on the *Finkbohner* reasoning and held that the losses incurred have been something
more than “mere market fluctuations” or “temporary buyer resistance.” (App. Resp. Letter, p. 6.)

1 regulation . . . require[s] that the award be really, not just ostensibly, based on the loss of [FMV].”
2 (App. Op. Br., p. 7 (quoting from *Finkbohner v. U.S.*, *supra*, 788 F.2d at pp. 725-726); App. Supp. Br.,
3 pp. 3-4.)

4 Appellant states that the court concluded as follows:

5 We conclude from these cases, and others defendant refers to, that evidence showing
6 willing buyers temporarily pay less for property only recently subjected to flooding, will
7 not by itself justify retaining in an award determined by loss in market value, the portion
8 ascertainably or inferentially due to such a factor. This is to allow the property owner to
9 deduct the consequences of future disasters as well as his own. We know the volatile
10 market will decline sharply on occurrence of a natural disaster, yet will rebound when it
11 is no longer fresh in people’s minds. New and more costly houses will then replace those
12 the flood damaged. It is different when the impact of the flood on the market value
13 shows itself not wholly or chiefly in the expectation that additional floods will in [the]
14 future occur, but more directly in changes in the neighborhood, or acts of public officials,
15 that will outlast the fresh recollection of disaster. That is another matter with which the
16 cited case authority does not deal. Plaintiffs, taxpayers, perceiving this, were astute
17 enough to state and present their case on the permanent impairment theory.

18 It is evident that, for example, the permanent removal of seven out of twelve neighboring
19 houses is a permanent change. Awareness of it by buyers does not reflect their
20 anticipation of a future catastrophe. It is something that exists right now. Since the loss
21 of value from this and other causes is permanent, there will not be any recovery of it as
22 fears for the future become less acute. A lower value plateau is reached, which will be the
23 “value before” if another catastrophe occurs. Therefore, the owner when the next
24 catastrophe occurs will not be able to claim a casualty loss founded upon it. It must be
25 claimed right now if it is going to be at all. Repeated claims for what is really the same
26 loss, the fear behind the cases cited, are not to be anticipated here.

27 (App. Op. Br., pp. 7-8 (quoting from *Finkbohner v. U.S.*, *supra*, 788 F.2d at p. 727).) (Emphasis added
28 by appellant.)

29 Appellant states that the *Finkbohner* court held that, due to the permanent nature of the
30 change caused by the flood (i.e., the destruction of the seven houses and the governmental mandate that
31 the lots remain as open space), the owners of the remaining homes were entitled to an IRC section 165
32 deduction. Appellant asserts that the court reiterated that the regulation required the government to give
33 more than just lip service to the concept of FMV by stating:

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1 Congress has let stand for many years the [FMV] before and after as the measure of the
2 loss, as stated in the regulations and in the cases. It could have substituted the cost of
3 repairs, either entirely or as a ceiling, but has not done so. Therefore, we must determine
4 the loss on the basis of value before and after. We cannot pursue the sound reasoning of
the *Kamanski* and other cases to the point where [FMV] is only ostensibly, not really, the
test.

5 (App. Op. Br., p. 8 (quoting from *Finkbohner v. U.S.*, *supra*.)

6 Appellant argues that the evidence shows in this case permanent damage to the
7 Santa Barbara property, as 850 square feet of the property has been washed out to sea. Citing
8 paragraph 20 of Exhibit 9 of the Declaration, appellant asserts that the bluff top cannot be repaired at
9 any cost because the Coastal Development Permit specifically provides that “there shall be no bluff or
10 shoreline protective device(s) constructed to protect development, including but not limited to the
11 residences, patio areas, and any future development.” Citing Exhibit 4 of the Declaration, appellant
12 also states that the Coastal Zoning Ordinance specifically prohibits the construction of such protective
13 devices. Appellant asserts that, even if a repair were allowed, the cost of such a repair would be
14 enormous. Quoting from page 3 of the Arnold appraisal (Exhibit 25 of the Declaration), appellant
15 asserts that “[t]he bluff top cannot be replaced and the impacts on the remaining property cannot be
16 reversed. There is no ‘cure.’” Appellant argues that, in light of the inability to repair, the only measure
17 of damage to the Santa Barbara property is the value immediately before the casualty as compared to
18 the value immediately after the casualty. (App. Op. Br., p. 8.)

19 Appellant states that, while the appraiser estimated that the loss of the 850 square feet of
20 the Santa Barbara property constituted a loss of 4.25 percent of the overall property, the appraiser’s
21 estimate speaks only to the loss of the dirt itself. Citing paragraph 15 of Exhibit 9 of the Declaration,
22 appellant argues that, in reality, the loss resulted in a loss of a much larger percentage of useable space
23 of the property when the required 10 foot fence setback is considered. Appellant also argues that the
24 required relocation of the rear fence that was necessary to comply with the Coastal Development Permit
25 further reduced the usable space in the rear yard considerably beyond the loss of the 10 foot wide strip
26 of land that collapsed. Appellant asserts that, in a very real sense, one ten foot strip of land was lost to
27 the sea and another 10 foot strip was lost to the fence setback, with the result that both of the losses
28 combined to reduce the usable space of the Santa Barbara property. (App. Op. Br., pp. 8-9.)

1 Appellant argues that this loss is not a matter of a temporary decline in market value.
2 Appellant states that a house that has burned can be rebuilt and that floods, fires, hurricanes, and
3 tornados will be forgotten and that a property which is restored after such damage will, in time, recover
4 the value lost because of the casualty. Appellant asserts that this loss is different because it resulted in
5 a loss to the economic life of the Santa Barbara property. Appellant argues that the physical loss to the
6 sea of large chunks of the property resulted not only in a permanent loss of the dirt but also in a
7 permanent diminution in value to the property that remains. Appellant states that less can be done with
8 the property because less of the property remains. Appellant states that the minimum 75-foot setback
9 from the bluff top, the 10-foot fence setback, and the 50-foot setback from the street remain in force.
10 Citing paragraph 11 of the Declaration, appellant states that, before the Final Certificate of Occupancy
11 was granted, the fence had to be moved. Appellant states that future development of the property will
12 be significantly impaired because the building envelope has been significantly reduced. Appellant
13 asserts that any future structure will be legally required to be smaller because of government
14 restrictions on the use of the property. Appellant alleges that the loss of the bluff top at a rate greater
15 than the rate planned for, the loss of overall square footage, and the loss of the building envelope
16 plainly makes the Santa Barbara property less attractive to potential purchasers of bluff top property.
17 (App. Op. Br., p. 9.)

18 Appellant argues that, like the government in the *Finkbohner* case, respondent merely
19 gives lip service to the notion of FMV. Appellant asserts that respondent sees a loss of the dirt that slid
20 down, making a new cliff, and pretends that such a loss has no impact on the remainder of the property.
21 Appellant argues that, if the FMV test of Treasury Regulation section 1.165-7(a) has any meaning at all,
22 it must take into account what the FMV of the Santa Barbara property was immediately before the
23 casualty versus what the FMV of the property was immediately after the casualty. Appellant states that,
24 although FMV is not defined for purposes of IRC section 165, R&TC section 110, subdivision (a),
25 provides the following meaningful definition, which is used for appraisal purposes across California for
26 determining property values:

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1 “[FMV]” means the amount of cash or its equivalent that property would bring if exposed
2 for sale in the open market under conditions in which neither buyer nor seller could take
3 advantage of the exigencies of the other, and both the buyer and the seller have
4 knowledge of all of the uses and purposes to which the property is adapted and for which
it is capable of being used, and of the enforceable restrictions upon those uses and
purposes.⁸

5 (App. Op. Br., pp. 8-9.)

6 Citing California Civil Code section 1102.6, and in particular to Disclosure Forms at
7 II.C.7 and II.C.9, appellant asserts that California law requires the seller of real estate to disclose “any
8 settling from any cause, or slippage, sliding, or other soil problems,” and “major damage to the property
9 or any of the structures from fire, earthquake, floods, or landslides.” Appellant argues that the bluff
10 collapses must be disclosed and that respondent cannot reasonably dispute that a willing buyer would
11 not take these collapses into consideration in determining how much he would be willing to pay for the
12 property. (App. Op. Br., p. 10.)

13 Appellant argues, moreover, that an appraisal of the Santa Barbara property must
14 presume that any buyer would be aware of how the property can be used and the enforceable
15 restrictions that exist. Appellant contends that one of the first things that a buyer would certainly do is
16 determine the required setback from the bluff and to calculate either the remaining economic life to the
17 bluff top and existing structures or the location of the building envelope. Appellant asserts that those
18 are exactly what the appraiser considered in his appraisal. Appellant states that the Santa Barbara
19 property originally had a 50-year economic life and that, as a result of the storm, the economic life was
20 reduced by 15 years. Appellant argues that the loss of 30 percent of the expected economic life has a
21 substantial and permanent impact on the FMV of the property. (App. Op. Br., p. 10.)

22 Appellant asserts that, in contrast, respondent pretends to apply a FMV standard but
23 ignores those factors that necessarily determine FMV. Appellant states that respondent sees only a loss
24 in the land that fell over the cliff but refuses to acknowledge that the land remaining has been impacted
25 significantly, or otherwise at all, by that loss. Appellant contends that respondent refuses to recognize
26 the loss of 30 percent of the economic life of the property. (App. Op. Br., p. 10.)

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28 ⁸ Board staff notes that this definition of fair market value is utilized by California local assessors for purposes of real property taxation.

1 Appellant argues that the loss to the Santa Barbara property is entitled to the loss
2 deduction either as property held for in a trade or business (a loss under IRC section 165(c)(1)) or for
3 property held for profit (a loss under IRC section 165(c)(2)). Appellant asserts that the storm of
4 December 2004 caused a severe loss to the Santa Barbara property that resulted in a reduction of the
5 economic life of the property. Appellant argues that, not only was there a loss of square footage of bluff
6 top that was washed out to the sea, there was an impairment to the remaining property that can never be
7 remediated. Appellant argues that respondent's determination of FMV is illusory and only considers the
8 value of the dirt that went over the cliff. Appellant contends that a FMV determination, to the contrary,
9 must consider the impact of the loss on the entire property. Appellant asserts that a competent appraisal
10 establishes the diminution of value of the Santa Barbara property to be \$1,300,000. (App. Op. Br.,
11 p. 13.)

12 Respondent's Opening Brief

13 Respondent argues that appellant is not entitled to a casualty loss deduction under IRC
14 section 165 because a decline in market value of appellant's property resulting from buyer's resistance
15 is not a casualty loss under IRC section 165. Citing the *Appeal of James C. and Monablance A.*
16 *Walshe* (75-SBE-073), decided by the Board on October 20, 1975, and other authority, respondent
17 states that it is settled law that deductions are a matter of legislative grace and that a taxpayer has the
18 burden of proving he is entitled to the deductions claimed. Citing the same authorities, respondent also
19 states that unsupported assertions are not sufficient to carry the taxpayer's burden of proof. Citing the
20 *Appeal of Robert R. Telles* (86-SBE-061), decided by the Board on March 4, 1986, respondent states
21 that, in order to carry his burden, a taxpayer must point to an applicable statute and show by credible
22 evidence that he comes within its terms. Citing the *Appeal of Gilbert W. Janke* (80-SBE-059), decided
23 by the Board on May 21, 1980, and other authority, appellant states that, furthermore, there is a
24 presumption of correctness to respondent's denial deductions. (Resp. Op. Br., p. 6.)

25 Citing *Pulvers v. Commissioner (Pulvers)* (9th Cir. 1969) 407 F.2d 838, 838-839,
26 respondent argues that IRC section 165(c) covers only casualty losses arising from physical damage
27 caused by other, similar casualties. Citing *Kamanski v. Commissioner (Kamanski)* (9th Cir. 1973) 477
28 F.2d 452, 453, respondent also argues that IRC section 165 was not intended to address mere

1 fluctuations in value arising from changes in market demand for real property, even when the change is
2 due to fear of a repetition of the particular casualty. Citing *Finkbohner v. Commissioner, supra*, 788
3 F.2d at p. 727, respondent asserts that IRC section 165 was also not intended to cover mere fluctuations
4 in value arising from a newfound awareness of an old risk attached to the property. Citing *Squirt v.*
5 *Commissioner* (9th Cir. 1970) 423 F.2d 710, 711, respondent contends that, while IRC section 165
6 covers expenses necessary to restore a property to its condition before the casualty, the statute does not
7 cover losses incurred as a result of the decline in the value of the property after the casualty. Citing
8 *Kamanski v. Commissioner, supra*, 477 F.2d at p. 452, respondent argues that such losses are not
9 covered even when incurred upon the disposition of the property. Citing *Thornton v. Commissioner*
10 (*Thornton*) (1966) 47 T.C. 1, respondent states that the burden of proving the loss and its amount is on
11 appellant. Respondent argues that, in the instant matter, appellant has not established his entitlement to
12 a deduction for a casualty loss in excess of the actual physical damage sustained by the property.
13 (Resp. Op. Br., p. 7.)

14 Respondent states that appellant increased his originally-reported casualty loss sustained
15 to the Santa Barbara property from \$224,070 to \$1,300,000. Respondent states that appellant's certified
16 appraiser, Mr. Arnold, came to the increased loss on the Santa Barbara property of \$1,309,531 by
17 bifurcating the loss into (a) the loss to the site itself and (b) the loss to the remaining property.
18 Respondent asserts that the Arnold appraisal stated that a loss occurred for the portion of the setback
19 area physically lost during the Santa Barbara storms. Respondent states that the Arnold appraisal
20 computed this loss as \$55,250 by taking the FMV of the Santa Barbara property before the casualty and
21 multiplying it by the percentage of physical land lost. Respondent states that the Arnold appraisal then
22 discounted the projected future losses to the remaining property to the present day. Respondent asserts
23 that, based on this formula, the Arnold appraisal arrived at a casualty loss amount of \$1,254,281. (Resp.
24 Op. Br., p. 7.)

25 However, respondent states that the actual physical loss to the Santa Barbara property,
26 as determined by the Arnold appraisal, is \$55,250. Respondent states that it does not dispute this
27 amount. Respondent asserts that it is the additional amount of \$1,254,281, arrived at by the Arnold
28 appraisal, with which it has issue. Respondent states that this amount was based on perceived buyer

1 resistance and was not based on actual physical damage to the Santa Barbara property. Respondent
2 argues that, for the reasons below, appellant is not entitled to his alleged losses based on buyer
3 resistance to the Santa Barbara property. (Resp. Op. Br., p. 8.)

4 Citing *Kamanski v. Commissioner* T.C. Memo 1970-352, affd. (9th Cir. 1973) 477 F.2d
5 452, respondent states that the Tax Court's analysis in *Kamanski* is instructive in respondent's denial of
6 appellant's alleged losses to his Santa Barbara property. Respondent states that, in *Kamanski*, the
7 taxpayers claimed that they suffered a casualty loss to their property (i.e., the taxpayers' personal
8 residence) as a result of an earth slide that occurred 250 feet from their property. Respondent states that
9 the earth slide did minor damage to the taxpayers' property but, as a consequence, the market value of
10 the taxpayers' property was reduced. Respondent states that, upon the transfer of their property, the
11 taxpayers claimed a casualty loss and included the decline in market value from the earth slide. (Resp.
12 Op. Br., p. 8.)

13 Respondent states that the Tax Court denied the taxpayers' deduction and determined
14 that the loss was a nondeductible personal loss in the disposition of residential property and not a
15 casualty loss. Respondent states that, furthermore, the Tax Court concluded that the drop in market
16 value was not due to the physical damage caused by the slide itself but to "buyer resistance" and that
17 the casualty loss was limited to damage directly caused by the casualty. Respondent asserts that, in
18 reaching its conclusion, the Tax Court determined that the drop in value of the taxpayers' property was
19 due to purchasing property in an area that had suffered a landslide and not to the small physical damage
20 actually done to the taxpayers' property. Respondent also asserts that, in addition, the Tax Court
21 determined that "the evidence as a whole showed that by far, the major portion of the loss in the
22 taxpayers' property was due to buyer resistance and not to physical damage of the property." Citing
23 *Kamanski*, respondent contends that the Ninth Circuit Court of Appeals (the Ninth Circuit) agreed with
24 the Tax Court and concluded that the loss claimed by the taxpayers was not attributable to the slide
25 itself but to the existence of soil conditions that the occurrence of the slide served to demonstrate.
26 (Resp. Op. Br., pp. 8-9.)

27 Respondent argues that, like the taxpayers in *Kamanski*, there was relatively small
28 physical damage (4.25 percent of the total area of the Santa Barbara property) and that the primary drop

1 in value, according to the Arnold appraisal, was due to buyer resistance to the erosion of the bluff and
2 the restrictions placed on the Santa Barbara property. Respondent states that the severe storms merely
3 accelerated the erosion of the bluff, allegedly a situation occurring before and after the severe storms.
4 Citing the Tax Court in *Kamanski*, respondent argues that, if the erosion to the bluff under the
5 Santa Barbara property occurred without the existence of the severe storms, appellant would not be able
6 to take a deduction for a casualty loss because of the decrease in value from the erosion. Respondent
7 asserts that, based on the holding in *Kamanski*, appellant is not entitled to his claimed loss as a result of
8 the buyer resistance to his Santa Barbara property. (Resp. Op. Br., p. 9.)

9 Respondent asserts that appellant's attempts to circumvent established precedent that
10 repeatedly rejects deductions premised on market fluctuations, through his reliance on *Finkbohner*, are
11 misplaced. Citing *Finkbohner v. U.S., supra*, 788 F.2d at p. 727, respondent states that the Eleventh
12 Circuit permitted a deduction based on permanent buyer resistance in the absence of physical damage.
13 Respondent states that the taxpayers in *Finkbohner* lived on a cul-de-sac with 12 homes, and after
14 flooding damaged several of the houses, municipal authorities ordered seven of the residences
15 demolished and the lots maintained as open space. (Citing *Finkbohner v. U.S., supra*, 788 F.2d at
16 p. 724.) Citing *Finkbohner v. U.S., supra*, 788 F.2d at p. 727, respondent asserts that such irreversible
17 changes in the character of the neighborhood were found to effect a permanent devaluation and to
18 constitute a casualty within the meaning of IRC section 165(c)(3). (Resp. Op. Br., pp. 9-10.)

19 Respondent argues, however, that, as previously explained, an essential element of the
20 deductible casualty loss is physical damage or, in some cases, physically-necessitated abandonment.
21 Moreover, respondent argues that appellant's circumstances do not reflect the permanent devaluation or
22 buyer resistance that would be analogous to that held deductible in *Finkbohner*. Respondent asserts that
23 the loss of the bluff and the restrictions imposed by the Coastal Commission reflected the consequences
24 of real estate development on coastal bluffs. Citing *Finkbohner v. U.S., supra*, respondent argues that
25 appellant has not demonstrated that the erosion of the bluff on which the Santa Barbara property sits has
26 led to "permanent changes in the neighborhood." Respondent argues that, as explained below, there is
27 still development on the bluff on which the Santa Barbara property sits. Respondent contends that this
28 alleged fact, in and by itself, contravenes the holding in *Finkbohner* on which appellant relies. (Resp.

1 Op. Br., p. 10.)

2 Respondent states that appellant relies heavily on the assertion that the deteriorating
3 condition of the bluff on which the Santa Barbara property sits should afford him a casualty loss in the
4 amount of \$1,254,281 because of projected future losses, instead of the \$55,250 amount for actual
5 losses to the property. However, respondent argues that appellant's own statements show that he is not
6 entitled to any casualty loss from projected future losses. (Resp. Op. Br., p. 10.)

7 Citing *White v. Commissioner (White)* (1967) 48 T.C. 430, 433, and *Heyn v.*
8 *Commissioner (Heyn)* (1966) 46 T.C. 302, 307-309, respondent argues first that the deterioration of the
9 bluff was not an event giving rise to a casualty loss through damage that was sudden, unexpected, or
10 unusual in nature. Respondent states that appellant himself acknowledges how the Santa Barbara
11 property has changed over the years, with losses of the bluff on which the Santa Barbara property was
12 located, from 2002 through 2008. Respondent argues that these are not the sort of losses contemplated
13 by IRC section 165(c). (Resp. Op. Br., p. 10.)

14 Citing *Kemper v. Commissioner* (1958) 30 T.C. 546, affd. (8th Cir. 1959) 269 F.2d 184
15 and *Maher v. Commissioner (Maher)* (1981) 76 T.C. 593, affd. (11th Cir. 1982) 680 F.2d 91,
16 respondent argues second that a governmental restriction, even if implemented in response to a
17 casualty, is not a casualty for purposes of IRC section 165. Respondent states that, here, appellant was
18 well aware of the conditions imposed by the Coastal Commission before obtaining his permit for
19 construction on the Santa Barbara property. Respondent states that, in paragraph 11 of the Declaration
20 (Resp. Op. Br., Exhibit K), appellant noted that Condition 15 of the Coastal Development Permit
21 prohibited any structural elements from being placed within 10 feet of the bluff. However, respondent
22 states that appellant relies on the fact that his restrictions on the use of the Santa Barbara property after
23 the severe storms are the primary reason for the \$1,309,531 casualty loss. (Resp. Op. Br., p. 11.)

24 Respondent argues that, for all the reasons stated above, appellant is not entitled to claim
25 casualty losses on the portion of the Santa Barbara property not physically damaged by the severe
26 storms in 2004. Instead, respondent argues, appellant is entitled only to the actual physical damage
27 incurred which, in this case, according to appellant's own appraiser, is \$55,250. (Resp. Op. Br., p. 11.)

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1 Appellant’s Reply Brief

2 Appellant argues that respondent mischaracterizes and misunderstands the nature of
3 appellant’s casualty loss. Appellant emphasizes that actual physical damage occurred to his property.
4 Appellant states that he provided the expert testimony of Mr. Arnold, MAI, who found a casualty loss in
5 the amount of \$1,309,531 resulting from a diminished economic life due to the effects of a devastating
6 storm, as well as a site loss. (App. Reply Br., p. 3.)

7 Appellant argues that respondent’s position is wrong on two bases. First, appellant
8 argues that respondent fails to rebut or to provide any evidence to controvert the Arnold appraisal. In
9 reply to respondent’s arguments in its opening brief that (1) IRC section 165 was not intended to cover
10 mere fluctuations in value arising from changes in market demand, (2) appellant has not established that
11 he is entitled to a deduction for casualty losses in excess of the actual physical damage, and (3) the
12 Arnold appraisal value and methodology are based on “perceived buyer resistance,” appellant asserts
13 that what is missing in respondent’s arguments is any evidence establishing its own FMV position or
14 any evidence rebutting the Arnold appraisal valuation. (App. Reply Br., p. 3.)

15 Appellant states that Mr. Arnold is an MAI, a Member of the Appraisal Institute, the
16 most prestigious professional organization for real estate appraisers in the United States. Appellant
17 alleges that one does not earn an MAI certification unless he has undergone extensive testing,
18 educational training, and a number of experienced years in the appraisal profession. Appellant states
19 that respondent is attacking the Arnold appraisal’s valuation but does not provide an alternative expert
20 to rebut that appraisal or to even provide its own non-expert valuation. Appellant argues that, because
21 he met his burden of producing evidence and respondent failed to rebut, the Board must accept
22 Mr. Arnold’s expert opinion and the resulting value. (App. Reply Br., p. 4.)

23 Second, appellant argues that respondent’s reliance on *Kamanski* is flawed because
24 *Kamanski* is factually inapposite. Appellant states that, although respondent relies on *Kamanski* as
25 precedent to undermine appellant’s case, the taxpayers in *Kamanski* claimed a casualty loss as a result
26 of an earth slide that occurred 250 feet away from their property, rather than as a result of the small
27 physical damage done to their property. Appellant argues that his matter is a different factual
28 circumstance than *Kamanski* because, as respondent admits, over 850 square feet of his property was

1 lost to the ocean. (App. Reply Br., p. 4.)

2 Appellant asserts that respondent then goes on to mischaracterize the Arnold appraisal
3 by stating that it concludes the primary drop in value was due to buyer resistance to the erosion of the
4 bluff and the restrictions placed on the Santa Barbara property. Appellant argues that respondent does
5 not understand the nature of the methodology of the Arnold appraisal. Appellant states that basic real
6 estate theory holds that a property (both land and improvement) has a useful life that is known as an
7 “economic life.” Appellant argues that the economic life of the Santa Barbara property was 50 years
8 or, put differently, the property’s useful life, for the purpose for which it was intended, was 50 years.
9 Appellant argues that the property’s economic life diminished considerably with the advent of torrential
10 rains in December 2004. Appellant states that a willing buyer after the December casualty would
11 determine his ability to utilize that property for its highest and best use. Appellant asserts that the
12 willing buyer, knowing that a large portion of the bluff fell into the sea and aware of the setback
13 restrictions of Santa Barbara County, would discount his asking price because of his knowledge that the
14 ability to utilize the property would be less than 50 years. Appellant argues that *Kamanski* is not on
15 point and is inapposite. (App. Reply. Br., pp. 4-5.)

16 Finally, appellant asserts that *Finkbohner* is more persuasive than *Kamanski*. Appellant
17 argues that respondent’s view, that his circumstances do not reflect the type of permanent devaluation
18 or buyer resistance that would be analogous to that held deductible in *Finkbohner*, is mistaken.
19 Appellant states that, while the taxpayer in *Finkbohner* did not suffer physical damage, appellant
20 clearly had physical damage, as admitted by respondent. With regard to respondent’s argument that he
21 has not demonstrated that the erosion of the bluff led to “permanent changes in the neighborhood,”
22 appellant argues that the erosion in the bluff has led to direct and permanent changes to his property.
23 Appellant argues that the facts of his matter are much stronger than those in *Finkbohner* because a
24 casualty loss was granted there even though no physical damage occurred in that matter. (App. Reply
25 Br., p. 5.)

26 Respondent’s Reply Brief

27 Respondent argues that appellant’s reliance on the Arnold appraisal does not support his
28 casualty loss. Respondent states that appellant misconstrues its comments regarding the Arnold

1 appraisal and states that it is not “attacking” the appraisal. Respondent argues, rather, that the valuation
2 of the Santa Barbara property after the casualty takes into consideration factors that are not relevant for
3 purposes of calculating a casualty loss under IRC section 165(c). (Resp. Reply Br., p. 2.)

4 Citing *Pulvers, Citizens Bank of Weston v. Commissioner (Citizens Bank)* (4th Cir.
5 1958) 252 F.2d 425, and Revenue Ruling 66-242, respondent argues that a casualty loss depends on
6 actual physical damage to a taxpayer’s property and not a hypothetical loss, a mere fluctuation in value,
7 or temporary buyer resistance. Respondent states that, in valuing the Santa Barbara property,
8 Mr. Arnold accounted for economic life, impaired utility, financing difficulties, and the governmental
9 restrictions on the property in computing the value of the property after the casualty. Respondent
10 argues that those factors do not go to the actual physical damage to the Santa Barbara property by the
11 storms. Respondent argues that the actual damage is measured by the loss of physical property and not
12 by the hypothetical factors used by Mr. Arnold in valuing the property for purposes of IRC section 165.
13 (Resp. Reply Br., p. 2.)

14 Respondent states that appellant initially computed his casualty loss for the
15 Santa Barbara property correctly as \$55,250. Respondent states that this calculation was completed by
16 taking the FMV of the site before the casualty and subtracting the actual loss suffered by the property.
17 Respondent asserts that the actual loss of the setback area was 4.25 percent of the total property and
18 that it allowed this deduction because the proper measure of a casualty loss is the difference between
19 the FMV of the property immediately before the casualty and its FMV immediately after the casualty,
20 but not exceeding its adjusted basis. (Resp. Reply Br., p. 2.)

21 Respondent alleges that appellant knew the risk inherent in building on ocean front
22 property. Respondent contends that appellant himself acknowledges that these types of developments
23 have only a 50-year planned life. Therefore, respondent argues, it is foreseeable that, in the event of a
24 severe storm, the useful life of ocean front property will be diminished. However, respondent argues
25 that, for purposes of IRC section 165, what is important in determining a loss is the actual damage to the
26 affected property and not the effects it will have on the future prospects of the property. (Resp. Reply
27 Br., p. 3.)

28 Citing *Kemper v. Commissioner, supra*, 30 T.C. at pp. 549-550, respondent argues that

1 any reduction in the value of the Santa Barbara property owing to government restrictions on that
2 property is not a casualty loss because the proximate cause of the loss is the government restriction
3 rather than the storm itself. Citing the opinion of the Eleventh Circuit in *Maher v. and Coleman v.*
4 *Commissioner* (1981) 76 T.C. 580, 589, respondent argues, moreover, that the government restriction
5 does not constitute a casualty, as defined in IRC section 165(c)(3) or “other casualty.” (Resp. Reply Br.,
6 p. 3.)

7 Respondent argues that the holding in *Kamanski* is applicable to this case. Respondent
8 states that appellant argues *Kamanski* is not applicable to this appeal because the facts there are
9 distinguishable from those in the instant matter. However, respondent argues that, in both the situation
10 in the instant matter and the facts in *Kamanski*, the issue is related to a casualty loss deduction being
11 denied because of a property’s valuation in which buyer resistance is taken into account. Respondent
12 contends that appellant mistakenly believes that, for a court case to stand for respondent’s proposition,
13 the facts from the case need to be identical to those present here. (Resp. Reply Br., p. 3.)

14 Respondent states that, in *Kamanski*, the taxpayers’ neighboring property had suffered a
15 casualty (a mudslide) resulting in only minimum damage to the taxpayers’ property but that the market
16 value of the property was reduced. Respondent states that, as a result, the taxpayers sought to claim a
17 casualty loss deduction under IRC section 165 not only for the actual damage to the property but also
18 for the reduction in market value. (Resp. Reply Br., p. 3.)

19 Respondent states that, here, the majority of appellant’s loss to the Santa Barbara
20 property resulting from the storms was attributable primarily to potential future losses attributable to
21 buyer resistance to purchasing the property, which would continue to erode. Respondent states that
22 appellant’s actual damage to the Santa Barbara property accounted for a small portion (\$55,250)
23 compared to the loss in value (\$1,254,281) resulting from the storms. Respondent argues that appellant
24 suffered relatively small damage to the Santa Barbara property and that the primary drop was due to
25 buyer resistance to purchasing property in an area that had suffered a landslide. (Resp. Reply Br., p. 3.)

26 Respondent argues that, in valuing their respective properties after the casualty, both the
27 taxpayers in *Kamanski* and appellant used factors not directly pertaining to actual damage to their
28 properties. As an example, respondent states that, in valuing their property after the mudslide, the

1 taxpayers in *Kamanski* used such factors as the unwillingness of financial institutions to make loans in
2 the areas affected by the slide. Respondent states that, in valuing the Santa Barbara property,
3 Mr. Arnold similarly used such factors as the loss of future rents, a 30 percent diminution of the
4 economic life⁹ of the property, financing difficulties, and the government restrictions related to the
5 setback on the property. Respondent argues that these factors were not considered by the *Kamanski*
6 Court and should not be considered by the Board.¹⁰ (Resp. Reply Br., pp. 3-4.)

7 Citing *Citizens Bank* and the opinion of the Ninth Circuit in *Pulvers*, respondent asserts
8 that the principle laid out in *Kamanski* is supported by a number of cases applicable to the case at hand.
9 Respondent argues that appellant is only allowed a casualty loss for the actual damage to the
10 Santa Barbara property in the amount of \$55,250 and that respondent properly denied the additional
11 loss amount of \$1,254,281 arising from buyer resistance to the property. (Resp. Reply Br., p. 4.)

12 Respondent argues that appellant's reliance on the holding in *Finkbohner* is misplaced.
13 Respondent contends that appellant seems to believe that, because the taxpayer in *Finkbohner* did not
14 suffer physical damage to his property and appellant did, *Finkbohner* supports his position.
15 Respondent states that the fact the taxpayer's property was not physically damaged in *Finkbohner* was
16 a central consideration in that case. Citing *Finkbohner v. Commissioner, supra*, 788 F.2d at p. 725,
17 respondent states that the court specifically addressed the treatment to be given to a loss of FMV due to
18 "buyer resistance" and not to physical damage. Respondent argues that, for appellant to state that the
19 holding in *Finkbohner* supports his position because the Santa Barbara property suffered actual
20 physical damage when the taxpayer in *Finkbohner* did not suffer such damage, misses the entire point
21 of the case. Respondent also states that the IRS, in an Action on Decision (AOD) (AOD 1987-008),
22 disagreed with the holding of the Eleventh Circuit in *Finkbohner* and indicated that it would continue to
23 abide by the longstanding position that casualty losses are limited to physical losses and do not include

24 _____
25 ⁹ Board staff notes that this is a term characterized by respondent as meaning the period over which real property will yield a
26 return on the investment over and above the economic ground rent due to the land.

27 ¹⁰ Respondent quotes *Kamanski v. Commissioner, supra*, at p.852 as follows: "[t]he [Tax] Court ruled that the loss sustained
28 was a nondeductible personal loss in disposition of residential property and not a casualty loss; that the drop in market value
was not due to physical damage caused by the slide, but to 'buyer resistance;' that casualty loss is limited to damage directly
caused by the casualty. We agree." (Resp. Reply Br., p. 4.)

1 such factors as “buyer resistance.”¹¹ (Resp. Reply Br., pp. 4-5.)

2 Appellant’s Supplemental Brief

3 With regard to the Arnold appraisal, appellant argues that, contrary to what respondent
4 stated in its reply brief, the loss of the bluff area and the attendant diminution in value to the
5 Santa Barbara property was not hypothetical or a “mere” fluctuation. Appellant argues that the
6 devastating nature of the storm caused bluff retreat that had severe ramifications on the value of the total
7 property. Appellant again asserts that Mr. Arnold is an experienced and well-regarded appraisal expert
8 in Santa Barbara while respondent has not provided its own affirmative appraisal or valuation
9 methodology. (App. Supp. Br., p. 2.)

10 Appellant states that, while respondent admits that the ocean front property has a 50-year
11 planned life, respondent goes on to assert that all that is important is the actual damage and not the
12 effects it will have on the future prospects of the property. Appellant states that this assertion
13 demonstrates respondent’s lack of understanding of value. Appellant states that respondent argues that,
14 at the time of the casualty, the Santa Barbara property suffered a present and real diminished value
15 rather than an effect for the future. Appellant states that the Arnold appraisal captured the immediate
16 loss of value to the total property in his valuation methodology. (App. Supp. Br., p. 2.)

17 Appellant alleges that, when he purchased the Santa Barbara property, he was assured by
18 a California State Licensed Geologist Report, which was used by the seller of the property to secure a
19 Coastal Development Permit from the County of Santa Barbara Planning Department, that the average
20 annual bluff retreat rate was 18 inches per year. However, appellant states that, within six months of the
21 lease of the property, the bluff retreated 10 feet (6.67 times the documented retreat rate) resulting in a
22

23 ¹¹ The AOD states that the *Finkbohner* court rejected the principle that losses not due to physical damage or to the
24 impairment of the taxpayer’s property are not to be taken into account. The AOD states that the principle is supported by a
25 number of cases and, at least until *Finkbohner*, was uniformly upheld. The AOD states that the cases supporting the
26 principle include the Ninth Circuit opinion in *Kamanski* and the Fourth Circuit opinion in *Citizens Bank*. Citing *Citizens
27 Bank of Weston v. Commissioner, supra*, 252 F.2d at p. 428, the AOD states that mere market fluctuations are not to be
28 taken into account. The AOD adds that “[a]s noted by the dissent [in *Finkbohner*], with which we agree, the taxpayers’
appraisal did not include the subsequent removal of adjacent houses so the taxpayers should not have been allowed to rely
on this factor.” The AOD summarizes by adding the gloss “the losses from casualty are limited by law to actual physical
losses and do not include factors such as ‘buyer resistance.’” In recommending “no certiorari,” the AOD states that,
although the opinion in *Finkbohner* conflicts in principle with the reasoning of the cases cited in the AOD and others cited in
the *Finkbohner* dissent, the conflict is not direct.

1 permanent loss. Appellant states that those “mere” 800 square feet of usable area lost to the ocean are
2 no longer usable by a tenant and could not be factored into the lease price. Appellant argues that this
3 was a very real loss and not a hypothetical loss. (App. Supp. Br., p. 2.)

4 Appellant states that, in the seven years he has owned the property, the bluff has
5 retreated in excess of 45 feet. Appellant asserts that, at the professionally-predicted retreat rate of
6 1.5 feet annually, this 2004 casualty loss event resulted in seven years of erosion occurring all at once.
7 Appellant states that, of the original 75-foot setback that was supposed to show a 50-year economic
8 life, only 30 feet remain today. Appellant argues that this equates to a 6.4 foot annual retreat rate,
9 which implies a useful economic life of only 4.6 years remaining in 2011 instead of 43 years indicated
10 by the State Licensed Geologist. (App. Supp. Br., p. 2.)

11 Lastly, appellant argues that respondent misunderstands the nature of the government
12 restrictions on the Santa Barbara property by focusing on respondent’s assertion that any reduction in
13 value of the property resulting from the government restriction on the property is not a casualty loss
14 because the proximate cause of the loss is the government restriction rather than the storm itself.
15 Appellant states that the government restriction at issue is a safety restriction implemented many years
16 before the 2004 storm and was in existence both before and after the casualty event. Appellant states
17 that Mr. Arnold, an experienced appraiser with significant experience in beach front properties,
18 understood that the preexisting restriction mandated a projected property life of 50 years with
19 corresponding setback conditions and performed his appraisal in light of that understanding. Appellant
20 again argues that respondent has failed to controvert with any evidence the Arnold appraisal. (App.
21 Supp. Br., pp. 2-3.)

22 Appellant asserts that the facts in *Kamanski* are different from the facts here and that
23 whether a property has a casualty loss and what is the value of that loss are questions of fact. Appellant
24 states that, in *Kamanski*, a neighbor’s property had a mudslide which minimally damaged the taxpayer’s
25 property. Appellant states that the court held that the minimal physical damage did not justify the large
26 diminution in value sought by the taxpayers. Appellant argues that this factual scenario must be
27 contrasted with the facts of the instant matter. First, appellant states it was appellant’s property that
28 suffered physical loss rather than the neighboring property. Second, appellant states that the physical

1 loss was over 800 square feet of picturesque, high demand, coastal bluff. Appellant asserts that, in point
2 of fact, the Santa Barbara property derives its value from the high demand for coastal property, which is
3 in scarce supply. Appellant argues that the foregoing facts are very different from those in *Kamanski*.
4 (App. Supp. Br., p. 3.)

5 Appellant again argues that *Finkbohner* provides strong support for his position.
6 Appellant states that, while in *Finkbohner* the taxpayers did not suffer physical damage, he suffered not
7 only physical damage but also the loss of over 800 square feet of sought after, scenic coastal bluff. As a
8 result, appellant argues, his case is much stronger by far. (App. Supp. Br., p. 3.)

9 Appellant states that the IRS's position in the language quoted immediately above is
10 precisely the same position taken by respondent. Appellant argues that the loss of over 800 square feet
11 of scenic bluff was permanent and not temporary and that the loss significantly and permanently
12 impaired the utility and value of his property. (App. Supp. Br., p. 4.)

13 Finally, appellant states that IRC section 165(c)(3) is based on FMV immediately before
14 the disaster versus FMV just after the disaster. Appellant states that FMV takes into consideration the
15 same factors utilized by Mr. Arnold, such as market demand, restriction on use (in this matter, bluff
16 setbacks), and permanent buyer resistance. Appellant states that FMV is much more than a simple
17 determination of costs and asserts, as an example, that value is determined under California Property
18 Tax Law under three approaches to value: (1) the comparative sales approach, (2) the reproduction and
19 replacement cost approaches, and (3) the income approach. Appellant states that both the Internal
20 Revenue Code and Revenue and Taxation Code contemplate FMV.

21 In conclusion, appellant states that, in 2004, he was engaged in a trade or business and
22 suffered a substantial casualty when over 800 square feet of bluff fell into the ocean. Appellant argues
23 that the proper legal standard is FMV and not merely cost (which is only one of three approaches to
24 determine FMV). Appellant argues that, while he provided a FMV market valuation study by an MAI
25 certified appraiser that utilized all approaches to value, respondent provided nothing. Appellant argues
26 that he met his burden of proof and must prevail. (App. Supp. Br., p. 5.)

27 Appellant's Additional Briefing

28 As for which party has the burden of proof regarding appellant's entitlement to a

1 deduction under IRC section 165, appellant argues that the Board must look at the NPA issued with the
2 perspective of how respondent asserted this issue “at any point before the issuance of its original
3 deficiency.”¹² With respect to the issue under IRC section 165, appellant indicates that the NPA states
4 only that the reported casualty loss was disallowed because neither the casualty event nor the reported
5 loss amount was documented. Appellant states that it is not clear exactly when respondent first raised
6 the personal-use issue. Appellant asserts that the NOA contained no new explanations and stated only
7 that the requirements of IRC section 165 were not met. (App. First Reply Letter, pp. 4-5.)

8 Appellant asserts that respondent failed to raise the possible personal nature of the loss
9 under IRC section 165 in the NPA such that, if the NPA constitutes “the issuance of its original
10 deficiency,” the burden of proof shifts under the rule stated in *Mendelsohn*. Appellant states that, in
11 *Mendelsohn*, respondent abandoned its original position and instead adopted a new contention on appeal
12 that involved a theory which would require new evidence by the taxpayer. Appellant states that, in
13 deciding the case, the Board applied a rule taken from *Achiro v. Commissioner (Achiro)* (1981) 77 T.C.
14 881. (App. First Reply Letter, p. 5.)

15 Appellant asserts that the Board, citing *Achiro*, stated in *Mendelsohn* that, if
16 respondent’s position on appeal either alters the original deficiency or requires the presentation of
17 different evidence, then a new matter has been introduced and the burden of proving that new position
18 shifts to respondent. In contrast, the assertion of a new theory that merely clarifies or develops the
19 original determination without being inconsistent or increasing the amount of the deficiency is not a
20 new matter requiring the shifting of the burden of proof to respondent. Appellant asserts that the Board
21 in *Mendelsohn* then concluded by stating that, as respondent raised a new theory in its brief on appeal
22 that does not clarify or develop its original position, it is respondent’s burden to present new evidence
23 to support its position on appeal. (App. First Reply Letter, p. 5.)

24 Appellant argues that, applying *Mendelsohn* to the facts here, the “original deficiency”
25

26 ¹² In the *Appeal of David G. and Helen Mendelsohn (Mendelsohn)*, 85-SBE-141, November 6, 1985, the Board found that, if
27 respondent’s position on appeal either alters an original deficiency or requires the presentation of different evidence, then a
28 new matter has been introduced and the burden of proving that new position shifts to respondent. On the other hand, the
Board further held that the assertion of a new theory which merely clarified or developed the original determination, without
being inconsistent or increasing the amount of the deficiency, is not a new matter that required the shifting of the burden of
proof to respondent.

1 made no reference to the casualty loss being personal in nature. Appellant states that, instead, the
2 assessment was based on an alleged lack of documentation. Appellant argues that to change the
3 grounds for disallowance based on an alleged personal loss limitation clearly “requires the presentation
4 of different evidence.” (App. First Reply Letter, p. 5.)

5 Appellant asserts that (1) the NPA did not allude to the personal nature of the
6 Santa Barbara property (either to disallow the IRC section 1031 exchange or to limit the loss under IRC
7 section 165(h)); (2) the NOA contained the same additional tax as the NPA, with no assertion of the
8 personal nature of the property; (3) *Mendelsohn* stands for the proposition that if respondent’s position
9 on appeal either alters the original deficiency or requires the presentation of additional evidence, then a
10 new matter has been introduced and the burden of proving the new proposition shifts to respondent; and
11 (4) in *Achiro*, the Tax Court upheld the shift of the burden of proof (even when the taxpayer was aware
12 of the new grounds five weeks before trial). Appellant argues that, in light of the foregoing points, the
13 burden of proof shifts to respondent to show why the Santa Barbara property was not connected with
14 (1) a trade or business or (2) a transaction entered into for profit. As a result, appellant argues that
15 respondent is unable to meet its burden and the property meets the trade business/for profit requirement.
16 (App. First Reply Letter, p. 6.)

17 Respondent’s Additional Briefing

18 Respondent argues that *Mendelsohn* does not shift the burden of proof in this matter.
19 Respondent states that, under *Mendelsohn*, if it raises a new issue on appeal, the burden of proof shifts
20 to respondent regarding the new issue. Respondent asserts that it raises a new issue if it adopts a
21 position on appeal that would either alter the amount of the deficiency or require the presentation of
22 additional evidence. Respondent argues that, in contrast, introducing a new theory that merely clarifies
23 or develops the original determination in a consistent manner without increasing the amount of the
24 deficiency is not a new matter under *Mendelsohn*. (Resp. Reply Letter, p. 4.)

25 Respondent argues that it did not raise a new issue in its opening brief in this matter.
26 Respondent states that it addressed during the protest stage the issue of whether appellant entered into a
27 valid property exchange under IRC section 1031. Respondent states that the issue of whether the
28 Santa Barbara property was used in a trade or business was examined to determine whether the

1 property qualified as like-kind property for purposes of IRC section 1031. Respondent contends that
2 part of its rationale for disallowing the like-kind exchange was appellant's failure to demonstrate that
3 the Santa Barbara property was a "rental property" and, therefore, like-kind property for purposes of
4 IRC section 1031. Respondent asserts that appellant has conceded that this issue was addressed and
5 resolved at protest in this matter. Respondent argues that, as a result, the issue of whether the
6 Santa Barbara property was connected with a trade or business or a transaction entered into for profit
7 was examined and presented to appellant before the issuance of the NOA and consequently the filing of
8 the appeal. (Resp. Reply Letter, p. 4.)

9 Respondent states that the Board's decision in *Mendelsohn*, as well as related cases, specifically
10 focuses on whether it is introducing a new issue at the appeals stage of the administrative process.
11 Respondent states that there is no mention in *Mendelsohn* or the related cases of prohibiting it from
12 raising an issue at protest, as it did here. Respondent asserts that it is common for new issues to be
13 brought up during the protest stage of the administrative process. Respondent argues that appellant's
14 attempt to use the holding in *Mendelsohn* to argue that respondent failed to address the character of the
15 Santa Barbara property "prior to the issuance of the original deficiency" is misplaced. (Resp. Reply
16 Letter, pp. 4-5.)

17 Board Member Inquiries

18 In October 2014, when this matter was previously scheduled for oral hearing, a Board
19 Member inquiry (BMI) was sent to the parties.¹³ In this BMI, the parties were asked the following:

- 20 1. Did either the January 7, 1999 report from CFS Engineering Geology Inc. or the Santa
21 Barbara County Zoning Administrator Hearing on February 11, 2002, indicate that the
22 erosion rate of 18 inches per year or the economic life of 50 years could change? Was
23 there any guarantee that the erosion rate would not exceed 18 inches per year or that the
24 economic life would be at least 50 years?
- 25 2. Please provide a complete copy of the January 7, 1999 report from CFS Engineering
26 Geology Inc. for the Santa Barbara property.
- 27 3. Please clarify how the Arnold appraisal arrived at the 35% to 40%, with the average of
28 37.5% being used to compute the impact to the remaining property.

¹³ This Board Member inquiry was distributed to the Board Members by way of an email on October 8, 2014.

1 In response to questions 1 and 2, appellant notes (referencing the CFS Engineering
2 Geology Report) various erosion rates that have been calculated, going back as far as 1968, of up to
3 approximately 18 inches per year. Appellant also notes that the report includes a statement in a section
4 labelled “Landslides” which provides that “There are no mapped landslides on the coast in the general
5 vicinity of the site.” Appellant contends that, because of this analysis, the construction of proposed
6 residences at this location was found to be geologically feasible. Nevertheless, appellant asserts that
7 there was never any guarantee about the erosion rate but that, barring an unusual storm that precipitated
8 a bluff retreat event, a reasonable person would conclude that the bluff would continue to retreat at its
9 historic rate of 18 inches per year.

10 As for question 3 above, appellant states that, according to the Arnold appraisal, the
11 economic life of the property was 30 percent less the day after the damages were sustained. Along with
12 this, appellant stated that “[t]o this 30% loss was added further problems with procuring insurance,
13 procuring a loan on the property, so Mr. Arnold added 5% - 10% to the 30% and decided to split the
14 difference at 7.5% to come up with 37.5%.”

15 In its response to the BMI, respondent defers to appellant regarding questions 1 and 2
16 above. As for question 3, respondent states that its review of the appraisal does not show the
17 methodology that Mr. Arnold used to arrive at the 37.5 percent discount rate.

18 Applicable Law

19 It is also well settled that a presumption of correctness attends respondent’s
20 determinations of fact and that a taxpayer has the burden of proving such determinations erroneous.
21 (*Appeal of George H. and Sky Williams, et al.*, 82-SBE-018, Jan. 5, 1982.) This presumption is a
22 rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary.
23 Respondent’s determinations cannot, however, be successfully rebutted when the taxpayer fails to
24 present credible, competent, and relevant evidence as to the issues in dispute. (*Appeal of George H.*
25 *and Sky Williams, et al., supra.*)

26 It is well settled that deductions are a matter of legislative grace and that the taxpayer
27 bears the burden of establishing his entitlement to the claimed deductions. (*Appeal of Robert R. Telles,*
28 *86-SBE-061, Mar. 4, 1986.*) To carry that burden, the taxpayer must point to an applicable statute and

1 show by credible evidence that he comes within its terms. Unsubstantiated assertions by the taxpayer
2 are not sufficient to satisfy the burden of proof. (*Appeal of Robert R. Telles, supra.*)

3 R&TC section 17201, subdivision (a), incorporates by reference IRC section 165,
4 except as otherwise provided. IRC section 165(a) provides generally that there shall be allowed as a
5 deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.
6 IRC section 165(b) provides that, for purposes of subsection (a), the basis for determining the amount
7 of the deduction for any loss shall be the adjusted basis provided in IRC section 1011 for determining
8 the loss from the sale or other disposition of property. IRC section 165(c) provides that, in the case of
9 an individual, the deduction under subsection (a) shall be limited to: (1) losses incurred in a trade or
10 business, (2) losses incurred in any transaction entered into for profit, though not connected with a
11 trade or business, and (3) except as provided in subsection (h), losses of property not connected with a
12 trade or business or a transaction entered into for profit, if such losses arise from fire, storm,
13 shipwreck, or other casualty, or theft.

14 Treasury Regulation section 1.165-1(b) provides, in part, that, to be allowable as a
15 deduction under IRC section 165(a), a loss must be evidenced by closed and completed transactions,
16 fixed by identifiable events, and, except for certain stated exceptions, actually sustained during the
17 taxable year. Treasury Regulation section 1.165-1(d) provides, in part, that a loss shall be allowed as a
18 deduction under IRC section 165(a) only for the taxable year in which the loss is sustained.

19 Treasury Regulation section 1.165-7(a)(2)(i) provides that, in determining the amount of
20 loss deductible under IRC section 165, the FMV of the property immediately before and immediately
21 after the casualty be generally be ascertained by a competent appraisal.¹⁴ Furthermore, the regulation
22 states that this appraisal must recognize the effects of any general market decline affecting undamaged
23 as well as damaged property that may occur simultaneously with the casualty, in order that any
24 deduction under IRC section 165(a) shall be limited to the actual loss resulting from damage to the
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27 ¹⁴ In *Thornton*, the Tax Court questioned the competence of an appraisal of property damaged by floodwaters because the
28 appraisal was not supported by evidence of post-flood sales and did not contain a segregation of the portion of the diminution
of the value of the taxpayer's property that was temporary in nature and based on the average buyer's reluctance to purchase
in a casualty neighborhood for fear that there might be a recurrence of the casualty. (*Thornton v. Commissioner, supra*, 47
T.C. at p. 5.)

1 property. Treasury Regulation section 1.165-7(a)(2)(ii) provides that the cost of repairs to the property
2 damaged is acceptable as evidence of the loss of value if the taxpayer shows that (a) the repairs are
3 necessary to restore the property to its condition immediately before the casualty, (b) the amount spent
4 for such repairs is not excessive, (c) the repairs do not care for more than the damage suffered, and (d)
5 the value of the property after the repairs does not as a result of the repairs exceed the value of the
6 property immediately before the casualty.

7 Treasury Regulation section 1.165-7(b)(1) states a general rule that, in the case of any
8 casualty loss, whether or not incurred in a trade or business or in any transaction entered into for profit,
9 the amount of the loss to be taken into account for purposes of IRC section 165(a) shall be the lesser of
10 either (i) the amount that is equal to the FMV of the property immediately before the casualty reduced
11 by the FMV of the property immediately after the casualty; or (ii) the amount of the property's adjusted
12 basis prescribed in Treasury Regulation section 1.1011-1 for determining the loss from the sale or other
13 disposition of the property involved.¹⁵

14 In interpreting the phrase "other casualty" in IRC section 165(c)(3), the Tax Court has
15 stated the cases make it clear that a casualty is an occurrence of a sudden unexpected nature.
16 (*Kamanski v. Commissioner, supra.*) The Tax Court had earlier stated that physical damage or
17 destruction of property is an inherent prerequisite in showing a casualty loss but also recognized that a
18 loss arising from the abandonment of property caused by the occurrence of a casualty could be
19 deducted under the general provisions of the predecessor section to IRC section 165 (rather than as a
20 casualty loss) as long as the taxpayer could prove that he actually sustained a loss. (*Citizens Bank of*
21 *Weston v. Commissioner, supra*, 28 T.C. at p. 720.) The Tax Court subsequently indicated that an
22 alleged casualty loss is not "sustained" during the taxable year if it resulted from a mere fluctuation in
23 value. (*Peterson v. Commissioner, supra*, 30 T.C. at p. 665.) In discussing casualty losses under IRC
24 section 165, The Tax Court emphasized the phrase "this section shall be limited to the actual loss
25 resulting from damage to the property" in Regulation 1.165-7(a)(2)(i) and stated that it is clear from
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28 ¹⁵ Treasury Regulation 1.165-7(b)(1) goes on to further provide however that, if the property is used in a trade or business or
is held for the production of income is totally destroyed by a casualty, and if the FMV of such property immediately before
the casualty is less than the adjusted basis of such property, the amount of the adjusted basis of such property shall be treated
as the amount of the loss for purposes of IRC section 165(a).

1 that emphasized phrase that “*only* the amount of the loss resulting from physical damage to property is
2 deductible under [IRC section 165].” (*Squirt Company v. Commissioner (Squirt)* (1969) 51 T.C. 543,
3 547.) In holding that the only loss the taxpayer was entitled to deduct was for the physical damage to
4 his property, the Tax Court in *Kamanski* reiterated that physical damage or destruction of property is an
5 inherent prerequisite in showing a casualty loss and stated that, under Treasury Regulation section
6 1.165-7(a)(2)(i), the portion of the decline of the market value of the taxpayer’s residence that was
7 attributable to a general decline in the value of the undamaged property cannot be counted in
8 determining the amount of the taxpayer’s casualty loss and the loss must be limited to the actual loss
9 resulting from the damage to the property by the flood. (*Kamanski v. Commissioner, supra.*) The
10 Fourth Circuit affirmed the Tax Court opinion in *Citizens Bank* at (1958) 252 F.2d 425. The Ninth
11 Circuit affirmed the Tax Court opinion in *Squirt* at (1970) 423 F.2d 710 and the Tax Court decision in
12 *Kamanski* at (1969) 407 F.2d 838.

13 In *Finkbohner*, a flood damaged several of the dozen homes on the cul-de-sac on which
14 the taxpayers resided but caused damage only to the driveway and grounds of their residence. The
15 municipal authorities decided after the flood to eliminate, for safety reasons, seven of the twelve houses
16 on the cul-des-sac. The seven houses were demolished and the lots acquired to be maintained for open
17 space. The taxpayer introduced evidence at trial that this change markedly diminished the amenities
18 and attractiveness of their residence, placing it in a lonesome neighborhood, more exposed to crime,
19 and with much diminished privacy in view of the proximity of heavily traveled streets and bridges. The
20 IRS disallowed all of the taxpayers’ claimed casualty loss under IRC section 165(c)(3) except for a
21 relatively small amount that represented the cost of physical repairs to their property. (*Finkbohner v.*
22 *United States, supra*, 788 F.2d at p. 724.) The Eleventh Circuit states that, at trial, the judge instructed
23 the jury, over the objections of the United States, that they could award compensation for loss of value
24 due to “buyer resistance” to the extent that such resistance was permanent and that the jury returned a
25 verdict reflecting its determination that some, though not all, “buyer resistance” resulting from the
26 flood would be permanent. (*Finkbohner v. United States, supra*, 788 F.2d at p. 725.)

27 On appeal, the Eleventh Circuit affirmed the judgment entered by the trial court and
28 remanded the case for a determination of the amount of the refund to which the taxpayers were entitled

1 according to the verdict of the jury. (*Finkbohner v. United States, supra*, 788 F.2d at p. 727.)
2 Regarding the exclusion of “general market decline,” affecting damaged and undamaged property alike,
3 from the calculation under Treasury Regulation section 1.165-7, the Eleventh Circuit states that the
4 regulation does not address the treatment to be given to the loss of FMV due to “buyer resistance” and
5 not to physical damage. (*Finkbohner v. United States, supra*, 788 F.2d at p. 725.) The Eleventh Circuit
6 distinguishes the appellate cases of *Citizens Bank* and *Kamanski*, as well as other cases, from its matter
7 on the basis that those cases dealt with fluctuations in value while the facts of its matter showed a
8 permanent impairment. (*Finkbohner v. United States, supra*, 788 F.2d at pp. 726-727.) The Eleventh
9 Circuit stated that “[i]t is different when the impact of the flood on the market value shows itself not
10 wholly or chiefly in the expectation that additional floods will in the future occur, but more directly in
11 changes in the neighborhood, or acts of public officials, that will outlast the fresh recollections of
12 disaster.” (*Finkbohner v. United States, supra*, 788 F.2d at p. 727.)

13 STAFF COMMENTS

14 As we noted above, respondent has conceded that appellant would be entitled to a
15 casualty loss in the amount of \$55,250, for physical damages, for the portion of his Santa Barbara
16 property that suddenly fell into the ocean in 2004 as a result of a storm in December of that year. The
17 issue that remains is whether appellant is entitled to a casualty loss deduction for the balance of the
18 Santa Barbara property, i.e., the portion of that property that did not suddenly fall into the ocean in
19 December of 2004.

20 At the hearing, the parties should be prepared to discuss whether the Arnold appraisal is
21 a competent appraisal in light of the Tax Court decision in *Thornton* and within the meaning of
22 Treasury Regulation section 1.165-7(a)(2)(i). In addition, appellant should be prepared to explain
23 whether he filed an amended 2004 federal return to likewise claim a \$1,300,000 casualty loss on that
24 return as well. Appellant should also be prepared to explain whether the IRS has examined his 2004
25 federal return and/or his 2004 amended federal return and whether such returns have been accepted by
26 the IRS. At least 14 days prior to the hearing, appellant should provide documentation or

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1 correspondence from the IRS regarding his 2004 federal return and or 2004 amended federal return.¹⁶

2 Appellant relies upon the zoning restrictions (by the County and the Coastal
3 Commission) on the use of the Santa Barbara property, limitations that were in place at the time that he
4 acquired the property, as a primary reason for the property's permanent impairment. The parties should
5 be prepared to address if a governmental restriction, which is in place prior to a casualty (as opposed to
6 being put in place as a result of the casualty), can be the basis for a casualty loss under IRC section
7 165(c).

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¹⁶ Appellant should submit the requested evidence, at least 14 days prior to the date of the hearing, to: Khaaliq A. Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.