**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

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| In the Matter of the Appeal of: | ) OTA Case No. 18010927 |
| **JOSEPH MICHAEL** | ) Date Issued: April 26, 2019 |

**OPINION**

Representing the Parties:

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| For Appellant: | Paul Rosenkranz, CPA |
| For Respondent: | David Hunter, Tax Counsel IV<br>Ciro Immordino, Tax Counsel IV |
| For Office of Tax Appeals (OTA): | Linda Frenklak, Tax Counsel IV |

N. DANG, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, Joseph Michael (appellant) appeals an action by respondent Franchise Tax Board (FTB) denying his protest of a proposed assessment of $56,362 additional tax, plus interest, for the 2009 tax year.

Administrative Law Judges Nguyen Dang, Sara A. Hosey, and Kenneth Gast held an oral hearing for this matter in Los Angeles, California, on February 21, 2019. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

## ISSUE

Whether appellant has established that 2009 is the proper year to claim his casualty loss deduction, and if so, the amount of that loss.

## FACTUAL FINDINGS

1. Appellant owned residential property located on Casiano Road in Los Angeles, California (the Casiano property). The eastern-half of the Casiano property contains a heavily vegetated and steeply declining slope (the Slope). Situated on the Slope was an oak tree

and two rows of retaining walls. The retaining walls structurally supported the steep grade of the Slope.

2. After a period of heavy rains in early February 2005, the oak tree fell, damaging the retaining walls and disturbing the surrounding land.

3. During an inspection of the Casiano property on February 21, 2005, the Los Angeles Department of Building and Safety (LADBS) discovered that the retaining walls on the Slope had failed. LADBS determined that the failure of these retaining walls constituted a safety hazard, and ordered appellant to repair them.

4. In June 2006, appellant had the condition of the Slope initially evaluated by Mountain Geology, Inc. (Mountain) for purposes of remediation and constructing an additional room and sports deck. Based on four test pits excavated around the central portion of the Slope surrounding the fallen oak tree, Mountain concluded in a September 8, 2006 geology report that a slope failure (i.e., a landslide) had occurred. Appellant also retained CalWest Geotechnical (CalWest), who, from 2006 through 2008, prepared several soils reports and drafted plans for the Slope remediation and construction project, which were submitted to LADBS for approval.

5. Appellant also filed a property damage claim with his insurer, State Farm, seeking compensation for the aforementioned damage to the Slope. In a letter dated September 14, 2007, State Farm denied appellant's claim because it determined that his policy coverage excluded damage relating to land instability, earth movement, and subsurface water.

6. Calwest had difficulty obtaining the necessary permits and approval from LADBS. In 2008, dissatisfied with CalWest's performance in this regard, appellant retained Sassan Geosciences, Inc. (Sassan).

7. In a December 3, 2008 engagement letter, Sassan stated that while it had reviewed and concurred with the prior geology and soils reports prepared by Mountain and CalWest, the remediation and construction plans proposed by CalWest were insufficient to correct the slope failure on the Casiano Property. Instead, Sassan recommended a more extensive remediation plan, which included reconstructing the entire Slope by replacing and recompacting the underlying soil, increasing the overall size and number of retaining walls, and constructing those walls on "soldier piles" built into the bedrock of the Slope.

8. On February 9, 2009, LADBS approved Sassan's remedial plan for the Slope, which appellant implemented (although there would be many minor changes, additional soil testing, and approvals by LADBS before the work was fully completed in 2011). Appellant also abandoned the construction of the sports deck, but continued with the construction of the additional room above the Slope.
9. Thereafter, appellant filed a timely 2009 California Resident Income Tax return, claiming a casualty loss deduction of $590,174, which he asserts represents his cost to remediate the Slope.
10. FTB audited appellant's 2009 return, and determined that appellant's alleged remediation expenses substantially improved the value of the Casiano property. Therefore, FTB concluded that these alleged expenses did not reflect appellant's casualty loss, but rather, they were capital expenditures. Consequently, FTB disallowed the claimed casualty loss deduction of $590,174, and issued a Notice of Proposed Assessment (NPA) for $56,362 additional tax, plus interest.
11. Appellant protested the NPA. Upon consideration of appellant's protest, FTB conceded that appellant suffered a casualty loss with respect to the Casiano Property and that he was entitled to deduct some of his repair expenses, but only to the extent that they restored the Slope to its condition immediately preceding the casualty. However, FTB determined that since the casualty loss was ultimately sustained in 2007 (the year appellant's insurance claim was denied), appellant was not entitled to deduct that loss on his 2009 return. As a result, FTB issued a Notice of Action denying appellant's protest. This timely appeal followed.

## DISCUSSION

It is well settled that a presumption of correctness attends FTB's denial of deductions. (*Appeal of Janke* (80-SBE-059) 1980 WL 4988.) The taxpayer bears the burden of proving both the year of loss and the amount when claiming entitlement to a casualty loss deduction. (*Appeal of Chappellet* (69-SBE-023) 1969 WL 1800.)

California conforms to Internal Revenue Code section 165,[1] except as otherwise provided. (R&TC, § 17201(a).) Section 165(a) allows as a deduction any loss sustained during the taxable year that is not compensated for by insurance or otherwise. (See also Treas. Reg. § 1.165-1(a).)[2] As applicable to individuals, losses of property not connected with a trade or business or a transaction entered into for profit are deductible only if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. (§ 165(c)(3).)

After a period of heavy rains in February 2005, the Casiano property suffered a slope failure when an oak tree fell and damaged the retaining walls supporting the Slope. The parties agree that this event was a casualty within the meaning of section 165(c)(3), and that some amount of loss was sustained, and therefore deductible, in a tax year subsequent to 2005. However, the parties disagree as to the year in which the casualty loss was properly sustained.

"The year of the loss is a threshold issue." (*Katz v. Commissioner*, T.C. Memo. 1983-8.) If the correct tax year in which the loss is deductible for tax purposes is not properly before the OTA, we are barred from addressing the amount of the deduction. (*Ibid.*) We therefore first address the proper year in which appellant may deduct the casualty loss, before addressing, if needed, the amount of that loss.

An uncompensated casualty loss is allowable as a deduction only in the taxable year in which the loss is "sustained." (§ 165(a).) In general, a loss is "treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year." (Treas. Reg. § 1.165-1(d)(1).) While the loss is generally sustained in the same year the casualty occurred, that is not always the case. One relevant exception here is where the taxpayer has a claim for reimbursement of a casualty loss and there is a reasonable prospect of recovery. In this situation, the loss is not

[1] All further statutory references are to sections of the Internal Revenue Code (IRC), unless otherwise stated. For the 2009 tax year, R&TC section 17024.5(a)(1)(N) provides that for Personal Income Tax Law (PITL) purposes, California conforms to the January 1, 2005, version of the IRC. Thus, references herein to the IRC are to that version.

[2] R&TC section 17024.5(d) provides that when applying the IRC for PITL purposes, federal regulations (temporary or final) issued by "the secretary" shall be applicable as California regulations to the extent they do not conflict with the R&TC or regulations issued by FTB. In addition, it is well settled that where federal law and California law are the same, federal rulings and regulations dealing with the IRC are persuasive authority in interpreting the applicable California statute. (See *J. H. McKnight Ranch v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, fn.1, citing *Calhoun v. Franchise Tax Bd.* (1978) 20 Cal.3d 881, 884.)

sustained until it can be ascertained with reasonable certainty that the reimbursement will be denied. (Treas. Reg. § 1.165-1(d)(2)(i).)

Although 2005 was the year the casualty at issue occurred, the record shows that appellant had insured the Casiano property against loss, and that his prospect of recovery from his insurer State Farm was not ascertainable until 2007, when his claim was ultimately denied. Thus, under the above exception, it was not until 2007 that appellant's casualty loss was sustained.

Appellant asserts, however, that the casualty loss at issue was properly deductible when the full extent of the damage to the Casiano property was determined in 2009. As support, he cites to *Bailey v. Commissioner*, T.C. Memo. 1983-685 (*Bailey*) and *United States v. Barret* (5th Cir. 1953) 202 F.2d 804 (*Barret*).

In *Bailey*, during a period of six to eight weeks from 1973 to 1974, large portions of the taxpayers' residential backyard, located on a gradual downward slope, fell away, eventually exposing the foundation of their house. After observing that assigning a precise moment when the damage occurred may be more difficult in cases involving soil movement, the Tax Court concluded, based on a practical approach, that since the aggregate loss could not be accurately measured until 1974, the casualty loss was properly sustained in that year.

In *Barret*, the taxpayer's trees were damaged by a severe freeze which occurred in 1943 and 1944. For the next two years, until 1946, the taxpayer attempted to save the trees through revival. When, in 1946, it became apparent that the trees could not be saved, the taxpayer abandoned his attempt at revival and claimed the casualty loss in that year. The Fifth Circuit concluded that while the injury to the trees occurred in 1943 and 1944, the extent of the damage and effect upon the trees were neither known nor ascertainable at that time, as the damage was still "latent and uncertain." (*Barret, supra*, 202 F.2d at p. 806.) Thus, according to the court, the loss, as distinguished from the casualty, occurred in 1946, when it was determined that the trees could not be saved.

Appellant argues that, similar to the facts in *Bailey* and *Barret*, it was not until 2009 that he was able to determine the full extent of the slope failure, as evidenced by the years of extensive testing and studies necessary to devise a remediation and construction plan for the Slope which would meet LADBS approval. Additionally, appellant alleges that due to the casualty loss, the Los Angeles County Property Tax Assessor's Office lowered the assessed

value of his home in 2009. All of these events, appellant maintains, show the casualty loss was properly deductible in 2009, when the full extent of the loss was determined. We disagree.

*Bailey* and *Barret* involve situations where the loss was sustained in a year following the casualty due to uncertainty as to whether a loss had in fact occurred, or there was continuing damage such that the full extent of the loss could not accurately be determined in the year of the casualty. However, neither of these situations are present here.

The record demonstrates that while there was much debate as to how to proceed in remediating the Slope, there was no uncertainty regarding the actual damage that had occurred. Following the collapse of the Slope retaining walls in 2005, appellant had the condition of the Slope initially evaluated by Mountain in 2006. Later that year, Mountain prepared a geology report that conclusively determined that a landslide had occurred on the Casiano property. In an engagement letter to appellant on December 3, 2008, Sassan stated that it reviewed and concurred with Mountain's geology report, "except as amended below to provide the recent seismic design parameters, as well as, an alternative remedial repair for the slope failure," indicating that the uncertainty at issue related not to the scope of the damage, but the extent of the repairs necessary to correct it. There is also no evidence or assertion that the landslide that occurred on the Casiano property in 2005 had somehow continued through 2009, or of any other factor that would have prevented appellant from reasonably ascertaining the extent of the slope failure until a subsequent year.

To be sure, starting in 2005 and for many years later, appellant had to work with LADBS to, among other things, obtain the necessary permits to start and restart the repairs to restore the Slope. There was much back-and-forth between the two about how to properly do and redo that work. The work was further complicated by the fact that appellant was attempting to simultaneously improve his property beyond its pre-casualty condition. However, these extensive communications between appellant and LADBS, and the additional testing performed by appellant's many consultants, only show the uncertainty of the *extent of the work and/or costs of repairs* required to remediate the Slope according to LADBS standards and improve the overall property beyond its pre-casualty condition. Also, the fact that the Casiano property's assessed value was reduced in 2009 does not negate any of the evidence recounted above which shows that, in 2006, appellant was fully aware of the slope failure on his property. For all the above reasons, we reject appellant's contention that his casualty loss was sustained in 2009.

We believe *Kunsman v. Commissioner* (1967) 49 T.C. 62 (*Kunsman*) and *Allen v. Commissioner*, T.C. Memo. 1984-630 (*Allen*), more aptly describe appellant's situation. In *Kunsman*, a tree was blown over by a sudden wind, tearing a hole in the bottom of the taxpayer's pool. Over the next two years, the taxpayer made two unsuccessful attempts to patch the hole in the pool, after which he had the entire pool replaced. In *Allen*, the taxpayer's driveway was "totally ruined" in a storm. The "plans and efforts to repair or replace the driveway were complicated and delayed by the fact that several springs had surfaced in the area after the storm," and took five years to complete. (*Ibid.*) In both cases, the Tax Court made a distinction between the year that the casualty loss was fully known to the taxpayer, and the year that the actual repairs costs were eventually determined. In doing so, the court specifically rejected the taxpayers' argument that their casualty loss was deductible in the latter instance, instead holding that the loss was properly sustained in the year the loss was fully known. While the Tax Court did not elaborate upon whether constructive knowledge would have been sufficient in these cases, even applying the standard of actual knowledge as used in *Kunsman* and *Allen* to the facts of this appeal, 2006 was the latest that appellant could deduct his casualty loss under this rule.

Accordingly, we conclude that although the casualty occurred in the 2005 tax year and appellant was made fully aware of the resulting loss in the 2006 tax year, it was sustained, and therefore, would have been deductible in the 2007 tax year when appellant's property damage insurance claim was denied. However, because the 2007 tax year is not properly before us, we are barred from addressing the amount of the deduction. (See Cal. Code Regs., tit. 18, § 30103(a); see also *Katz v. Commissioner, supra.*)

## HOLDING

For the 2009 tax year, appellant is not entitled to claim a casualty loss deduction under section 165.

## DISPOSITION

FTB's action is sustained.

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Nguyen Dang
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Nguyen Dang
Administrative Law Judge

We concur:

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