BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
RUBEN AND LYDIA CARRILLO,)
PAUL G. AND EILEEN M. BARNHOUSE:)
AND ROBERT C. AND JULIA DEMPSTER)

Appearances:

For Appellants: Stephen J. Kennedy
Attorney at Law

For Respondent: Mark McEvilly
Counsel

O P I N I O N

These appeals are made pursuant to sections 18593 and 19057, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Ruben and Lydia Carrillo and Paul G. and Eileen M. Barnhouse against proposed assessments of personal income tax in the amounts of $537.20 and $435.92, respectively, for the year 1974, and from the action of the Franchise Tax Board in denying the claim of Robert C. and Julia Dempster for refund of personal income tax in the amount of $454.84 for the year 1974.

The issue for decision is whether appellants are entitled to deduct a casualty loss in 1974 when appellants had filed suit in that year against third parties to recover the loss incurred.

Appellants Carrillo, Barnhouse and Dempster filed joint returns for the year 1974 and deducted, respectively $19,900.00, $19,150.00 and $7,400.00 as a casualty loss. The nature of the claimed casualty loss in each case was that rainfall caused soil displacement and, on or about April 1, 1974, appellants' single family residences and lots subsided.

In December of 1974, appellants filed suit in the Superior Court of the County of Contra Costa against the City of Pinole, the Department of Transportation of the State of California, the Pacific Gas and Electric Company, and Earl Smith and Company to recover the amount of loss incurred.[1/] When respondent received information that action was pending against third parties to recover the loss at the same time appellants had deducted same on their 1974 returns, respondent disallowed the loss claimed by each set of appellants. Respondent's position is that appellants were not entitled to a casualty loss deduction for the taxable year 1974 due to the fact that their legal action against third parties created a reasonable prospect of recovery. Appellants protested. They maintained that there was no reasonable prospect of recovery in 1974, despite the fact that the suit was filed that year, because the third party defendants denied liability.

After due consideration of appellants' protests, respondent affirmed the proposed assessments. Appellants Robert C. and Julia Dempster have remitted the tax and interest and they appeal from respondent's denial of their claim for refund. The remaining appellants contest the proposed assessments.

Section 17206 of the Revenue and Taxation Code allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. This section is virtually identical to Section 165 of the Internal Revenue Code. Respondent's regulation, California Administrative Code, title 18,

1/ In February, 1979, subsequent to the filing of this appeal, the Superior Court of Contra Costa County entered a judgment denying appellants recovery from the third parties. Appellants are presently appealing that decision.

section 17206(a), subdivision (4), virtually identical to Treasury Regulation section 1.165-1(d), prescribes the taxable year a casualty loss is deductible. Regulation 17206(a), subdivision (4), as it read during the year at issue[2], is as follows:

> (4) Year of deduction (A) A loss shall be allowed as a deduction under Section 17206'(a) only for the taxable year in which the loss is sustained.. For, this purpose, a loss shall be 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.
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> (B)(i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of Section 17206, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and, circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim, when a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement he must be able to produce objective evidence of his abandonment of the claim, such as execution of a release.

Respondent argues that appellants did not 'sustain the alleged loss during the income year in question since appellants during that year had instituted a civil lawsuit in which there existed a reasonable prospect of' recovery. If respondent is

2/ Repealer filed January 15, 1981; effective 30th day thereafter (Register 81, No. 3).

correct, then the amount of loss is not '*sustained" for purposes of 17206 until the adverse decision of the final appellate court makes it clear that appellants will not receive any reimbursement for their loss or until the loss is ascertained with reasonable certainty in some other manner. On the other hand, appellants' position is that inasmuch as the third parties denied liability, there was no reasonable prospect of recovery in 1974. We agree with respondent.

As we stated in Appeal of Dahlquist Drilling, Inc., decided by this board August 19, 1975, although denials of liability may certainly be considered in evaluating a taxpayer's prospects for recovery, they are not enough, standing'alone, to constitute the decisive factor in appellant's favor. Of equal or greater significance is appellant's prosecution of their lawsuit despite the defendants' denials of liability. At the least such conduct casts doubts on the assertion that appellant believed it had no reasonable chance of recovery (Cf. Ramsay Scarlett & Co., 61 T.C. 795, 813, n. 12, (1974.)

In addition to this, appellants' reliance on Montgomery v. Commissioner, 65 T.C. 511 (1975), is completely unfounded. The taxpayer in that case deducted a casualty loss suffered in 1969 on his income tax return filed for that year. Subsequently, in 1970, he accepted two insurance settlements for the loss and attempted to amend his 1969 return by decreasing the previously 'reported casualty loss by the amount of his insurance recovery. The court decided, as noted by appellants, that the proper year for claiming the casualty loss deduction was the year in which the casualty was suffered rather than the year in which the settlement was received. However, the case is factually distinguishable from the instant appeal. In Montgomery, the taxpayer did not file suit against the third party insurance company. In fact, through the end of 1969, he held the belief that the insurance policies involved did not cover the nature of the casualty loss which he had suffered. It was on the basis of these factors that the court made its determination that no reasonable prospect for recovery existed during the year of the casualty and that the taxpayer's initial casualty loss claim was properly made. The court further clarified that "[t]he

existence of a reasonable prospect of recovery depends on the facts and circumstances as of the last day of the tax year in which the casualty occurred." (Montgomery, supra, p. 519. (Emphasis added).)

Moreover, it should be noted that case law in general is adverse to appellants' position. As we stated in the Appeal of Mildred A. Dunwoody, decided by this board June 12, 1957, in cases where the taxpayer has brought suit in order to recover a casualty loss, the Tax Court has consistently held that the loss is deductible in the year in which the suit is settled. (See Allied Furriers Corporation, 24 B.T.A. 457 (1931); Rose Licht, 37 B.T.A., 1096 (1935); Charles F. and Eleanor Jeffrey, ¶ 53,173 P-H Memo. T.C. (1953).)

In order to have prevailed in this matter appellants had to show that their prospect for recovery was no longer reasonable as of the end of the income year in issue. (Louis Gale, 41 T.C. 269 (1963).) On the basis of the foregoing, we hold that they have failed to do so. Accordingly, respondent properly denied the deductions in question.

O R D E R ,

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

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to sections 18595 and 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Ruben and Lydia Carrillo and Paul G. and Eileen M. Barnhouse against proposed assessments of personal income tax in the amounts of $537.20 and $435.92, respectively, for the year 1974; and that the action of the Franchise Tax Board in denying the claim of Robert C. and Julia Dempster for refund of personal income tax in the amount of $454.84 for the year 1974, be and the same are hereby sustained.

Done at Sacramento, California, this 19th day of May , 1981, by the State Board of Equalization, with all Board members present.

Ernest J. Dronenburg, Jr. , Chairman

George R. Reilly , Member

William M. Bennett , Member

Richard Nevins , Member

Kenneth Cory , Member