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Rev. Rul. 66-242

Advice has been requested whether a deductible casualty loss can be determined by an appraisal which is made immediately after a flood, and which under the circumstances below purports to show a decline in fair market value because of adverse buyer resistance to the flooded property.

The taxpayer's residence was inundated by flood waters. In addition to certain physical damage to the structure, the taxpayer's appraisal, made immediately after the flood, indicated an additional decline in the fair market value of the property due to "economic obsolescence" attributed to buyer resistance which attached to the property. The estimated economic obsolescence was demonstrated by the use of the so-called "cost approach to value" which is, essentially, a computation of reproduction cost, new, of the property less accrued depreciation. The accrued depreciation was measured by a capitalization of the estimated loss in rental potential of the property over the remaining useful life of the property.

Section 165 of the Internal Revenue Code of 1954 provides, in part, as follows:

(a) General Rule.- There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(c) Limitations on Losses of Individuals.- In the case of an individual, the deduction under subsection (a) shall be limited to-

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. ***

Section 1.165-7(a)(2)(i) of the Income Tax Regulations provides that in determining the amount of loss deductible under this section, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property.

Consistent with the foregoing a deductible casualty loss must be more than a mere diminution in value demonstrable solely by some economic concept or theory. Standing alone, an appraiser's estimate of adverse buyer resistance has no real or tangible relation to the price at which a property may change hands in the market. In the absence of corroborating market data shown by actual bona fide purchases and sales of comparable properties at declining prices, an appraisal reflecting a potential buyer resistance represents speculative estimates of rental loss.

In conjunction therewith the loss must be more than a mere fluctuation in value. The phenomenon of a decline and rise in market value which commonly occurs after a flood due to psychological resistance to inundated properties is usually short lived and is more often than not a mere "fluctuation" in value. In such case it does not represent an actual loss resulting from damage to the property. *Clarence A. Peterson et ux. v. Commissioner*, 30 T.C. 660 (1958). See

also *United States v. White Dental Manufacturing Co.*, 274 U.S. 398 (1927), T.D. 4059, C.B. VI-2, 198 (1927); and *John W. Burdan et al. v. Commissioner*, 106 Fed. (2d) 207, affirming, 37 B.T.A. 642 (1938).

Accordingly, in the instant case the amount of loss sustained from damage to the taxpayer's personal residence as a result of a flood is deductible under section 165 of the Code only to the extent that the loss has been sustained. The loss cannot be merely a fluctuation in value, and it cannot be a hypothetical economic decline in value in the nature of "economic obsolescence" based only upon an estimate of future buyer resistance.

The principles enunciated in this Revenue Ruling apply solely to a speculative "economic" and "transitory" loss demonstrated by a formal appraisal under section 1.165-7(a)(2)(i) of the regulations and are in no way or manner intended to preempt the provisions of section 1.165-7(a)(2)(ii) of the regulations which provide a means for measurement of the loss in lieu of an appraisal. In such a case the amount of loss may be demonstrated by the cost of repairs if the taxpayer shows that (a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amount spent for such repairs is not excessive, (c) the repairs do not take care of more than the damage suffered, and (d) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.