DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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WTA-N-108545-98
November 24, 1998

MEMORANDUM FOR

North Central District

FROM: Assistant Chief Counsel (Income Tax and Accounting)
by_______________________________________
David L. Crawford
Chief, Branch 5

SUBJECT: Business Rehabilitation Expenses WTA-N-108545-98

This is in response to your memorandum dated March 27, 1998, in which you requested assistance in determining the proper tax treatment for the cost of restoring uninsured property damage caused by severe flooding in the Red River Valley of North Dakota and Minnesota in April 1997. Specifically, you raised the issue as to how taxpayers should treat the expenses relating to the restoration of business property to its pre-flood condition. You questioned whether such costs should be treated as part of the casualty loss under § 165 of the Internal Revenue Code, as repairs deductible under § 162(a), or as capital expenditures under § 263.

Section 165(a) allows taxpayers to deduct any loss sustained during the taxable year and not compensated for by insurance or otherwise. In general, any loss arising from fire, storm , shipwreck or other casualty is allowable as a deduction under § 165(a) in the taxable year in which such loss is sustained. Section 1.165-7(a)(1) of the Income Tax Regulations. However, no casualty loss is permitted in those instances in which the subject property lacked basis because it had been fully depreciated. Section 165(b).

Assuming, however, that a taxpayer had basis in business property, that the property was damaged as a result of the flooding, and that the taxpayer lacked any reasonable prospect of reimbursement for the loss, a taxpayer would be entitled to a deduction under § 165(a). Generally, the amount of the deduction is the difference between the fair market value of the subject property before and after the casualty, to the extent such amount does not exceed the property's adjusted basis. Section 1.165-7(b)(1). Thus, the casualty loss does not include the repair or restoration expenses.

While the cost of repairs is not deductible as a casualty loss, the cost of repairs can serve as evidence of the diminution in fair market value caused by the casualty. Under the regulations, a taxpayer must show that (1) the repairs are necessary to restore the property to its condition immediately before the casualty, (2) the amount spent for such repairs is not excessive, (3) the repairs do not care for more than the damage suffered, and (4) 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. Section 1.165-7(a)(2)(ii).

It should be noted that a taxpayer deducting a casualty loss measured by repair costs is not deducting the repair costs themselves. The § 165(a) deduction will result in a decrease in the taxpayer's basis in the subject property. Section 1016(a)(1).

While the costs of restoring flood damaged business property are not deductible as part of a casualty loss, these costs may be deducted under § 162 or they may be treated as capital expenditures under § 263. Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. In particular, § 1.162-4 provides that taxpayers may deduct the costs of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in ordinary efficient operating condition. In general, the courts have permitted taxpayers to deduct the costs of repairing property damaged in a casualty if they meet the requirements of § 162. See R.R. Hensler, Inc. v. Commissioner, 73 T.C. 168 (1979).

However, § 263 prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase to the value of any property or estate. Moreover, § 263(a)(2) provides that any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. Capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Section 1.263(a)-1(b).

The determination of whether certain costs are deductible as repairs under § 162 or must be treated as capital expenditures under § 263 generally turns on the taxpayer's particular set of facts. If the expenditure returns the taxpayer's property to the state it was in before the situation prompting the expenditure arose, and does not make the relevant property more valuable, more useful, or longer-lived, then it is usually deemed a deductible repair. Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 337 (1962), nonacq. on other grounds, 1964-2 C.B. 8. If, on the other hand, the expenditure materially enhances the value, use, life expectancy, strength or capacity of the property as compared with its status prior to the condition necessitating the expenditure, then this expenditure is capital in nature. Id. at 338.

Accordingly, if taxpayers in the Red River Valley area incur costs simply to restore their business properties to their pre-flood state, and such expenditures do not materially enhance the value, use, life expectancy, strength or capacity of such property beyond that state, then these costs may be currently deducted as repair expenses under § 162. These costs are not generally treated as capital expenditures under § 263.

We hope this information is helpful. If you have any questions, please call of my office at 202-622-4950.