AKO POLICYHOLDER ADVISOR
The Policyholder Law Firm
Volume 9 Number 9 www.andersonkill.com September 2000

Tax Deductible Losses and Insurance — Are They Mutually Exclusive?


Phillip England

With certain exceptions, the Internal Revenue Code does not focus on taxpayers' insurance coverage. Indeed, the term "insurance" is nowhere defined in the Code. However, insurance and the receipt of insurance proceeds is of fundamental importance in several areas of tax law. One of these is business losses.

The Code and case law have, for some time, tied together the existence of insurance and the tax deduction for a business loss. Code Section 165 states, as a general rule, that corporations are allowed to deduct virtually any loss (arising from legal activities) for which they are not reimbursed by insurance or otherwise. A corporate taxpayer can deduct an amount up to the adjusted basis of the property involved in the loss, but this amount is reduced by any insurance or other recovery. This has been in the tax law for some time.

Older cases have, for example, held that a business loss by fire is not deductible where insurance equal to the value of the property is collected, even if the taxpayer uses the insurance proceeds to rebuild the property at a cost in excess of the insurance money received. Moreover, to the extent that a business deducts a loss and later recovers insurance proceeds, the business has to include as income the amount of insurance received.

Actual Loss

Code Section 165(a) requires that a loss must actually be sustained by the taxpayer in order to be deductible. Where insurance is involved, a loss may not actually be sustained. In other words, the receipt of insurance proceeds or even the mere existence of insurance may eliminate the availability of a business loss deduction under Section 165. In a somewhat curious sentence, Treas. Reg. 1.165-1(b) also adds that; "substance and not mere form shall govern in determining a deductible loss."

Taxpayers might not always agree that the existence of an insurance policy relating to destroyed property means that the taxpayer has not actually sustained a loss for that property. For example, the insurance company might argue that there has been only a partial loss, or that the value of the loss is less than the value measured by the taxpayer. There may also be an issue as to whether a taxpayer's insurance policy covers the loss at all.

In such situations, tax law requires judgment calls. For example, assume that an event occurs in year one and either the taxpayer files an insurance claim that year or the taxpayer might do so at some later time. Under these circumstances, Treas. Reg. § 1.165-d(2)(i) provides that "where 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 165 until it can be ascertained with reasonable certainty whether or not such reimbursement will be received."

Note that the focus is on whether a reimbursement will actually be received. Therefore, a taxpayer must stand ready to justify his determination as to whether or when a reimbursement is or is not to be received, taking into account all the facts and circumstances surrounding a claim.

Expectation of Recovery

What constitutes a reasonable expectation of recovery, precluding a deduction under Section 165, is unclear. The mere existence of insurance in and of itself should not be dispositive of whether a reasonable prospect for recovery exists. For example, a taxpayer may clearly have a loss and clearly have an insurance policy relating to the destroyed property and yet have no prospect of recovery. In Coastal Terminals, Inc. v. C.I.R., a storage tank collapsed. A claim was filed with the insurance company, but the only relevant insurable risk was wind, and it was apparent that wind had not caused the collapse. The investigators were of the opinion that improper soil conditions, which were the responsibility of the taxpayer, were the cause of the collapse. Moreover, the investigating engineer found that the construction company was blameless. The court therefore held that there was no reasonable prospect for recovery.

In determining whether a reasonable prospect of recovery exists, the IRS considers such factors as the willingness of a taxpayer to settle or pursue a claim or whether a claim has been abandoned. As one court stated it "a reasonable prospect for recovery is an objective inquiry requiring an examination of the facts and circumstances surrounding the deduction." A reasonable prospect of recovery may be found to exist even where litigation over an issue is expected to take years. The tax court in Bacon v. C.I.R., held that a "reasonable prospect of recovery" can exist even if an action involving the loss is commenced some time after the loss has actually occurred.

If a claim for reimbursement could reasonably be said to exist, a taxpayer cannot claim that there is no prospect of recovery simply because he decides not to pursue a claim. The regulations under Section 165 give an example to the effect that if a taxpayer asserts that the taxable year for the loss deduction is fixed by the abandonment of his claim for reimbursement he must produce objective evidence of the abandonment of the claim. However, there is some authority for a taxpayer claiming a loss if it foregoes a claim. In several, very fact-specific cases, the court has allowed a casualty loss deduction even through there was insurance. However, as noted, the cases are quite specific and their logic somewhat strained and somewhat at variance with the "reasonable prospect" view discussed above.

"Tax Benefit Rule"

Brief mention should be made at this point about the "tax benefit rule." This concept generally applies where an amount (such as a loss) is deducted from the taxpayer's gross income in one year and is recovered in a later year. In other words it applies where the original assumption underlying a deduction is subsequently proven wrong.

In general, under the tax benefit rule, an amount must be included in gross income in the current year, if and to the extent that the amount was deducted in a prior year, the deduction resulted in a tax benefit, and the inclusion of the recovery in gross income is not precluded by a nonrecognition provision of the Code. The tax benefit rule applies to recovered amounts deducted as casualty losses in prior years and has to be taken into account if a monetary recovery is received in a year other than the year in which the deduction was taken.

Final Thought

In summary, a taxpayer is well-advised to tread carefully in the area of business loss tax deductions and insurance. Some of the rules and concepts, such as a "sustained loss" can be downright tricky, and as noted above can require difficult and complicated judgment calls. While the existence of insurance and the deduction of a loss under Section 165 of the Code are not necessarily mutually exclusive, they can have an uneasy co-existence. ■

PHILLIP ENGLAND IS A LAWYER IN THE NEW YORK OFFICE OF ANDERSON KILL & OLICK, P.C. HE IS A MEMBER OF THE NEW YORK AND NEW JERSEY BARS. HE HAS A J.D. FROM THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL AND AN LLM (IN TAXATION) FROM NEW YORK UNIVERSITY. PHILLIP CAN BE REACHED AT (212)278-1483 OR **pengland@andersonkill.com**