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Damage from collapsed retaining wall is not deductible to co-op stockholder

The collapse was caused by progressive deterioration, not an identifiable event of a sudden, unexpected, or unusual nature, the Tax Court holds.

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On remand from the Second Circuit, the Tax Court found that damage from a collapsed retaining wall on the premises of a residential cooperative housing corporation did not arise from a casualty as defined for tax purposes. Rather, it was caused by progressive deterioration in and around the wall that had begun at least 20 years earlier. Thus, the court held that a stockholder in the co-op was not entitled to a casualty loss deduction for her share of an assessment paid to fix the wall.

Facts: Christina Alphonso owned stock in Castle Village, a cooperative housing corporation, and leased an apartment in upper Manhattan from it pursuant to a proprietary lease. In May 2005, a 150-foot section of a retaining wall on the property collapsed, causing substantial damage. Castle Village levied an assessment against each of its stockholder-tenants to repair the damage. Alphonso's share of the assessment came to $26,390, and on her 2005 tax return she claimed a casualty loss deduction of $23,188.

The IRS disallowed Alphonso's casualty loss deduction on two grounds. First, it argued that the wall's collapse was a result of gradual weakening and not, as required by statute, a swift and precipitous event. Second, it claimed that because the collapse of the wall occurred on Castle Village's property, any casualty loss had to be claimed by the corporation and not its stockholders.

Originally, the Tax Court held for the IRS based on its second argument, concluding that Alphonso did not possess a property interest in the grounds surrounding her apartment (*Alphonso*, 136 T.C. 247 (2011); see also "Tax Matters: Co-ops and Casualties (http://www.journalofaccountancy.com/issues/2011/jun/casualties.html)," *JofA*, June 2011). Thus, she was not entitled to a casualty loss deduction for damage from the collapse of the retaining wall. On appeal, however, the Second Circuit vacated the Tax Court's decision and held that Alphonso had a sufficient property interest under New York state law to claim a loss deduction (*Alphonso*, 708 F.3d 344 (2d Cir. 2013)). The Second Circuit remanded the case to the Tax Court so it could address the IRS's first argument regarding the cause of the wall's collapse.

Issues: Under Sec. 165(c)(3), an individual may deduct "losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty." "Other casualty" generally refers to an event that shares characteristics with a fire, storm, or shipwreck, and the courts and the IRS have interpreted the term as an identifiable event that is due to a sudden, unexpected, or unusual cause. The courts have long held that the progressive deterioration of property through a steadily operating cause is not a casualty. For further discussion, see "Tax Practice Corner: When Is a Casualty 'Sudden, Unexpected, or Unusual'? (http://www.journalofaccountancy.com/issues/2013/may/20137351.html)" *JofA*, May 2013.

Alphonso argued that the wall collapsed from excessive rainfall in early 2005, which overstressed a recently installed drainage system and caused rapidly accelerating movement of the wall in the four weeks preceding the collapse. She submitted an engineering expert's report to that effect. On cross-examination, however, the expert admitted that he was not fully prepared to answer questions because he had written the report five years earlier and had not thoroughly reviewed it before testifying. He also admitted that he had erroneously used an engineering guideline for retaining walls constructed of different materials than those used in the wall at Castle Village. The Tax Court considered his report and testimony unreliable, stating that he was "at best careless and at worst not competent."

In contrast, the court viewed a report and testimony by an expert for the IRS as impressive and persuasive. The causes of the wall's collapse, according to this expert, were cracks, deformations, and groundwater that added unintended pressure against the wall and possibly weakened its mortar and/or rocks over time due to weathering. Although the spring 2005 rainfall and recent drainage modifications may have contributed to the particular time when the retaining wall collapsed, they did not cause the collapse, according to the expert.

Holding: The Tax Court determined that the cause of the retaining wall's collapse was progressive deterioration that had begun at least 20 years earlier. The court therefore held that the collapse was not a casualty for tax purposes and that Alphonso was not entitled to a casualty loss deduction.

- *Alphonso*, T.C. Memo. 2016-130

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