IN THE OREGON TAX COURT
MAGISTRATE DIVISION
Income Tax

TIMOTHY A. MUSTOLA and CONNIE A. MUSTOLA, Plaintiffs,	)	TC-MD 060070A
v.	)	
DEPARTMENT OF REVENUE, State of Oregon, Defendant.	)	**DECISION**

Plaintiff's appeal from Defendant's assessments for tax years 2001, 2002, and 2003, and from a notice of proposed refund adjustment for tax year 2004. At issue is a net operating loss (NOL) carryforward stemming from a 1996 casualty loss, and Schedule A medical and employee business expenses.

Plaintiffs were represented at trial by Cher Fillman (Fillman), a licensed tax consultant, Kick Butt Taxes & Accounting. Defendant was represented by Kevin Cole (Cole), an auditor with the Oregon Department of Revenue.

I. STATEMENT OF FACTS

There are not a lot of facts known in this case because Plaintiffs' representative did not submit the majority of her exhibits to the court prior to trial, as required by Tax Court Rules-Magistrate Divison (TCR-MD) 10 C, and she did not have her clients (Plaintiffs) testify. What is known is that Plaintiffs owned a 3,400 square foot home that was destroyed in February 1996 by a rain-triggered landslide. Plaintiffs'1,080 square foot garage on the property was also destroyed by the landslide. The Small Business Administration (SBA) evaluated the property in connection with a disaster loan it made in April 1996, and determined that the home and garage were a total loss valued at $357,000. The SBA determined that Plaintiffs lost personal property valued at $3,817. The parties agree that Plaintiffs were not reimbursed by insurance for the loss. Defendant contacted the Columbia County assessor's office and was informed that the value of the home for property tax purposes was $74,770 before the landslide and $25,070 after the landslide. However, it appears that that value may pertain to the old homestead rather than the new residence.

Kick Butt Taxes and Accounting originally figured the amount of the casualty loss to be $177,750 before the applicable statutory deductions that reduced the allowable amount of the loss to $176,167. Plaintiffs first took the loss on their 1995 return, as authorized by Internal Revenue Code (IRC) section 165(i)(1).[1] Plaintiffs also reported business losses on their 1995 return and, because of their limited income (AGI) that year, they reported a net operating loss (NOL) carryforward of $191,136. All but $5,027 of that amount was used on Plaintiffs' returns from tax years 1996 through 1999. Then, in 2000, Plaintiffs determined a larger loss should have been claimed, and they increased the carryforward by $179,580, which Plaintiffs added to the $5,027 remaining balance carryforward from the original calculation. (Def's Answer at 7, 8.) Plaintiffs then claimed the additional loss on their returns for tax years 2000 through 2004, inclusive, using all but $382 of the total loss amount of $357,330. (Def's Answer at 13.) Defendant audited the 2001 through 2004 returns and denied the additional NOL carryforward.

As indicated above, neither the tax returns nor accompanying schedules were submitted for the years at issue. There is no evidence pertaining to the claimed medical and employee business expense deductions. Nor was there testimony on those matters.

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[1] Assuming the loss was actually caused by a disaster in a presidentially declared disaster area.

II. ANALYSIS

A. *Casualty Loss Deduction*

IRC section 165(a)[2] provides for a deduction for casualty losses. That section provides: "[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." Allowable nonbusiness losses include those arising from "fire, storm, shipwreck, or other casualty, or from theft." IRC § 165(c)(3). The loss in this case was caused by a storm which triggered a landslide that destroyed Plaintiffs' home.

The general rule is that the amount of the claimed loss is the *lesser* of "the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty[,]" or the adjusted basis of the property. Treas Reg § 1.165-7(b)(1). The result of the rule is that the amount claimed cannot exceed the adjusted basis of the property. *Id*. Moreover, the taxpayer is generally required to establish the fair market value before and after the loss "by competent appraisal." Treas Reg § 1.165-7(a)(2)(i). There are other regulatory limitations not relevant here.

Plaintiffs assert that they are allowed to deduct the amount of the loss as determined by the SBA in connection with the disaster loan it made. The SBA estimated the loss to be $357,000, plus $3,817 for personal property. (Ptfs' Ex 1 at 2.) The court disagrees.

The applicable provision is IRC section 165(i)(4), which provides:

> "Nothing in this title shall be construed to prohibit the Secretary from prescribing regulations or other guidance under which an appraisal for the purpose of obtaining a loan of Federal funds or a loan guarantee from the Federal Government as a result of a Presidentially declared disaster (as defined by section 1033(h)(3)) may be used to establish the amount of any loss[.]"

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[2] Unless noted otherwise, all references to the Internal Revenue Code (IRC) are to 2000, the code in effect on December 31, 2000.

That provision allows the Secretary to authorize, by regulation or other guidance, the use of an appraisal obtained in connection with a federal loan to establish the amount of a casualty loss. No regulations have been promulgated. Fillman asserted there was a provision in an Internal Revenue Service (IRS) manual allowing use of the appraisal, but did not cite any authority. Although the Guidebook to the 2007 Master Tax Guide implies that the IRS (through the Secretary) has not authorized use of such an appraisal,[3] the court, after extensive research, discovered two Internal Revenue Manual (IRM) procedures, apparently released on June 1, 2003, authorizing the use of a federal loan appraisal to establish the amount of the disaster loss. IRM 25.16.5.2.1, IRM 25.16.5.3. However, the code provision allowing the Secretary to authorize use of such an appraisal – IRC section 165(i)(4) – only applies to disasters occurring after August 4, 1997. PL 105-34, § 912, 111 Stat 788, 878 (1997); *see also* BNA, 503-2nd at A-76 (Jul 24, 2006) . IRM 25.16.5.2.1(1) confirms that the restriction, providing in relevant part:

> "(b.) For disasters occurring after August 4, 1997, taxpayers may use an appraisal that was obtained to get a Federal loan or loan guarantee as the result of a Presidentially declared disaster to establish the amount of a disaster loss."

Plaintiffs' loss occurred in February 1996, approximately one and one-half years before the effective date of the act.

Finally, it has not been definitively established that Plaintiffs obtained a loan "as a result of a Presidentially declared disaster," as required by IRC section 165(i)(4) set forth above. IRC section 1033(h)(3) defines a "Presidentially declared disaster" as "any disaster which, with respect to the area in which the property is located, resulted in a subsequent determination by the

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[3] The Guidebook to the 2007 US Master Tax Guide provides: "*[s]hould* the IRS authorize a new valuation method, it would apply in a presidentially-declared disaster area (Code Sec. 165(i)(4))." Guidebook, 2007 US Master Tax Guide (CCH), 1141. (Emphasis added.)

President that such area warrants assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act." There is no evidence of a presidentially declared disaster in this case. That does not mean there was none; only that it has not been properly established.

The amount of the allowable deduction must, therefore, be based on the difference between the before and after fair market values of the property, or the adjusted basis, whichever is lower. Treas Reg § 1.165-7(b)(1). Plaintiffs have not established the fair market value of the property before and after the casualty, nor have they established the adjusted basis of the property. By statute, Plaintiffs have the burden of proof and must establish the case by a preponderance of the evidence. ORS 305.427.[4] Plaintiffs have failed to do so. The court therefore declines to disturb Defendant's disallowance of the NOL carryforwards related to the increased casualty loss calculation Plaintiffs reported in 2000 and carried on their returns through 2004. Plaintiffs are therefore limited to the $176,167 loss previously deducted between 1995 and 2000.

B. *Business Expenses*

The court now turns to Plaintiffs' employee business expense deductions. Plaintiffs claimed expenses for mileage, food, lodging and "other" expenses, the latter category apparently including union dues, laundry, telephone, work clothing, supplies, and haircuts. Some of those expenses can be claimed under IRC section 162, provided they are "ordinary and necessary" business expenses. However, under IRC section 274(d), such expenses must be substantiated "by adequate records or by sufficient evidence corroborating the taxpayer's own statement[.]" Even if an expense is otherwise deductible, the deduction may be denied if the substantiation to support the expense is insufficient. *See* Temp Treas Reg § 1.274-5T(a)(4) (as amended in

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[4] All references to the Oregon Revised Statutes (ORS) are to 2005.

2003).[5] Other expenses, such as laundry, telephone, and haircuts, are generally disallowed under IRC section 262 as "personal, living, or family expenses." Moreover, ORS 305.427 requires taxpayers to prove their entitlement to any claimed deduction by a preponderance of the evidence. In this case, there is no information about the claimed expenses other than Fillman's trial testimony about the amounts originally claimed and the revised amounts presented by Fillman at trial. Fillman advised the court that she had substantiated the revised amounts she was presenting at trial. Also, there are no receipts to substantiate the claimed expenses. Accordingly, Defendant's disallowance of the deductions is affirmed.

C. *Medical Expenses*

Finally, Plaintiffs deducted medical expenses for the years 2001 to 2004. IRC section 213 allows a deduction for medical expenses to the extent that they exceed 7.5 percent of the taxpayer's adjusted gross income. As with other deductions, Plaintiffs must establish their entitlement to the deduction by a preponderance of the evidence. ORS 305.427. Again, there are no receipts nor are any other information pertaining to the claimed expenses, except for Defendant's concession at trial to allow $1,577 for expenses for 2001. Without more, the disallowance for tax years 2002, 2003, and 2004 is affirmed.

III. CONCLUSION

Based on the foregoing, the court concludes that Plaintiffs have not established their entitlement to the additional NOL carryforward claimed on their returns for tax years 2001, 2002, 2003, and 2004. Therefore, Defendant's assessments for tax years 2001 through 2003, inclusive,

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[5] Temporary Treasury Regulation section 1.274-5T(a)(4) (as amended in 2003) requires substantiation pursuant to paragraph (c) of that section for expenses incurred while traveling away from home, and notes that the "limitation supersedes the doctrine found in *Cohan v. Commissioner*, 39 F2d 540 (2d Cir 1930)[,]" which allowed for the court to make a close approximation of the expenses where evidence indicated the expenses were incurred. Paragraph (c), in turn, contains the requirement of adequate records.

stand, as does Defendant's notice of proposed refund adjustment for 2004. Additionally, Plaintiffs have not substantiated their entitlement to the employee business expenses claimed for the years at issue (2001 through 2004) and those expenses are therefore denied. Finally, Plaintiffs have not established their entitlement to the medical expenses claimed for the years at issue and Defendant's disallowance is affirmed, except for the parties' agreement that Plaintiffs shall be allowed a medical expense deduction of $1,577 for tax year 2001. Now, therefore,

IT IS THE DECISION OF THIS COURT that Plaintiffs are entitled to a medical expense deduction of $1,577 for the 2001 tax year, and

IT IS FURTHER DECIDED that, except for the 2001 medical expense deduction, Plaintiffs' appeal is denied and Defendant's actions disallowing the other deductions are affirmed.

Dated this _____ day of June 2007.

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DAN ROBINSON
MAGISTRATE

If you want to appeal this Decision, file a Complaint in the Regular Division of the Oregon Tax Court, by mailing to: 1163 State Street, Salem, OR 97301-2563; or by hand delivery to: Fourth Floor, 1241 State Street, Salem, OR.

Your Complaint must be submitted within 60 days after the date of the Decision or this Decision becomes final and cannot be changed.

This document was signed by Magistrate Dan Robinson on June 12, 2007. The Court filed and entered this document on June 12, 2007.