

JACKIE W. & SHIRLEY J. HODGES §  
149 County Road 455 §  
Killen, AL 35645, §

STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 01-308

v. §

STATE OF ALABAMA §  
DEPARTMENT OF REVENUE.

### **FINAL ORDER DENYING DEPARTMENT'S APPLICATION FOR REHEARING**

The Taxpayers' home and its contents were completely destroyed in a fire in September 1997. The Taxpayers claimed a casualty loss of \$177,514 relating to the fire on their 1997 Alabama return, which resulted in a net loss of \$149,302. The Taxpayers consequently claimed a refund of \$1,268 in Alabama tax they had paid through withholding in the year.

The Department audited the Taxpayers' 1997 return and requested records substantiating the casualty loss. The Taxpayers' were unable to provide such records because they were burned in the fire. The Department consequently allowed the Taxpayers a house basis of only \$26,900 based on a mortgage they took out on the house in 1989. That amount was reduced by \$14,883 in mortgage insurance received by the Taxpayers, which reduced the basis to \$12,017. The Department also estimated the value of the Taxpayers' furniture, clothing, and other house contents destroyed in the fire to be \$10,000. Based on the above adjustments, the Department disallowed the refund claimed by the Taxpayers, and instead assessed them for additional tax and interest of \$566.68. The Taxpayers appealed.

A hearing was conducted on October 16, 2001. The Taxpayers testified at the hearing that they paid \$30,000 for the house in 1984. They made extensive repairs, improvements, and additions to the house in both the 1980's and 1990's. They also testified concerning the estimated value of the furniture, clothes, and other personal items destroyed in the fire. A summary of the testimony is set out in the January 17, 2002 Preliminary Order entered in the case.

A Final Order was entered on March 6, 2003 dismissing the final assessment in issue. In substance, the Taxpayers were allowed an additional loss (approximately \$9,000) sufficient to offset the \$453 in additional tax assessed by the Department. The balance of the claimed loss was disallowed. Consequently, the \$1,268 refund claimed by the Taxpayers was disallowed.

The Department has applied for a rehearing, arguing that the final assessment should be affirmed because the Taxpayers failed to provide records substantiating the loss. I disagree.

In hundreds of prior cases, the Administrative Law Division affirmed the Department's disallowance of a deduction or deductions because the subject taxpayers failed to provide adequate records or other substantiation. *Thornton v. State of Alabama, Inc.* 03-122 (Admin. Law Div. 3/18/03); *Brewer v. State of Alabama, Inc.* 01-498 (Admin. Law Div. 9/23/02); *Sanders v. State of Alabama, Inc.* 02-412 (Admin. Law Div. 8/21/02); *Daniels v. State of Alabama, Inc.* 01-641 (Admin. Law Div. 6/25/02); *Davis v. State of Alabama, Inc.* 02-173 (Admin. Law Div. 5/24/02); *Taylor v. State of Alabama, Inc.* 01-596 (Admin. Law Div. 12/11/01); *Bailey v. State of Alabama, Inc.* 01-224 (Admin. Law Div. 5/30/01); *Lacey v. State of Alabama, Inc.* 01-239 (Admin. Law Div. 5/22/01); *Johnson v.*

*State of Alabama*, Inc. 01-278 (Admin. Law Div. 8/31/01); *Draper v. State of Alabama*, Inc. 00-544 (Admin. Law Div. 3/29/01), to cite only a few. However, a reasonable deduction can be allowed in certain circumstances in the absence of exact records.

In *Alexander v. State of Alabama*, Inc. 02-145 (Admin. Law Div. O.P.O. 5/23/02), the issue was whether the taxpayer should be allowed a casualty loss after a fire destroyed her house. As in this case, the taxpayer's records were destroyed in the fire. The taxpayer testified concerning the cost and value of the home and its contents at the administrative hearing in the case. The Administrative Law Division ruled as follows:

Alabama law allows a nonbusiness casualty loss to the same extent allowed by federal law at 26 U.S.C. §165(c)(3). See, Code of Ala. 1975, §40-18-15(a)(6). In such cases, federal case law and authority should control in interpreting the Alabama statute. *State Dept. of Revenue v. Acker*, 636 So.2d 470 (Ala.Civ.App. 1994).

The allowable amount of a nonbusiness casualty loss is the difference between the fair market value of the property immediately before the casualty and its value immediately after the casualty, not to exceed the taxpayer's adjusted basis in the property. As with all deductions, taxpayers are generally required to establish by adequate records that they are entitled to a casualty loss. However, if a taxpayer's records are destroyed by fire, storm, or otherwise through no fault of the taxpayer, the taxpayer may reasonably reconstruct such records. *Hentges v. C.I.R.*, T.C. Memo 1998-244 (U.S. Tax Court 1998). Further, the rule established in *Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930) is that if a taxpayer is entitled to a deduction, but is unable to prove the exact amount of the deduction, the taxpayer may reconstruct the amount using reasonable evidence.

In *Blass v. C.I.R.*, T.C. Memo 1977-254 (U.S. Tax Court 1977), the taxpayer claimed a \$35,000 casualty loss when his house was destroyed by fire. The taxpayer had no records showing his cost basis in the structure. The IRS allowed the taxpayer a \$5,000 loss. The Tax Court weighed the evidence and increased the amount to \$12,000.

Petitioner testified that he incurred \$35,000 of out-of-pocket costs in the construction of his self-built four room, one story, frame brick-veneer twelve hundred square feet house with no

basement. The house was constructed in or around 1964. Petitioner presented no specific evidence of the cost of any of the materials and components. He testified that the house had “ebony” shingles and oak floors. He submitted a photograph of the house under construction just before the brick veneer was constructed. On the record, we are unable to accept his entirely unsubstantiated testimony that the materials for the house cost him \$35,000. The house was relatively small, with ordinary construction, and we believe that \$35,000 is a grossly inflated estimate of cost. On the other hand, we consider the \$5,000 cost determined by respondent (also unsupported by evidence) to be unrealistically low. Under the circumstances, and on a very unsatisfactory record, we believe it appropriate to apply the rule of *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). Weighing the facts against petitioner, who had the burden of proof, we are convinced the materials, components and appliances which went into the house cost not less than \$10 per square foot, or \$12,000, and we find \$12,000 to have been the basis for the house and the amount of the casualty loss.

*Blass*, T.C. Memo 1977-254.

*Alexander* at 4-6.

As in *Alexander*, the Tax Court’s rationale in *Blass* also applies in this case. While the entire \$177,000 loss claimed by the Taxpayers cannot be allowed, the \$26,900 house basis and the \$10,000 contents basis allowed by the Department is unrealistically low.

The Taxpayers claim they purchased the house for \$30,000 in 1984. They then spent approximately \$40,000 remodeling and improving the house in the 1980’s and 1990’s. They testified extensively concerning what repairs and additions were made, who performed the work, how much the work cost, etc. They also testified concerning a painting previously valued by a Birmingham appraiser at \$30,000, an antique family statute, old baseball cards, a \$10,000 cherry bedroom suite, and other personal items destroyed in the fire.

The Taxpayers appear to be honest individuals. Their sworn testimony at the October 16, 2001 hearing was believable. If taken at face value, the Taxpayers' testimony clearly established a loss sufficient to entitle them to a refund of the \$1,268 paid through withholding in 1997. Unfortunately, the Taxpayers were unable to support their testimony with receipts and other records. But at the least, the Taxpayers have established and should be allowed an increased basis of approximately \$9,000 in the house and contents sufficient to offset the additional tax of \$453 assessed by the Department.<sup>1</sup> Consequently, the Final Order voiding the final assessment in issue is affirmed. The Department's application for rehearing is denied.

This Final Order Denying Department's Application for Rehearing may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 2, 2003.

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<sup>1</sup>The Department examiner's reluctance to allow the Taxpayers an additional basis in the house and contents is understandable due to the lack of records. But the examiner did not have the benefit of the Taxpayers' sworn testimony in making her decision.