An Atypical Casualty Loss Case: Tax Law, Co-ops, and Gardens.

Section 165 of the Code provides a deduction for non-business losses that "arise from fire, storm, shipwreck, or other casualty, or from theft." I.R.C. § 165(c)(3). So if something happens to my house that is not covered by homeowners insurance, I may qualify for a deduction. What if I live in a co-op? The Second Circuit recently looked at that question in *Alphonso v. Commissioner*, 2013 U.S. App. LEXIS 2595 (2d Cir. Feb. 6 2013).

Christina Alphonso lived in a co-op apartment in Castle Village. The grounds of the apartment complex featured a large retaining wall owned by the co-op that was approximately 65 feet high and 250 feet wide. The wall collapsed, causing significant damage. To repair the wall, the co-op issued an assessment to all of the tenant-shareholders. 2013 U.S. App. LEXIS 2595, slip op. at *2-*3. Ms. Alphonso paid the assessment and claimed a casualty loss on her return. *Id.* at *3-*4.

The IRS disallowed the deduction on the basis that the wall collapsed due to gradual erosion or inundation. In tax court, the IRS raised this issue and also asserted that Ms. Alphonso was not entitled to claim a casualty loss deduction because she lacked a sufficient property interest in the grounds. *Id.* at *5. Tabling its contention that the wall collapsed due to gradual weakening, the IRS sought summary judgment on the technical ground that Ms. Alphonso had no legal entitlement to a deduction which would properly be claimed by the corporation. Instead, the government argued that her sole property interest was in the apartment that she occupied, and the tax court agreed. *Id.* at *6-*13.

On appeal the Second Circuit reversed, ruling that Ms. Alphonso had a sufficient property interest in the grounds of the apartment complex to support a casualty deduction. *Id.* at *22-*27. The two key factors in the Court's decision were that house rules adopted by the co-op board were incorporated into the lease and that the house rules provided that use of the grounds of the apartment complex was restricted to residents and their guests. *Id.* at *26-*27. On this basis, the Second Circuit distinguished *West v. United States*, 163 F. Supp. 739 (E.D. Pa. 1955), *aff'd*, 259 F.2d 704 (3d Cir. 1958). *West* had involved a club that owned a lake and lots surrounding it; members of the club had the right to use the lake and could lease property and build cottages on the leased property. When damage to the lake gave rise to an assessment against members, a casualty loss was denied because the right to use the lake was incident to membership in the club, not the lease of property.

Given the narrow basis for the Second Circuit's decision, co-op boards should review whether their leases with their shareholders clearly provide that lessees enjoy property rights in common areas of the property.

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