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Hills v. Commissioner: Failure to File Insurance Claim Not a Bar to Theft Loss Deduction

I. Introduction

Section 165(a) of the Internal Revenue Code[1] (I.R.C.) permits a deduction for certain uncompensated losses sustained by a taxpayer during a taxable year. Section 165(c)(3)[2] limits losses of property not connected with the taxpayer's trade or business to those arising from casualty or theft, where the amount of the loss exceeds $100. Section 165(a) limits deductible losses to those which are "not compensated for by insurance."[3] In *Hills v. Commissioner,*[4] the Tax Court, for the first time, interpreted the phrase "not compensated for by insurance" as specified in I.R.C. § 165(a), and held that where the taxpayers suffered a theft loss but did not claim the insurance proceeds to which they were entitled under a homeowners' insurance policy, the loss was "not compensated for by insurance" within the meaning of the statute.[5] Consequently, a loss deduction was permitted.

The petitioners had suffered a loss of $760 when their home was burglarized for the fourth time within an eight-year period.[6]

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1. I.R.C. § 165(a) (1982) provides:

(a) General Rule — There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

2. I.R.C. § 165(c)(3) (1982) provides:

(c) Limitation on Losses of Individuals. - In the case of an individual, the deduction under subsection (a) shall be limited to . . .

> (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100.

3. I.R.C. § 165(a) (1982).
4. 76 T.C. 484 (1981).
5. *Id.* at 486.
6. This sum included the value of stolen property, costs of repairing doors and locks and of installing additional locks and keys, travel expenses incurred in connection with testifying against burglary suspects, and miscellaneous phone calls. *Id.* at 485.

The petitioners owned an Aetna Homeowners Insurance Policy under which they had filed three previous claims for the prior burglaries.[7] Fearing that their policy would not be renewed, the petitioners declined to file a claim for the losses incurred by the fourth burglary. Instead, they claimed a $660 theft loss deduction from their 1976 joint Federal income tax return,[8] pursuant to I.R.C. § 165(a).

The Internal Service disallowed the deduction because the petitioners' insurance policy covered the losses for which the deductions were claimed. The Tax Court, however, disagreed with the Service, finding that "not compensated for by insurance" is not the same as "not covered by insurance."[9] Hence, the deduction was permitted.

Hills v. Commissioner marks a significant departure by the Tax Court from the twenty-year trend disallowing deductions for casualty and theft losses where insurance compensation was available but not claimed. This note analyzes the *Hills* decision against the background of the earlier cases which traditionally disallowed such deductions.

II. Analysis

A. *Decision of the Hills Court*

The Service, in *Hills,* maintained that since the theft was covered by insurance and would have been paid for had the petitioners filed a claim, the loss was not a loss "not compensated for by insurance" within the meaning of I.R.C. § 165(a), and therefore was not deductible. In addition, the Service argued that where the petitioners voluntarily elected not to claim the insurance reimbursement to which they were entitled, the loss was attributable to their failure to file, rather than to the theft.

In rejecting the Service's first argument, the majority held that "not compensated for by insurance" must be restricted to claims actually not paid, despite their being covered by insurance. In support of its conclusion, the court first defined the

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7. *Id.*

8. $660 represented the amount of the loss which exceeded $100, as required by I.R.C. § 165(c)(3) (1982). *Id.*

9. Hills v. Commissioner, 76 T.C. at 486.

word "compensated" in its everyday context,[10] and then examined the legislative history of I.R.C. § 165(a).[11]

The court further cited the Treasury Regulations in support of a narrow constrution of "compensated for." It noted that Treasury Regulation section 1.165-1(a) allows a deduction for "any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation."[12] In addition, Treasury Regulation section 1.165-1(c)(4) requires that adjustment be made "for any salvage value and for any insurance or other compensation received."[13] The court concluded that "[b]oth of these provisions in the regulations are consistent with the idea of actually receiving payment or being made whole."[14]

The majority also found the Service's second argument to be unpersuasive. To hold that the loss was occasioned by a failure to demand reimbursement rather than by the theft, would be to favor those who chose to forego coverage over those who chose to carry insurance but not to file a claim:

> [A]ny theft or casualty loss suffered by an individal taxpayer who voluntarily chooses not to maintain insurance coverage can likewise be said to result from the choice to forego insurance coverage. When a taxpayer fails to pursue a right of insurance recovery, his economic loss is nonetheless sustained and a deduction should be allowed. To hold otherwise would unjustifiably advantage taxpayers who voluntarily decline insurance coverage.[15]

In addition, the court emphasized that Treasury Regulation section 1.165-1(d)(2)(i) recognizes abandonment of a litigation claim for purposes of determining in which year to take a deduction. It concluded that there is no reason why a taxpayer should be accorded different treatment for abandoning an insurance claim when practical considerations so dictate.

In a brief dissent,[16] four judges supported the Service's position that the taxpayer's loss was caused by their failure to file a

10. *Id.* at 486-87.
11. *Id.* at 487.
12. *Id.* (quoting Treas. Reg. § 1.165-1(a) (1960)).
13. Treas. Reg. § 1.165-1(c)(4) (1960).
14. Hills v. Commissioner, 76 T.C. at 488.
15. *Id.* (footnote omitted).
16. *Id.* at 492 (Sterrett, J., dissenting).

claim for the insurance proceeds to which they were entitled. In support of their argument, they pointed out that I.R.C. § 165(c)(3) narrowly limits the circumstances under which a deduction may be taken to losses which "arise from fire, storm, shipwreck, or other casualty, or from theft."[17] They further noted that "[t]he . . . circumstances have a common denominator: they are caused by forces external to the taxpayer and they are beyond the victim's volition."[18] The dissent concluded that the majority, by distinguishing between "covered" and "compensated", and by permitting deductions for losses occasioned by the taxpayers' failure to claim reimbursement, was "judicially . . . [amending] subsection (c)(3) by adding another circumstance under which a taxpayer may take a deduction for a loss."[19]

B. *The Legal Background*

The leading case in the area of non-deductible casualty losses under circumstances where a taxpayer might have claimed insurance reimbursement was *Kentucky Utilities Company v. Glenn.*[20] In that case, a steam generator owned by Kentucky Utilities (K-U) was damaged as a result of an accident, necessitating repairs of nearly $150,000. K-U was insured by Lloyds of London (Lloyds) for damages in excess of $10,000, and in addition, K-U's investigation of the accident revealed that the damages were covered by the manufacturer's warranty in its contract between K-U and Westinghouse Electic Corporation (Westinghouse).

Westinghouse, however, denied liability under its warranty, claiming no responsibility for the damage. Lloyds was willing to cover the entire cost of the damages in excess of $10,000, but insisted upon its right of subrogation against Westinghouse. While K-U believed that litigation would have adversely affected its relationship with Westinghouse, it feared that if Lloyds were to pay the entire loss, K-U would have difficulty in retaining in-

17. *Id.*

18. *Id.*

19. *Id.* at 493.

20. 250 F. Supp. 265 (W.D. Ky. 1965), *aff'd in part, rev'd in part,* 394 F.2d 631 (6th Cir. 1968).

surance coverage. As a result, Westinghouse, K-U, and Lloyds entered a settlement agreement in which K-U assumed responsibility for nearly $44,500 of the repair costs, all but $10,000 of which could have been recovered under its insurance policy with Lloyds.[21]

The court concluded that apart from the $10,000 deductible, K-U did not sustain any loss which was not compensated for by insurance, within the meaning of section 23(f) of the Internal Revenue Code of 1939.[22] The court relied on a basic rule enunciated in *Protzmann v. Commissioner*,[23] that "[w]hen a claim is disputed and a settlement is made, the amount not recovered is allowable as a loss."[24] Although *Protzmann* involved a claim which was settled through litigation,[25] the court in *Kentucky Utilities* interpreted the *Protzmann* rule to also encompass settlements of disputed claims against insurance companies.[26] It then held, however, that because K-U's claim against Lloyds was *not* in dispute, K-U was not entitled to deduct amounts it assumed for repairs as a loss "not compensated for by insurance."[27] Although the court arrived at its conclusion without defining the crucial phrase at issue, *Kentucky Utilities* came to stand for the proposition that a taxpayer could not take a deduction for a loss "not compensated for by insurance" where the taxpayer was covered for the loss, but declined, for whatever reason, to file a claim.

In *Axelrod v. Commissioner*,[28] the Internal Revenue Service relied upon *Kentucky Utilities* in disallowing casualty losses claimed by the owner of a boat damaged during a severe storm.[29]

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21. In that settlement, Westinghouse paid over $65,500; Lloyds paid $37,500, and relinquished any right of subrogation against Westinghouse. *Id.* at 270.

22. *Id.* This section was the forerunner of § 165(a) of the I.R.C. of 1954.

23. 276 F.2d 684, 686 (1st Cir. 1960).

24. *Id.*

25. In *Protzmann*, the settlement was effected between a receiver and a third party to a business transaction in which the taxpayer had invested for profit. The court ruled that by settling for less than he had originally invested, the taxpayer suffered a fully deductible "loss incurred on a transaction entered into for a profit," 276 F.2d at 686, and not merely a bad debt only partially deductible under § 23(k)(4) of the I.R.C. of 1939.

26. *See* Treas. Reg. 1.165-8(f) (1960) for an example of the application of the *Protzmann* rule.

27. Kentucky Utilities Co. v. Glenn, 250 F. Supp. at 271.

28. 56 T.C. 248 (1971).

29. *Id.* at 259 (Fay, J., concurring).

Although the taxpayer carried insurance on the boat, he filed no claim, fearing that his insurance policy would be cancelled.[30] The Service advanced a two-pronged argument against the taxpayer. First, it maintained that the taxpayer could not substantiate his losses to establish that he was entitled to a casualty loss deduction.[31] Secondly, it maintained that even if the taxpayer could substantiate his claim, the losses were covered by insurance, and thus he did not sustain a loss "not compensated for by insurance."[32] With this argument, the Service clearly equated "compensated for by insurance" with "covered by insurance."

The Tax Court never reached the second issue, holding that the taxpayer did not establish his casualty loss and was therefore not entitled to the deduction.[33] In a lengthy concurrence,[34] however, Judge Quealy criticized the majority's failure to determine whether or not the taxpayer's loss was one which was compensated for by insurance.[35] Judge Quealy echoed the Service's familiar claim that the taxpayer's loss resulted from his voluntary failure to demand the insurance to which he was entitled;[36] he then summarily concluded, without analyzing the phrase, that such losses *were* compensated for by insurance because coverge existed, and that they were therefore not deductible under I.R.C. § 165(a).[37] In arriving at his conclusion, Judge Quealy relied heavily upon *Kentucky Utilities,* claiming that it should control the *Axelrod* decision.[38]

In *Bartlett v. United States,*[39] the Service advanced the identical two arguments presented in *Axelrod* in disallowing the taxpayer's casualty losses for damage to their automobile.[40] In

30. *Id.* at 261 (Quealy, J., concurring).

31. The Service's position was that, indeed, the taxpayer could not even substantiate his claim to the insurance carrier, and that this was the real reason that he declined to file a claim under the policy in the first instance. *Id.* at 253.

32. *Id.*

33. *Id.* at 256.

34. Axelrod v. Commissioner, 56 T.C. 248, 260 (1971) (Quealy, J., concurring). Judge Sterrett, who wrote the dissenting opinion in *Hills v. Commissioner,* was one of four judges who joined in this portion of the opinion.

35. *Id.*

36. *Id.* at 261.

37. *Id.* at 262.

38. *Id.*

39. 397 F. Supp. 216 (D. Md. 1975).

40. *Id.* at 218. The automobile was destroyed in an accident while being driven by

finding that the taxpayers' failure to file for insurance was the immediate cause of their loss, the court focused on the voluntary character of the taxpayer's action.

> [T]o the extent the loss exceeded the insurance policy's $100.00 deductible clause, the "losses" arose from the taxpayers' voluntary election not to claim and to receive insurance proceeds to which they were legally entitled. In other words, the taxpayers voluntarily assumed the expenses touched off by the accident and, thus, their assumption of the costs was not a "casualty" loss within the contemplation of § 165.[41]

This statement went directly to the definition of a "casualty" loss as specified in I.R.C. § 165(c) rather than to the definition of the phrase "not compensated for by insurance." The implied sequence of the court's logic was as follows:

1. The taxpayers' loss was caused by their voluntary failure to file for insurance;
2. Such a loss is not one of those enumerated by § 165(c)(1), (2) or (3); and
3. The loss is therefore not one "not compensated for by insurance or otherwise," and, hence, is not deductible under I.R.C. 165(a).

This conclusion begged the crucial issue, since it relied not upon an analysis of "not compensated for by insurance," but instead upon faulty reasoning and a forced conclusion which did not logically follow. While the court acknowledged that "this exact issue has apparently never been decided in any reported opinion,"[42] it relied upon "the weight of the available authority,"[43] citing, *inter alia, Kentucky Utilities* and *Axelrod* to support its conclusion.[44]

In adopting Judge Quealey's concurring opinion in *Axelrod,* the *Bartlett* Court concluded, as did Judge Quealy, "first, that

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their sixteen-year old son. *Id.1r at 217.*

41. *Id.* at 218.

42. *Id.*

43. *Id.*

44. *Id.* at 218-20. Reliance is also placed on Sam Wallingford Grain Corp. v. Commissioner, 74 F.2d 453 (10th Cir. 1934), where a taxpayer deducted the voluntary payment of the debts of a bankrupt predecessor corporation. The Court there stated: "It has been repeatedly held that voluntary payments do not give rise to losses within the meaning of [§ 23(f) of I.R.C. of 1939]." *Id.* at 454.

because of the voluntary assumption of the loss there was no casualty loss and, second, that because the loss was covered by a valid insurance policy, it was 'compensated by insurance or otherwise.' "[45]

Subsequent cases in the area add very little to the analysis of "not compensated for by insurance." They adopted the conclusions of the prior cases without analysis of the reasoning which led to those conclusions. For example, in Revenue Ruling 78-141,[46] an attorney repaid his client large sums which the client had incurred as a result of the attorney's erroneous advice. The attorney failed to claim reimbursement under his malpractice insurance policy, and the Service, relying on *Kentucky Utilities, Bartlett,* and Judge Quealey's concurrence in *Axelrod,* determined that the attorney's payment was not a deductible loss within the purview of I.R.C. § 165(a).[47]

In a cursory memorandum decision, the Tax Court, in *Morgan v. Commissioner,*[48] disallowed a casualty loss deduction claimed by a taxpayer for hurricane damage to his yacht.[49] Noting that the taxpayer failed to file a claim for insurance, the court held: "For purposes of applying [§ 165(c)(3)] 'compensated for by insurance' means covered by insurance. *Axelrod* v. *Commissioner,* 56 T.C. 248 (1971)."[50] It is noteworthy that although the *Morgan* court cited the above proposition as the holding in *Axelrod,* the conclusion relied upon was *never reached* by the majority of the *Axelrod* court. Rather, this was the position of Judge Quealy in his concurring opinion, later adopted by the court in *Bartlett v. United States.*[51]

Finally, in *Waxler Towing Co. v. United States,*[52] a federal district court in Tennessee summarily concluded that a deduc-

45. Bartlett v. United States, 397 F. Supp. at 220.

46. 1978-1 C.B. 58.

47. *Id.* at 59. Presumably, the attorney's payment would have been a loss under I.R.C. § 165(c)(1) which provides:

> (c) Limitation on Losses of Individuals. In the case of an individual, the deduction under subsection (a) shall be limited to-
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> (1) losses incurred in a trade or business. . . .

48. 37 T.C.M. (CCH) 524 (1978).

49. *Id.* at 529.

50. *Id.*

51. 397 F. Supp. 216 (D. Md. 1975). *See supra* text accompanying notes 33-37.

52. 510 F. Supp. 297 (W.D. Tenn. 1980).

tion was not available for casualty losses under circumstances similar to those described previously, stating:[53]

> This Court is prepared to follow the rule stated in *Kentucky Utilities, Bartlett,* and *Morgan,* as to the unavailability of the loss deduction in the fact situation presented here by plaintiff. Although the Code and its interpretive regulations do not specifically state that "not compensated for" means "not covered by" insurance, the case law makes a convincing basis for such a meaning.[54]

This court apparently believed it to be totally unnecessary to determine whether "not compensated for" means "not covered by" insurance, as the equation appeared to be firmly embedded in both federal court and tax court case law.

C. *The Hills Decision—A Fresh Approach*

It was against this background of misplaced reliance upon and blind adherence to poorly reasoned case law that the *Hills* court critically analyzed and defined "not compensated for by insurance." Relying simply upon a basic dictionary definition of "compensation,"[55] the court stated that "[t]o compensate denotes 'to pay' or 'to make up for'. . . . However, to expand the meaning of compensated from actual to *potential* recoupment defies the word's acceptation."[56]

The court might also have noted that Black's Law Dictionary similarly defines "compensation" as "[i]ndemnification; payment of damages; making amends; making whole; giving an equivalent or substitute of equal value; that which is necessary *to restore an injured party to his former* position. . . . "[57] It might also have noted that, on the other hand, Black's defines to "cover" as "[t]o protect by means of insurance; sometimes orally pending issuance of policy."[58] It is clear from these two defini-

53. *Id.* at 300. The plaintiff, who was in the maritime towing business, suffered losses when one of its barges was damaged in a collision. The plaintiff decided not to file a claim for a refund under his insurance policy for fear of cancellation of the policy and inability to get alternate coverage. *Id.* at 298.

54. *Id.* at 300 (footnote omitted).

55. *See* Hills v. Commissioner, 76 T.C. at 487 and n.3.

56. *Id.* (emphasis in original).

57. BLACK'S LAW DICTIONARY 354 (rev. 4th ed. 1968) (emphasis added).

58. *Id.* at 439.

tions that "to compensate" and "to cover" are not functional equivalents in the eyes of the law. The court in *Hills* arrived at a similar conclusion, by relying solely upon the everyday, commonplace usage of these terms.

Further, the court's examination of the legislative history of the phrase "not compensated for by insurance" yielded persuasive evidence that "to compensate" and "to cover" are not synonymous.[59] In comparing I.R.C. section 165(a) to the earlier version derived from the Revenue Act of 1894,[60] the court stated:

> As originally reported by the Committee on Ways and Means, the bill allowed deductions for "losses actually sustained during the year * * * and not covered by insurance or otherwise and compensated for." The Senate Finance Committee amended the bill so that the final version read: "losses not compensated for by insurance." . . . A reasonable inference as to the reason for the revision is that the Finance Committee sought to eliminate the redundancy in the first draft: all losses compensated by insurance are also, as a necessary concomitant, covered by insurance. Nonetheless, it should be equally obvious that the converse, i.e., that all losses covered by insurance are also compensated for, is not necessarily true.[61]

The court could have carried its logic one step further, for it is entirely plausible that the Finance Committee deliberately omitted "and not covered by insurance" from the original draft because it misstated the committee's intent; i.e., one may argue that if the Committee had wanted to disallow deductions for losses *not covered* by insurance, it would have explicitly stated so. Instead, the drafters chose to permit deductions for losses "not compensated for," or paid for, as suggested by ordinary, everyday usage.

The dissent's continued reliance upon the voluntary nature of the taxpayers' payments[62] does nothing to advance the understanding of the concept "not compensated for by insurance." The dissent states that "[t]o try to draw a distinction between

59. Hills v. Commissioner, 76 T.C. at 487. *See supra* note 1 for text of statute.

60. Revenue Act of 1894, § 28, Pub. L. No. 227, ch. 349, 28 Stat. 509, 553 (current version at 26 U.S.C. § 165(a) (1976)).

61. Hills v. Commissioner, 76 T.C. at 487 (footnotes and citation omitted).

62. *See id.* at 492 (Sterett, J., dissenting).

covered and compensation, in a section 165 setting, is to amend, judicially, subsection (c)(3) by adding another circumstance under which a taxpayer may take a deduction for a loss."[63] This statement, however, ignores the threshold requirement that a loss must first have been sustained under the circumstances enumerated by I.R.C. § 165(c), in order for the taxpayer to subsequently have *had* the choice of whether or not to voluntarily assume responsibility for his losses, and thereby claim a tax deduction.

III. Conclusion

One may question the wisdom of Congress in permitting tax deductions for losses which are covered by insurance. At least one court has suggested that the taxpayer ought not to be able to use the federal government as an alternate insurer of his losses.[64] One may posit, however, various situations where it is to the taxpayers' advantage not to file an insurance claim, but where doing so nonetheless results in an actual economic loss.[65]

By any reasoning, however, it is not the Tax Court's function either to engraft or to perpetuate unintended meanings upon Congressional statutes. In this context, the *Hills* court has attempted to stem the tide of judicial redrafting of § 165(a), by strictly limiting the interpretaton of "not compensated for by insurance" to that which was originally intended by Congress and to that which is most consistent with its ordinary, everyday usage.

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63. *Id.* at 493.

64. *See* Bartlett v. United States, 397 F. Supp. at 218, where the court stated: "Nor did Congress intend § 165(c)(3) to serve as optional insurance coverage for those who suffer property damage but who choose to collect from Uncle Sam rather than their insurance company."

65. *See, e.g.,* Kentucky Utilities v. Glenn, 250 F. Supp. 265 (W.D. Ky. 1965), *aff'd in part, rev'd in part,* 394 F.2d 631 (6th Cir. 1968)(taxpayer feared a negative impact on business relations and the inability to reinsure his property); Bartlett v. United States, 397 F. Supp. 216 (D. Md. 1975)(it was reasonable to infer that the taxpayers feared a substantial increase in their auto insurance rates due to their teenage son's accident); Waxler Towing Co. v. United States, 510 F. Supp. 297 (W.D. Tenn. 1980) (plaintiff feared cancellation of its policy and an inability to find alternate coverage).