

APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE PAPER

INDUSTRY: Forest Products

ISSUE: Timber Losses following Tree Mortality
brought on by Insects

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UIL NO.: 165.19-00

FACTUAL/LEGAL ISSUE: Factual

APPROVED:

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DATE
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DATE

EFFECTIVE DATE: 6/23/93

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SETTLEMENT GUIDELINES

Losses of Timber following an Epidemic Attack of Southern Pine Beetles

STATEMENT OF ISSUES

- (1) Is a deduction allowable as a casualty loss under Internal Revenue Code Section 165(a) for loss of timber following an epidemic attack of Southern Pine Beetles?
- (2) If not, is a deduction allowable under Section 165(a) as a non-casualty loss incurred in a trade or business, or must the cost of the lost timber be recovered through depletion under Treasury Regulation Section 1.611-3(e)?
- (3) If a deduction is allowed, what is the proper method of determining the amount of the allowable loss, and what is the proper treatment of the loss under Internal Revenue Code Section 1231?
- (4) May the recognition of gains derived under Internal Revenue Code Section 631(a) from salvaging timber in beetle-infested trees be deferred under Internal Revenue Code Section 1033? Is Section 1033 treatment allowable for Section 631(a) gains derived from the cutting of healthy trees to isolate beetle infestations? Do the same results hold for Section 631(b) gains from such timber?

EXAMINATION DIVISION POSITION

The basis for the Examination position is GCM 39427 dated 6/21/85, a lengthy document which should be read for a full discussion of the issues.

1. No deduction on the basis of casualty is allowable, because the events causing the losses lack the requisite suddenness. The loss in question was the death of beetle-infested trees--those that contained timber that ultimately could not be salvaged--and the worthlessness of the timber in those trees. This loss was the direct result, not just of the beetle attacks--which killed the trees but left the merchantable timber largely intact--but also of ensuing progressive physical damage caused by wood-destroying insects and fungi.

Settlement Guidelines

2. A finding of casualty is not a prerequisite to the allowance of a loss. The taxpayer is entitled to deduct under Section 165(a) any timber loss in excess of normal, expected mortality losses, to the extent it can establish through objective facts that, as of a determinable date, that timber had deteriorated to the point of being unsalvageable.
3. The amount the taxpayer is entitled to deduct under Section 165(a) is its adjusted basis in each worthless unit of timber. The losses, since they resulted from the involuntary conversion of real property used in a trade or business, must be included in the computation of net gain or loss under Internal Revenue Code Section 1231(a). Since they do not arise from a casualty, they do not enter into the "preliminary hotchpot" computation under Treasury Regulation Section 1.1231-1(e)(3). For most cases, this will result in a reduction of the net capital gain rather than an ordinary loss.
4. Section 631(a) gains resulting from the salvage of timber from the beetle-infested trees may be treated as gains from the involuntary conversion of property under Section 1033(a). Section 631(a) gains resulting from the cutting of healthy trees to isolate the beetle infestation are not eligible for Section 1033 treatment, since they were cut as a result of the threat or imminence of the attack, not as a result of the attack itself.

SCOPE

The major focus of the ISP position and that of this paper concerns the first of the questions outlined above, i.e., casualty losses claimed due to beetle infestation. The remaining questions are, in most part, non-controversial. However, controversy may arise as to the method of determining the amount of loss (Question 3, above). This question is addressed in the ISP position regarding computation of timber casualty losses. Another area of possible controversy involves Section 1033 treatment on Sections 631(a) and 631(b) gains derived from the removal of healthy trees to isolate infected trees (Question 4 above). This question is discussed at Issue 4 of GCM 39427 which concludes that healthy tree removal for purposes of isolating beetle infestation does not result in Section 1033 treatment. Until arguments to the contrary are developed through litigation, this position should be followed in Appeals.

Settlement Guidelines

DISCUSSION

BACKGROUND FACTS:

The Southern Pine Beetle is a tiny critter about the size of your pencil point. As many as 100,000 to 150,000 may attack one pine tree. The beetles do not eat the tree, but bore through the bark to the surface of the wood known as the phloem-cambium tissue. The cambium layer is where new wood and bark develop. The beetles bore long, narrow tunnels in the cambium and eggs are laid in the tunnels. With sufficient beetles in a tree, these tunnels will eventually girdle a tree. This cuts off the life support system for the tree and kills it.

This position paper guideline is intended to cover instances where, factually, losses associated with the Southern Pine Beetles result from beetle attacks in epidemic proportions. "Epidemic" in this context is when the local forested land suffers two to three infected areas (called spots), or more, within 1,000-acres. In epidemic situations, a loss may be "unusual and unexpected," but not necessarily "sudden" as discussed below. The beetle is endemic to the forest lands where losses are likely to occur. In normal populations, any loss would not be "unusual and unexpected."

The focus of this guideline is upon corporate and other business property where the timber loss would be ultimately recovered in one way or another; either through depletion, a Section 165(a) ordinary loss, or as a casualty loss. The categorization, however, can greatly affect tax for timber companies in years with capital gains rates. A casualty loss usually will be deductible as an "ordinary" loss while a Section 165(a) loss will become a part of the Section 1231(a) "hotchpot" and, thus, will offset capital gain. It should be noted however, that where capital gains exceed taxable income, this could benefit the taxpayer.

FACTS AND ANALYSIS OF THE TERM "SUDDEN":

The focal point of this issue for the Appeals Officer will be an analysis of the term "sudden" as used in the general definition of casualty losses. If it is determined, factually, that an epidemic infestation has occurred, the key question is: Do we look to the "suddenness" of the attack or the "suddenness" of the deterioration of the wood (the loss itself) to determine whether a casualty loss has occurred?

Settlement Guidelines

Southern Pine Beetles can, under the right conditions, (warm weather; unhealthy or stressed trees) kill a tree in a matter of days (perhaps, 2-3 days). The death of the tree, however, has no immediate effect on the usefulness of its timber since the pine beetle tunnels do not appreciably damage the wood. The damage of the wood occurs after death of the tree and is due to other insects and decay organisms. These elements deteriorate the wood over a period of time, depending upon environmental factors.

The taxpayer will likely argue that the event causing the loss happened suddenly; i.e., 2-3 days, or certainly within 30 days. The Government will argue that, the suddenness of the precipitating event does not establish the loss as casualty loss. Rather, one must look to the time period over which the loss was manifested. The loss occurs over a long period of time, perhaps 6-9 months and would not be termed "sudden". To this, the taxpayer will likely argue that, at death, the loss is inevitable; the tree will decay and become useless so that the focal point should be the suddenness of the precipitating event, not the time it takes to become worthless. The Government has rejected this last argument in GCM 39427, stating that a "causation" analysis is not consistent with case law in the casualty loss area.

Section 165(a) of the Internal Revenue Code generally allows as a deduction any losses arising from fire, storm, shipwreck, or other casualty. Treasury Regulation Section 1.165-7(a)(1). "Other casualty" has been defined as "an event due to some sudden, unexpected, or unusual cause." Matheson v. Commissioner, 54 F.2d 537, 539 (2d Cir. 1931). Although the three elements of a casualty event are linked by the disjunctive "or," they are applied in the conjunctive: i.e., "sudden, unusual, and unexpected." Suddenness is an essential element. It must be recognized that the term "sudden" is comparative, and gives rise to an issue of fact.

Revenue Ruling 87-59 deals with deductibility as casualty or non-casualty loss of the taxpayer's loss of timber in trees killed by attacks of Southern Pine Beetles in epidemic proportions. This ruling concludes that the key to this question is the term "sudden" as used to define casualty losses, and that the suddenness of the loss should be the focus of attention, not the suddenness of the event precipitating the loss. This ruling concludes that although the onset of the beetles and death of the trees may be sudden, the period of time from the attack to the fixing of the loss, worthlessness caused by deterioration of the wood in the trees, was not sudden. The ruling, therefore, denied casualty loss treatment. The ruling does provide, however, that the loss resulting from the unusual and unexpected attack (epidemic attack), was an allowable business loss deduction under Section 165(a). Not being a casualty loss, the loss must be netted with other noncasualty, Section 1231 gains and losses.

LITIGATION AFFECTING THE ISSUE:

There is no clear precedent regarding timber property and the Southern Pine Beetle. There is precedent, however, for the sudden loss of ornamental trees as a result of an attack of Southern Pine Beetles being treated as casualty losses. Nelson v. Commissioner, T.C. Memo. 1968-35; Black v. Commissioner, T.C. Memo 1977-33. Also, in Revenue Ruling 79-174, 1979-1 C.B. 99, a loss resulting from the death of ornamental trees in 5-10 days following a massive Southern Pine Beetle attack was allowed as a casualty loss. These cases and the Ruling, however, are distinguishable from the timber losses in that, at death, an ornamental tree has no value; thus, the ornamental tree losses were sudden.

PRECEDENT FOR THE GOVERNMENT POSITION:

- (1). In Oregon Mesabi Corp. v. Commissioner, 39 BTA 1033 (1939), acq., 1944 C.B. 22, although timber had been killed by fire, it had not been made worthless. A loss was not allowable in the year of the fire, but was allowable in the year destruction and worthlessness occurred through progressive deterioration. The Court pointed out that the timber remained sound and marketable after the fire and had it been logged before the insects and fungi had penetrated the wood, no loss would have, in fact, occurred. The mere possibility of a loss did not result in a deduction.
- (2). In Maher v. Commissioner, 76 T.C. 593 (1981), aff'd., 680 F.2d 91 (11th Cir. 1982), a casualty loss was not allowed on ornamental palm trees that died following their infection by insects with lethal yellowing, a disease that kills palm trees in an average of 9 to 10 months. When the palm trees were infected, the

Settlement Guidelines

death of the trees was inevitable. Many of the precedents on the "suddenness" element of the casualty loss were brought together and discussed by the court. The court decided that the prevalent view in determining whether the suddenness requirement is met is to measure the suddenness of the loss itself, not the suddenness of the precipitating event. In applying this reasoning to the ornamental palm trees, the court determined that the suddenness requirement was not met. The period from infection of the trees to death indicated not a sudden loss, but a loss resulting from gradual deterioration over an extended period.

The point in MaHer is that the loss itself must be sudden to qualify as a casualty loss. Comparing MaHer to Black, supra, and Nelson, supra, where casualty losses were allowed on the loss of ornamental trees, we note that in MaHer the loss (death) occurred over a long period, whereas, in Black and Nelson the losses (deaths) occurred "suddenly." In all three cases, the death was irreversible and known at the time of the precipitating event. In MaHer, even though death was known to be an eventuality, the loss would not be complete until death occurred. In Black and Nelson, death was immediate and, because the trees were ornamental, the losses were fixed at that time. Extending this theory to a factual situation where the property is timber property, it appears that while death of the trees could be sudden under an attack of Southern Pine Beetles in epidemic proportions, the loss very likely would occur over time as the wood gradually deteriorated and not meet the suddenness test.

Under the above analysis, in deciding a Southern Pine Beetle timber case the courts could find that the loss of value does not occur suddenly and that there should, therefore, be no allowable casualty loss.

There could be an argument raised, however, that at death of the trees, the timber therein has no value due to the company's inability to recover it. If the timber is inaccessible, for example, it might be presumed to have lost its value at death. The Service has not yet taken a position on this issue. The Service could argue that worthlessness depends on the condition of the timber because until the timber is no longer physically fit for use, it is available for harvest as is any timber in adjacent live trees.