

APPEALS

COORDINATED ISSUE PROGRAM

APPEALS SETTLEMENT GUIDELINES

INDUSTRY: Forest Products

ISSUE: Losses of Timber following an Epidemic Attack of
Southern Pine Beetles

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SETTLEMENT GUIDELINES

Losses of Timber following an Epidemic Attack of Southern Pine Beetles

STATEMENT OF ISSUES

Issue 1

Is a deduction allowable as a casualty loss under I.R.C. Section 165(a) for loss of timber following an epidemic attack of Southern Pine Beetles?

Issue 2

If a deduction is not allowable as a casualty loss, is a deduction allowable under I.R.C. 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 Treas. Reg. 1.611-3(e)?

Issue 3

If a deduction is allowed as a non-casualty loss, what is the proper method of determining the amount of the allowable loss, and what is the proper treatment of the loss under I.R.C. Section 1231?

Issue 4

Is I.R.C. Section 1033 treatment allowable for I.R.C. Section 631(a) gains derived from cutting healthy trees to isolate beetle infestations?

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COMPLIANCE POSITION

Issue 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.

Issue 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 (as of a determinable date) that timber had deteriorated to the point of being unsalvageable.

Issue 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 (see Rev. Rul. 87-59, 1987-2 CB 59) 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.

Issue 4

Section 631(a) gains resulting from the cutting of healthy trees to isolate the beetle

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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.

INDUSTRY/TAXPAYER POSITION

Issue 1

A deduction on the basis of a casualty loss is allowable. An epidemic attack of Southern Pine Beetles satisfies the “sudden, unexpected or unusual” test for a deductible casualty under Section 165. The focal point should be the suddenness of the precipitating event, not the time it takes to become worthless.

Issue 2

If a deduction is not allowable as a casualty loss, a deduction is allowable as a non-casualty loss incurred in a trade or business.

Issue 3

The amount the taxpayer is entitled to deduct as an ordinary loss is the diminution in the fair market value, limited to the taxpayer’s adjusted basis in the single, identifiable property damaged or destroyed.

Issue 4

Taxpayer’s position has not been articulated.

DISCUSSION

Overview

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. Controversy may arise as to the method of determining the amount of loss (Question 3, above). This question is addressed in the former ISP position regarding computation of timber casualty losses. This former position (now a de-coordinated issue), regarding the "Single Identifiable Unit of Property", (the block of timber effected, or, the board foot destroyed) may be obtained, for background information, should the need arise.

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Another area of possible controversy involves Section 1033 treatment on Section 631(a) gain derived from the removal of healthy trees to isolate infected trees (Question 4 above). This question is discussed at Issue 4 of GCM 39427 (dated 6/21/85), 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.

Background Facts

The Southern Pine Beetle is a tiny insect 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 forestlands 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 deductible either as a Section 165(a) ordinary loss, or as a casualty loss. The categorization is important because the loss is computed differently depending on whether the loss is a casualty loss or a non-casualty loss. For casualty losses, the loss is measured by the diminution in the fair market value of the single, identifiable property damaged or destroyed (hereinafter "SIP"), limited to the adjusted basis of the SIP (i.e. the appropriate depletion block). SIP is a phrase used in the regulations to address the issue of aggregating property for purposes of computing the loss. See Treasury Regulation § 1.165-7(b)(2). For non-casualty business losses, the amount of loss allowable is limited to the adjusted basis in the units (e.g., board feet, cords) destroyed, as reflected by their unit depletion rate.

The categorization is also important in that a Section 165 non-casualty loss requires that a complete loss be incurred in order for the loss to be deductible, while a casualty loss may be permitted with respect to casualty events which adversely affect the condition of timber.

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The categorization also has an effect if the capital gains tax is available to the taxpayer. 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" (see Rev. Rul. 87-59, supra) 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 should be an analysis of the term "sudden" as used in the general definition of casualty losses. (The amount of the loss is a factual question and is discussed later). 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?

Southern Pine Beetles can, under the right conditions, (warm weather; unhealthy or stressed trees) kill a tree in a matter of days (perhaps, 4-7 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 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. 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.

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Revenue Ruling 87-59, *supra*, 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 non-casualty, Section 1231 gains and losses. Furthermore, the loss is limited to the adjusted basis in the units that are lost.

Litigation Affecting the Issue

The Tax Court first considered whether an infestation of Southern Pine Beetles ("SPB") gives rise to a casualty loss in Nelson v. Commissioner, T.C. Memo. 1968-35. The taxpayer in this case owned six acres of residential property in Texas that contained 48 loblolly pine trees that stood greater than 50 feet tall. In 1962 24 trees died within 5 to 10 days of an epidemic attack by SPB. The epidemic was unexpected in the area; there were no known attacks in epidemic proportions prior to or subsequent to 1962. The court said an SPB attack is an occurrence of nature and many trees are killed in this way every year. Still, it is unexpected by property owners such as the taxpayer that their particular property may be attacked. The court noted that the death of these trees was far more sudden than damage shown in certain termite cases considered by the court. The court held that a casualty loss was allowable.

In 1977 the Tax Court again determined a casualty loss was allowable to a taxpayer in Atlanta who lost 30 pine trees to SPB. Black v. Commissioner, T.C. Memo 1977-33. The trees in this case measured 50-65 feet high and stood on 2.7 acres. The trees died within 30 days of attack. The taxpayer pushed the felled trees into a ravine and covered them with soil. The court said that whether the cause of destruction of property is "sudden" is a question of fact in each case. Citing its decision in Nelson, the court concluded that the infestation of trees by SPB is a sufficiently sudden event to be classed as a casualty under Section 165(c)(3).

In 1980 the District Court in northern Georgia considered the issue in Smithgall v. U.S., 81-1 USTC 9121 (N.D. Ga 1980). Once again the taxpayer was a residential owner, although in this case the amount of acreage was much larger – 180 acres. SPB destroyed a number of "ornamental" pine trees within 5 to 14 days. The court found that

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the attack was of epidemic proportion and unusual for the area. The district court, citing Nelson and Black, held that the loss was a casualty.

The Smithgall case was the first in which a court referred to trees destroyed by SPB as “ornamental” trees. Ornamental pines are commonly thought of as “yard” trees owned for aesthetic purposes as compared to trees held for commercial exploitation. This is an important distinction, as we will see below. The Nelson, Black and Smithgall decisions all involve ornamental trees. By 1979, the Government had conceded that ornamental trees destroyed by an epidemic attack of SPB constituted a casualty loss. Revenue Ruling 79-174, 1979-1 C.B. 99.

In 1981 the issue developed a new dimension. In the case of Maier v. Commissioner, 76 T.C. 593 (1981) aff'd 680 F.2d 91 (11th Cir. 1982), the Tax Court considered whether the death of 22 coconut palm trees from a disease called “lethal yellowing” was a casualty loss. No court had previously allowed a casualty loss deduction for losses resulting from a disease. The Tax Court noted that disease is an everyday occurrence and that death resulting from disease is not regarded as an accident. With respect to the question of “suddenness”, the Tax Court said:

Although there is some support for petitioner’s view that the suddenness requirement refers to the suddenness of the precipitating event, ...**we believe the better and more prevalent view is to measure the suddenness of the loss itself, i.e., the lapse of time between the precipitating event and the loss proximately caused by that event.** [Emphasis added] In our view, a disease spanning a nine to ten month time frame...constitutes a lingering, gradual deterioration. This is in contradistinction to the relatively swift consequences accompanying the onslaught of southern pine beetles on pine trees.

As a result of the Maier case, specifically the Tax Court’s focus on the “suddenness” question, the Government began theorizing that for timber held for commercial exploitation, the period of time between the SPB attack and the ultimate worthlessness of the timber should be taken into account in determining whether the suddenness requirement is met. Unlike ornamental trees, wood in a tree grown for timber is of interest to the timber owner beyond death caused by SPB. Death of a tree containing timber does not provide the same focal point for measuring loss as with an ornamental tree. The economic loss of a tree grown for timber continues gradually. Since the period over which a tree loses its value is nine months or more, the period is not sufficiently sudden to indicate a casualty loss. See GCM 39427, Rev. Rul. 87-59, 1987-2 C.B. 59, and LTR 8544001. Each of these documents reflect the Government position that a loss of timber held for commercial exploitation following an epidemic attack of SPB gives rise to an allowable non-casualty business loss, but not a casualty loss.

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There is additional support for the Government's position on the suddenness question in the case of Oregon Mesabi Corp. v. Commissioner, 39 BTA 1033 (1939), acq., 1944 C.B. 22. In this case, timber had been killed by fire, although 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.

After Smithgall, the SPB issue was not litigated again until 1994. Weyerhaeuser Company took the issue to the U.S. Court of Federal Claims. Weyerhaeuser v. United States, 32 Fed. CL. 80 (1994). The taxpayer alleged that it sustained numerous casualty losses to timber as a result of the Mt. St. Helens volcanic eruption, various forest fires, and a SPB infestation.

With respect to the losses resulting from the volcanic eruption and the forest fires, the Government stipulated that the losses resulted from casualty events. The issue litigated on these events related to determination of the "single identifiable property" of the property destroyed.

With respect to the SPB infestation, the Government argued that the SPB infestation did not constitute a casualty under §165(a). The Court's ruling makes no reference to the argument that the suddenness requirement had not been met because the loss reflected gradual deterioration over an extended period. The Court found that a mass attack of SPB in epidemic proportions is a sudden and unexpected occurrence and is a casualty loss "as a matter of law." Nelson, Black and Smithgall were cited by the Court as support for its conclusion.

The Court recognized that Nelson, Black and Smithgall could be distinguished from Weyerhaeuser, but it appears the Court failed to make the correct distinction. The Court stated:

We recognize, of course, that the explicit language with regard to the holding in *Smithgall*, *Nelson*, and *Black* applies to cases involving individual taxpayers, and not corporations such as Weyerhaeuser. However, the operative language in §165(c)(3) relating to individuals—"losses aris[ing] from fire, storm, shipwreck or other casualty"—is not significantly different from the language in Treas. Reg. §1.165-7(a)(1)—"loss arising from fire, storm, shipwreck, or other casualty"—for persons other than individuals. This circumstance compels us to hold that, on the facts presently at bar, the distinction is not sufficiently significant to warrant a contrary holding.

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The distinction noted by the Court (that Weyerhaeuser is a corporation as compared to an individual) is a superficial distinction that is neither relevant nor one that presumably would give rise to any disagreement by the Government. The significant distinction that the Court appears not to have considered is the question of whether the destroyed trees were held for aesthetic purposes or for commercial exploitation. Trees held for aesthetic purposes may very well lose all of their value to a residential home owner within two weeks of a SPB attack. On the other hand, trees held for commercial exploitation that are destroyed by SPB lose their value to the timber owner over an extended period of time. The loss of value over an extended period of time raises a doubt as to whether the suddenness requirement is met in order for a casualty to have occurred.

Another very significant thing occurred in the Weyerhaeuser case. The taxpayer could not prove the amount of the casualty loss incurred as a result of the SPB infestation. With regard to the volcanic eruption loss and the loss due to fires, the Court held that the tree stand, rather than the depletion block, was the appropriate single, identifiable property to use when computing adjusted basis for purposes of the timber casualty loss. On appeal, the U.S. Court of Appeals, Federal Circuit, concluded that the depletion block, not the tree stand, is the SIP. Weyerhaeuser v. U.S., 92 F3d 1148 (aff'g. rev'g and rem'g Fed Cl). But the Government was unable to appeal the SPB issue because no loss was allowed and the taxpayer declined to pursue an allowable amount at the Circuit Court.

Consequently, the U.S. Court of Federal Claims decision leaves unanswered two very significant questions concerning the SPB casualty loss issue: (1) what must a taxpayer do to prove the amount of an allowable loss? and (2) has the "suddenness" issue been properly considered by the judiciary?

SETTLEMENT GUIDELINES

Issue 1

Where it is determined factually that an epidemic of Southern Pine Beetles has not occurred, any timber loss resulting from Southern Pine Beetle attacks should not be deductible, but should be recovered through depletion under Section 611(a).

Where an epidemic infestation has occurred with respect to ornamental trees, any loss resulting is allowable as a casualty loss.

Where an epidemic infestation has occurred with respect to timber held for commercial exploitation, consideration must be given to the Government's formal position, the results of earlier litigation, the potential for future litigation, and the specific facts of the

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case.

The Government's formal published position on an epidemic infestation continues to be Rev. Rul. 87-59. For taxpayers that grow, manage, and harvest pine timber, a loss of timber over a nine month period following an unexpected and unusual insect attack gives rise to an allowable non-casualty business loss that must be netted with other non-casualty section 1231 gains and losses. It has been many years since the Court of Federal Claims decided Weyerhaeuser. There appears to be no effort to revoke Rev. Rul. 87-59, even though the decision appears to be in conflict with the ruling. Nor does there appear to be any effort at issuing an Action on Decision regarding Weyerhaeuser.

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If the issue were to be litigated again, presumably the Government would make a sound argument that the facts in Black, Nelson and Smithgall are distinguishable from the facts in Weyerhaeuser. Presumably the Government would argue forcefully that, in the context of a taxpayer that holds timber for commercial exploitation, trees destroyed by SPB lose their value over an extended period of time and, consequently, the suddenness requirement is not met. This argument appears not only in Rev. Rul. 87-59, but also in GCM 39427.

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The specific facts of a case must be taken into account. For example, a taxpayer may be able to establish that at death there was no possibility of recovery of the timber in the dead trees. This may be a result of inaccessibility, weather conditions, market conditions, etc. On the other hand, a taxpayer may be able to harvest a large majority of the infested timber, particularly if the area infested had been a part of the taxpayer's management plan for the current tax year. The use of hindsight would be appropriate to confirm the specific facts of the case.

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Finally, recall that the burden is on the taxpayer to prove the amount of the loss. This apparently was a very difficult (in fact, impossible) burden for Weyerhaeuser in its case before the Court.

Issue 2

A section 165(a) loss is still allowable (even though a "casualty" has not occurred) where any timber lost was in excess of normal, expected, mortality losses, to the extent it can be established through objective facts that the subject timber had deteriorated to the point of being unsalvageable. This issue is legally non-controversial and is resolved factually.

Issue 3

Amount of the Loss

An amount allowable as a non-casualty loss depends on the adjusted basis in each worthless unit of unsalvageable timber (e.g., board feet, cords) as recorded in the depletion account. Any loss must be netted with other non-casualty Section 1231 gains and losses. See Rev. Rul. 87-59.

If the taxpayer has claimed a casualty loss, care must first be taken to ensure that the loss was properly computed. Treasury Regulation §1.165-7(b)(1) provides that the amount of the loss is the lesser of either the decrease in the fair market value of the property, or the amount of the adjusted basis of the property. Reg. §1.165-7(b)(2) provides that the diminution in fair market value be determined on the basis of the SIP (i.e. the appropriate depletion block), not just the affected property. Therefore, the taxpayer must determine the fair market value of the SIP immediately before and immediately after the casualty, and compare the decrease in value to the adjusted basis of the SIP.

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Section 1231 Treatment

As was mentioned above, the distinction of whether the Section 165 loss is a "Casualty Loss" or a Section 165 "non-casualty loss of property used in the Trade or Business" can be important because, if the "casualty loss" exceeds casualty gains, those losses need not be used in the netting process against other Section 1231 gains. [Treas. Regs. 1.1231-1(e)(3)]. The result then, is that most casualty losses will be ordinary, rather than offsetting capital gains.

If it is determined in question (1) above that a casualty loss has occurred, the loss will be treated as an ordinary loss not involved in the Section 1231 computation.

If it is determined in question (1) above that there was no casualty loss, any loss will be subject to Section 1231 such that it is first netted against any Section 1231 capital gains.

Issue 4

Section 631(a) gains from salvaged timber may be deferred under Section 1033, but those gains resulting from timber in healthy trees cut to isolate the infested trees are not entitled to Section 1033 treatment. The position of GCM 39427 is, therefore, adopted as to Issue 4.

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