



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

April 05, 2002

Number: **200229007**
Release Date: 7/19/2002
POSTF-164802-01/CC:PSI:B7
UILC: 165.07-00, 631.01-01, 631.01-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL INDUSTRY PROGRAMS
(LARGE AND MID-SIZE BUSINESS) CC:LM:NR:DAL
Attn: Todd A. Ludeke

FROM: ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND
SPECIAL INDUSTRIES) CC:PSI

SUBJECT: _____

This Chief Counsel Advice responds to your memorandum dated January 7, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:

EIN:

a:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Date 6:

ISSUE

1. Whether Taxpayer may value only the portion of a timber property affected by an ice storm for purposes of determining a casualty loss under I.R.C. § 165.
2. Whether Taxpayer, who harvested timber from a timber property that had been adversely affected by an ice storm, may take into account the condition of the harvested timber as if it were harvested before the ice storm for purposes of I.R.C. § 631(a).

CONCLUSION

1. Taxpayer may not value only the portion of a timber property affected by an ice storm for purposes of determining a casualty loss under section 165.
2. Taxpayer, who harvested timber from a timber property that had been adversely affected by an ice storm, may take into account the condition of the harvested timber as if it were harvested before the ice storm for purposes of section 631(a).

FACTS

Taxpayer is an integrated forest products company using a calendar year for tax purposes. Taxpayer operates paper mills and lumber mills. On Date 1, an ice storm completely destroyed or adversely affected the condition of several hundred acres of Taxpayer's timber.

Taxpayer determined that the depletion block consisting of a acres of timber was its single, identifiable property (SIP) for purposes of determining any casualty loss under section 165. Taxpayer determined the timber volume contained in the affected trees before the ice storm and the remaining timber volume contained in the affected trees after the ice storm. Then, Taxpayer calculated a loss for pine pulpwood, pine sawtimber, hardwood pulpwood, and hardwood sawtimber by taking the difference between the fair market value for the volume of timber for each before the ice storm and the reduced fair market value (reduced to reflect the impact of the ice storm on the quality of the affected trees) for the remaining volume of timber for each after the ice storm.

For taxable years ending Date 2, Date 3, Date 4, and Date 5, Taxpayer had a section 631(a) election in effect. Taxpayer calculated its section 631(a) gain by taking the difference between the fair market value for the remaining timber volume contained in the affected trees based on the condition the timber was in before the ice storm on Date 6 and the adjusted basis.

Taxpayer used the proceeds from the section 631(a) hypothetical sale of timber to plant new plantations. Taxpayer deferred the section 631(a) gain as an involuntary conversion under I.R.C. § 1033. Taxpayer transferred the remaining timber to Taxpayer's mills.

LAW AND ANALYSIS

I Section 165 Casualty Losses

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c) provides that

the deduction shall be limited to, *inter alia*, casualty losses. Section 165(c) defines casualty losses as losses arising from fire, storm, shipwreck, or other casualty.

Treas. Reg. § 1.165-1(b) provides in part that, to be allowable as a deduction under section 165(a), a loss must be actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss. Section 1.165-1(b).

Treas. Reg. § 1.165-1(c) provides that the amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by Treas. Reg. § 1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved.

Treas. Reg. § 1.165-7(b)(1) provides that in the case of any casualty loss whether or not incurred in a trade or business or in any transaction entered into for profit, the amount of the loss to be taken into account for purposes of section 165(a) shall be the lesser of either (i) The amount which is equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or (ii) The amount of the adjusted basis prescribed in Treas. Reg. § 1.1011-1 for determining the loss from the sale or other disposition of the property involved. Section 1011 of the Internal Revenue Code provides that the adjusted basis of the property is generally the cost of such property under I.R.C. § 1012 adjusted as provided in I.R.C. § 1016.

Treas. Reg. § 1.165-7(b)(2)(i) provides that a loss incurred in a trade or business or in any transaction entered into for profit shall be determined under section 1.165-7(b)(1) by reference to the SIP damaged or destroyed.

A taxpayer is not entitled to a casualty loss deduction simply because some of its timber has been either completely destroyed or adversely affected by a casualty event. To qualify for a casualty loss deduction, a taxpayer must demonstrate that it incurred an actual loss. Section 1.165-1(b). Under section 1.165-7(b)(1), a loss exists only if there has been a diminution in the fair market value of the SIP. *Westvaco Corp. v. United States*, 639 F.2d 700 (Ct. Cl. 1980)(finding that it is not enough for plaintiff to establish direct physical damage occurred to merchantable timber in order to satisfy the test for an allowable casualty loss, but plaintiff must also establish that there has been a reduction in the fair market value of the SIP).

In cases involving timber, the SIP is as a matter of law the depletion block if the depletion block “serves for commercial, forest management, and depletion purposes”. *Weyerhaeuser Co. v. United States*, 92 F.3d 1148 (Fed. Cir. 1996); *International Paper Co. v. United States*, 39 Fed. Cl. 478 (1997); *Westvaco*, 639 F.2d 700 (Ct. Cl. 1980). The depletion block is an area into which a taxpayer aggregates its timber for purposes of ensuring logical and reasonable timber valuation and tracking of the timber’s adjusted basis. See Treas. Reg. § 1.611-3. Treas. Reg. § 1.611-3(d)(1) sets forth standards by which a taxpayer selects its

depletion block. For example, a taxpayer may choose a depletion block based on manufacturing points, geographical or political boundaries, or management areas. Id.

Taxpayer determined that a depletion block consisting of a acres was its SIP. Accordingly, Taxpayer must determine whether there has been a diminution in value by taking the difference between the fair market value of the depletion block as a unitary property immediately before the ice storm and the depletion block as a unitary property immediately after the ice storm. Section 1.165-7(b)(1) and (2)(i). *See also Weyerhaeuser Co. v. United States*, 39 Fed. Cl. 410 (1997); *International Paper*, 39 Fed. Cl. 478 (1997); *International Paper Co. v. United States*, 36 Fed. Cl. 313 (1996); *Westvaco*, 639 F.2d 700 (Ct. Cl. 1980).

II Section 631 Election to Consider Cutting of Timber as Sale or Exchange

Section 631(a) provides that if a taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 1 year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber and the adjusted basis for depletion of such timber in the hands of the taxpayer. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor.

Treas. Reg. § 1.631-1(d)(2) provides that the fair market value of the timber as of the first day of the taxable year in which such timber is cut shall be determined, subject to approval or revision by the district director upon examination of the taxpayer's return, by the taxpayer in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, methods of exploitation, degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of that particular day. Due consideration will be given to factors and the principles involved in the determination of the fair market value of timber as described in the regulations under I.R.C. § 611.

Section 1.631-1(d)(2) is an administrative provision intended to simplify and prevent multiplicity of valuations during the taxable year. *See Revenue Revision of 1943: House Hearings Before the Comm. on Ways and Means, 78th Cong., 1st Sess. 805 and 816 (1943)(Supplemental Statement Re. Timber Tax Reform Submitted by the Forest Industries Committee on Timber Taxation Valuation and Taxation).* Taxpayer may take into account the condition of the harvested timber as if it were

harvested before the ice storm for purposes of section 631(a) because section 1.631-1(d)(2) requires Taxpayer to determine the fair market value of the timber cut based on the condition of the property as it existed as of the first day of the taxable year.

This office expresses or implies no opinion concerning Taxpayer's application of section 1033.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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