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Internal Revenue Service

Department of the Treasury

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Legend

Taxpayer =
X =
B =
F =
f =
D =
O =
R =
Rs =
$A =
$B =
$C =
$D =
$E =
$F =
Year A =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
x% =
y% =

This responds to the letter dated April 13, 1999, requesting a private letter ruling on the question of whether an accidental poisoning of Taxpayer's R plants constitutes an involuntary conversion. Taxpayer represents the following facts:

Taxpayer is engaged in the business of growing, marketing, distributing and selling O, including Rs. During all relevant times, Taxpayer conducted its business on property it owned in the state of X. The plants at issue are perennial plants that are expected to be productive for an extended period of time producing Rs that are then harvested and sold in Taxpayer's business.

B is a F marketed for use on ornamental plants and various crops such as tomatoes and cucumbers. B is manufactured by D. Taxpayer purchased B for use as a F on its R plants. The application of B on Taxpayer's R plants caused mutations, discoloration, chlorosis, stunting and necrosis of Taxpayer's crops. Subsequent to its application, fields treated with B have experienced serious recropping problems, contamination and damage to the extent that most of the property can no longer be commercially utilized for agricultural and other purposes.

On Date 1, Taxpayer filed suit against D and others, alleging that the B manufactured by D was defective and caused the damage and destruction of Taxpayer's R plants, as well as contamination of its fields. As a result, Taxpayer sought both economic and punitive damages. Taxpayer's economic damage claim in the amount of $A was comprised of plant replacement costs in the amount of $B and lost income in the amount of $C. On Date 2, a judgment was entered awarding Taxpayer economic damages in the amount of $D, plus pre-judgment interest, punitive damages and certain other fees and costs, for a total award of $E. Before D exhausted all of its appeal rights, the parties to the action entered into a settlement agreement on Date 3 and payment in the amount of $E was received on Date 4. For purposes of this ruling this office believes the facts permit a reasonable inference that Taxpayer's losses were caused by B.

Taxpayer requests the following rulings:

1. The damage to and destruction of Taxpayer's R plants and the amount awarded to Taxpayer as economic damages in the lawsuit against D qualify as an involuntary conversion of Taxpayer's property into money under section 1033(a)(2) of the Internal Revenue Code.

2. The election provided in section 1033(a)(2)(A) of the Code is therefore available to Taxpayer to the extent that Taxpayer replaces the involuntarily converted property by

the purchase of property similar or related in service or use to the property so converted within the time period specified in section 1033(a)(2)(B).

3. For purposes of section 1033(a)(2)(B)(i), the fiscal year ended Date 5 is the taxable year in which Taxpayer first realized any part of the gain upon the conversion of the property pursuant to the Date 3 settlement agreement.

Section 1033(a)(2)(A) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition, or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money and if the taxpayer during the time specified purchases property similar or related in service or use to the property so converted, at the election of the taxpayer, the gain shall be recognized only to the extent the amount realized on such conversion exceeds the cost of such other property.

Section 1033(a)(2)(B) of the Code provides, in part, that the period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property and ending two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

Property has been involuntarily converted when some outside force or agency places it outside a taxpayer's control so that it is no longer useful or available to the taxpayer. C.G. Willis, Inc. v. Commissioner, 41 T.C. 468, 476 (1964), aff'd per curiam, 342 F.2d 996 (3rd Cir. 1965). To come within the general rule of section 1033(a) of the Code, the involuntary conversion in a given case must be by destruction, theft, seizure, requisition, condemnation or threat or imminence of requisition or condemnation. Historically, the term "destruction," in the context of section 1033(a), had been equated with the term "casualty." According to Rev. Rul. 59-102, 1959-1 C.B. 200, "casualty" denotes an accident, a mishap, or a sudden invasion by a hostile agency, but does not include progressive deterioration. The ruling further states that a casualty may proceed from an unknown cause or may be the unusual effect of a known cause and that, in either instance, a casualty occurs by chance or unexpectedly. The ruling states that suddenness of a mishap is not an essential element of "destruction" for purposes of section 1033(a). Rev. Rul. 54-395, 1954-2 C.B. 143, holds that loss of cattle by accidental poisoning amounted to destruction of property within the meaning of section 1033(a). Other examples of "destruction" include losses of honeybees from application of pesticides on nearby property and contamination of fresh water with salt water. See Rev. Rul. 75-381, 1975-2 C.B. 25, and Rev. Rul. 66-334, 1966-2 C.B. 302.

In this case, the R plants were neither stolen, seized, requisitioned, condemned, nor under the threat or imminence of requisition or condemnation. The only ground possible for application of section 1033(a) is that they were destroyed. Taxpayer represents that its crops suffered mutations, discoloration, chlorosis, stunting and necrosis and that its fields experienced serious recropping problems, contamination

and damage to the extent that most of the property can no longer be commercially utilized for agricultural and other purposes. Taxpayer purchased and used B with the expectation that the B would benefit the plants by inhibiting the growth of f. Taxpayer did not expect that the B would destroy its plants or contaminate its fields. Through causes outside the control of Taxpayer, Taxpayer's property was rendered unusable. The situation here is similar to that of the cattle poisoning described in Rev. Rul. 54-395. Thus, we believe the facts warrant the conclusion that Taxpayer's R plants and fields were destroyed, apparently by its application of B, and that Taxpayer is entitled (at least to some extent) to section 1033(a)(2) relief.

The question is to what extent recognition of the gain realized upon receipt of the $E payment may be deferred under section 1033(a)(2). The federal income tax consequences of receiving a payment in settlement of litigation depend upon the nature of the underlying item for which the payment is intended to be compensation. See section 1.1033(a)-2(c)(8); Rev. Rul. 75-381, 1975-2 C.B. 25; Rev. Rul. 73-477, 1973-2 C.B. 302; Miller v. Hocking Glass Co., 80 F.2d 436 (6th Cir. 1935), cert. denied, 298 U.S. 659 (1936)(sum received by an insured manufacturer under use and occupancy policies offering earnings insurance held to be includible in taxable income since it was received in lieu of profits which are taxable).

Both in its complaint and throughout the underlying litigation, Taxpayer claimed economic damages for the loss resulting from the destruction of its physical assets and for lost income (past and future). The non-recognition provisions of section 1033(a)(2), however, do not apply to amounts received for lost income. See Commissioner v. Gillette Motor Co., 364 U.S. 130 (1960); Rev. Rul. 75-381; Rev. Rul. 73-477. Thus, Taxpayer would not be entitled to section 1033(a)(2) relief to the extent it was reimbursed for lost earnings.

None of the information provided by Taxpayer directly establishes the amount of damages it received for lost income. The jury simply awarded a single amount, $D, for all economic damages claimed. The settlement agreement, as we understand it, also does not provide a breakdown. In addition, the total amount of economic damages awarded to Taxpayer was less than the full amount sought; however, it was substantially more than the amount claimed by Taxpayer for either physical damage or lost income. Accordingly, we must determine the proper allocation to be made of the amount received for all economic damages claimed.

Factors to be considered in making such an allocation generally include the allegations contained in the complaint, the defenses asserted, the background of the litigation, and other facts pertinent to the controversy giving rise to the verdict and/or settlement. See Estate of Morgan v. Commissioner, 332 F.2d 144, 151 (5th Cir. 1964); Bent v. Commissioner, 87 T.C. 236, 245 (1986). In the instant case, the only relevant information provided was that contained in the complaint itself and in an exhibit offered into evidence by Taxpayer in the underlying litigation. The complaint indicates that

Taxpayer sought damages for the physical destruction of its property and for its lost income. The exhibit shows the amount sought for each. Of $A, the total amount of economic damages sought, x% ($B/$A) related to the destruction of Taxpayer's property and y% ($C/$A) related to its lost income. Since no other information is provided, it is appropriate to use these same percentages in allocating the amount of economic damages actually received. See Robinson v. Commissioner, 70 F.3d 34 (5th Cir. 1995); Miller v. Commissioner, T.C. Memo. 1993-49.

Therefore, we conclude that Taxpayer received $F (x% of $D) for the destruction of its R plants, and recognition of the gain realized on that portion of the settlement payment may be deferred under section 1033(a)(2). Taxpayer does not qualify for section 1033(a)(2) relief with respect to the remaining amount of economic damages received, nor with respect to any amounts received as punitive damages, interest, or fees.

In addition, the election provided in section 1033(a)(2)(A) is available to Taxpayer. Should Taxpayer make such an election, and timely acquire property similar or related in service or use to the converted property, it will recognize gain only to the extent the amount realized on such conversion exceeds the cost of the replacement property.

For purposes of subsection 1033(a)(2)(B)(i), the taxable year in which any gain from the conversion of the property was first realized was Year A, the year in which Taxpayer received payment under the terms of the Date 3 settlement agreement.

Pursuant to the requirement in section 1033(a)(2)(A)(ii) that the unadjusted basis of any property purchased for the purpose of replacing the converted property be its cost within the meaning of section 1012, the above rulings are conditioned on Taxpayer capitalizing into the basis of any qualifying replacement property the costs incurred in connection with the acquisition of the property. In addition, the ruling regarding the year in which gain is first realized is conditioned on an assumption that, during the pendency of the defendants' appeals, no amounts were deposited with the court, or in any escrow or similar arrangement, in such a manner as to be treated as constructively received by Taxpayer under section 1.451-2 of the regulations.

No opinion is expressed as to the tax treatment of this item(s) (or transaction(s)) under the provisions of any other section of the Code or regulations which may be applicable thereto, or the tax treatment of any conditions existing at the time of, or effects resulting from, the item(s) (or transaction(s)) described which are not specifically covered in the above ruling.

A copy of this ruling should be attached to the federal tax return for the year in which the item(s) (transaction(s)) in question occurs. This ruling is directed only to Taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used as precedent.

Sincerely,

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By: Douglas A. Fahey

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