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Internal Revenue Service

Department of the Treasury

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Person to Contact:

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TY:

Taxpayer =
S =
X =
B =
F =
f =
D =
AA =
MM =
G =
Gs =
N =
$X =
$Y =
$Z =
Year A =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

Dear

This responds to your letter dated November 12, 1998, and subsequent correspondence submitted June 2, 1999, requesting a private letter ruling on the

question of whether an accidental poisoning of Taxpayer's AA and MM crops constitutes an involuntary conversion. The Taxpayer represents the following facts:

Taxpayer is engaged in the business of growing, marketing and distributing agricultural products, including AA and MM farming (i.e., growing AA plants and MM trees and selling the Gs and N to wholesale and retail G and N vendors), as well as other crops not addressed in this ruling. The AA plants at issue are perennial plants that are expected to be productive for an extended period of time producing Gs that are then harvested and sold in Taxpayer's business. Taxpayer capitalizes the cost of the plants and trees in question. Taxpayer and S grew the AA plants and MM trees on various parcels of real property located on X. Taxpayer and S held a fee simple interest in some of the property and a leasehold interest in other property. As part of a property settlement dated as of Date 5 between Taxpayer and S, Taxpayer became the sole owner of the business and the property. Taxpayer and S agreed in the property settlement to equally divide any proceeds of the then-pending litigation against D discussed herein, although Taxpayer agreed to an $X equalizing payment to S to take into account the property retained by Taxpayer.

B is an 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 an F on its AA plants and MM trees. After the B was applied, the plants and trees died or sustained severe physiological and genetic damage. Damage to the plants included stunting, root damage, leaf deformities, and substantially reduced and deformed G production. In addition, the soil contained in the beds where the B was used was found to be contaminated with high concentrates of a herbicide residue, which made it unfit for plant growth. Also, the covering structures under which the plants were grown were contaminated.

The damaged plants are no longer usable for G or other production. In order for Taxpayer to resume its G production, it must replace all the plants affected by the B. In addition, the soil in the contaminated G beds must either be treated or replaced to remove the contamination before new plants can be planted or other suitable uncontaminated real property will need to be acquired. The covering structures will also need to be replaced.

On Date 1, Taxpayer and S filed suit against D, alleging that the B manufactured by D was defective and caused the damage and destruction of its plants and trees, the contamination of its soil, and loss of use of personal property used for agricultural purposes. On Date 2, a judgment was entered awarding Taxpayer and S economic damages in the amount of $Y, plus pre-judgment interest, post-judgment interest, punitive damages and certain other fees and costs, for a total award of $Z. Before D exhausted all of its appeal rights, the parties to the action entered into a settlement agreement on Date 3 and the payment was received on Date 4. The settlement agreement did not alter the amounts received by the Taxpayer. In accordance with the

terms of the property settlement, Taxpayer and S each received one-half of the award. 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 AA and MM property and Taxpayer's receipt of one half of the amount awarded as economic damages in the settlement of Taxpayer's lawsuit against D, as it pertains to the AA and MM property, qualify as an involuntary conversion of Taxpayer's property into money under section 1033(a)(2) of the Internal Revenue Code (the "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), calendar year A is the taxable year in which the 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 curium, 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 or condemnation. Historically, the term "destruction," in the context of section 1033(a), has 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 sand 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 AA plants and MM trees were neither stolen, seized, requisitioned, condemned, nor converted 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 the AA plants and MM trees either died or sustained severe physiological and genetic damage, the manifestations of which included stunting, root damage, leaf deformities, and a reduced G and N production. The soil beds and coverings were also contaminated. Taxpayer purchased and used B with the expectation that the B would benefit the plants and trees by inhibiting the growth of f. Taxpayer did not expect that the B would destroy its plants and trees or contaminate its soil beds and coverings. Through causes outside the control of Taxpayer, Taxpayer's property was rendered unusable. Thus, we believe the facts warrant the conclusion that Taxpayer's AA plants, MM trees, soil beds and coverings were destroyed, apparently by its application of B. The situation here is similar to that of the cattle poisoning described in Rev. Rul. 54-395.

Therefore, the damage to and destruction of Taxpayer's AA plants and MM trees and an allocable portion of the $Y proceeds received by Taxpayer as economic damages for such destruction (but not including any amounts received as punitive damages, interest, fees, or other amounts not representing actual economic damages, or any amount relating to economic damages to assets or plants not specifically addressed herein) in the settlement of Taxpayer's lawsuit against D qualifies as an involuntary conversion of Taxpayer's property into money under section 1033(a)(2) of the Code. Moreover, the election provided in section 1033(a)(2)(A) is available to the Taxpayer. If the Taxpayer makes the election, and timely replaces the converted property with property similar or related in service or use to such 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.

Taxpayer has not requested a ruling under section 1033 of the Code on the tax treatment of any other crops grown by Taxpayer damaged or destroyed by use of B. As such, no opinion is expressed or implied as to the tax consequences under section

1033 of the Code with regards to any other crop grown by Taxpayer. This ruling also does not address how much of the $Y is properly allocable to the AA plants and MM trees.

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 letter 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,

Assistant Chief Counsel
(Income Tax & Accounting)

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