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Federal Income Tax - Casualty Loss Deduction - Determining the Proper Basis Figure in a Partial Casualty Loss to a Timber Tract - What Is the Single, Identifiable Property Damaged or Destroyed, the Trees or the Entire Tract?

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FEDERAL INCOME TAX—CASUALTY LOSS DEDUCTION—Determining the Proper Basis Figure in a Partial Casualty Loss to a Timber Tract—What is the Single, Identifiable Property Damaged or Destroyed, the Trees or the Entire Tract?

Taxpayers, Fred and Irene Rosenthal and others, were participants in the Namarib Company-Timber Venture, a joint venture which owned a timber tract in the state of Tennessee. On January 1, 1960, this tract consisted of 24,605.6 acres. The venture’s adjusted basis$ in the land was $11,080.93 and its adjusted basis in the timber was $212,476.30. The total amount of saw timber on the tract at this time was estimated, for purposes of determining the venture’s depletion deduction, to be 58,445,000 board feet.

On March 2, 1960, an ice storm struck the tract, damaging the timber on it. There was no dispute that the fair market value of the entire timber tract immediately preceding the storm exceeded the fair market value of the tract immediately thereafter by at least $130,000. The taxpayers computed this loss, for which they had received no compensation, by insurance or otherwise, as follows:

1. destruction of 4,757,200 board feet of “saw timber” (timber from trees more than 8 inches in diameter at breast height) having a fair market value of $104,787.29
2. destruction of 5,058.3 cords of “pulpwood” (timber from trees between 4 and 8 inches in diameter at breast height) having a market value of 11,643.09
3. destruction of naturally produced “young growth” (trees measuring less than 4 inches in diameter at

1. INT. REV. CODE of 1954, § 1011 (hereinafter referred to by section number only). The adjusted basis is the basis provided in Section 1012 which states that the basis of the property shall be the cost of such property adjusted as provided in Section 1016.
2. Treas. Reg. §1.611-3(c), and (d)(3) (1960), which require an allocation of the basis between the land and the timber.
3. Timber from trees more than 8 inches in diameter at breast height and measured in “board feet.”
4. Section 611 allows as a deduction in computing the taxable income of a timber owner “a reasonable allowance for depletion.” Section 612 provides that the basis for depletion of property, such as timber, is the adjusted basis of such property (i.e., its cost). This allowance is deductible from the taxpayer’s gross income for the year and is then subtracted from the adjusted basis of the tract. Treas. Reg. §1.611-3(b) (1960).
5. Treas. Reg. §1.6113(e) (1960), each taxpayer claiming a deduction for depletion is required to estimate the number of units of timber reasonably known at the date of acquisition of the property.
breast height) having a market value of 12,173.00

4. destruction of "plantations"
   (trees less than 3 feet in height, planted by the
taxpayer) having a market value of 1,906.00

$130,509.38

On its 1960 partnership information return, the venture claimed $130,500.38 as a Section 165 casualty loss, and each taxpayer took his appropriate percentage of this amount as a deduction on his individual income tax return. The Commissioner allowed the $1,906 claimed as damage to the plantations, but he disallowed all but $17,315 of the remaining amount claimed as a casualty loss. The Commissioner computed the $17,315 deduction by estimating the number of board feet of merchantable timber which were contained in this tract at the beginning of the taxable year, and then dividing the adjusted basis of the entire tract of timber by the number of board feet of merchantable timber. The quotient produced is called the cost depletion unit, which the Commissioner contended was the basis that should be used in determining the amount of the casualty loss deduction. This basis per unit of merchantable timber multiplied by the number of units destroyed would then produce the maximum amount deductible under the casualty loss provisions.

The tax court agreed with the Commissioner's finding of a deficiency in the taxpayers' returns. On appeal to the United States Court of Appeals, Second Circuit, the decision of the tax court was affirmed. The court held:

1. The individual trees were the "single, identifiable property"
contemplated by the Code and the regulations, not the entire tract of timber.

2. The taxpayers had an allocated cost basis in their tract for the determination of the depletion allowance for partial sales of timber, and that same allocation of basis should be applied in the case of partial, involuntary conversions.

3. The loss should be limited to the adjusted basis of the timber actually destroyed, as measured in units of merchantable timber.

Judge Moore dissented, agreeing with the amici curiae that the “property,” for purposes of determining the amount of the casualty loss, is the entire timber tract that the taxpayers purchased and not units of merchantable timber. He reasoned that the “single, identifiable property” should be the tract of timber, which is a living growing business unit, damage to which is not analogous to a voluntary sale of merchantable timber.

Obviously, the allowable casualty loss deduction will vary greatly, depending upon the interpretation given the phrase “single, identifiable property damaged or destroyed.” Rosenthal v. Commissioner of Internal Revenue presented this issue squarely, and because of the considerable impact which an adverse decision could have on the entire timber industry, five representatives of the timber industry joined in an amicus brief. Also at issue in Rosenthal was whether a casualty loss may be compared to a partial sale of timber in assigning a basis to the “property”. Because of the Commissioner's stand on these two issues, a final question of discriminatory treatment of timber owners under the casualty loss provisions of the Internal Revenue Code was also raised.
THE SINGLE, IDENTIFIABLE PROPERTY ISSUE

The essential issue that the Second Circuit had to determine in Rosenthal was the proper basis figure to be used in computing the amount of the casualty loss deduction. Before this question could be answered, however, the court had to interpret the phrase "single, identifiable property damaged or destroyed," which the regulations refer to as the property whose basis is to be used in determining the loss deduction.

Section 165(a) of the Internal Revenue Code (1954) permits a deduction for a casualty loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(b) limits this deduction to no more than the basis of the property destroyed or damaged. Section 165(b) further states that this basis is the adjusted basis provided in Section 1011 for determining the loss from the sale or other disposition of property. Section 1011, in turn, refers to Section 1012, which defines the basis as the "cost" of the "property" adjusted as provided in Section 1016. But the regulations and Section 1012 are inconclusive, for neither defines the term "property." The casualty loss regulations provide only that the loss incurred is to be determined by reference to the "single identifiable property damaged or destroyed."

The taxpayers argued that the "property" referred to in each of these Code sections is the unit of property that they originally purchased, the entire tract of timber. The Commissioner, however, argued that the "single, identifiable property" is each individual merchantable tree that was damaged or destroyed.

In determining the "single, identifiable property," according to the

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18. Treas. Reg. §1.165-7(b)(2)(i) (1964). A loss incurred in a trade or business or in any transaction entered into for profit shall be determined . . . by reference to the single, identifiable property damaged or destroyed.
19. Section 165(a) General Rule—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
20. Section 165(b) Amount of the Deduction—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.
21. Section 1011 provides that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters, C, K, and P) adjusted as provided in section 1016.
22. Section 1012, the basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C, K, and P.
23. Treas. Reg. §1.1016 (1957) provides the method of making adjustments to basis.
regulations, the taxpayer must first determine the amount of the loss to each separate identifiable part of the property affected.\textsuperscript{25} In other words, the timber tract becomes two separate identifiable pieces of property for the purpose of determining the allowable casualty loss deduction. The nondepreciable land is one such “property” and the depletable trees growing on the land is considered another separate “property.”

This allocation of cost basis between depreciable and nondepreciable property for the purpose of determining casualty losses was first used in \textit{United States v. Koshland}.\textsuperscript{26} There the taxpayer owned a hotel which was totally destroyed by fire. At the time of the fire the hotel building had been fully depreciated. The court held that the deduction for the casualty loss was limited to the adjusted basis of the hotel building apart from the land. For, if the property were aggregated, the taxpayer would be able to use the basis of the nondepreciable land to increase his allowable loss on the fully depreciated hotel building. This same principle was also applied in \textit{Carloate Industries Inc. v. United States},\textsuperscript{27} in the case of a casualty loss to a citrus grove. The basis of the property was allocated between the depreciable fruit trees and the nondepreciable land in calculating the deduction for the loss. Finally, with regard to the timber industry itself, the principle is used to determine the amount of a casualty loss deduction by allocating the cost basis of the timber tract between the land and the depletable timber growing thereon.\textsuperscript{28} Based on these cases and the regulations, both the Commissioner and the taxpayers agreed that the timber tract became at least two separate “single, identifiable properties” for purposes of determining the casualty loss.\textsuperscript{29} The taxpayers stopped at this point and maintained that the “single, identifiable property” was the partially damaged timber tract.

The Commissioner and the majority admitted that the 24,605.6 acres were operated as a single tract, and were managed and depleted as an operating unit. However, the Commissioner argued that in ascertaining the “single, identifiable property” damaged, one must apply the allocated cost principle to the timber tract itself in order to

\begin{footnotes}
26. 208 F.2d 636 (9th Cir. 1953).
27. 354 F.2d 814 (5th Cir. 1966).
\end{footnotes}
separate the damaged from the undamaged timber and produce the adjusted basis of each individual damaged tree. Furthermore, the Commissioner did not stop in his analysis with the individual tree, but reallocated cost through a narrower definition of "property." He asserted that each tree has its own adjusted basis, measured in board feet, and that the "single identifiable property" referred to in the casualty loss regulations is a "board foot" of timber.

A board foot of timber refers to a unit of timber for the purpose of sale. Timber which is not mature enough can not be measured in board feet.\(^\text{30}\) Thus trees not capable of being measured in terms of board feet, are excluded from the Commissioner's formula for determining the allowable casualty loss deduction because they have no adjusted basis. The Commissioner's theory is that because the cost depletion unit is used to determine the adjusted basis of the timber when it is sold, it should also be used to determine the adjusted basis of the timber in calculating the allowable casualty loss deduction.\(^\text{31}\)

The majority rejected the view that the timber tract is an "organic unit," an injury to which cannot be fully measured by estimating the number of board feet of merchantible timber destroyed. Thus it refuses to recognize any difference between a tract of growing timber and an inventory of cut timber in a lumber yard. The amici argued that a timber tract is a living, growing business unit\(^\text{32}\) whose value depends primarily on its ability to produce marketable timber over a long period of time without interruption or diminution.\(^\text{33}\) Random damage to the tract caused by a casualty loss decreases the value of the entire tract. Intangible damage, such as a decrease in the density of the tract due to the random destruction, increases the hazards of fire, insect damage, disease and further storm damage.\(^\text{34}\) In fact, it is possible for a casualty loss which destroys less than all the timber to make the tract worthless for logging purposes\(^\text{35}\) since there is a minimum density below which it is not profitable to log the tract at all.\(^\text{36}\)

\(^{30}\) Brief for Amici Curiae at 36, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969).

\(^{31}\) Brief for the Commissioner at 15, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969).


\(^{34}\) Brief for Amici Curiae at 35, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969).

\(^{35}\) See Note, Taxpayer's Basis For Limiting Casualty Loss Deduction For Damage To Part Of Timber Tract Is Equal To Depletion Allowance For Trees Damaged And Not To Basis For Entire Tract, 83 Harv. L. Rev. 478, 481 (1969).

\(^{36}\) See L. Minkler & J. Hosner, How To Farm Your Forest 15 (U.S. Dept.
density of the tract affects the value of the remaining undamaged timber because of the higher costs of removing such timber.\textsuperscript{37} In the instant case some portions of the tract in question had to be "clear cut" and replanted. The loss of young growth is of great significance to the present and future value of the tract, both as an organic unit and as a business unit. All these elements reduce the value of the timber tract, yet the Commissioner's theory, which the majority accepted, totally excluded them from any consideration.

The majority pointed out that the taxpayers failed to assign any dollar value to the intangible damage to the entire tract caused by the decrease in the density. Thus, they failed to carry the burden of proof on this point. Nevertheless, the amici argued that this failure to prove the amount of the intangible loss does not change the inherent character of the tract as a whole. The fact that it wasn't claimed does not establish that it could not have been.

The majority in \textit{Rosenthal} relied heavily on the decision of the Fourth Circuit Court of Appeals in \textit{Harper v. United States}.\textsuperscript{38} In \textit{Harper} the taxpayer had stipulated that his loss consisted solely of a specified number of board feet of timber destroyed. The taxpayers in \textit{Rosenthal} made no such stipulation. In fact, they submitted evidence as to the value of both the mature and immature timber physically destroyed. That also established that the tract as a whole had declined in value as a result of the casualty by at least $130,500. Thus, while the Fourth Circuit may have been precluded from considering the decline in value of the entire tract due to the decrease in density and loss of the immature growth,\textsuperscript{39} the Second Circuit was not so precluded.

The majority in \textit{Rosenthal} also rejected the taxpayers' hypothetical designed to show the incongruity of the Commissioner's theory of the case. The hypothetical involved the selective destruction of only the young trees which were not large enough to be measured in board

\textsuperscript{37} Brief for \textit{Amici Curiae} at 35, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969).

\textsuperscript{38} 274 F. Supp. 809 (D.S.C. 1967), aff'd, 396 F.2d 223 (4th Cir. 1968).

\textsuperscript{39} See brief for \textit{Amici Curiae} at 29, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969) as follows: "In claiming damages at common law for injuries to a timber tract, it is clear that under a properly drawn complaint damages are measured by the difference in the value of the property before and after the damage. However, evidence as to the value of the timber injured or destroyed is always admissible in determining the diminution in the value of the property and may, in the absence of other evidence, establish the diminution in the value of the property." See, e.g., Alabama Great Southern v. Russell, 254 Ala. 701, 48 S.2d 949 (1949); Stertz v. Stewart, 74 Wisc. 160, 42 N.W. 214 (1889).
feet. Obviously, serious loss to the entire tract would result which would greatly impair the value of the entire tract, yet the Commissioner would allow no loss deduction on the ground that these immature trees had no adjusted basis for depletion. Judge Moore and the amici argued that the taxpayers do have a basis in the timber tract and that the loss of immature trees, not of marketable size, can only be considered as damage to the tract itself. By using the timber tract as the unit of "property" involved in the casualty, the loss, resulting from the destruction of young growth, and the resulting detrimental affect on the remainder of the tract due to the decrease in the tract's density, are all taken into consideration in determining the amount of the casualty loss deduction. The Commissioner's formula simply eliminates these elements of economic loss from the allowable deduction. This result forces the timber owners to bear the decrease in value of their property without any effective tax relief. Judge Moore continually suggested that this result is contrary to the express intent of Congress to allow full deductions for uncompensated losses.

In determining what the "single, identifiable property" is, it must be pointed out that nowhere in the Code or regulations does it state that each tree has its own adjusted basis. Also, nowhere in the depletion regulations does one find support for the Commissioner's contention that each tree has a basis for depletion or that each board foot of timber has a basis for depletion. A timber tract, as the amici argued, is more aptly described by the phrase "single, identifiable property." For such a tract of timber, managed and depleted as an operating business unit is both "single" and "identifiable." It is also significant to note that the depletion regulations upon which the Commissioner relies for his theory, defines "property" in accord with the taxpayers' view as follows:

In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property . . . . "Property" means . . . in the case of timber, an economic interest

40. Brief for Commissioner at 17, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969).
41. Compare brief for Amici Curiae at 36, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969) as follows: "A casualty loss is denied in the case of a growing crop or a fully depreciated capital asset. See Reg. §1.165-6(c). In both cases the cost of growing or acquiring the property has been fully recovered as deductions against ordinary income, and to allow a casualty loss deduction would be to allow a double deduction. With Flona Corp. v. United States, 218 F. Supp. 364 (S.D. Fla. 1963), appeal dismissed by government, 62-2 U.S. Tax. Cas. 9489 (1964), which allowed a deduction for a casualty loss to growing crops to the extent of basis. The allowance of a deduction for a casualty loss which includes loss of young growth does not produce a double deduction since no more than the cost of the tract can ever be recovered."
in standing timber in each tract or block representing a separate timber account §1.611-1(a)(1) (Emphasis added).

Finally, Judge Moore contended that the Commissioner's own regulations under the casualty loss provisions "not only fail to support him, but undermine his position." The section in question is § 1.165-7 (b)(2), which concerns the method of calculating the allowable loss deduction. It states in pertinent part:

[I]n determining the fair market value of property before and after the casualty has occurred to a building and ornamental or fruit trees used in a trade or business, the decrease in value shall be measured by taking the building and trees into account separately . . . and separate losses shall be determined for such building and trees.

As can readily be seen, the regulation itself treats all trees as the "single, identifiable property" and it does not differentiate between types of trees or between trees that were damaged and those that were not.

Partial Sale Analogy

After determining that the "property" involved in the casualty was the individual trees, the Commissioner then used a partial sale analogy in order to apply the allocated basis of salable timber to destroyed timber. The Commissioner contended that §165(b) makes the adjusted basis for a casualty loss the same as the adjusted basis for a sale or other disposition as provided in §1011 and the casualty loss must be treated as a pro tanto sale of the estimated number of merchantable timber units destroyed.43 The amici, however, argued that the timber tract itself had a basis for sale,44 and that, therefore, the Commissioner's analogy could just as easily have been applied to the entire tract of timber.

The difference between the cutting of timber for purposes of sale and the destruction of timber as result of a casualty loss is substantial. In Alcoma Association Inc. v. United States,46 where the Commissioner applied the partial sale analogy to a citrus grove damaged by a hurricane, the Fifth Circuit Court of Appeals emphasized the difference as follows:

A partial sale indicates that there is at least an economic divisi-

43. See Harper v. United States, supra note 38, at 811 as follows: To apply "adjusted basis" one way in calculating a gain or loss and depletion and another in fixing the allowable deduction for casualty loss would be illogical, and violative of the established canons of statutory construction.
44. Brief for Amici Curiae at 33, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969).
45. 239 F.2d 365, 370 (5th Cir. 1956).
bility of the property, and it seems reasonable to apportion the basis of the property to what is kept and what is disposed of. A partial casualty loss indicates no such divisibility for frequently the entire damage must be restored before the whole is to have any productive value. Furthermore a sale is generally voluntary and endows the seller with assets roughly equivalent to the value of the part sold, which he may productively reinvest after the payment of some taxes; an uninsured loss yields no such assets—rather there is a need to obtain funds to restore the property.46

In a partial sale of timber, the cost depletion allowance47 serves the same function as does the basis figure in a sale of nondepletable goods. The Commissioner argued that the taxpayers' allocated basis for depletion ought to determine the limit on his deduction for a casualty loss to the timber. This view, however, fails to recognize the fact that a casualty loss of a certain number of merchantable trees may reduce the value of the entire tract by more than a partial sale of an equal number of trees.48 When timber is sold, it is sold in units of board feet and a depletion deduction is allowed. The Commissioner contended that this depletion deduction represents the allocated cost basis and that, therefore, it should be the limit of the allowable casualty loss deduction. Section 1011 provides for an “adjusted basis” which sets the maximum limitation on the casualty loss deduction allowed under §165(b). The Commissioner’s argument is that because “adjusted basis for depletion” referred to in §631(a) and defined in Regulation §1.631-1(d) is the equivalent of the “adjusted basis” of §1011, and the “adjusted basis for depletion” is the equivalent of the depletion deduction allowed under §611, the §1011 adjusted basis and §611 depletion deduction are equivalents. Accordingly, the depletion deduction would establish the maximum limitation on the casualty loss deduction.

Judge Moore, agreeing with the amici, believed that the Commissioner had erroneously interpreted the phrase “adjusted basis for depletion”.49 Section 631(a) is the only place in the Code where this

46. See 83 HARV. L. REV. 478, 481, supra note 35.
47. Depletion is the process of using up capital assets during the normal business operations. For tax purposes, cost depletion is an allowance from income, which represents the exhaustion of such capital assets. Depreciation is essentially the same process. Depreciation signifies the consuming of capital assets and for tax purposes it is an allowance from income for wear and tear to such assets.
48. See 83 HARV. L. REV. 478, 481, supra note 35.
49. Brief for Amici Curiae at 24, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969) as follows: “For convenience of reference this amount is referred to as the "basis for depletion", but it is clear from the context of the Code and regulations that the phrase is not meant to define the basis of timber for any purpose. Certainly Congress expressed no intention, and had no intention, of changing the application to timber of the casualty loss deduction provisions of the Code when, in 1943, it enacted the predecessor provisions of section 631(a).”
phrase occurs, and there is no reference in §631(a) to the "adjusted basis" in §165(b). There also is no reference in § 1011 or in §165(b) to any depletion provisions.

The amici argued that the Commissioner was confusing "basis for depletion with the "depletion unit". All agree that the "basis for depletion" is the adjusted basis of the property. However, the "depletion unit" is used to calculate the annual allowance for depletion and not for computing leases under § 165(b). Consequently, the amici could not agree that there is no significant different between the two terms. In addition to a lack of statutory justification for equating "depletion unit" with adjusted basis, the amici contended that the practical effect of using the depletion unit to limit casualty loss deductions is to arbitrarily eliminate much of the actual economic loss from the allowable deduction.

It is by no means clear that a taxpayer's allocation of basis for depletion purposes ought to determine the limit on his deduction for a casualty loss. The Board of Tax Appeals rejected the use of depletion provisions to determine the allowable casualty loss deduction in Lock, Moore & Co., Ltd. v. Commissioner, where it said:

[D]epletion signifies the process of using up a capital asset in the production of goods and the provisions of law governing depletion allowances do not extend to the determination of deductible losses on account of storms, fire, or other casualty. . . . It is the normal shrinkage of timber due to its use that the depletion allowance of the statute is designed to take care of and not the extraordinary losses due to casualty.

Judge Moore argued that there was no legislative history offered or found which would justify the use of cost depletion in casualty loss situations. Neither the casualty loss provisions nor the depletion provisions refer to each other. Additionally, the definition of "property" in the regulations which is applicable to timber owners is found in the depletion provisions, and it indicates that the entire timber tract is the "property" considered for purposes of the depletion provisions. Judge Moore thus concluded that the majority had erred in looking solely to the "depletion unit" to limit the allowable casualty loss deduction instead of focusing on the property the taxpayers actually purchased, the entire tract of timber.

51. 7 B.T.A. 1008, 1011 (1927).
Another serious question is raised by the Commissioner's use of the partial sale analogy. In the dissenting view of Judge Moore, this analogy is simply a device for achieving the same result as the percentage-of-basis formula, which has been held to deny the full casualty loss deduction that Congress intended. Under the old percentage-of-basis formula, the amount allowable as a deduction was limited to a percentage of the taxpayer's basis. This percentage was equal to the ratio between the decrease in value after the casualty and the value of the property immediately before the casualty. The amici contended that the Commissioner's formula allows for only a fraction of the loss actually sustained to timber properties only, and in direct conflict with the mandate of the regulations.

The use of the percentage-of-basis rule by the Commissioner in limiting casualty loss deductions was rejected by the Supreme Court and the full deduction approach was ratified instead. The Court's decision in *Helvering v. Owens*, involving non-business property, explicitly determined that the allowable casualty loss was to be the actual decrease in the market value immediately before and immediately after the casualty, but limited to the total adjusted basis of the property. The Court's decision also weakened the validity of the partial sale analogy, which is the essence of the percentage-of-basis formula.

Later, in *Alcoma Associations Inc. v. United States* the percentage-of-basis formula was rejected by the Fifth Circuit in relation to a partial casualty loss to business property. The taxpayer in *Alcoma* claimed a deduction because of hurricane damage to his citrus grove. The hurricane had caused a decrease in the value of the grove by $191,500, which was 12.18% of the $1,571,575 value of the grove before the casualty. The adjusted basis of the property before the casualty was $523,000. The taxpayer claimed a deduction for the full amount of the loss of $191,500. The Commissioner used the percentage-of-basis formula, which allowed only 12.18% of the adjudged basis of $523,000 or $63,700 as a deduction. The Fifth Circuit held that the percentage-

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52. Percentage-of-basis formula:

\[
\text{Amount Deductible as a casualty loss} = \frac{\text{Adjusted Basis}}{X} \times \frac{\text{Decrease in Value due to casualty}}{\text{Value Before Casualty}}
\]

54. 305 U.S. 468 (1939).
55. 239 F.2d 365 (5th Cir. 1956).
56. See notes 43-48 and accompanying text supra.
of-basis rule and the partial sale analogy are inconsistent with the Supreme Court decision in *Owens* and also with the congressional policy of allowing a deduction for the full amount of the uncompensated loss. The court further stated that the Commissioner's formula limiting the allowable loss in the case of partial destruction of business property to a fraction of the adjusted basis, rather than the full amount of the adjudicated basis, was not directly supported by pertinent statutory provisions.

In response to the decision in *Alcoma*, the Commissioner adopted a new regulation, which became §1.165(b)(1) of the regulations. This provision incorporated the *Owens* and *Alcoma* decisions into the casualty loss provisions.

In *Rosenthal*, the Commissioner determined the casualty loss deduction by multiplying the depletion unit by the estimated number of board feet of timber destroyed. The depletion unit had been computed by dividing the estimated amount of saw timber on the tract before the storm into the adjusted basis of the timber tract in 1960. The deduction produced by this method was $17,315.

Judge Moore, agreed with the amici that if the percentage-of-basis formula were applied to the taxpayers' timber tract instead of the Commissioner's formula, the mathematical result would be substantially the same. Under the percentage-of-basis formula, the ratio of the casualty loss to the value of the property immediately before the casualty multiplied by the basis of the property produces the allowable deduction.

<table>
<thead>
<tr>
<th>Adjusted Basis</th>
<th>=</th>
<th>Depletion Unit</th>
<th>X Timber Destroyed (board feet)</th>
<th>=</th>
<th>Casualty Loss Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>$212,476</td>
<td>=</td>
<td>$3.64</td>
<td>4,757,000 board feet</td>
<td>=</td>
<td>$17,315</td>
</tr>
</tbody>
</table>

### Percentage-of-Basis Formula

\[
\text{Decrease in Value due to Casualty} \times \frac{\text{Adjusted Basis}}{\text{Total Timber before Casualty (board feet)}} = \text{Amount Deductible as a Casualty Loss}
\]

- $4,757,000 \times \frac{\text{Adjusted Basis}}{58,445,000} = $17,315

58. Because the value of the tract before the storm is not available from the record,
Evidently the formula applied by the Commissioner in the present case will produce basically the same result that was rejected by the Supreme Court in *Owens*, and by the Fifth Circuit in *Alcoma*.

The Commissioner, on the other hand, argued that the amici completely disregarded the reason for the rejection of the percentage-of-basis rule. Arguably, the *Owens* and *Alcoma* decisions did not discredit the percentage-of-basis rule in cases of partial destruction of property that is readily divisible, such as a tract of timber. The Fourth Circuit has in fact upheld the Commissioner's present formula in *Harper v. United States* and reached the same result based on facts similar to those in *Rosenthal*. In contrast, Judge Moore and the amici believed that *Harper* was distinguishable on its facts, and because the decision was premised on the partial sale analogy. This in turn leads to a percentage-of-basis treatment for casualty losses of timber owners. Therefore, they argued that *Harper* was inconsistent with the intent of Congress underlying the casualty loss provisions.

**Discriminatory Treatment**

The majority's decision in *Rosenthal* presents yet another point of controversy, namely, whether or not the Commissioner's position results in discriminatory treatment of timber owners under the casualty loss provisions of the Code. The formula makes a distinction between damaged and undamaged trees. Section 1.165-7(b)(2) on which the Commissioner relies, however, does not make that distinction. The Commissioner's formula also distinguished the types of damaged trees that could be considered in determining the casualty loss deduction.

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it is not possible to make the precise computation. But the use of the quantity of timber instead of the value of the tract should produce a similar ratio and therefore approximately the same answer. Any difference in the result is due to the fact that the depletion rate is uniform for each board foot of timber even though the value of the timber varies by the species and the accessibility, plus the losses to young growth and the affect on the value of the remaining timber. All of these elements are not considered in the Commissioner's computations.

60. Brief for Commissioner at 19, 20, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969).
61. 396 F.2d 223 (4th Cir. 1968).
62. See brief for Amici Curiae at 29, Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969), as follows: "the difference between *Harper* and the case at bar is that the case at bar clearly establishes the amount of the decline in value of the entire tract caused by the storm; whereas in *Harper* the evidence did not show the amount of the decline in value and therefore, did not provide a basis satisfactory to the Court for the allowance of a deduction for economic loss suffered."
63. Treas. Reg. §1.165-7(b)(2)(1) (1964). In determining the fair market value of the property before and after the casualty has occurred to a building and ornamental and fruit trees used in a trade or business, the decrease in value shall be measured by taking the building and the trees into account separately . . . and separate losses shall be determined for such building and trees.
Damaged trees were artificially separated into those that were mature enough to be of marketable size, and those that were too young to be of marketable size, allowing a deduction only for the merchantable trees. Judge Moore pointed out that the Commissioner seemed to recognize some merit in this point because he explicitly allowed the $1,906 loss deduction for the value of the damaged “plantations” which are immature growth of non-merchantable size. The $1,906 represented destruction of 10% of the tract’s plantations and was permitted without differentiating between damaged and undamaged plantations.

In *Frank R. Hinman*, the Commissioner did not apply the percentage-of-basis formula to a partially destroyed farm. There the taxpayer suffered a loss from flooding which rendered 58% of the farm’s 264.8 acres completely valueless. In authorizing a deduction of their entire $12,875 basis, the court made no suggestion that the percentage-of-basis formula was required or that the loss should be treated as sale or other disposition of the valueless land. Similarly, in *United States v. Koshland*, where an improvement to land which was partially damaged by fire, the taxpayer was allowed to deduct the full extent of his uncompensated loss limited only by his adjusted basis in the entire improvement. More in point, the owners of shrubbery and ornamental or fruit trees are allowed a deduction for casualty losses to the full extent of the loss, up to the adjusted basis in all the trees.

Thus, in *Alcoma* the taxpayer was permitted to deduct the full extent of his loss within the limit of his adjusted basis in the entire citrus grove.

The taxpayers in *Rosenthal* were not afforded this same treatment. While the majority contended that timber is distinguishable from farm land, shrubbery, and fruit trees because timber is cut and sold as an end product, farm land is also divisible into parcels and salable as an end product. Ornamental and fruit trees are also sold as end products. The major error with this type of analysis is that a casualty loss is not the equivalent of a sale of timber. They are essentially different,  

64. 12 CCH T.C.M. 1347 (1953).
65. 208 F.2d 636 (9th Cir. 1953).
67. The Commissioner, in construing the casualty loss provision with respect to orchards, has also continued to regard the orchard and not each tree in the orchard as the “identifiable property.” This can be seen from the 1967 edition of the Farmer’s Tax Guide, IRS Publication No. 225 at 49, 50. The Commissioner has also treated hurricane damage to a citrus grove by permitting deduction for the full loss within the limits of the adjusted basis and, therefore, without distinguishing between damaged and undamaged trees. See Rev. Rul. 68-531, I.R.B. 1968-41, 10.
68. See 83 Harv. L. Rev. 478, 481, note 35, supra.
and treating them as similar disregards the congressional purpose in the casualty loss provisions.

The majority expressed concern that to allow a full deduction for the taxpayers' loss would give them a windfall because they would be allowed a tax-free benefit on the appreciated value of their property. This issue was considered by the Fifth Circuit in *Alcoma*, and there the court said:

Finally the Commissioner objects that the taxpayer's formula in effect allows him to take losses against anticipated profits from the appreciation of his property, for which he has paid no taxes. This argument is deceptive. The only real amount is the out-of-pocket loss suffered by the taxpayer; this loss might indeed be larger than otherwise because of the appreciation in value and cost of the property, but it is nevertheless a real loss. This loss can in any event be deducted only to the extent of the original investment reduced by the previously allowed depreciation [adjusted basis].

No windfall loss deduction will arise from allowing the taxpayers in *Rosenthal* to deduct the loss up to their adjusted basis in the entire timber tract. Because the allowable deduction must then be subtracted from their adjusted basis, they will have an accordingly lower adjusted basis for purposes of future dispositions.

The casualty loss provisions are basically intended to provide compensation for uninsured losses. To timber owners these provisions are of tremendous importance because insurance against losses to standing timber caused by fire, ice, windstorm or other casualty is generally not available in the United States, requiring each timber owner to bear the full brunt of such casualties. By denying tax losses in areas where economic losses are a reality, the Commissioner has frustrated the intent of Congress. Viewing the timber tract as the "single, identifiable property damaged or destroyed" and using its adjusted basis as the limit on the allowable casualty loss deduction, produces a more equitable result which is in line with the express purpose of the casualty loss provisions.

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70. Treas. Reg. §1.1016-1 requires the taxpayer to adjust his basis in the property due to any loss deductions allowed to him.