



**United States
Department of
Agriculture**

**Forest
Service**

**Agriculture
Handbook
Number 596**

A Guide to Federal Income Tax for Timber Owners



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Income Tax"

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Preface

This publication was originally issued in 1953 as Agriculture Handbook No. 52 and was revised in 1964, 1970, and 1974. The revisions were published as Agriculture Handbook 274, "The Timber Owner and His Federal Income Tax." This publication was undertaken in the belief that (1) the Federal income tax treatment of timber activities can be very complex, (2) summarizing the application of the law to timber activities will improve compliance, (3) compliance with the law will increase after-tax financial returns to timber growers, and (4) increased returns will encourage individual owners to improve the management of their holdings.

This publication has been reviewed by the Internal Revenue Service. It is not, however, to be construed as an official interpretation of the Internal Revenue Code or Income Tax Regulations. It is intended merely as a guide for the application of the law to your particular set of facts and circumstances.

The information in this publication is current as of October 1981.

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Chapter 1 Introduction

How should you report timber sale receipts and expenditures when making out your Federal income tax return? Can you claim a deduction when your timber is damaged or destroyed by fire or windstorm? How large a deduction can you claim? This publication is designed to answer these and other questions and to present in nontechnical language other information that you, the timber owner, need to know in order to handle the Federal income tax aspects of your operation. The material covered in this handbook should be useful not only to you but also to those who may advise you. Such persons include consulting foresters, industry foresters, extension foresters, and State service foresters; and in connection with income tax matters, your attorney, banker, accountant, or other business consultant.

This handbook may help you in several ways. Provisions of the Internal Revenue Code are complex, and as a result you may not be figuring your tax liability correctly. You may not be using the specific tax provisions relating to timber, you may not be taking full advantage of the deductions permitted by law, or, on the other hand, you may be claiming as deductions certain expenditures that you should capitalize. It is unfortunate both for you and for the economy if your timberland is not fully utilized because of a misunderstanding of tax law and the tax incentives that have been provided to encourage better use of timberlands.

A clearer understanding of income tax procedures may benefit you financially and as a result encourage better forest management. It is hoped that savings from correct reporting of timber receipts and expenditures will act as an incentive for you to grow more timber, to protect it, and to utilize it wisely.

The material covered falls under four broad headings. First is the treatment of timber expenditures (Chapter 2), not only those that may be deducted annually as operating expenses, but also those that must be capitalized and recovered over a period of years through depletion or depreciation. This section deals with money that you pay out. Second is the treatment of receipts from the sales of timber and forest products, and cost-share payments (Chapters 3 and 4). This section deals with the money you take in. Third is the treatment of timber losses from fire, windstorm, or other casualties (Chapter 5). Such losses do not necessarily involve cash transactions, but may constitute a deduction that you can claim on your tax return. The final section discusses the self-employment social security tax, Christmas tree production, and the minimum tax (Chapter 6). The appendix includes a facsimile of Form T, the text of the timber-related provisions of the Internal Revenue Code and Regulations, and selected revenue rulings of the Internal Revenue Service.

The field of Federal income taxation is extensive, and it has been practical to cover only the more usual questions of interest to you, the timber owner. If you have special tax prob-

lems, you may need to consult the Internal Revenue Service or your tax counsel.

The scope of this edition has been expanded somewhat. Background information on the Federal income tax system has been added where needed to explain the treatment of timber income and expenses. Heavy reliance is placed, however, on the Internal Revenue Service taxpayer publications listed below. You should consult these publications for more detailed information.

Your Federal Income Tax, Publication 17
Farmer's Tax Guide, Publication 225
Tax Guide for Small Business, Publication 334
Travel, Entertainment, and Gift Expenses, Publication 463
Income Averaging, Publication 506
Taxable and Nontaxable Income, Publication 525
Self-Employment Tax, Publication 533
Depreciation, Publication 534
Business Expenses and Operating Losses, Publication 535
Installment Sales, Publication 537
Sales and Other Dispositions of Assets, Publication 544
Interest Expense, Publication 545
Tax information on Disasters, Casualties, and Thefts, Publication 547
Condemnations of Private Property for Public Use, Publication 549
Investment Income and Expenses, Publication 550
Basis of Assets, Publication 551
Minimum Tax and Maximum Tax, Publication 909

You can get single copies of these publications free from many Internal Revenue offices or by calling the toll-free telephone number listed in your phone book under United States Government, Internal Revenue Service.

An index and glossary have been added to make the material more accessible to the casual user and those unfamiliar with tax or forestry terminology.

Types of Forest Ownership and Operation

How you treat the expenses and income items associated with your forest property usually depends on your intended and actual use of the property, as well as the nature of the item itself. Property taxes and mortgage interest, for example, are usually deductible simply because they are included in the list of allowable itemized deductions. Expenses for protecting your property from fire, however, can be deducted only if you hold the property for the production of taxable income.

Income can be produced whether you hold the property as an investment or as part of a trade or business. Income you receive in the form of hunting or other fees is always ordinary income. Income from the sale of timber, however, may qualify for long-term capital gain treatment. Such treatment depends

on how the timber is sold and whether or not it is part of a trade or business.

Forest property can be held for three basic purposes or some combination of them:

1. *Personal use.*—Property not used to produce income is held for personal use. The house and land that serve as your residence are examples. Even though you might expect to sell them some day for more than you paid for them, your primary reason for holding them is to give you a place to live. Likewise, you may own forest property mainly for your personal use as a site for a second home or for recreation.

2. *Investment.*—Property used to produce income but not as an integral part of a trade or business is investment property. The land holdings of many farmers, for example, include woodlots. In most cases the activities associated with the woodlot are incidental to the primary crop or livestock activity. As such, the timber would be considered investment property. If, however, the timber-related activities are extensive in relation to the overall activities carried out on the farm, the timber may constitute a separate business.

3. *Business.*—Property is held for use in a trade or business if it is an integral part of an activity entered into and carried on in good faith for the purpose of making a profit. Two characteristic elements of a business are regularity of activities and transactions, and the production of income. (See Publication 334, "Tax Guide for Small Business," Chapter 1.)

The determination of your primary reason for holding a particular forest property is based on all the facts related to your intended and actual use of the property. No single factor is controlling. Your intent when first acquiring the property is not conclusive if your activities after acquisition are inconsistent with this intent.

Form T—Forest Industries Schedules

You should become familiar with Form T (see appendix page 36). This is the basic document used by the Internal Revenue Service to review your timber transactions. It is also very useful as a guide to the records you must keep for tax purposes. Details on how to report the various types of timber transactions on Form T are contained in the text.

For income tax purposes your expenditures as a forest owner are classified as (a) additions to capital, such as the acquisition of land and timber; (b) deductions from gross income, such as operating expenses; or (c) deductions from timber sale proceeds, such as timber sale expenses. Certain expenditures that are deductible otherwise may be treated as additions to capital if you choose (or "elect") to do so.

Capital Expenditures

Money you spend to acquire real estate or equipment, or to make improvements that increase the value of real estate or equipment already owned, is classified as a capital expenditure. Examples of capital expenditures are purchases of land, timber, buildings, equipment having a useful life of more than 1 year, and the acquisition of rights-of-way or other easements extending more than 1 year. Examples of other capital expenditures are money spent for the construction of bridges, roads, and firebreaks; money spent for tree planting and seeding; and money spent for major repairs that prolong the life of equipment.

You cannot deduct capital expenditures from gross income in the year they are incurred. Instead such expenditures are recorded, that is, used to establish or add to a capital account. The process of recording an expenditure in an account, instead of deducting it from income in the year made, is referred to as capitalization. At any given time the dollar value recorded in each account represents how much you have invested in that property. This amount is the basis of the property. (See Publication 551, "Basis of Assets.") When you acquire assets such as land, timber, buildings, and equipment, the amount paid for the asset is recorded in the account reflecting the asset. This amount is the original cost basis of the asset. The original basis may change as capital improvements are made to the asset or as allowances for depletion or depreciation are claimed. As noted earlier, capital improvements increase the basis, while allowances for depletion and depreciation decrease it. The balance in an account after the account is established is referred to as the adjusted basis. You use the adjusted basis to determine the allowance for depletion for timber that is cut, the basis for gain or loss for timber that is sold, or depreciation for equipment, buildings, and depreciable land improvements. The basic land, timber, and equipment accounts may each have one or more subaccounts. Buildings are usually carried in separate accounts.

Original Cost or Other Basis. The dollar amount entered in an account when you first acquire an asset depends on how you acquire it. If you buy the asset, the first entry is the actual cost. However, there are several other ways to acquire timberland and associated property. The most common is by inheritance.

Inherited assets take as their basis the fair market value of the asset on the date the deceased died or on the alternative valuation date. This market value is usually greater than the de-

ceased's basis. Passing title by inheritance, therefore, usually results in a "stepped-up" basis in the property. If the deceased's estate was required to file an estate tax return, use the fair market value recorded on the Federal estate tax return. If the estate was not required to file a Federal estate tax return, use the appraised value used for the State inheritance or transmission tax.

Other types of acquisition that may apply to you are gift, nontaxable or partly taxable exchange, or replacement of involuntarily converted property. In these cases, consult Publication 551.

You must establish a separate basis for the timber to determine the gain or loss if you sell the timber or the allowance for depletion if you cut it. The difference between the basis for gain or loss and an allowance for depletion is explained on page 12.

Forest property may also include roads, fences, buildings, and other assets. In most cases you will want to establish capital accounts for each class of asset in order to claim depreciation deductions. This is the only way you will be able to recover your basis in some of these assets before you have completely disposed of the property.

Sales contracts and other instruments of transfer usually do not list separate prices or values for the land, timber, and other assets acquired in a single transaction. So you must allocate the total cost or other basis of the property among the land, timber, and depreciable assets acquired with the property. The portion of the basis you attribute to the land apart from the timber and improvements must be separated out because you can only recover this portion when you sell the land or dispose of it some other way.

Determine the basis of the various assets acquired by allocating the total basis according to the separate fair market value of each. Here is an example to help explain this procedure.

Example 1.—You bought a 100-acre tract of timberland in 1975. The contract price was \$41,000, but you also paid \$800 to have the boundaries surveyed, \$200 for a title search and filing, and \$1,600 to have the timber cruised and evaluated. Therefore, your total acquisition cost was \$43,600.

The timber cruise conducted at the time you bought the tract determined that the tract contained 1,000 cords of merchantable pine pulpwood on 90 acres. There were also 10 acres of young growth (trees of premerchantable size) which contributed to the value of the property. The fair market value of the timber on the date of purchase was \$18 per cord. The young growth had a fair market value of

\$25 per acre. The fair market value of the land itself, not considering the timber, was \$200 per acre. Therefore, the sum of the separate fair market values of all of the assets purchased was \$38,250.

Now, you can figure your original cost basis for the land, merchantable timber, and young growth by determining the proportion of the total fair market value represented by each, and multiplying this ratio by the total acquisition cost. For example, dividing the fair market value of the merchantable timber by the total fair market value, $\$18,000/\$38,250 = 0.4706$, and multiplying by the total acquisition cost, $0.4706 \times \$43,600$, gives an original cost basis of \$20,519 for the merchantable timber. The original cost basis for all of the assets are given in the following tabulation, and reported on Schedule B of Form T (figure 1).

Determination of Cost Basis:

Asset	Fair Market Value	Proportion of Total Fair Market Value	Original Cost Basis
Land	\$20,000	0.5229	\$22,798
Young growth	250	0.0065	283
Merchantable timber	18,000	0.4706	20,519
Total	\$38,250	1.0000	\$43,600

Remember, you must allocate the basis according to the relative values of the assets at the time the property is acquired. This requirement applies no matter when the allocation is made. If the timber value is a significant part of the total value of the property when you buy it, but you don't know its quantity and value, you will probably need the assistance of a forester to find out. Only timber that has a fair market value as of the date of acquisition should be included in the valuation. This means that the present quantity of timber must be reduced by the amount of timber growth since you acquired the property. You should try to obtain the best available information on market values as of the date of acquisition, as discussed on page 20.

Cutover timberland, or land with little or no merchantable timber on it when you acquired it, would probably have no original basis to allocate to the capital account for timber.

Revaluation is generally not allowed. Once the value of a timber property for purposes of determining the original basis has been determined and approved by the Internal Revenue Service, you cannot revalue it for as long as you own the property unless you become aware of misrepresentation, fraud, or gross error as to the facts known on the valuation date. Even in these cases, you still need the written approval of the Internal Revenue Service.

Land Account. Assets that you place in the land account include the land itself, nondepreciable land improvements, and depreciable land improvements. You should put depreciable land improvements into separate subaccounts, so you can claim depreciation as the asset is used. You may not need separate subaccounts for nondepreciable land improvements.

Nondepreciable land improvements include earthwork betterments of a permanent character either acquired with the property or constructed later. Clearing, grading, and ditching of roads with an indeterminable life; land leveling; and impoundments are examples. The basis of such assets, like that of the land itself, can only be recovered when you sell the land or otherwise dispose of it.

Depreciable land improvements include bridges, culverts, graving, fences, fire towers, and other nonpermanent structures and improvements. Roads may be fully or only partially depreciable, depending on your intended use of them. Permanent roads, intended for general uses such as administration, fire access, or logging are depreciable only to the extent that the bridges, culverts, and graveling may be depreciated. Temporary roads, such as roads to be abandoned after a logging operation has been completed, may be depreciated. Treat costs of firebreak construction as you do costs for constructing temporary roads. Most depreciable land improvements are 15-year real property under the accelerated cost recovery system (ACRS). For information on depreciation, including ACRS, see Publication 534, "Depreciation."

Road maintenance costs such as grading are generally deductible with your operating expenses, as discussed on page 7.

Timber (Depletion) Account. You should place items included in the timber (depletion) account into one of three subaccounts: (1) timber, (2) young growth (trees of premerchantable size), or (3) plantation or deferred reforestation (trees that are planted or seeded). (See Internal Revenue Code (IRC) Sec. 611, appendix, page 43.) Each of these subaccounts includes entries reflecting the volume of timber, or the number of acres of young growth or plantation, as well as the dollar basis for each. When you acquire timberland, you should allocate a reasonable part of the basis to the young growth if it contributes to the overall value of the property. You should use the procedure discussed on page 3. Remember that the allocation is made with reference to the relative values of the assets at the time the property is acquired. The cost or other basis attributable to the land itself is charged to the land account, as explained earlier. If you only acquire cutting rights, charge all costs related to the acquisition, including cruising costs, to the separate timber account.

The quantity of timber to be entered in your timber account when the timber is first acquired should include the total volume that the tract would have produced on the date of acquisition if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in the region at that time. The quantity should be expressed in board feet, cords, or some other standard unit of measure.

The plantation subaccount, also referred to as the deferred reforestation subaccount, reflects amounts incurred in connection with the establishment of timber stands by planting, or natural or artificial seeding (Revenue Ruling (Rev. Rul.) 75-467, see appendix, page 64). Report such amounts on Schedule E (Form T). A stand is established when a number of individual stems sufficient to adequately stock the site with the desired species are capable of surviving without further effort to reduce competition from other vegetation (Rev. Rul. 76-290, see appendix, page 64). Establishment costs include, for example,

Forest Industries Schedules

▶ Attach to your tax return.

Check form of organization: <input type="checkbox"/> Corporation <input type="checkbox"/> Partnership <input type="checkbox"/> Fiduciary <input type="checkbox"/> Individual	Name _____ Address (number and street) _____ City or town, State and ZIP code _____	Taxpayer identifying number _____ For tax year ended _____
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GENERAL INSTRUCTIONS

(References are to the Internal Revenue Code.)

Paperwork Reduction Act Notice

The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you have to give it to us. We ask for the information to carry out the Internal Revenue laws of the United States. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Who must complete Form T.—If you claim a deduction for depletion of timber, you must complete and attach Form T to your income tax return.

Generally, Form T must be filed when a taxpayer sells, cuts, or purchases standing timber or is involved with other timber transactions. In addition, taxpayers who elect on their income tax returns to claim gain or loss from cutting timber, as provided by section 631(a), must file Form T with their returns.

Complete this form in accordance with sections 611, 631, and 1231 and related regulations. If you need more space, attach separate sheets and number each answer so that we can identify it with the appropriate question on Form T.

Schedule A Maps

1. This schedule consists of a map (or maps) of your timber properties. Whether you file the maps with your income tax return is your option, but you must make them available on examination of your return. Maps of convenient size are desirable, varying in scale from approximately 4 inches to the mile in small tracts to 1/2 inch to the mile in tracts larger than 200,000 acres. The maps should show your name and the tax year

covered. Give standard map symbols in enough detail to show clearly the location of: (a) timber cutting contracts acquired separately from the land, (b) forest lands acquired, (c) areas where you cut timber, (d) timber cutting contracts sold or otherwise disposed of, (e) forest land sold or otherwise disposed of, and (f) forest land sold or otherwise disposed of with the timber cutting rights reserved to you or outstanding in third parties.

Schedule B Purchases

2. For the tax year, report acquisitions (such as purchases or exchanges, whether taxable or not) of timber, timber cutting contracts, or forest land. Report separately each single purchase totaling \$10,000 or more, giving month and year of purchase. You may combine purchases of less than \$10,000 for each timber or land account, and omit item 5 for combined small purchases. For a purchase or lease of timber cutting rights on a pay-as-cut basis, do not answer items 6 through 10. Instead,

give briefly the provisions of the purchase or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may report totals for small purchases on a pay-as-cut basis completed within the tax year. Follow the format of items 3 through 10 on additional sheets if you need more space.

3. Name of block and title of account

(Your name) Timber Account

4. Location of property (by legal subdivisions, or map surveys)

W 1/2 of NE 1/4 of Section 5, and W 1/2 of SE 1/4 of NE 1/4 of Section 5, Spring Township, Pine County, Alabama

5. (a) Seller's name and address (to be completed)	(b) Date of purchase Oct. 2, 1975
6. Amount paid: (a) in cash (b) in interest bearing notes (c) in non-interest bearing notes	\$41,000 0
7. (a) Amount paid in other considerations (b) Explanation of the nature of other considerations and how value given in 7(a) was determined ▶	<div style="background-color: #cccccc; height: 20px; width: 100%;"></div> 200
8. (a) Legal expense (b) Cruising, surveying, and other acquisition expenses	2,400 \$43,600
9. Total cost of property (Add lines 6(a) through 8(b))	

Figure 1.—Schedule B of Form T (Timber).

Schedule B Purchases (Continued)

10. Allocation of total cost on books:	Unit or kind	Number of units	Cost per unit	Total cost
(a) Forested land	Acre	100	\$227.98	\$22,798
(b) Other unimproved land	Acre			
(c) Improved land (Describe) ▶.....	Acre			
(d) Timber (Estimated total quantity of timber present on the acquisition date. (See section 1.611-3(e) of the regulations.) Details of the timber estimate, made for purposes of the acquisition, should be available on examination of your return.)	Cords	1,000	\$20.52	\$20,519
(e) Premerchantable timber (Make an allocation here only if it is a factor in the total cost or value of the land.)	Acres	10	\$28.30	\$283
(f) Improvements (List separately)				
(g) Mineral rights				
(h) Total cost (same as line 9)				\$43,600

Schedule C Profit or Loss from Land and Timber Sales

11. For the tax year, report all dispositions (such as by sale or exchange, whether taxable or tax free) of timber, timber cutting contracts, or forest land. Report separately each single sale involving a total consideration of \$10,000 or more. You may combine sales of less than \$10,000 for each timber or land account. You may omit item 14 for such combined small sales. For a sale or lease of timber cutting rights on a pay-as-cut basis, to be paid for at intervals during the cutting period according to the number of units cut, answer items 15, 19, and

20 for the tax year only. Instead of answering items 16, 17, and 18, give briefly the provisions of the sale or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may combine small sales on a pay-as-cut basis completed within the tax year. Follow the format of items 12 through 20 on additional sheets if you need more space.

12. Name of block and title of account

(Your Name) Timber Account

13. Location of property (by legal subdivisions or map surveys)

W 1/2 of NE 1/4 of Section 5, W 1/2 of SE 1/4 of NE 1/4 of Section 5, NE 1/4 of NW 1/4 of Section 5, and N 1/4 of SE 1/4 of NW 1/4 of Section 5, Spring Township, Pince County, Alabama.

14. (a) Purchaser's name and address

(to be completed)

(b) Date of sale

May 5, 1980

15. Amount received: (a) in cash
 (b) in interest bearing notes
 (c) in non-interest bearing notes

\$22,000

16. Amount received in other considerations

17. Explanation of the nature of other considerations and how you determined the value given in item 16 ▶.....

18. Total amount received for property (Add lines 15 and 16)

\$22,000

Figure 1. (Continued)

money you spend to prepare the site for tree planting or seeding, and the cost of the seedlings or tree seeds. Site preparation costs include those for brush or stump removal, and for leveling and conditioning the land to afford good growing conditions and to facilitate planting or seeding. Other items you must charge to the plantation account are tool expenses, including depreciation charges for equipment used in planting, such as trucks, tractors, and tree planters. You must also capitalize the cost of hired labor employed in tree planting or seeding. The term "hired labor" includes members of your family who are actually paid for their services, but it does not include yourself.

You should also capitalize the costs of replanting after tree mortality, as in Christmas tree plantations. If young growth is destroyed by fire or other casualty, you should claim the loss as an income tax deduction and capitalize the cost of replacement in a plantation subaccount. For the treatment of seedlings killed, but not by a casualty, see Rev. Rul. 81-2, appendix page 70. For the deductibility of losses from casualties, see "Casualties, Thefts, and Condemnations," page 24.

A limited amount of your capitalized reforestation costs may be amortized, as discussed in "Amortization and Investment Credit," page 10. Your plantation subaccount is reduced by the amount of these amortized costs.

You should transfer amounts from the young growth and plantation accounts to the timber subaccount as the trees reflected in these accounts become merchantable. Add the dollar amounts and the estimated number of units to the timber account.

Example 2.—In 1977 you remeasure the timber you bought in example 1. You determine that the young growth has reached merchantable size and contains 10 cords. Therefore, you transfer the dollar amount shown in the young growth subaccount and the estimated number of units to the timber subaccount. The closing 1977 (opening 1978) balance in the timber subaccount is, therefore, \$20,802 (\$20,519 plus \$283). The balance in the young growth subaccount is reduced to \$-0-. The remeasurement also indicated that the timber on the 90 acres grew by 200 cords. Report the transfer on Schedule F of Form T as shown on figure 2.

Equipment Account. This account will usually consist of a set of subaccounts for each item or class of items of equipment. Powersaws, tractors, trucks, and tree planting machines are examples. Increase the basis of equipment by any amounts spent for major repairs or reconstruction that significantly increases the value or prolongs the life of the equipment. You can recover through depreciation allowances any expenses for equipment purchases, major repairs, and improvements to the equipment. (See Publication 534, "Depreciation.")

Operating Expenses

If you hold forest property for use in a trade or business, you can deduct from your business's gross income the ordinary and

necessary expenses incurred in carrying on the trade or business during the year. (See Publication 334, "Tax Guide for Small Business," Parts III and IV.) The activities associated with many forest properties, however, are infrequent and do not provide income regularly. Such property is probably not being held primarily for use in a trade or business. But it may constitute property held for the production of income as an investment.

An individual may deduct the ordinary and necessary expenses for producing or collecting income; or for managing, conserving, or maintaining property held for the production of income. Under this broad provision of the Internal Revenue Code, you may deduct operating costs whether or not you are operating a trade or business, and whether or not the property is producing income currently. To be deductible, the expenses must be ordinary, necessary, and directly related to the income potential of the property. (See Publication 550, "Investment Income and Expenses.")

Operating Expenses Defined. Operating expenses include what you spend for tools of short life (usually 1 year or less) or small cost, such as axes, handsaws, sledges, and wedges. The cost of operating and maintaining equipment used in your operations may be included in this category, depending on what you use it for. Also included are salaries or other compensation for services actually rendered by others, such as hired labor, consulting foresters, lawyers, and accountants. You can deduct travel expenses if your trip is primarily and directly related to the income potential of the property, and you keep a record of your expenses. (See Publication 463, "Travel, Entertainment, and Gift Expenses.") Rental or other payments for land, equipment, or other business or investment property in which you have no equity (ownership) interest may be deductible. Any expenditures directly related to the purchase of timberland, reforestation, or sale of timber are capital expenditures and are therefore not deductible as operating expenses. However, certain reforestation expenses may be amortized. (See "Amortization and Investment Credit," page 10.)

How you treat taxes, interest, insurance premiums, and similar items in the nature of carrying charges depends on the character of your operations, as discussed in "Carrying Charges," page 9.

Taxes, such as property, forest yield, severance, and State or local sales taxes are for the most part deductible. Taxes that cannot be deducted include Federal income, estate, and gift taxes and State inheritance, legacy, and succession taxes. Special assessments for local benefits, such as water lines and roads, that tend to increase the value of the property also generally are not deductible. Taxes on gasoline and other fuel and lubricating oil used in your business are deductible as part of the cost of the fuel and oil. License fees for business vehicles, although not taxes, generally are deductible.

Interest payments that you can deduct include those on bank and other short-term loans, and long-term loans such as mortgages. Only actual out-of-pocket interest expenses can be deducted.

Insurance premiums for fire, windstorm, theft, general liability, and workman's compensation may also be deductible.

Road and fireline maintenance costs such as grading and cleaning ditches are usually deductible.

Reporting Operating Expenses. The tax form used to report operating expenses depends on the type of operation you are engaged in. Basically there are three possibilities.

If you hold your forest property as an investment, list your expenses on Schedule A (Form 1040), "Itemized Deductions," as "Miscellaneous Deductions." This is possible only if you itemize deductions for the year. If in any year you do not itemize or do not elect to capitalize these expenses, these costs are wasted for tax purposes, and you will not be able to recover them. (See "Carrying Charges," page 9.)

If your timber operations are incidental to your farming activities, list your operating expenses along with your farming expenses on Schedule F (Form 1040), "Farm Income and Expenses," as "Other" expenses. You should list individually the expenses you are claiming. Report timber-related expenses and income as "farm expenses and income" only if the timber activities are incidental to other activities producing "farm income." This is the case even if you refer to your timber activities as farming, or engage in the activities under a name which includes the term "farm."

If you are engaged in a timber business or your operations are incidental to a nonfarm business, report your operating expenses on Schedule C (Form 1040), "Profit or (Loss) from Business or Profession."

Activity Must Produce Profit. Except as otherwise provided, you cannot deduct operating expenses paid or incurred in carrying on a trade or business; for the production or collection of income; or for the management, conservation, or maintenance of property held for the production of income, unless you engage in the activity for profit. (See Publication 334, "Tax Guide for Small Business," Chapter 1.) Your activity is presumed to have been engaged in for profit if it results in a profit for 2 or more years in a period of 5 consecutive years. The converse presumption does not apply, however. If your activity does not result in a profit in 2 out of 5 consecutive years, your deductions are not automatically disqualified. All of the facts and circumstances in your case are considered.

The term "profit" includes appreciation in the value of assets, such as land and timber, used in the activity. So you may intend that, even if you realize no profit from current operations, you will have an overall profit when appreciation in value of the land, timber, or both is realized. Profit in this case is defined as the amount by which income from the activity plus the appreciation in the value of these assets exceeds the expenses of operation.

Carrying Charges

Carrying charges are taxes, interest, and certain other expenses related to the development and operation of timber properties that may be treated as either deductible expenses or capital costs. You would usually deduct such expenses as operating

costs, but you may capitalize them if you so elect. (See Publication 334, Chapter 5.)

Items Included. Taxes you may treat as carrying charges include annual property taxes. This includes taxes payable on forest lands subject to a yield tax. You may not capitalize yield or severance taxes payable only at the time of harvest, but you can usually deduct them as ordinary and necessary business or investment expenses. You may also treat as carrying charges any interest on mortgage or other loans made to acquire or improve your property. Other expenses you may treat as carrying charges include administrative costs, premiums for liability insurance or for insuring standing timber against loss by fire or other hazards; contributions to fire-protection organizations; and expenditures for labor, materials, and tools used in the maintenance of fire lanes, in other protective measures, or in actual fire suppression. Protection costs incurred for controlling outbreaks of forest insects or diseases are treated similarly.

Making the Election to Capitalize. You elect to capitalize by filing with your original return for the year for which the election is to be effective a statement indicating the items you are capitalizing. Ordinarily you would not want to capitalize your carrying charges, even if you only receive income from the timber property sporadically since a dollar saved today is better than one saved later. However, if you have acquired timber as an investment you would want to capitalize your carrying charges in any year you do not itemize your deductions. Otherwise the cost will be lost for tax purposes.

Election is effective only for the year it is made. This applies to annual taxes, mortgage interest, and other deductible carrying charges on unimproved and unproductive real property. Unimproved real property is generally defined as land without significant buildings, structures, or any other improvements that contribute to its value. Real property is unproductive in any year no income is produced from the use of the property, sale of timber, or sale of products cut from the timber. You may not capitalize carrying charges for any year your property is productive.

Noncommercial Thinning and TSI. Noncommercial thinnings of immature stands and timber stand improvement (TSI) work are not, strictly speaking, activities involving carrying charges. If such work is done after the stand is established, you can deduct the cost as an operating expense. Although not strictly covered by the language of the Code or Regulations, such expenditures may be capitalized to the timber account as carrying charges if you do it consistently from year to year.

Expenses of Sale

You recover costs associated with the sale of your timber by deducting them from the proceeds of the sale. For example, advertising, timber cruising, marking, and scaling that are directly related to a sale are expenses of sale. Other expenses of sale are fees of consulting foresters, appraisers, selling agents, lawyers, or other advisors for work directly related to a sale of timber. Even if you report the income resulting from the sale as a capital gain, you must deduct these expenses from timber sale proceeds and not as ordinary and necessary business or investment expenses. If costs are incurred for multiple purposes

that include timber sale activities, the proportion related to the sale must be allocated to the sale and offset against the gains from the sale.

If you report the transaction as ordinary income on a business schedule, such as Schedule C (Form 1040) or Schedule F (Form 1040), report the expenses of sale on that schedule. Sales that qualify as capital gains are reported on Schedule D (Form 1040) or Form 4797, depending on the type of timber sale. In this case, add the selling expenses to the allowable basis of the timber sold, and then subtract this total from the sale proceeds. You can list details of the selling expenses and gross proceeds on an attachment to Schedule D (Form 1040) or Form 4797. Reporting requirements are discussed in greater detail in "Receipts from Timber," page 11.

Depreciation

You are permitted a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used for the production of income. This allowance takes the form of an annual depreciation deduction on your tax return. You may also be eligible to claim investment tax credits. The procedures you use to determine the depreciation deductions for various types of equipment (fences, roads, etc.) used in timber operations are the same as for all other operations using depreciable assets. (See Publication 534, "Depreciation.")

Amortization and Investment Credit

Qualified reforestation expenditures made or incurred after December 31, 1979, can be amortized over an 84-month period. You can also claim the regular investment credit on the amortizable amount.

Qualified expenditures are the direct costs you incur in connection with stand establishment, discussed on page 7. Such costs include those for site preparation; seeds or seedlings; and labor and tools, including depreciation of equipment used in planting or seeding. The property forested or reforested must be located in the United States. The site must as a result of the activity contain trees in significant commercial quantities and must be held by you for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products. Any site less than 1 acre will generally not be considered capable of the commercial production of timber. The portion, if any, of the reforestation expenditure

for which you have been reimbursed under any governmental cost-sharing program, such as the Forestry Incentive Program (FIP), does not qualify, unless the amount received was included in your gross income for tax purposes, (see page 23).

The maximum dollar amount that qualifies is \$10,000 per year (\$5,000 in the case of a separate tax return by a married individual). In the case of partnerships this limit applies both to the partnership and each partner. (See IRC Sec. 194, page 42, for corporate limits.) Estates qualify for amortization and for investment credit; however, trusts do not.

How you apply amortization and investment credit is demonstrated in the following example:

Example 3.—You own a 50-acre tract of cutover timberland that needed to be planted in order to establish adequate pine stocking. You contracted with ABC Forestry Services, Inc. to prepare the site and plant seedlings in the spring of 1980. The cost was \$150 per acre, which you paid in full in May 1980.

You elect to amortize the full amount, \$7,500. The monthly amortizable amount is \$89.29, determined by dividing \$7,500 by 84. On your 1980 tax return you deduct \$535.74, determined by multiplying \$89.29 by 6 months. You use 6 months because the 84-month amortization period begins on the first day of the second half of the taxable year in which the expenditure is made. This is July 1 since you are a calendar year taxpayer.

Assuming you make no other reforestation expenditures, you would deduct \$1,071.48 (\$89.29 multiplied by 12) in each of the years 1981 through 1986. The balance of \$535.38 would be deducted in 1987. You would file an attachment to your Form 1040 in which you describe the expenditures and when you made them.

Since the trees planted have a life of more than 7 years, you can also claim on your 1980 tax return the full 10 percent investment credit, \$750, by filing Form 3468, "Computation of Investment Credit."

When you report proceeds from the sale of timber on your Federal income tax return, you must determine the amount as well as the kind of gain or loss. To determine the amount you must know your basis for cost depletion of the timber sold. Determining the kind of gain or loss requires considering how long you held the timber, what type of timber-related activities you engage in, and how you dispose of the timber.

Determining the Amount of Gain or Loss

You determine the gain or loss from the sale or exchange of timber in the same way as for assets in general. Reduce the total proceeds by the basis of the asset sold or exchanged and by any expenses directly related to the transaction. Because timber is usually acquired as a unit but disposed of over a period of years as the trees mature, you must use special procedures to determine the basis of the timber disposed of at any one time.

Once you have established the original basis of the timber, as discussed on page 3, you must adjust this basis as needed.

Adjusted Basis. Adjustments may be needed from year to year to keep current, as of the beginning of each year, the dollar amounts and volumes shown in the timber accounts. In any year you dispose of timber you may need to make additional adjustments. However, if you own a small tract and sell or otherwise dispose of timber infrequently, you may need to make adjustments only at the time of disposal.

You should make adjustments annually to reflect additional timber acquired, timber disposed of since the last adjustment, capital improvements, losses claimed, and carrying charges that you capitalized, as called for by Schedule F (Form T). If you maintain only one account for all of your timber (average depletion), make all of the adjustments to this account. If you maintain several accounts (species or value depletion, for example), allocate the amounts involved among the accounts.

Each time you acquire additional timber, you should enter it into your timber account. Such an entry would increase the account balance. Likewise, if you sell or cut timber, decrease the account by the number of units sold or cut and reduce the allowable basis or depletion sustained. If you sustain any casualty losses to your timber, and claim those losses on your tax return for any year, you would reduce the timber quantity by the number of timber units destroyed, and the dollar balance in the account by an amount equal to the unit depletion rate times the number of units destroyed. The quantity shown at the beginning of any year should thus reflect how much merchantable timber is available for cutting, subject to the adjustments explained below.

You should adjust the number of units shown in the timber account at the beginning of the tax year to correct inaccuracies, or to reflect changed standards of utilization. You should also adjust the account if you change to a different log rule or other

unit of measure. The timber quantity should be increased by the following: (1) the volume of additional timber purchased or otherwise acquired during the year, (2) transfers during the year from young growth or plantation subaccounts to reflect the volume of such timber that has become merchantable, and (3) the number of units gained through growth since the last such adjustment. You should make periodic adjustments for growth. If, however, you have a small timber holding and infrequent transactions, you would generally be required to make this determination only for a year in which you sell, cut, or otherwise dispose of timber. In the case of a timber sale, you can make this determination easily by reestimating the total volume of merchantable timber present on the tract at the same time that you mark or select the trees for cutting.

How to adjust the timber quantity account is illustrated in the following example, and is summarized in "Record Requirements," page 14.

Example 4.—In 1979 you purchased a 50-acre tract of timberland next to your original tract (example 1). The total purchase cost was \$22,500, of which \$10,589 was allocated to the timber and the balance of \$11,911 to the land. A timber cruise and valuation conducted at the time of purchase was used to allocate the cost basis between the land and timber. The procedure shown in example 1 was used to make the allocation, and the purchase was reported on Schedule B of Form T (not shown). The estimated volume of merchantable timber was 700 cords. The cost basis and volume for this timber were added to the existing timber account for the 100-acre tract.

In the same year you had the timber recruised in anticipation of making a sale. The cruise indicated that the total volume of merchantable timber on the 150 acres was 2,110 cords.

You usually expensed your carrying charges for the property; however, in 1979 you capitalized carrying charges of \$1,017.

The adjusted timber account as of the end of 1979 was:

Schedule F (Form T) Capital Returnable through Depletion

Line number on Form T	Quantity in board feet, log scale, or other unit (1)	Cost or other basis (2)
28. Estimated quantity . . . [at end of 1977].	1,210 cords	\$20,802
30. (a) Addition for growth (2 years)	200	—
31. Timber acquired during year . .	700	10,589
32. Addition to capital during year		1,017
33. Total at end of year	2,110	\$32,408
41. Total reductions	0	0
42. Net quantity and value at end of year	2,110 cords	\$32,408

Depletion Unit. You determine the depletion unit by dividing the adjusted basis shown in the timber account by the total quantity of timber in the account. This unit is usually expressed in dollars per thousand board feet or cord, but the individual tree may be the physical unit for Christmas tree plantations. Determine a depletion unit for each timber account but only after the adjustments described above have been made. The calculation of the depletion unit is demonstrated in example 5, on this page.

Ways to Recover Your Basis. Although you always determine the depletion unit in the same way, how you recover your basis in timber sold or otherwise disposed of depends on the type of disposal made. The types of disposals are discussed on page 16.

If you cut the timber yourself or contract to have it cut for you and then sell the cut products, you recover your basis by claiming the "depletion sustained" on line 36, Schedule F (Form T) as demonstrated below. If you dispose of standing timber by sale or under a pay-as-cut contract, you recover your basis by reducing any proceeds received by the basis of the timber disposed of. Report the basis recovered in this manner on line 38, Schedule F (Form T), as the "allowable basis." Line 40 is used to report the allowable basis for timber lost by fire or other cause.

Net Gain or Loss for Tax Purposes. *The net gain or loss on the sale or other disposal of standing timber* is the total proceeds received, less the allowable basis for the timber disposed of, less the expenses of disposing of the timber:

Total proceeds from sale or other disposal

Less:

Allowable basis of timber, and

Expenses of sale or other disposal

Equals:

Net gain or loss

The following example demonstrates use of the depletion unit to determine the net gain from the disposal of standing timber.

Example 5.—In 1980, you sold 1,000 cords of the timber available on your 150-acre tract. The contract price was \$22,000 payable in cash on the effective date of the contract. You had not sold, cut, or otherwise disposed of any timber in prior years. You contracted with a consulting forester to cruise, mark, and sell the mature trees. The consultant charged 10 percent of the gross sale proceeds, \$2,200, for providing these services.

You determine your allowable basis for the timber sold by multiplying the depletion unit by the number of units sold. After adjusting the volume in the timber account, determined in example 4, for growth during 1980, the depletion unit was \$13.97 per cord, obtained by dividing the adjusted basis, \$32,408, by the adjusted volume, 2,320 cords. The allowable basis was therefore, \$13,970, determined by multiplying the depletion unit, \$13.97, by the number of units sold, 1,000 cords. Report the amount allowable as the basis of the timber sold on Schedule F of Form T, as shown below, and report the net gain from the sale on Schedule C (Form T) as shown in figure 3.

Schedule F (Form T) Capital Returnable through Depletion

Line number on Form T	Quantity in board feet, log scale, or other unit (1)	Cost or other basis (2)
28. Estimated quantity . . . [at end of 1979].	2,110 cords	\$32,408
30. (a) Addition for growth (1 year)	210	—
33. Total at end of year, before depletion	2,320	\$32,408
34. Unit rate	—	13.97
37. Quantity of timber sold	1,000	—
38. Allowable as basis of sale	—	13,970
41. Total reductions during year:		
(a) Sum of lines 35, 37, and 39	1,000	—
(b) Sum of lines 36, 38, and 40	—	13,970
42. Net quantity and value at end of year	1,320 cords	\$18,438

The net gain or loss on the sale of logs or other products produced from standing timber is the total proceeds received, less the depletion sustained, less the expenses of cutting, hauling, and selling. The sale of products produced from standing timber always results in ordinary income or loss. The cutting of the timber may, however, be treated as a sale of timber and generate long-term capital gain or loss as explained on page

Timber Depletion. Timber depletion occurs when you cut standing timber. You determine the depletion allowance in the same manner as you determine the basis for gain or loss when standing timber is sold or otherwise disposed of. You may cut the timber yourself or contract to have someone cut it for you.

Schedule C Profit or Loss from Land and Timber Sales (Continued)

19. Adjusted basis (cost) in property on sale or exchange date:	Unit or kind	Number of units	Cost per unit	Total cost
(a) Forested land	Acre			
(b) Nonforested land	Acre			
(c) Improved land (Describe) ▶	Acre			
(d) Merchantable timber. (Estimated total quantity of merchantable timber present on sale or exchange date. Give a detailed estimate as made for sale or exchange purposes. Include the quantity of each species of timber by diameter (DBH) classes. Name the log rule or other units of measure used.)	Cords	1,000	\$13.97	\$13,970
(e) Premerchantable timber				
(f) Improvements (List separately)				
(g) Mineral rights				
(h) Total adjusted basis				\$13,970
(i) Direct sale expenses (cruising, marking, selling)				2,200
20. Profit or loss (line 18 less lines 19(h) and 19(i))				5,830

Schedule D Losses

21. If you had losses during the tax year from fire, insects, wind, or other causes, and if you claimed the loss on your income tax return, show separately the proof of the loss for each timber account and complete lines 22 through 25.

22. Cause of loss

23. Location and area of land on which loss took place

24. (a) Total loss before any insurance recovery
 (b) Less amount received from insurance
 (c) Loss as claimed on tax return

25. Explain in detail how total loss (line 24) was determined

Schedule E Reforestation and Timber Stand Improvement

26. This schedule summarizes your expenses for reforestation and timber stand improvement during the tax year. You should keep on file the detailed information necessary to support the costs reported in this schedule and make it available on examination of your return. The total in Schedule E includes such things as supplies, labor, overhead, transportation, tools, and depreciation on equipment.

Site Preparation.—Report all expenses incurred during the tax year for preparation of the land for planting or seeding (including natural seeding). Include expenses for clearing the land of brush and culling trees by burning, disking, chopping, KG blade, spraying with herbicides, or other measures taken to aid in the successful reforestation of the site. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Planting or Seeding.—Report your expenses incurred during the tax year for planting seedlings or sowing seed to reforest the land. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work. You must make detailed records available to the examining agent upon request, including separate costs for hand planting and machine planting or any other explanation of the kind of expenditures.

Precommercial Thinning or Fertilization.—Report all expenditures incurred during the tax year for precommercial thinning and fertilization. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Figure 3.—Schedule C of Form T (Timber).

You realize a profit or loss when you sell the logs or products produced from the logs, such as lumber. The proceeds received, less the depletion sustained and conversion costs, must be reported as ordinary income. The depletion sustained is claimed whether or not you make an "election to treat the cutting as a sale," discussed on page 20.

You cannot claim the depletion deduction until the logs or other cut products are sold, even though timber depletion occurs when the timber is cut. Thus, if you cut timber during 1981 but do not sell the logs produced until 1982, you may not claim a deduction for the depletion allowance or for cutting expenses on your return for the year of cutting, 1981. Instead, you must set up a cut timber (in this example, a log) inventory account at the end of the year and include the depletion allowance and cutting expenses in this account. In 1982 when the logs are sold, the amount in the inventory account is offset against the proceeds of sale to determine the gain or loss. The following example shows how the inventory account would be established if wood were sold over a 2-year period, 1981 and 1982.

Example 6.—You cut 500 cords of your timber from the 150-acre tract. The cutting was completed in 1981 at a cost of \$7,520 for fuel and depreciation on equipment. However, you could sell only 300 cords by the end of your 1981 tax year. You received \$40 per cord for the wood sold. Your depletion unit for the timber cut was \$12.89 per cord, determined as shown on Schedule F of Form T, where the values are carried forward from example 5, page .

Schedule F (Form T) Capital Returnable through Depletion

Line number on Form T	Quantity in board feet, log scale, or other unit (1)	Cost or other basis (2)
28. Estimated quantity . . . [at end of 1980]	1,320 cords	\$18,438
30. (a) Addition for growth (1 year)	110	—
33. Total at end of year, before depletion	1,430	18,438
34. Unit rate	—	12.89
35. Quantity cut	500	—
36. Depletion sustained	—	6,445
41. Total reductions during year:		
(a) Sum of lines 35, 37, and 39	500	—
(b) Sum of lines 36, 38, and 40	—	6,445
42. Net quantity and value at end of year	930 cords	\$11,993

You report the profit on the sale of the wood on Schedule C of your Form 1040, as follows:
1981 Income on Sale of Wood
 Proceeds from wood sales—
 (300 cords × \$40 per cord) \$12,000

Less:

Depletion allowance— (300 cords × \$12.89 per cord)	3,867
Logging expenses— (300 cords × \$15.04 per cord)	4,512
Total expenses	8,379
Profit on wood sales	\$ 3,621

You may have been able to report the gain on the timber cut if you elected and qualified under the provisions of Section 631(a). Such an election would qualify a portion of the income for capital gain treatment, discussed on page 20.

The wood not sold in 1981 is entered into a wood inventory account, as follows:

Closing 1981—Opening 1982 Wood Inventory Account

Volume (cords)	200
Cost:	
Depletion allowance— (200 cords × \$12.89 per cord)	\$2,578
Logging expenses— (200 cords × \$15.04 per cord)	3,008
Total	\$5,586

You cannot claim a depletion allowance for timber cut for personal use, such as firewood for your home, and you do not adjust the dollar amount in your timber account when you cut timber for personal use. However, if you cut very much timber for personal use, you may need to adjust the quantity shown in the timber account to reflect the decrease in timber available for cutting or sale.

Record Requirements. No specific type of records is required by the Income Tax Regulations, but you must keep accurate and complete records to back up entries made on Form T. Your records should include copies of timber sale contracts and other receipts and records of all expenditures showing the date, amount, and purpose of each item. If you reduce your proceeds from the sale or other disposal by the adjusted basis for gain or loss for such timber, or claim a depletion allowance for timber cut, you will need to maintain timber accounts. To find out the specific types of information required, review the entries required on Form T.

You should file Form T with your income tax return for any year in which you have cut standing timber in which you owned an interest; have acquired standing timber by purchase or lease; or have sold or otherwise disposed of standing timber or timberland. You must also file Form T if you have elected in your income tax return to claim gain or loss from cutting timber as provided by Section 631(a) of the Internal Revenue Code (see page 43). Copies of Form T may be obtained from the Internal Revenue Service. Call the toll free number listed in your phone book under United States Government, Internal Revenue Service. Form T is reproduced in the appendix starting on page 36.

The accounts shown in example 7 might be enough for you if you acquired your timberland as an investment. Owners of

Example 7.

Timber Account—Value

		Debit (increase)	Credit (decrease)
10/2/75	Tract No. 1 purchased:		
	Total cost		\$43,600
	Less amount charged to land		22,798
	Less amount charged to young growth		283
	Charged to timber account	\$20,519	
1/1/76	Adjusted basis for depletion carried forward	20,519	
12/31/77	Transferred from young growth		283
1/1/78	Adjusted basis for depletion carried forward	20,802	
3/5/79	Tract No. 2 purchased:		
	Total cost		\$22,500
	Less amount charged to land		11,911
	Charged to timber account	10,589	
12/31/79	Carrying charges capitalized	1,017	
1/1/80	Adjusted basis for depletion carried forward	32,408	
12/31/80	Basis for sale of 1,000 cords (\$32,408 ÷ 2,320 cords = \$13.97 [depletion unit]; \$13.97 × 1,000 cords = \$13,970 [allowable basis])		\$13,970
12/31/80	Adjusted basis for depletion to be carried forward		18,438
		32,408	32,408
1/1/81	Adjusted basis for depletion carried forward	18,438	
12/31/81	Basis for cutting of 500 cords (\$18,438 ÷ 1,430 cords = \$12.89 [depletion unit]; \$12.89 × 500 cords = \$6,445 [depletion allowance])		6,445
12/31/81	Adjusted basis for depletion to be carried forward		11,993
		18,438	18,438
1/1/82	Adjusted basis for depletion carried forward	11,993	

Timber Account—Quantity
(Standard cords)

		Debit (increase)	Credit (decrease)
10/2/75	Tract 1, estimated merchantable quantity at purchase		1,000
12/31/77	Adjustments: Transferred from young growth timber account	10	
	Growth for 1976 and 1977	200	
	Total adjustment	210	
1/1/78	Quantity carried forward	1,210	
3/5/79	Tract 2, estimated merchantable quantity at purchase		700
	Adjusted for growth for 1978 and 1979	200	
	Total adjustment	200	
1/1/80	Quantity carried forward	2,110	
12/31/80	Adjustment for growth for 1980	210	
	Total adjustment	210	
12/31/80	Quantity at end of year, before depletion	2,320	
12/31/80	1,000 cords sold, 12/31/80		1,000
12/31/80	Quantity to be carried forward		1,320
		2,320	2,320
1/1/81	Quantity to be carried forward	1,320	
12/31/81	Adjustment for growth for 1981	110	
	Total adjustment	110	
12/31/81	Quantity at end of year, before depletion	1,430	
12/31/81	500 cords cut		500
12/31/81	Quantity to be carried forward		930
		1,430	1,430
1/1/82	Quantity carried forward	930	

small tracts will usually find it simpler to establish one timber account for purposes of figuring the allowable basis for timber disposals or depletion allowances for timber cut, rather than figuring these values separately for individual tracts, species, or product classes.

Once established, timber accounts may be divided into two or more subaccounts only under exceptional circumstances. Such changes are subject to the approval of the District Director of Internal Revenue on audit of your tax return. Your accounts may be divided, for example, by tree species or special timber products.

Determining the Kind of Gain or Loss

Your standing timber for income tax purposes is either a capital asset or a noncapital (or ordinary) asset. This distinction is the basic factor that determines how you report your gains and losses from sales and other dispositions of your timber. It is critical in determining whether you have an "ordinary" or a "capital" gain or loss; and whether the gain or loss is reported on Schedule D (Form 1040) or Form 4797.

Ordinary gains (income) are fully taxable, and ordinary losses (except for losses on transactions between certain related taxpayers) are fully deductible. Special rules that apply to capital gains and losses may result in a tax benefit to you. If you are an individual taxpayer, and your net gains from the sale or exchange of assets held more than 1 year exceed your net losses from the sale or exchange of assets held 1 year or less, only 40 percent of the excess, referred to as "net long-term capital gain," is subject to tax. The 40 percent subject to tax is added to your other income and taxed at the rate for ordinary income. The 60 percent of your net long-term capital gain not subject to tax is referred to as the "capital gains deduction."

The capital gains deduction may be subject to the alternative minimum tax for noncorporate taxpayers. It is not subject to the add-on minimum tax, however (see page 27). You can find detailed examples of capital gain computations and reporting procedures in Publication 544, "Sales and Other Dispositions of Assets." Corporate taxpayers should consult Publication 334, "Tax Guide for Small Business," for rates and procedures.

Capital Gains From Timber Transactions. *Whether your timber gains and losses qualify for capital gains treatment depends on these three factors:*

1. *Your primary purpose for holding the timber.* Timber is a capital asset in your hands if it is not used in your trade or business nor held by you primarily for sale to customers in the ordinary course of a trade or business. Gain on the sale or exchange of such timber, if you have owned it for more than 1 year, is long-term capital gain.

2. *How you dispose of the timber.* An owner may dispose of timber in one of three ways, namely, (1) by sale or exchange, (2) under a pay-as-cut contract, or (3) by cutting and conversion to salable products such as logs, pulpwood, or lumber. Timber is also subject to being disposed of involuntarily by theft, or casualty such as fire or storm. For reasons explained in detail below, the term "timber sale" must be used with caution. For tax purposes, the term refers

to the situation discussed under "Sales of Standing Timber for a Lump Sum," page 16. It is a sale because the owner has exchanged all of his or her interest in all of the designated standing timber for an amount of money or other considerations agreed on at the time the transaction is entered into. If the timber is disposed of under a contract that gives the buyer the right to cut designated timber and the obligation to pay a designated amount for each unit of timber as it is cut, the provisions of section 631(b) of the Internal Revenue Code may apply (see "Disposal of Standing Timber with an Economic Interest Retained," page 00). When trees are cut down they are no longer timber for tax purposes. Therefore, if you sell products produced from your trees, such as logs, and not the standing trees themselves, you are not selling timber. Unless you elect the provisions of section 631(a) of the Internal Revenue Code, the entire profit from the sale of the cut products is taxed as ordinary income (see "Cutting of Standing Timber with Election to Treat as a Sale," page 20).

The complexity of timber leases/long-term cutting contracts are beyond the scope of this publication. For this information, consult Revenue Rulings 62-81, appendix, page 56; 62-82, appendix, page 57; 75-59, appendix, page 63; and 78-267, appendix, page 67, and appropriate tax counsel.

3. *How long you hold the timber.* Timber must be held for more than 1 year to qualify for long-term capital gains treatment, as discussed later.

Sales of Standing Timber for a Lump Sum. A sale for a lump sum is the outright sale (usually by means of a timber deed or sale contract) of standing timber for a fixed amount agreed on in advance. The transaction may cover all timber on a specified tract or only certain species, diameter classes, or individually marked trees on a specified tract.

Capital gains treatment will apply if the timber is a capital asset in the hands of the seller. Timber is a capital asset in your hands if it is *not* held primarily for sale to customers in the ordinary course of a trade or business, and is *not* property that constitutes an integral part of a trade or business (IRS Sec. 1221, appendix, page 44). Therefore, timber is a capital asset in your hands if you are holding it primarily for personal use or as an investment, as discussed in "Types of Forest Ownership and Operation," page 1. Whether timber is held by you primarily for sale in the ordinary course of a trade or business is not always easy to determine. This question can only be answered by weighing all of the facts and circumstances surrounding each particular transaction. No single factor, such as the number of timber sales you have made in the past or the size of the sale, is determining. Some of the factors that have a bearing on the determination are:

1. The original purpose for which you acquired the timber, whether for sale or investment;
2. The number, continuity, and frequency of your sales as opposed to isolated transactions;
3. Your promotional activity with reference to the sales or of those acting under your instructions or in your behalf; and

4. Any other facts indicating that sales or transactions were part of your occupation.

In general, if you make only an occasional sale of timber that is unrelated to a trade or business in which you are engaged (not necessarily your principal occupation), the timber will qualify as a capital asset and the proceeds will qualify for capital gains treatment. On the other hand, if you are a dealer in timber, or make repeated sales of standing timber from property assembled or held for that purpose, or because of the other factors listed above, you may run the risk, on audit of your return, of having the capital asset status of your timber questioned.

If you are in doubt about the capital asset status of your timber and you intend to dispose of standing timber that you have held for more than 1 year, you should consider entering into a contract for disposal with an "economic interest retained" (see page 19).

Holding period is critical for long-term capital gains treatment. Assuming that your timber sale otherwise qualifies for capital gains treatment, the proceeds will qualify for the lower capital gains rate only if the gain is a long-term capital gain. The sale or exchange of a capital asset held for more than 1 year (sold no sooner than 1 year and 1 day after it was acquired) at the time of the transaction results in a long-term capital gain or loss, while sale or exchange of a capital asset held 1 year or less results in a short-term capital gain or loss. As mentioned below, if you have an excess of net long-term capital gains over net short-term capital losses, only 40 percent of the excess is taxed. Net short-term gains do not have this advantage and are taxed at the same rate as ordinary income. The term "net" refers to the fact that any short-term gains are first used to offset any short-term losses. If a net short-term gain results, it offsets any long-term capital losses. If all of your capital transactions result in a net capital loss you may be limited as to how much of the loss you can use to offset other income reported for the year. You can carry over any unused loss to other years. Because of these special rules, you enter capital gains and losses on your return differently from ordinary income. The rules for reporting capital gains and losses are discussed in Publication 544, "Sales and Other Dispositions of Assets."

You use Schedule D (Form 1040), "Capital Gains and Losses," to report lump-sum sales of timber that qualify as capital gains. Other capital gains transactions are also summarized on Schedule D (Form 1040). If you have held the timber more than 1 year as of the date of sale, enter the transaction in Part II, "Long-term capital gains and losses—assets held more than one year." If you have held the timber 1 year or less, enter the transaction in Part I under "Short-term capital gains and losses—assets held one year or less." The use of Schedule D (Form 1040) is demonstrated in the following example.

Example 8.—You sold 60 thousand board feet (M bd. ft.) of standing timber in a lump-sum sale on August 15, 1981. The contract price was \$2,100. The timber was located on land acquired as part of your farm. You had bought the

farm on March 1, 1960. Your allowable basis in the timber sold was \$355.80, computed according to the procedures discussed in "Determining the Amount of Gain or Loss," page 11. The State service forester for the county in which the farm is located marked and tallied the trees sold, and estimated the total volume of timber on the tract. This service was provided free by the State department of forestry. However, you paid \$100 in legal fees to have the contract checked and to close the sale. You are engaged in crop and livestock production on your farm and sell timber infrequently. The timber is considered to be a capital asset in your hands.

This sale resulted in a long-term capital gain of \$1,644.20 (sale proceeds of \$2,100, less \$100 for sale expenses, and less the allowable basis of \$355.80). This transaction is entered in Part II of Schedule D (Form 1040), as shown on page 18.

The gain shown in example 8 would be combined with any other capital gains or losses you incurred during the year, according to the instructions given on Schedule D (Form 1040). Transfer the net taxable gain or loss to Form 1040. If you have no other capital gains or losses, the amount transferred would be only 40 percent of \$1,644.20, or \$657.68. This would be the amount included in your taxable income.

The explanation that follows may further help you in providing the information called for in columns "a" to "g" of Schedule D (Form 1040).

- a. *Kind of property and description.*—Indicate here that you have sold timber, the form in which it was sold, the type of timber, and how much you sold.
- b. *Date acquired.*—Show here the date the property came into your possession, whether by purchase, gift, inheritance, or in some other manner.
- c. *Date sold.*—Show here the date that title to the timber passed to the buyer.
- d. *Gross sales price less expense of sale.*—Show the full contract price reduced by the expenses of sale. A statement should be attached itemizing the expenses of sale. These expenses would include advertising the timber sale to attract buyers; cost of timber survey or cruises; cost of marking trees to be cut or sale boundaries; travel costs; fees of consulting foresters, accountants, or attorneys who helped with the sale; and other expenses of a similar nature (see page 9).
- e. *Cost or other basis, as adjusted.*—Enter the allowable basis of the timber sold. Attach a statement showing the calculation of the allowable basis. You may use Schedules C and F (Form T) for this purpose. However, if you have infrequent timber transactions, you can provide this information in any convenient form, as long as all of the necessary information is clearly shown and properly labeled. The statement should indicate the original cost or other basis of the tract as a whole, and the portion of the purchase price or other basis allocated to land, improvements (if any), and timber. Also mention the

quantity and quality of merchantable timber present on the tract when you bought it, and the quantity of subsequent growth to date, reduced by prior sales and any losses sustained, as discussed on page 11.

f. and g. *Loss or Gain.*—If the amount in column “e” is more than the amount in column “d,” subtract the amount in column “d” from the amount in column “e” and enter the loss in column “f.” If the amount in column “d” is more than the amount in column “e,” subtract the amount in column “e” from the amount in column “d” and enter the gain in column “g.”

Installment payments extending beyond the year of sale in the case of timber sold on a lump-sum basis raise the question of which tax year(s) the gain should be reported in. The provisions of the “Installment Sales Revision Act of 1980” eliminate most of the complicated provisions that previously applied to installment sales. Under previous law you had to elect to report on the installment basis. For sales after October 19, 1980, the installment sales provisions automatically apply. You may, however, elect not to have them apply.

Under the new provisions, you report payments in the year received, regardless of how much, if any, of the total amount due is received in the year of sale. Payments taken into account as being received in a taxable year do not include the buyer's obligations for future payments unless the obligations are payable on demand or are in the form of bonds or other evidences of indebtedness that are readily tradeable. Also, a third party guarantee will not be taken into account in determining if the buyer's evidence of indebtedness constitutes payment to the seller, unless the third party note or other type of third party obligation is transferable or marketable before default by the buyer.

The installment method applies only to gains. If you have a deductible loss you must deduct it in full on your return for the year of sale. If you are considering the installment method of reporting, see Publication 537, “Installment Sales.”

For lump-sum sales of standing timber that do not qualify for capital gains treatment because you held the timber primarily for sale to customers in the ordinary course of your business, the gain or loss from the sale is ordinary gain or loss and you must report the transaction on a business schedule. Ordinarily, you report such a sale on Schedule C (Form 1040), “Profit or (Loss) from Business or Profession.” If you are a farmer, you may include the transaction on your Schedule F (Form 1040), “Farm Income and Expenses,” Part I, “Other.” Include an attachment detailing the sale and showing the calculation of your allowable basis for the timber sold, if any.

Disposal of Standing Timber With an Economic Interest Retained (Sec. 631 (b)). Timber cut under a contract that requires payment only at a specified rate for each unit of timber actually cut, rather than a lump-sum amount of money or other consideration agreed on in advance, is a disposal with an economic interest retained (timber lease) rather than a sale of timber. Section 631(b) is reprinted in the appendix, page 44.

Disposal with an economic interest retained can be described as a type of executory contract under which the cutting of

timber by the buyer obligates the buyer to purchase the logs cut at the unit price specified in the contract. This type of contract is sometimes referred to as a “pay as cut contract.” The term “economic interest” arises from the fact that although the contract must give the buyer the right to cut designated timber, the sale of a unit of timber does not occur until it has been cut. As such, the seller usually retains legal title (according to applicable State law) to the timber until it is cut and thus is at risk for any damage to or loss of the standing timber. Sales of timber with provision merely for installment payments falling due, whether or not the timber is cut, do not satisfy the requirements for retention of an economic interest. Advance payments do not disqualify a transaction. However, if required, the contract must clearly specify that, on completion of the cutting, adjustments in favor of the buyer or seller, as the case may require, must be made in order that the total amount paid under the contract is determined by the volume of timber actually cut multiplied by the specified unit price.

Scaling of logs cut from the contracted timber is the usual but not the only method acceptable for determining the volume of timber disposed of with an economic interest retained. An alternative is to determine the volume of timber cut by “cruising” the contracted timber before and after cutting. The amount actually disposed of is the difference between the cruised volume before and after cutting. (Rev. Rul. 78-104, see appendix page 66.)

Two important advantages are offered by Section 631 (b). First the gain realized from a Section 631(b) transaction is reported as a capital gain regardless of whether the timber is held primarily for sale, even if you are a dealer or speculator in timber.

A second advantage is that timber qualifying under the section is Section 1231 property, which entitles you to capital gains treatment when aggregate gains exceed aggregate losses from dispositions of such property. The other kinds of property included under Section 1231 are listed in the appendix, page 44. The Section 1231 gains and losses are reported on Form 4797. If you add up all of these gains and losses and a net gain results, treat it as a net long-term capital gain. Transfer this net gain from Form 4797 to Schedule D (Form 1040), Part II, and combine it with any other long-term capital gains and losses for the year. But if the summation of Section 1231 gains and losses results in a net loss, treat it as an ordinary loss. This means it is fully deductible from ordinary income in the current year. Transfer the net loss to Part II of Form 4797 and combine it with any other ordinary gains and losses for the tax year. (See Publication 544, “Sales and Other Dispositions of Assets.”)

How to qualify under Section 631 (b) of the Internal Revenue Code.

1. You must not be paid unless the timber is cut and your payments must be based strictly on the volume cut, not on a total volume or total amount agreed upon before the cutting. The retention of a security interest like a mortgage, or the retention of certain partial rights to the trees, is not retention of an economic interest for purposes of Section 631(b) of the Internal Revenue Code.

2. The purchaser must have, during the term of the contract, the right to cut and use the timber to the exclusion of all others. Thus, a contract under which someone cuts trees for you at so much per unit and sells the logs or other products at your discretion would not qualify.

3. You must have held the timber for more than 1 year as of the date of disposal.

Three provisions require detailed explanation. These relate to the definition of "owner," "timber," and "date of disposal" for purposes of Section 631(b).

Owner for the purpose of qualifying under the provisions of Section 631(b) is broadly defined to include any person, including a sublessor, and the holder of a contract to cut timber. To qualify as an owner you must also have an "interest" in the timber. An interest in timber results from an investment in and possession of the right to cut timber for sale on your own account or for use in your trade or business. An operator who simply provides a logging service does not qualify.

Timber for purposes of qualifying under the provisions of Section 631(b) includes the parts of standing trees usable or used for lumber, pulpwood, veneer, poles, pilings, crossties, and other wood products. Also included are evergreen trees that are more than 6 years old when severed from their roots and which are sold for ornamental purposes, such as Christmas trees. The provisions do not apply to evergreen trees sold in a live state whether or not for ornamental purposes. Tops and other parts of standing trees likewise are not considered as timber or evergreen trees. The term evergreen is used in the commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

This definition of timber applies for all income tax purposes.

Date of disposal is the date the timber is cut. However, it is not usually practical to measure the quantity of timber in the woods as it is cut. So, timber is considered "cut" when in the ordinary course of business the quantity of timber felled is first definitely determined. The date of disposal, therefore, would be the time when, in accordance with common and consistent practice, the quantity of felled timber is first determined whether at a log landing, dump, wood yard, or after the follow-up timber cruise is completed.

This definition of cut could help you in determining whether your sale under a cutting contract qualifies under Section 631(b), since you may not have owned the timber more than 1 year when it was felled, but you may have owned it more than 1 year when the quantity was actually determined in accordance with common and consistent practice. You may not shift the scaling point to obtain a tax advantage.

Date payments are received may be treated as the date of disposal. You may elect to treat the date of payment as the date of disposal if one or more payments under the contract are made before cutting. To do this, you must attach to your return for the taxable year in which the payment is received a statement saying you are making the election. However, if you make the election but have not held the timber for more than 1 year before the date of payment, the provisions of Section

631(b) do not apply to any payments received before more than 1 year has elapsed. Further, if advance payments were included on your return as amounts realized from the sale of timber, and the cutting right expires, is terminated, or is abandoned before the timber paid for is cut, you must refigure your income and file an amended return. Such payments are then treated as ordinary income, not as income received from the disposal of timber under a cutting contract.

How to report your gain or loss from a disposal of timber with an economic interest retained. Three steps are involved. First, determine the amount of the gain or loss; second, group the gain or loss with certain other gains and losses that you may have sustained during the tax year and that are reported on Form 4797 as Section 1231 gains and losses; and third, if the result of the grouping of Section 1231 gains and losses results in a net gain, the gain is carried over to Schedule D (Form 1040).

You determine the gain or loss by subtracting from the total payments received during the tax year, the sum of your allowable basis in the timber cut and the expenses of sale (Rev. Rul. 71-334, see appendix, page 61). Report this information in Part I of Form 4797.

Cutting of Standing Timber With Election to Treat as a Sale (Sec. 631(a)). When standing timber is cut by the owner and the logs or other timber products are sold, the proceeds represent (1) the value added to the standing timber by converting it into products, and (2) the gain from holding the standing timber. Any profit realized from converting the standing timber is ordinary income; so, the proceeds from the sale of the converted products are not capital gains. However, Section 631(a) allows you to cut timber for sale or for use in your trade or business and to receive capital gains treatment just as if you had sold the standing timber outright, instead of converting it yourself. Section 631(a) is reprinted in the appendix, page 43.

Reporting the Gain or Loss. Under the provisions of Section 631(a), if you cut timber that you owned or had a contract right to cut for more than 1 year and such timber was cut for sale or for use in your business, and you elect to use Section 631(a), report your gain or loss from the cutting and sale of cut products in two parts, as follows:

1. *Report as long-term capital gains* the difference between the adjusted basis for depletion of the standing timber cut during the tax year and its fair market value on the first day of the tax year in which it was cut. This same fair market value is treated as the cost of timber for inventory and cost of goods sold.
2. *Report as ordinary gain or loss* the profit or loss resulting from the conversion of the standing timber into products, such as sawlogs or pulpwood. Determine the profit or loss as you would for any other business operation. Reduce the income received from the sale of the products by the cost of converting the timber and the cost of the timber itself. The cost of timber used is the fair market value of the timber cut, as of the first day of the tax year in which the timber was cut.

Six aspects of Section 631(a) require explanation, namely, the meaning of owner, timber, timber use, holding period, fair market value, and how the election to use Section 631(a) is made.

Owner for purposes of Section 631(a) is any taxpayer who has owned or has held a contract right to cut timber for more than 1 year. In order to have a contract right to cut timber, you must have the unrestricted right to sell the timber cut under the contract or to use such cut timber in your trade or business (Rev. Rul. 58-295, see appendix, page 56). This means that if you were, for example, a sawmill operator and bought timber under a cutting contract, you would be the owner of that timber just as if you had outright title to the timber or the land and timber together.

If, however, you have only a contract to cut timber and must deliver the logs, pulpwood, or other products back to the owner or to a buyer specified by the owner, you are merely performing a logging service and do not qualify as an owner or holder of a contract right to cut timber. A logging service contract so worded that the terms "buy" and "sell" or "stumpage charge" appear will not overcome this requirement.

Timber for the purposes of Section 631(a) is defined in the same terms as under Section 631(b).

The timber must be cut for sale or for use in your trade or business, not for personal use. This includes timber cut and sold as logs, pulpwood, pilings, fuel wood, etc., or cut and used in your conversion business, such as sawmilling or other wood processing operation. "Timber cut by the taxpayer" includes what you cut personally as well as what is cut by persons you pay to cut it for you.

Holding period requirement is more than 1 year. The more-than-1-year holding period needed to qualify under Section 631(a) runs from the date you acquired the timber or the contract right to cut the timber to the date the timber is cut. As explained on page 20, timber is considered cut when, in the ordinary course of business, the quantity felled is first definitely determined.

The fair market value used as the sales price is the price at which the standing timber that was cut would have changed hands between a buyer and a seller on the first day of the tax year in which the timber was cut, assuming that both the buyer and seller had reasonable knowledge of all the necessary facts, and neither was required to buy or sell. In the case of a calendar year taxpayer the valuation date is January 1. The timber must be valued as it existed on the first day of the tax year regardless of any changes that have occurred to the timber between that date and the actual cutting.

The best indicators of fair market value are the prices paid for actual sales of similar timber in the area in which the timber being valued was located. However, you must adjust such prices to account for any difference between the condition of and market for the timber being valued, as compared to the timber for which actual prices are known. If you have cut a relatively small amount of timber during the year, you may be able to obtain price information by contacting mill operators and timber buyers in your area. If you have cut a large

amount of timber, you should perhaps obtain one or more appraisals by qualified timber appraisers. Consulting foresters are available in most areas. Many timber buyers will also appraise timber for a fee. Public foresters are also available, but in most States they are not permitted to provide timber appraisal service to the public.

The fair market value used must be for the actual timber cut. If an approximate price per thousand board feet, cord, or other unit, for similar stumpage in your area is used, you must adjust it to reflect the condition of the timber cut. Among the factors to be considered are the following:

1. The character and quality of the timber as determined by species, age, size, and condition;
2. The quantity of the timber per acre, the total quantity of timber under consideration, and its location with reference to available markets;
3. The accessibility of the timber from the standpoint of probable cost of cutting and transportation; and
4. The competition likely to develop from other buyers of stumpage.

The timber in each instance must be valued on its own merits and not on the basis of general averages for regions. The cost of the timber cut may be a valuable clue to its fair market value if it was purchased no more than 2 to 3 years prior to cutting. Actual prices paid in recent sales of similar timber should, however, provide the most reliable value evidence.

You elect to use 631(a) merely by computing your taxes according to the provisions of Section 631(a). Your election is indicated by completing lines 44 to 51 of Schedule F (Form T). The election must be made on your original tax return for the year to which it applies, including extensions, and not on an amended return for that year.

Although the law lets you choose whether or not to use this provision, you will generally want to use it. A situation in which you might prefer not to make use of the election is if you need additional self-employment income to qualify for social security benefits (see p. 27).

An election under Section 631(a) is binding with respect to all eligible timber that you cut in the year of the election and all subsequent years. To discontinue it, you must get the consent of the Internal Revenue Service. This permission may be given only where there is a showing of undue hardship. If you discontinue it, however, consent to resume the practice must also be obtained from the Internal Revenue Service.

Reporting requirements under Section 631(a) are the same as for Section 1231 gains and losses in general and for any other income realized from a trade or business. Report the gain or loss on the standing timber on Form 4797 with other Section 1231 transactions for the year, as discussed on page 19. Report your profit or loss from the sale of the cut products on a business schedule, usually Schedule C (Form 1040). If you are a farmer, however, you may include proceeds from the sale of the cut products on Schedule F (Form 1040), as "Other"

farm income. List the associated cost of timber cut (fair market value used in computing gain or loss on the standing timber) and expenses of cutting and sale as "Other" farm expenses.

An attachment giving the details of the cutting and sale should be included with your tax return, as indicated in Schedule F (Form T). Be certain to include the details regarding the determination of the depletion basis used, if any, in calculating the net gain or loss on the standing timber. Also, include the information used to estimate the fair market value.

The following example demonstrates how to determine the two parts of the gain realized under a Section 631(a) election.

Example 9.—You file your tax return on a calendar year basis, and you cut 60 M bd. ft. of timber during 1981 from a tract purchased in 1965. Also in 1981, you sold, at the roadside next to the tract, the sawlogs produced. You received \$3,300 for the logs. The fair market value of the standing timber that you cut was \$30 per M bd. ft., or \$1,800, as of January 1, 1981. Your basis in the timber cut (determined as explained in "Determining the Amount of the Gain or Loss," page 11) was \$355.80. Your logging and skidding costs totaled \$1,080. Since you had owned the timber cut for more than 1 year, you elect to report the cutting under Section 631(a).

You determine the gain or loss on the cutting of the timber separately from the gain or loss from the sale of sawlogs, as follows:

Gain from cutting

Fair market value, as of 1-1-81, of timber cut during 1981	\$1,800.00
Less: Cost or other basis (allowable basis)	355.80
Section 1231 gain	\$1,444.20

Gain from sale of sawlogs at roadside

Proceeds from sale of sawlogs	\$3,300.00
Less: Fair market value, as of 1-1-81, of timber cut and sold during 1981 (depletion allowance)	\$1,800
Logging costs	1,080
Cost of logs sold	2,880.00
Ordinary income	\$ 420.00

You had a \$1,444.20 gain to report with any other Section 1231 gains or losses on Form 4797, Part I. You also have income of \$3,300 and expenses of \$2,880 to report on Schedule C (Form 1040), or Schedule F (Form 1040) if you are a farmer filing Schedule F (Form 1040). How to report Section 1231 gains and losses on Form 4797 was discussed on page 21.

Sales of Forest Products

Ordinary gain or loss results from the sale of products produced from timber. This is true not only for products derived from harvested trees, such as logs, lumber, pulpwood, poles, mine timbers, cross-ties, fence posts, fuelwood, and chips, but also for products derived from the trees as they stand, such as gum naval stores, maple sirup, fruits, nuts, bark, and Christmas greens. Gains from sales of trees for landscaping purposes, such as balled nursery stock, are also ordinary income.

Tree stumps from cutover land are sometimes an exception. If you make a lump-sum sale of tree stumps from cutover timberland acquired for investment, you may be entitled to treat gain from the sale as capital gain (Rev. Rul. 57-9, see appendix, page 56). You must sell all the stumps on the property. Repeated lump-sum sales from the same property do not qualify nor does the sale of stumps by the ton, even though all the stumps are sold. Capital gains treatment does not apply to gain from the sale of stumps by persons in the timber or stump business either as a buyer, seller, or processor. So, proceeds from the sale of tree stumps by timber operators after merchantable timber has been harvested are ordinary income.

Gain from the sale of limbs and tops left after logging is also ordinary income, even if the timber was subject to the election under Section 631(a) (Rev. Rul. 56-434, see appendix, page 55).

Agricultural Program Payments

Agricultural program payments granted before October 1, 1979, and those granted on or after this date may be treated differently.

Agricultural program payments granted before October 1, 1979, had to be reported as ordinary income in the year received (Rev. Rul. 76-6, see appendix, page 64). This included payments received under the Forestry Incentives Program (FIP) and other State or Federal Government cost-sharing programs for approved conservation practices, such as forest tree planting; thinning; cutting, girdling, or poisoning of cull trees or unwanted species; fencing to protect stands from livestock; and firebreak construction. You had to report the payments as ordinary income whether you received them in the form of cash, materials, or services.

You treated payments as ordinary income even though, as in the case of tree planting and reforestation, the related expenditures were capitalized for eventual recovery through the depletion allowance when the planted trees became merchantable. The entire cost of the planting or reforestation had to be capitalized, even that portion for which you were reimbursed. This treatment also applied to fencing. If the expenditure qualified as a current deduction, the payments had to be reported as ordinary income and the full expenditure deducted, as discussed below.

Naval Stores Conservation Program payments also had to be reported as ordinary income.

If you filed Schedule F (Form 1040), "Farm Income and Expenses," you reported the payments as farm income, on the line for "Agricultural program payments," in two parts: payments received in cash and those received in the form of materials and services. If you did not file Schedule F, you entered payments on the Form 1040 line for "Other" income.

Agricultural program payments granted after September 30, 1979, and meeting the requirements contained in the regulations may be excluded from gross income (IRS Sec. 126, see appendix, page 42). But you may elect not to have this exclusion apply and thereby include the payments as ordinary income in the year received. If you elect not to exclude the payments, the rules for payments granted before October 1, 1979, apply. Payments excluded may be subject to recapture as ordinary income when you realize capital gains from the sale of the property improved by the payments. Excluded payments would be recaptured in full if the property were disposed of within 10 years (IRC Sec. 1255, see appendix, page 46). The proportion subject to recapture declines 10 percent per year for each year the property is held beyond 10 years. After 20 years, therefore, no portion is subject to recapture.

You may not exclude payments received for practices whose cost is deductible, such as timber stand improvement (TSI). Instead, report the payments as income and deduct the full cost of the practice.

If part or all of your timber is destroyed or stolen, or if your forest land is condemned for public use, you may be entitled to claim a deduction on your income tax return. To do this, you need to know what kinds of losses are deductible, why you hold the timber, how to determine the amount of loss recognized for tax purposes, and how to determine the type of deduction—capital or ordinary. If, because of insurance recovery or other compensation, the destruction, theft, or condemnation results in a gain, you must include the gain in your income, unless you elect to postpone reporting such gain, as explained in "Gains From Involuntary Exchanges," page 26.

To be allowed as a deduction, a loss must be evidenced by closed and completed transactions fixed by identifiable events and must actually have been sustained during the taxable year. Physical losses of timber will generally come under the heading of casualties, that is, losses caused by natural or other external forces acting in a sudden, unexpected, or unusual manner. Casualty losses include those resulting from fire, hurricane or other windstorm, sleetstorm, and hail. Casualty losses also include destruction or damage from plane crashes, automobile accidents, and similar events.

Losses resulting from theft, sometimes referred to as "timber trespass," and condemnation of property for public use, are treated similarly to casualty losses.

Disease or insect infestation leading to the death of trees held as timber does not ordinarily result in a casualty loss. Losses resulting from a low level of pest incidence, usually present under normal conditions, are not deductible. Also not deductible are indirect losses such as reduced timber growth rates after physical damage, site deterioration, or loss of prospective earnings (Rev. Rul. 73-51, see appendix, page 62). The same is true of other minor losses.

Combinations of factors sometimes cause timber damage. A nondestructive fire may be followed by insect attacks. Trees weakened by interior rot or characterized by shallow root systems may be uprooted or broken off as a result of repeated windstorms, or may die as a result of drought. If possible, you should salvage the affected timber. When losses of this character are heavy but the timber is not salvageable, adjust the timber accounts to reflect the loss of timber volume as an adjustment against annual growth in computing the depletion unit.

Determining the Amount of Deductible Loss

Casualty Losses. If timber held for use in your business or for the production of income as an investment is destroyed by fire or other casualty, your deductible loss is the allowable basis in the timber destroyed less any insurance or other compensation received (Rev. Rul. 66-9, see appendix, page 58). Timber damaged but not made unmerchantable should be salvaged and is not included in a loss due to casualty. Determine your

gain or loss upon cutting, sale, or other disposal as you would for timber sales in general.

Figure the basis of timber destroyed as you would for a sale or other disposition, as discussed in "Determining the Amount of Gain or Loss," page 11. First, determine the depletion unit by dividing the adjusted basis for depletion as shown in your timber account, by the quantity of merchantable timber in the account. Then, multiply the depletion unit by the number of units destroyed to find the amount allowable as a loss.

The quantity of timber destroyed must be established by fair and reasonable measurement to justify a deduction. You may wish to employ a consulting forester to cruise the timber if the area is extensive and much work is involved. In some cases, however, the local public forester, or other representative of the State forestry department can furnish you with an estimate of the quantity destroyed.

The year of deduction for a loss arising from a casualty is generally the year in which the casualty occurs. This is true even if you have not settled or received already agreed upon insurance or other compensation. If a claim for reimbursement has been made, and you think you will recover all or part of the loss, reduce the loss for the year of the casualty by the amount you expect to recover, even though you do not receive payment until a subsequent year. If you later recover less than the amount you estimated, you may deduct the difference for the year in which you become certain that no more reimbursement or recovery can be expected (see example 10).

Example 10.—Timber that you owned was destroyed by fire in 1980. The allowable basis of the timber destroyed was \$800 and you expected to recover \$600 of the loss from fire insurance on the timber. Even though the insurance company does not make payment to you in 1980, your loss for 1980 is limited to \$200, the difference between the loss and the amount you expect to recover. In 1981, the company offers to settle the claim for \$500, and you accept. The \$100 difference between the amount you expected and what you actually received may be claimed as a casualty loss on your return for 1981.

Report as income any reimbursement for more than the amount expected. If, after you have claimed a deduction for a loss, you receive reimbursement for more than you estimated would be recovered (but not more than the total amount of the loss computed), you must include such excess in income on your return for the year received. Do not file an amended return for the year in which you claimed the deduction (see example 11).

Example 11.—Timber that you owned was destroyed by fire in 1980. For tax purposes, your loss from the casualty was \$1,000 and you estimated that insurance would cover \$750 of the loss. You therefore claimed a loss of \$250 on your 1980 return. In 1981 the insurance company pays you \$850, or \$100 more than you estimated in computing your deductible loss for 1980. The \$100 difference is included as income on your return for 1981.

Destruction of unmerchantable timber may provide a deductible loss. This applies both to plantations or young growth resulting from natural regeneration. You can claim a loss only if (1) you maintain separate plantation or young growth accounts, as explained in "Timber (Depletion) Account," page 4, (2) you have costs allocated to such accounts, and (3) the destruction is due to casualty (Rev. Rul. 81-2, see appendix, page 70). If these requirements are satisfied, figure your allowable basis for the unmerchantable timber destroyed by dividing the cost shown in the account by the number of acres in plantation or young growth, and then by multiplying that amount by the number of acres destroyed.

Buildings and equipment used in timber operations may be partially or totally destroyed by casualty. If property used in your business or held for the production of income is totally destroyed, your deductible casualty loss is the adjusted basis of the property destroyed, less salvage value and less any insurance or other compensation received or expected to be received (see example 12). If such property is only partially destroyed, your deductible loss is limited to whichever is less—either your adjusted basis reduced by any compensation you receive, or the decrease in the fair market value of the property reduced by any compensation (see example 13).

Example 12.—Your sawmill was completely destroyed by a fire and you carried no insurance on the property. The adjusted basis for depreciation of the sawmill building and equipment at the time of the fire was \$6,500. The value of the equipment after the fire was only scrap value, amounting to \$300. Your deductible casualty loss is \$6,200, the adjusted basis of \$6,500 less salvage value of \$300.

Example 13.—Assume that the sawmill in example 12 was damaged by the fire but not completely destroyed. Just before the fire the sawmill had a fair market value of \$7,650 and immediately after the fire its fair market value was \$3,500. Under these facts, your loss is limited to \$4,150, the decrease in the fair market value since this amount is less than the adjusted basis of \$6,500.

Had the fair market value of the sawmill been \$8,000 just before the fire and \$200 just afterward, the decrease in fair market value would be \$7,800 and your deductible casualty loss would be limited to your adjusted basis in the property, \$6,500.

Determining the decrease in fair market value resulting from a casualty is sometimes difficult. Your cost of restoring and cleaning up after the casualty may be acceptable as evidence of the decrease in the value of the property if (1) such costs are necessary to restore the property to its precasualty condition, (2) the amount spent for restoration is not excessive, (3) the expenses do no more than take care of the damage suffered, and (4) the value of the property after restoration is not more than its value before the casualty.

Theft Losses. Determine the amount of loss you can claim from a theft of timber, frequently referred to as "timber trespass," as you would for losses from casualty. If you hold your timber for the production of income, your deductible loss is the allowable basis of the timber stolen—that is, the depletion unit multiplied by the number of units stolen—less insurance or other recoverable amounts received.

Generally, you can only deduct theft losses in the year of discovery. So, the quantity of timber used in finding the depletion unit is the quantity at the time the theft is discovered. To establish a theft loss, you do not have to prove when the timber was stolen, only that the theft occurred and when you discovered it.

You must reduce the amount of theft loss by anticipated recovery. Such reduction is required even though you do not receive payment until sometime after the close of the tax year. Also, if you are reimbursed for more than you anticipated (but not more than the amount of the loss) when you estimated the amount of the deductible loss for a prior year, you include the excess as ordinary income on your return for the year you receive the excess.

Condemnations. Condemnation is the taking of private property for public use without the consent of the owner, but with payment of compensation. The tax consequences are the same if you sell property under threat of condemnation. So, if the public condemning authority tells you that it intends to acquire your property by negotiation or if necessary by condemnation, and you sell the property to the authority at a mutually agreed on price, treat the sale as if your property had actually been condemned and you were granted an award.

The computation of your gain or loss when your forest land is condemned or sold under the threat of condemnation will in all cases involve the land, but may or may not involve standing timber, depending on whether you are permitted to harvest such timber. Determine the basis of your timber as you would for an ordinary sale. Your land account should show the part of the original basis of the timber property allocated to land, exclusive of timber and any improvements (see page 4). The basis of the land condemned or sold under threat of condemnation is the proportion of the cost or other basis of that land as shown in the land account (see example 14).

Example 14.—You purchased a 50-acre timber tract and allocated \$200 per acre, or \$10,000, to the land account. A strip of land totaling 5 acres and running through the timber tract was condemned for use in building a new highway. The basis of the land (exclusive of timber) to be used

In computing the gain or loss on the condemnation is 5/50ths of \$10,000, or \$1,000.

The allowable basis for figuring gain or loss on timber is your depletion unit multiplied by the number of units standing on the property condemned. If, however, the condemning authority allows you to harvest the timber before the land is taken over, and you sell the timber, or cut and sell the logs or other products, only the land would be involved in the computation.

Condemnation of property for public use can raise many specialized questions. For example, besides receiving an award for your condemned property, you might also receive severance damages or consequential damages resulting from a decrease in value or damage to that part of your property not condemned. A condemnation might also result in a special assessment being charged to you because of resulting improvements to your property. For a detailed explanation of the treatment of these special problems, see Publication 549, "Condemnations of Private Property for Public Use."

Gains From Involuntary Exchanges

An involuntary exchange occurs when your property is completely or partially destroyed, stolen, requisitioned, condemned for public use, or disposed of under the threat or imminence of condemnation and you receive insurance or a condemnation award. Involuntary exchanges are also called involuntary conversions. If you have a gain resulting from an involuntary exchange, you may elect to postpone paying tax on all or part of the gain even though the involuntary exchange may not necessarily qualify as a casualty. This occurs, for example, when damages are awarded by court order, or when parties who have damaged your property make a voluntary settlement. An example would be a settlement made by an operator working in property next to yours, who inadvertently removes timber from your side of the property line.

Determine gain or loss on involuntary conversions as you would for other dispositions (see page 11). An exception exists in the case of a casualty or theft. Your loss is determined as discussed on page 24.

You realize a gain from an involuntary conversion if the insurance, condemnation award, or other compensation that you receive is greater than your basis in the property. Ordinarily, you would include the gain on an involuntary conversion in your income for the year it is realized. However, under certain condi-

tions you may defer the gain or a portion of the gain until you sell the replacement property you bought with the proceeds.

Gain is not taxed if the following conditions are met. You purchase as replacement for the property destroyed, stolen, or condemned either property that is similar or related in service or use to the property converted, or the controlling interest in a corporation owning such property, at a cost that equals or exceeds the amount you received as compensation. The replacement must be made within 2 years if you held the property for personal use, or 3 years if you held it for use in a business or as an investment for the production of income. The replacement period starts after the close of the tax year in which you first realize any portion of the gain. If you elect to defer reporting the gain, you must file a statement with your tax return stating that the election is being made and including all the pertinent information concerning the conversion and the replacement property. If you make the election but do not spend all of your gain on replacement property, the balance is reported as a Section 1231 gain, as discussed on page 19.

For more information, see Publication 547, "Tax Information on Disasters, Casualties, and Thefts," and Publication 549, "Condemnations of Private Property for Public Use."

You may defer gains from selling timber downed by high winds, earthquake, or volcanic eruption if you use the proceeds to purchase other standing timber (Rev. Rul. 80-175, see appendix, page 69). The purchase of other standing timber includes the purchase of replacement timber sites, seeds and seedlings, and what it costs you to plant the trees on currently owned or replacement timber sites. The tax otherwise due is deferred under the provisions of Section 1033(a)(2)(A) of the Internal Revenue Code. See "Postponement of Gain," in Publication 547, "Tax Information on Disasters, Casualties, and Thefts."

Reporting Gains and Losses From Casualties, Thefts, and Condemnations

Report casualties and thefts on Form 4684, "Casualties and Thefts." This form includes instructions on how to summarize the transactions and where to report the results.

Do not include condemnation gains in taxable income if you elect to defer tax on the gain by acquiring replacement property, as discussed above. If you do not make the election or if it is not available to you, the gains or losses are reported as Section 1231 transactions of Form 4797.

Self-Employment Social Security Tax

The self-employment tax is imposed on individuals engaged in a trade or business as a sole proprietor or partnership, for the purpose of providing them with social security coverage. If your income from timber operations is considered received in the course of a trade or business, it may be subject to the self-employment tax even though your timber transactions are infrequent and you are primarily engaged in some other business, trade, or profession. For example, a farmer whose property includes a tract of timber, or a person employed in the city and owning a tract of timber outside the city, who occasionally cuts and sells timber for firewood, may be liable for self-employment tax on the income received.

Gains that qualify for capital gains treatment are not subject to self-employment tax. This will be the case if your timber is not used in a business and you either sell it on the stump or dispose of it under the provisions of Section 631(b) (see page 19). If you cut timber and elect to treat the cutting as a sale under Section 631(a) (see page 20), any profit made on the sale of the cut products may be subject to the self-employment tax.

Standing timber sold for a lump sum is regarded as a capital asset unless held for sale to customers in the ordinary course of a trade or business. Gains from such sales would be subject to the self-employment tax only if you are a dealer or you make repeated sales. Under these circumstances the timber is not classified as a capital asset and therefore does not qualify for capital gains treatment when sold for a lump sum.

Christmas tree growers may be subject to the self-employment tax on any ordinary income received from the sale of trees. Christmas trees may qualify as timber, as discussed on page 28, and result in capital gains under the conditions discussed for timber in general.

Forest products produce ordinary income when sold. Receipts from these sources are therefore subject to the self-employment tax.

Agricultural conservation program payments, such as those received under the Forestry Incentive Program (FIP), are subject to the self-employment tax, unless such payments qualify for exclusion from income (Rev. Rul. 60-32, 1960-1 C.B. 23). As discussed on page 23, payments received after September 30, 1979, may be excluded from income.

How to calculate self-employment tax. Use Schedule SE (Form 1040), "Computation of Social Security Self-Employment Tax." The maximum amount subject to social security tax (FICA) during the 1981 tax year is \$29,700. The maximum will increase to \$32,400 for 1982. This maximum includes both self-employment earnings subject to the tax and wages subject to social security withholdings. If you work for wages subject to withholdings that equal or exceed the

maximum amount subject to social security and also have income from a trade or business, you do not pay self-employment tax on your earnings from the trade or business. However, if you work for wages subject to withholding which total less than the maximum amount, and also have income from timber operations subject to the self-employment tax, your gains from timber operations will be taxed to the extent of the difference between your wages and the maximum.

You may want all or part of your timber gains taxed. Qualification for social security benefits depends in part on how much social security tax you have paid. If you are not certain that you will qualify for full benefits on retirement, you should check on your status by contacting the Social Security Administration Office listed in your phone book under "United States Government, Social Security Administration." If you need to make additional contributions you may prefer not to make an election under Section 631(a) to treat the cutting of timber as a sale. If you are a farmer who cuts and sells timber, you may, for the sake of obtaining benefits, decide not to make the election. If so, include your timber income and expenses, and the basis of the timber sold, as farm income and expenses on Schedule F (Form 1040). Such income would be subject to self-employment tax and would be reported on Schedule SE (Form 1040). Remember, however, that if this election has been made in prior years, you may not forego the election in any following year without the permission of the Commissioner of Internal Revenue.

For more information on this subject, see Publication 533, "Self-Employment Tax." If you are a farmer, refer to Publication 225, "Farmer's Tax Guide."

Minimum Tax

If you report timber income as long-term capital gain you may be required to figure your tax liability two ways. Your tax liability determined by the normal procedure should be compared with that determined under the provisions of the alternative minimum tax (Form 6251) for noncorporate taxpayers, and if the latter is greater, it applies. In general, the alternative minimum tax will apply only if your long-term capital gains or excess itemized deductions are very large in relation to your ordinary income, or if credits reduce your regular income tax. You must calculate the tax both ways to make this determination, however.

Add-on minimum tax does not apply to long-term capital gains received after December 31, 1978 (Form 4625). The capital gains deduction, the portion not taxed, is no longer included as an item of tax preference subject to this additional tax. Corporate long-term capital gains are subject to the add-on minimum tax, however.

Depletion allowance for timber you cut and the allowable basis for timber you sell are not subject to the minimum tax. The reference to "excess depletion" in discussions of the items in-

cluded as tax preferences subject to the add-on minimum tax applies only to percentage depletion. Under the rules of cost depletion, which apply to timber, it is not possible to deplete your timber account below the adjusted basis; therefore, it is not possible to realize "excess depletion" from timber.

Christmas Tree Production

Most Christmas tree producers are subject to the same provisions as timber owners in general. The Regulations provide that for purposes of Section 631 of the Code, the term "timber" includes evergreen trees that are more than 6 years old at the time severed from their roots and sold for ornamental purposes, such as Christmas decorations (see page 49).

Christmas tree growing generally constitutes a trade or business. As such, capital gains treatment depends on qualifying for treatment under Section 631(a) if you cut the trees yourself, or Section 631(b) if you sell the trees on the stump. The rules are the same as for any other timber.

"Choose and cut" sales may not qualify the proceeds for capital gains treatment (Rev. Rul. 77-229, see appendix, page 65). In a typical situation, the grower lends a handsaw to the customer who, after cutting a chosen tree, returns the saw, pays for the tree at the agreed price, loads the tree into his car, and leaves the farm. Under these circumstances the grower retains all rights and interest in the standing timber. Consequently, the customer never acquires title to the tree, an economic interest in it, or a contract right to cut it. By the act of cutting a tree, the customer acquires both the right and the obligation to purchase the cut tree. The grower is therefore selling cut Christmas trees, not standing timber. An election under Section 631(a) is required to receive capital gains treatment in this situation. Reporting proceeds under Section 631(a) is discussed for timber owners generally on page 20. These requirements include determination of the fair market value of the trees cut during the year. This value must be determined as of the first day of the taxable year in which the timber is cut. For growers reporting on a calendar year basis, this date would be January 1. For calendar year taxpayers, fair market value is generally determined by the condition of the trees at the time they are cut and prevailing market prices during the previous cutting season. However, to convert this value to one as of the first day of the taxable year you must discount for the time element, the risks borne during the growing season, and the lump-sum purchase factor.

A recognized method of pricing Christmas trees, both in the wholesale and retail market, makes use of the "value per foot of height," as demonstrated in the following examples.

Example 15.—You needed to determine January 1, 1980, stumpage value for trees cut in November 1980. You compared the trees you cut in November 1980 with those of growers who had sold similar trees to independent jobber-cutters in November 1979. You estimated that an independent jobber-cutter would have paid \$0.60 per foot at the plantation and would have received \$0.70 per foot delivered to the wholesaler. The jobber-cutter's net return for buying, cutting, and delivering the trees, including profit,

would be \$0.10 per foot. If the trees averaged 6 feet in height, the jobber would have received \$4.20 per tree for which he or she had paid the owner \$3.60.

The trees you cut in November 1980 were 6 feet in height. The value per tree would be 6 times \$0.60 per foot, \$3.60. You determined the value of the trees on January 1, 1980, by discounting this value for 10 months. Use the interest rate charged by the Federal Land Bank for the Federal Land Bank District in which the plantation is located. The formula you would use is

$$\frac{\text{Value}}{(1.0 + (i/12))^{10}} = \frac{\$3.60}{(1.0 + (0.10/12))^{10}} = \$3.31$$

The application of 631(a) is demonstrated in example 16.

Example 16.—You are a calendar year taxpayer, and you established five Christmas tree plantations in 5 successive years, each comprising 10 acres and each containing 12,000 trees of fast growing pine species. Two-year-old nursery stock was used, so the trees in the first plantation are now above the minimum age (more than 6 years) required to qualify as timber under Section 631(a) of the Internal Revenue Code.

You spent \$1,210 to establish the first plantation. Later, you incurred \$1,060 as capital costs, representing (a) certain carrying charges you had elected to capitalize; and (b) the cost of replanting lost trees. The adjusted basis just before the first cutting in November of 1980 thus amounted to \$2,270. An inventory showed that there were now 11,000 well-formed trees present. Of these, 6,000 were of sizes to be cut this year and 5,000 to be left for further growth. A depletion unit of \$0.21 per tree was derived by dividing the \$2,270 adjusted basis for gain or loss by 11,000 trees.

You cut the 6,000 salable trees yourself and delivered them to a wholesaler. You received \$4.30 per tree from the wholesaler. The total cost to you for cutting and delivering the trees was \$1,800.

You elect on your 1980 tax return to treat the cutting of the trees as a sale under Section 631(a) of the Internal Revenue Code. So you had to find the January 1, 1980, value of the 6,000 trees cut and sold in November 1980. You determine the value of the trees on the stump as shown in example 15.

You determine your taxable gain as follows:

Gain from cutting

6,000 trees cut with a fair market value of	
\$3.31 per tree.....	\$19,860
Less:	
Basis for gain or loss at \$0.21 per tree.....	(1,260)
Gain on timber (taxed as Section 1231 gain)....	\$18,600

Gain on sale of trees

6,000 trees sold for \$4.30 per tree.....	\$25,800
Less:	
Depletion allowance (Jan. 1 fair market value of \$3.31 per tree)	\$19,860
Cost of cutting and delivering	1,800 (21,660)
Gain from harvesting and delivering (taxed as ordinary income).....	\$4,140

If you had not harvested the trees but had entered into a cutting contract with a jobber, you would calculate the gain as follows,

6,000 trees sold for \$3.60 per tree.....	\$21,600
Less:	
Basis for gain or loss at \$0.21 per tree	\$ 1,260
Expenses for administering cutting contract.....	120 (1,380)
Income.....	\$20,220

If the cutting contract qualified as a disposal with an economic interest retained under the provisions of Section 631(b) of the Internal Revenue Code, the \$20,220 would be reported as a Section 1231 gain. Otherwise this amount would be reported as ordinary income.

If you sell Christmas trees and are a calendar year taxpayer, you can simplify your 631(a) calculation by changing to a fiscal tax year. If the tax year were to start on November 1 and end on October 31, the November fair market value of the trees would be used to determine the gain on the timber. However, you may need to obtain the permission of the Internal Revenue Service to change tax years, as explained in Publication 334, Chapter 3.

Costs of shearing and basal pruning Christmas trees are deductible business expenses (Rev. Rul. 71-228, see appendix, page 61). This only applies, however, if the trees were originally planted and grown as Christmas trees, rather than trees which were regenerated naturally and are being converted to Christmas trees, or planted for reforestation and are being converted to Christmas trees.

Basis. In general, the amount paid for property, including expenditures made in connection with the purchase, is the basis of the property. The basis of property acquired by other means is determined by the manner of acquisition (for determining the basis of property acquired by inheritance or gift, see page 3).

Adjusted.—The original basis less any reductions made because of depreciation, depletion, amortization, or losses claimed, plus any additions made by capitalization of improvements, carrying charges, or additions to the asset.

Stepped-up.—Assets acquired by inheritance take as their basis the fair market value of the asset on the deceased's date of death or on the alternate valuation date. This value is generally greater than the basis of the asset in the hands of the deceased. The basis is therefore stepped-up (increased) in passing from the deceased to the person inheriting it.

Board Foot (bd. ft.). The standard of measure for certain trees, logs, and other products cut therefrom. The unit is 1 foot square and 1 inch thick. Tables based on various "log rules" are used to convert tree and log lengths and diameters into board foot volumes.

Capital Account. An account used to keep track of the basis and quantity of such assets as land, timber, buildings, and equipment.

Capital Gain or Loss. Generally, the gain or loss realized on the sale or exchange of capital assets such as land, timber, buildings, and equipment. Income received in this manner is treated differently for tax purposes than income received in the form of wages or salary, or the profit realized from the operation of a business.

Capitalize. The process of adding the amount paid for property and additional qualifying expenditures to a capital account. The capitalized amount is recoverable through depreciation, depletion, amortization, or sale or exchange of property.

Carrying Charge. Expenditures made to carry an asset, that is, maintain possession.

Casualty. An identifiable event of a sudden, unexpected, or unusual nature. The complete or partial loss (destruction) of property resulting from a casualty is known as a casualty loss.

Code. Refers to the Internal Revenue Code of 1954, as amended. This is the written law as enacted by the U.S. Congress. Since the Code is general in nature, it is amplified or explained by Regulations issued by the Department of the Treasury, and Revenue Rulings of the Internal Revenue Service.

Conversion Cost. The cost of converting standing timber into a salable product, such as logs, lumber, and railroad ties. In the case of producing lumber, the costs include those incurred to cut down (fell) the trees, cut off the limbs, section the tree stem into logs (buck), move the logs to a point where they can be loaded on a truck (skid), transport the logs to a sawmill and saw the logs into lumber.

Cord. A unit of measure used in conjunction with timber to be converted into pulpwood, firewood, or other products that are not produced or measured in terms of board feet. A standard cord is a 4 × 4 × 8 foot stack of wood.

Cruise. The process by which the volume, type, and quality of timber within a designated area is determined. The cruise can be made by actually measuring the dimensions of each tree, referred to as a timber inventory. A cruise can also be made by measuring only those trees selected in a statistically based sampling scheme. If the timber within the designated area is uniform, the total volume within the area can be estimated to a predetermined level of accuracy by measuring the trees on a portion of the total area.

Depletion. The using up or wasting away of a natural resource. In the case of timber, it is the recovery of the owner's basis in timber which is cut by the owner and the logs cut from the timber are sold or used in the owner's business.

Average.—If all of the timber from more than one tract and of various grades and species is included in one timber account, the depletion unit, and therefore the depletion allowance or allowable basis, is an average of all the timber in the account.

Species or Value.—Under certain conditions it may be permissible to maintain separate timber depletion accounts for individual species, value, or product classes of timber from one or more tracts.

Depreciation. The process by which the basis of assets, such as equipment, buildings, and fences, is recovered as the assets are used for the production of income.

Disposal. Timber is disposed of when the owner cuts, sells, or exchanges timber. In the case of a timber lease to which Section 631(b) of the Code applies, timber is disposed of when it is cut or, at the option of the lessor, on the date of any advance payment.

Economic Interest. This concept was developed by the U.S. Supreme Court to determine which taxpayers in addition to the fee owner of property qualify for certain tax benefits. Section 631(b), discussed on page 19, requires that an economic interest be *retained*. An economic interest is retained in every

case in which the taxpayer has acquired by investment any interest in standing timber and secures, by any form of legal relationship, income derived from the severance of timber to which the taxpayer must look for a return of capital.

Executory Contract. A contract that specified the agreement reached between the contracting parties, but that does not become effective unless and until some specified event or action has occurred. A timber sale contract may, for example, specify that the timber is not sold under the contract until the buyer has cut the timber and determined the volume cut.

Expensing. Recovery of expenses by deducting in full in the year paid or incurred.

Fair Market Value. The price at which property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts.

Felled Timber. Trees which have been cut down (severed) and are lying on the ground.

Forester

Consulting.—Foresters for hire on a contract basis. They charge a daily fee plus expenses for certain types of services and provide other services on a fixed cost contract basis. Some charge a fixed percentage of the sale price to provide all or a portion of the services required in connection with timber sales.

Extension.—Foresters employed by the Cooperative Extension Service of the State. They are usually based at the State's land-grant university. Their primary function is to provide educational materials and related services. In some States they are available for a limited amount of on-the-ground assistance to individual landowners.

Industry.—Foresters employed by a timber growing and/or processing company. They frequently provide technical assistance in conjunction with timber purchased from private individual landowners. Many companies also have formal programs through which they make their foresters available to assist landowners in all aspects of timber management.

Service.—Also referred to as "District" or "State" foresters, they are employed by the State agency charged with responsibility for protecting the state's public and private forest lands. These foresters are available for a wide variety of services, although the amount of time they can devote to any one landowner is generally limited. They also approve and certify financial assistance to landowners under the Forestry Incentives and Agricultural Conservation Programs. Their services are usually free.

Girdling. The process of encircling the trunk of a tree with a cut that stops the flow of nutrients between leaves and roots, resulting in the death of the tree.

Income

Farm.—Income received from the sale of agricultural commodities such as grain, livestock, fruit, vegetables, dairy products, poultry, and fish.

Ordinary.—Income received in the form of wages, salary, rent, etc.

Capital.—See capital gain.

Involuntary Exchange. The exchange of an asset, for money or other property, when the exchange results from a cause beyond the control of the owner, such as a casualty, theft, or condemnation.

Lessee. The person to whom the lease is made. For example, the timber company in the case of a timberland owner who leases land to a timber company.

Lessor. The person granting the lease. For example, a timberland owner who leases to a timber company the right to cut and grow timber on the land.

Log Rule. A measuring formula that gives the relationship between the diameter and length of a log and the board foot volume of lumber which could be sawn from the log. It is assumed that the entire log is sawn into 1-inch thick boards. Several rules have been developed based on varying assumptions about the thickness of the saw and sawing practice used. Some of the standard rules are International $\frac{1}{4}$ inch, Scribner decimal C, and Doyle.

Marking. The process of designating the trees that are to be sold and cut. A common practice is to spray indelible paint on the tree at eye level and at ground level. This allows the buyer to identify the trees to be sold and the seller to determine that only marked trees were cut.

Proceeds. The total amount received from the disposition of an asset, either as payment in cash, notes or other securities, services in kind, or any other valuable consideration.

Regulations. The interpretations by the Department of the Treasury, of the Federal tax laws. They provide the official rules for applying the Code to the circumstances of specific taxpayers.

Revenue Rulings. The official interpretations by the Internal Revenue Service of the application of the Code and Regulations to specific circumstances that have general interest and applicability.

Scaling. The process of measuring the dimensions of individual logs or trees. The measurements are used to estimate the volume of the logs or trees by applying the dimensions to a log rule or tree volume table.

Severance Tax. A State excise tax levied on the cutting of timber. In most States in which the tax is levied, it is in addition to any property taxes levied or taxes in lieu of property taxes. Funds generated are often designated for specific forestry related purposes such as fire control, reforestation, and public forestry assistance.

Site Preparation. The preparation of land for the planting of tree seedlings or tree seed. The objectives include reduction of brush and other obstacles to allow planting equipment to operate, reduction of vegetation that would compete with young trees, scarification of the soil to provide a suitable seedbed, and any other action that may be required to alter the site to accommodate the new trees.

Stumpage. Standing timber or, more generally, those trees that have not been severed from their roots by cutting. Stumpage would therefore include trees that have been blown over or broken by wind or ice storms.

Sublessor. A lessee who leases a leasehold interest to a third party.

Transaction. An accounting term used to designate an action or event that leads to an entry in the books of account.

Yield Tax. A State tax due when income is realized from harvesting timber. It is usually levied in lieu of an ad valorem tax that would otherwise be due on the timber itself.

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Form **T** (Timber)
 (Rev. November 1981)
 Department of the Treasury
 Internal Revenue Service

Forest Industries Schedules

OMB No. 1545-0007

Expires 9-30-84

▶ Attach to your tax return.

Check form of organization: <input type="checkbox"/> Corporation <input type="checkbox"/> Partnership <input type="checkbox"/> Fiduciary <input type="checkbox"/> Individual	Name	Taxpayer identifying number For tax year ended
	Address (number and street)	
	City or town, State and ZIP code	

GENERAL INSTRUCTIONS

(References are to the Internal Revenue Code.)

Paperwork Reduction Act Notice

The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you have to give it to us. We ask for the information to carry out the Internal Revenue laws of the United States. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Who must complete Form T.—If you claim a deduction for depletion of timber, you must complete and attach Form T to your income tax return.

Generally, Form T must be filed when a taxpayer sells, cuts, or purchases standing timber or is involved with other timber transactions. In addition, taxpayers who elect on their income tax returns to claim gain or loss from cutting timber, as provided by section 631(a), must file Form T with their returns.

Complete this form in accordance with sections 611, 631, and 1231 and related regulations. If you need more space, attach separate sheets and number each answer so that we can identify it with the appropriate question on Form T.

Schedule A Maps

1. This schedule consists of a map (or maps) of your timber properties. Whether you file the maps with your income tax return is your option, but you must make them available on examination of your return. Maps of convenient size are desirable, varying in scale from approximately 4 inches to the mile in small tracts to 1/2 inch to the mile in tracts larger than 200,000 acres. The maps should show your name and the tax year

covered. Give standard map symbols in enough detail to show clearly the location of: (a) timber cutting contracts acquired separately from the land, (b) forest lands acquired, (c) areas where you cut timber, (d) timber cutting contracts sold or otherwise disposed of, (e) forest land sold or otherwise disposed of, and (f) forest land sold or otherwise disposed of with the timber cutting rights reserved to you or outstanding in third parties.

Schedule B Purchases

2. For the tax year, report acquisitions (such as purchases or exchanges, whether taxable or not) of timber, timber cutting contracts, or forest land. Report separately each single purchase totaling \$10,000 or more, giving month and year of purchase. You may combine purchases of less than \$10,000 for each timber or land account, and omit item 5 for combined small purchases. For a purchase or lease of timber cutting rights on a pay-as-cut basis, do not answer items 6 through 10. Instead,

give briefly the provisions of the purchase or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may report totals for small purchases on a pay-as-cut basis completed within the tax year. Follow the format of items 3 through 10 on additional sheets if you need more space.

3. Name of block and title of account

4. Location of property (by legal subdivisions, or map surveys)

5. (a) Seller's name and address

(b) Date of purchase

6. Amount paid: (a) in cash
 (b) in interest bearing notes
 (c) in non-interest bearing notes

7. (a) Amount paid in other considerations
 (b) Explanation of the nature of other considerations and how value given in 7(a) was determined ▶

8. (a) Legal expense
 (b) Cruising, surveying, and other acquisition expenses

9. Total cost of property (Add lines 6(a) through 8(b))

Schedule B Purchases (Continued)

10. Allocation of total cost on books:	Unit or kind	Number of units	Cost per unit	Total cost
(a) Forested land	Acre			
(b) Other unimproved land	Acre			
(c) Improved land (Describe) ▶	Acre			
(d) Timber (Estimated total quantity of timber present on the acquisition date. (See section 1.611-3(e) of the regulations.) Details of the timber estimate, made for purposes of the acquisition, should be available on examination of your return.)				
(e) Premerchantable timber (Make an allocation here only if it is a factor in the total cost or value of the land.)				
(f) Improvements (List separately)				
(g) Mineral rights				
(h) Total cost (same as line 9)				

Schedule C Profit or Loss from Land and Timber Sales

11. For the tax year, report all dispositions (such as by sale or exchange, whether taxable or tax free) of timber, timber cutting contracts, or forest land. Report separately each single sale involving a total consideration of \$10,000 or more. You may combine sales of less than \$10,000 for each timber or land account. You may omit item 14 for such combined small sales. For a sale or lease of timber cutting rights on a pay-as-cut basis, to be paid for at intervals during the cutting period according to the number of units cut, answer items 15, 19, and

20 for the tax year only. Instead of answering items 16, 17, and 18, give briefly the provisions of the sale or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may combine small sales on a pay-as-cut basis completed within the tax year. Follow the format of items 12 through 20 on additional sheets if you need more space.

12. Name of block and title of account

13. Location of property (by legal subdivisions or map surveys)

14. (a) Purchaser's name and address	(b) Date of sale
15. Amount received: (a) in cash	
(b) in interest bearing notes	
(c) in non-interest bearing notes	
16. Amount received in other considerations	
17. Explanation of the nature of other considerations and how you determined the value given in item 16 ▶	
18. Total amount received for property (Add lines 15 and 16)	

Schedule C Profit or Loss from Land and Timber Sales (Continued)

19. Adjusted basis (cost) in property on sale or exchange date:	Unit or kind	Number of units	Cost per unit	Total cost
(a) Forested land	Acre			
(b) Nonforested land	Acre			
(c) Improved land (Describe) ▶	Acre			
(d) Merchantable timber. (Estimated total quantity of merchantable timber present on sale or exchange date. Give a detailed estimate as made for sale or exchange purposes. Include the quantity of each species of timber by diameter (DBH) classes. Name the log rule or other units of measure used.)				
(e) Premerchantable timber				
(f) Improvements (List separately)				
(g) Mineral rights				
(h) Total adjusted basis				
(i) Direct sale expenses (cruising, marking, selling)				

20. Profit or loss (line 18 less lines 19(h) and 19(i))

Schedule D Losses

21. If you had losses during the tax year from fire, insects, wind, or other causes, and if you claimed the loss on your income tax return, show separately the proof of the loss for each timber account and complete lines 22 through 25.

22. Cause of loss

23. Location and area of land on which loss took place

24. (a) Total loss before any insurance recovery	
(b) Less amount received from insurance	
(c) Loss as claimed on tax return	

25. Explain in detail how total loss (line 24) was determined

Schedule E Reforestation and Timber Stand Improvement

26. This schedule summarizes your expenses for reforestation and timber stand improvement during the tax year. You should keep on file the detailed information necessary to support the costs reported in this schedule and make it available on examination of your return. The total in Schedule E includes such things as supplies, labor, overhead, transportation, tools, and depreciation on equipment.

Site Preparation.—Report all expenses incurred during the tax year for preparation of the land for planting or seeding (including natural seeding). Include expenses for clearing the land of brush and culling trees by burning, disking, chopping, KG blade, spraying with herbicides, or other measures taken to aid in the successful reforestation of the site. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Planting or Seeding.—Report your expenses incurred during the tax year for planting seedlings or sowing seed to reforest the land. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work. You must make detailed records available to the examining agent upon request, including separate costs for hand planting and machine planting or any other explanation of the kind of expenditures.

Precommercial Thinning or Fertilization.—Report all expenditures incurred during the tax year for precommercial thinning and fertilization. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Schedule F Capital Returnable through Depletion (Continued)

47. Section 631(a) requires that you determine as of the beginning of the tax year, the fair market value of the timber cut during the year, if you owned the timber or held a contract right to cut it for more than 12 months. List the value of the timber as it stood in the forest on the first day of the tax year. Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, stand per acre, size of the average tree, logging conditions, distance to markets, and the like.

cut over during the year, as they affect logging and transportation conditions. You may show this in accompanying maps.

(b) The location of the sawmill, log market, or other point of delivery of the logs or wood to the user or buyer.

(c) The total log scale or other units of timber cut, and the length and diameter of the average log or the average number of units per tree.

(d) The percentage of rough lumber grades, by species, produced from the timber manufactured during the year or, if the timber is sold in the log, the percentage of log grades, by species.

48. Give evidence in the form of actual sales of comparable timber as of the valuation date, along with other value evidence used. Include a computation showing the difference between the cost (excluding timber or stumpage cost) and value of the primary wood product (logs or other roundwood, chips, etc.) at the mill or plant. Give detailed evidence that permits a comparison with the timber on which you report a value.

51. Section 631(a) applies only to timber owned, or held under a contract right to cut for more than 12 months. In your records show the quantity of timber cut that you held for the required period. Show separately the quantity of timber cut that was not so held. Also, the scale of logs purchased during the year must be shown by species and quantity and excluded from the quantity shown as cut under section 631(a). Records must also show the number, cost, and point of delivery of purchased logs by species and grade.

49. For all purchases and sales of timber you make, and for all other transactions you report, furnish the relevant information called for by items 2 through 20.

50. Furnish the following additional information:

(a) The log transportation system used, such as truck roads, railroads, etc., and the main topographic features of the area

Schedule G Land Ownership

52. Show changes in land accounts as carried on your books. Attach as many additional sheets as you need, following the format of items 53 through 58.

53. Name of account ▶	Acres	Total cost or value. Give amount of March 1, 1913, appreciation, if included	Average rate per acre
54. Balance at beginning of year			
55. Purchases during year			
56. Sales during year			
57. Other changes			
58. Balance at end of year (Add lines 54 and 55, less lines 56 and 57) .			

Optional Schedules

59. If the supporting statements for Schedules H and I are too numerous to file with your return, you must retain this information and make it available on examination of your return. Include

separate cost accounts for construction by you and by the contractor.

Schedule H Road Construction Cost

60. Report under items 61 and 62 the expenditures incurred for road construction during the tax year. Report separately for

each depletion account, block, tract, or geographic area tributary to a mill or mill complex.

61. Roads constructed on lands owned in fee:			
(a) Miles constructed			
(b) Amount capitalized to non-depreciable account			
(c) Amount placed in depreciation account			
(d) Amount claimed as an ordinary expense			
(e) Total amount spent (Add lines 61(b), (c), and (d))			
(f) Amount reported as section 38 property			
62. Roads constructed for logging timber held under leases or cutting contracts having a term of 2 years or longer:			
(a) Miles constructed			
(b) Amount to be amortized			
(c) Amount claimed as an ordinary expense			
(d) Total amount spent (Add lines 62(b) and (c))			
(e) Amount reported as section 38 property			

Schedule I Drainage Structures

63. Report expenses incurred during the tax year for construction of water level control devices such as ditches and canals. List each kind of structure separately for each depletion account, block, tract, or geographic area tributary to a mill or mill complex:

- (a) Kind of structure ▶
- (b) Miles constructed
- (c) Purpose of structure ▶
- (d) Amount capitalized to non-depreciable account
- (e) Amount placed in depreciable or amortizable account
- (f) Amount reported as an ordinary expense
- (g) Total amount spent (Add lines 63(d), (e), and (f))

B. Internal Revenue Code of 1954 As Amended

Sec. 48. Definitions; Special Rules. (a) Section 38

Property.—

(1) *In general.*—Except as provided in this subsection, the term “section 38 property” means—

* * * * *

(F) in the case of qualified timber property (within the meaning of section 194(c)(1)), that portion of the basis of such property constituting the amortizable basis acquired during the taxable year (other than that portion of such amortizable basis attributable to property which otherwise qualifies as section 38 property) and taken into account under section 194 (after the application of section 194(b)(1)), or

* * * *

Such term includes only recovery property (within the meaning of section 168 without regard to any useful life) and any other property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more. The preceding sentence shall not apply to property described in subparagraph (F) and, for purposes of this subpart, the useful life of such property shall be treated as its normal growing period.

* * * * *

Sec. 126. Certain Cost-Sharing Payments. (a) General Rule.—Gross income does not include the excludable portion of payments received under—

(1) The rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act (33 U.S.C. 1288(j)).

(2) The rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977 (30 U.S.C. 1236).

(3) The water bank program authorized by the Water Bank Act (16 U.S.C. 1301 et seq.).

(4) The emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978.

(5) The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act (16 U.S.C. 590a).

(6) The great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act (16 U.S.C. 590p (b)).

(7) The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act (7 U.S.C. 1010; 16 U.S.C. 590a et seq.).

(8) The forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978 (16 U.S.C. 2103).

(9) Any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the Treasury or his delegate to be substantially similar to the type of programs described in paragraphs (1) through (8).

(10) Any program of a State, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

(b) *Excludable Portion.*—For purposes of this section—

(1) *In general.*—The term “excludable portion” means that portion (or all) of a payment made to any person under any program described in subsection (a) which—

(A) is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife, and

(B) is determined by the Secretary of the Treasury or his delegate as not increasing substantially the annual income derived from the property.

(2) *Payments not chargeable to capital account.*—The term “excludable portion” does not include that portion of any payment which is properly associated with an amount which is allowable as a deduction for the taxable year in which such amount is paid or incurred.

(c) *Election for Section Not To Apply.*—

(1) *In general.*—The taxpayer may elect not to have this section (and section 1255) apply to any excludable portion (or portion thereof).

(2) *Manner and time for making election.*—Any election under paragraph (1) shall be made in the manner prescribed by the Secretary by regulations and shall be made not later than the due date prescribed by law (including extensions) for filing the return of tax under this chapter for the taxable year in which the payment was received or accrued.

(d) *Denial of Double Benefits.*—No deduction or credit shall be allowed with respect to any expenditure which is properly associated with any amount excluded from gross income under subsection (a).

(e) *Basis of Property Not Increased by Reason of Excludable Payments.*—Notwithstanding any provision of section 1016 to the contrary, no adjustment to basis shall be made with respect to property acquired or improved through the use of any payment, to the extent that such adjustment would reflect any amount which is excluded from gross income under subsection (a).

(See Section 1255, page 46)

Sec. 194. Amortization of Reforestation Expenditures.

(a) *Allowance of Deduction.*—In the case of any qualified timber property with respect to which the taxpayer has made (in accordance with regulations prescribed by the Secretary) an election under this subsection, the taxpayer shall be entitled to a deduction with respect to the amortization of the amortizable basis of qualified timber property based on a period of 84 months. Such amortization deduction shall be an amount, with respect to each month of such period within the taxable year, equal to the amortizable basis at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such amortizable basis at the end of the month shall be computed without regard to the amortization deduction for such month. The 84-month period shall begin on the first day of the first month of the second half of the taxable year in which the amortizable basis is acquired.

(b) *Limitations.*—

(1) *Maximum dollar amount.*—The aggregate amount of amortizable basis acquired during the taxable year which may be taken into account under subsection (a) for such taxable year shall not exceed \$10,000 (\$5,000 in the case of a separate return by a married individual (as defined in section 143)).

(2) *Allocation of dollar limit.*—

(A) *Controlled group.*—For purposes of applying the dollar limitation under paragraph (1)—

(i) all component members of a controlled group shall be treated as one taxpayer, and

(ii) the Secretary shall, under regulations prescribed by him, apportion such dollar limitation among the component members of such controlled group.

For purposes of the preceding sentence, the term “controlled group” has the meaning assigned to it by section 1563(a), except that the phrase “more than 50 percent” shall be substituted for the phrase “at least 80 percent” each place it appears in section 1563(a)(1).

(B) *Partnerships.*—In the case of a partnership, the dollar limitation contained in paragraph (1) shall apply with respect to the partnership and with respect to each partner.

(3) *Section not to apply to trusts.*—This section shall not apply to trusts.

(4) *Estates.*—The benefit of the deduction for amortization provided by this section shall be allowed to estates in the same manner as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiary and the fiduciary under regulations prescribed by the Secretary. Any amount so apportioned to a beneficiary shall be taken into account for purposes of determining the amount allowable as a deduction under this section to such beneficiary.

(c) *Definitions and Special Rule.*—For purposes of this section—

(1) *Qualified timber property.*—The term “qualified timber property” means a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.

(2) *Amortizable basis.*—The term “amortizable basis” means that portion of the basis of the qualified timber property attributable to reforestation expenditures.

(3) *Reforestation expenditures.*—

(A) *In general.*—The term “reforestation expenditures” means direct costs incurred in connection with forestation or reforestation by planting or artificial or natural seeding, including costs—

(i) for the preparation of the site;

(ii) of seeds or seedlings; and

(iii) for labor and tools, including depreciation of equipment such as tractors, trucks, tree planters, and similar machines used in planting or seeding.

(B) *Cost-sharing programs.*—Reforestation expenditures shall not include any expenditures for which the taxpayer has been reimbursed under any governmental reforestation cost-sharing program unless the amounts reimbursed have been included in the gross income of the taxpayer.

(4) *Basis allocation.*—If the amount of the amortizable basis acquired during the taxable year of all qualified timber property with respect to which the taxpayer has made an election under subsection (a) exceeds the amount of the limitation under subsection (b)(1), the taxpayer shall allocate that portion of such amortizable basis with respect to which a deduction is allowable under subsection (a) to each such qualified timber property in such manner as the Secretary may by regulations prescribe.

(d) *Life Tenant and Remainderman.*—In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant.

(See Section 48(a)(1), page 42, and Section 1245, page 45)

Sec. 611. Allowance of Deduction for Depletion. (a) *General rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. For purposes of this part, the term “mines” includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

(b) *Special Rules.*—

(1) *Leases.*—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

(2) *Life tenant and remainderman.*—In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

(3) *Property held in trust.*—In the case of property held in trust, the deduction under this section shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

(4) *Property held by estate.*—In the case of an estate, the deduction under this section shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

(c) *Cross Reference.*—

For other rules applicable to depreciation of improvements, see section 167.

(See applicable Regulations, page 46)

Sec. 612. Basis for Cost Depletion. Except as otherwise provided in this subchapter, the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain upon the sale or other disposition of such property. (See applicable Regulations, page 48)

Sec. 631. Gain or Loss in the Case of Timber, Coal, or Domestic Iron Ore. (a) *Election to Consider Cutting as Sale or Exchange.*—If the 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. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary. For purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes.

(See applicable Regulations, page 49)

(b) *Disposal of Timber With a Retained Economic Interest.*—In the case of the disposal of timber held for more than 1 year before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

(See applicable Regulations, page 50)

Sec. 1221. Capital Asset Defined. For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).

Sec. 1231. Property Used in the Trade or Business and Involuntary Conversions. (a) *General rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 1 year into other property or money, exceed the recognized losses from such sales, exchanges, and conversions such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 1 year. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection—

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

(2) losses (including losses not compensated for by insurance or otherwise) upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of

(A) property used in the trade or business or (B) capital assets held for more than 1 year shall be considered losses from a compulsory or involuntary conversion.

In the case of any involuntary conversion (subject to the provisions of this subsection but for this sentence) arising from fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 1 year, this subsection shall not apply to such conversion (whether resulting in gain or loss) if during the taxable year the recognized losses from such conversions exceed the recognized gains from such conversions.

(b) *Definition of Property Used in the Trade or Business.*—For purposes of this section—

(1) *General rule.*—The term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year, which is not—

(A) property of a kind which would properly be includable in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

(C) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221, or

(D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section 1221.

(2) *Timber, coal, or domestic iron ore.*—Such term includes timber, coal, and iron ore with respect to which section 631 applies.

(3) *Livestock.*—Such term includes—

(A) cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and

(B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) *Unharvested crop.*—In the case of an unharvested crop on land used in the trade or business and held for more than 1 year, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as “property used in the trade or business.”

(See applicable Regulations, page 52)

Sec. 1245. Gain From Dispositions of Certain Depreciable Property. (a) *General Rule.*—

(1) *Ordinary income.*—Except as otherwise provided in this section, if section 1245 property is disposed of during a taxable year beginning after December 31, 1962, the amount by which the lower of—

(A) the recomputed basis of the property, or

(B) (i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) in the case of any other disposition, the fair market value of such property, exceeds the adjusted basis of such property shall be treated as ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(2) *Recomputed basis.*—For purposes of this section, the term “recomputed basis” means—

(A) with respect to any property referred to in paragraph (3)(A) or (B), its adjusted basis recomputed adding thereto all adjustments, attributable to periods after December 31, 1961.

(B) with respect to any property referred to in paragraph (3)(C), its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after June 30, 1963,

(C) with respect to livestock, its adjusted basis recomputed by adding thereto all adjustments attributable to periods after December 31, 1969, or

(D) with respect to any property referred to in paragraph (3)(D), its adjusted basis recomputed by adding thereto all adjustments attributable to periods beginning with the first month for which a deduction for amortization is allowed under section 169, 179, 185, 190, 193, or 194, or

(E) with respect to any section 1245 recovery property, the adjusted basis of such property recomputed by adding thereto all adjustments attributable to periods for which a deduction is allowed under section 168(a) (as added by the Economic Recovery Tax Act of 1981) with respect to such property,

reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168 (as in effect before its repeal by the Tax Reform Act of 1976), 169, 179, 184, 185, 188, 190, 193, 194, or (in the case of property described in paragraph (3)(C)) 191 (as in effect before its repeal by the Economic Recovery Tax Act of 1981). For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation, or for amortization under section 168 (as in effect before its repeal by the Tax Reform Act of 1976), 169, 179, 184, 185, 188, 190, 193, 194, or (in the case of property described in paragraph (3)(C)) 191 (as in effect before its repeal by the Economic Recovery Tax Act of 1981), for any period was less than the amount allowable, the amount added for such period shall be the amount allowed. For purposes of this section, any deduction allowable under section 179, 190, 193, or 194 shall be treated as if it were a deduction allowable for amortization.

(3) *Section 1245 property.*—For purposes of this section, the term “section 1245 property” means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 (or subject to the allowance of amortization provided in section 185) and is either—

(A) personal property,

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,

(ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state),

(C) an elevator or an escalator, or

(D) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 185, 188, 190, 193, or 194,

(E) a single purpose agricultural or horticultural structure (as defined in section 48(p)), or

(F) a storage facility used in connection with the distribution of petroleum or any primary product of petroleum.

* * * * *

(5) *Section 1245 recovery property.*—For purposes of this section, the term “section 1245 recovery property” means recovery property (within the meaning of section 168) other than—

(A) 15-year real property which is residential rental property (as defined in section 167(j)(2)(B)),

(B) 15-year real property which is described in section 168(f)(2),

(C) 15-year real property with respect to which an election under subsection (b)(3) of section 168 to use a different recovery percentage is in effect, and

(D) 15-year real property which is described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B).

If only a portion of a building (or other structure) is section 1245 recovery property, gain from any disposition of such building (or other structure) shall be allocated first to the portion of the building (or other structure) which is section 1245 recovery property (to the extent of the amount which may be treated as ordinary income under this section) and then to the portion of the building or other structure which is not section 1245 recovery property.

(6) *Special rule for qualified leased property.*—In any case in which—

(A) the lessor of qualified leased property (within the meaning of section 168(f)(8)(D)) is treated as the owner of such property for purposes of this subtitle under section 168(f)(8), and

(B) the lessee acquires such property, the recomputed basis of the lessee under this subsection shall be determined by taking into account any adjustments which would be taken into account in determining the recomputed basis of the lessor.

(b) *Exceptions and Limitations.*—

* * * * *

(8) *Timber property.*—In determining, under subsection (a)(2), the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, the taxpayer shall not take into account adjustments under section 194 to the extent such adjustments are attributable to the amortizable basis of the taxpayer acquired before the 10th taxable year preceding the taxable year in which gain with respect to the property is recognized.

* * * * *

Sec. 1255. Gain From Disposition of Section 126 Property.

(a) *General Rule.*—

(1) *Ordinary income.*—Except as otherwise provided in this section, if section 126 property is disposed of, the lower of—

(A) the applicable percentage of the aggregate payments, with respect to such property, excluded from gross income under section 126, or

(B) the excess of—

(i) the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of such section 126 property (in the case of any other disposition), over

(ii) the adjusted basis of such property, shall be treated as ordinary income.

Such gain shall be recognized notwithstanding any other provision of this subtitle, except that this section shall not apply to the extent such gain is recognized as ordinary income under any other provision of this part.

(2) *Section 126 property.*—For purposes of this section, “section 126 property” means any property acquired, improved, or otherwise modified by the application of payments excluded from gross income under section 126.

(3) *Applicable percentage.*—For purposes of this section, if section 126 property is disposed of less than 10 years after the date of receipt of payments excluded from gross income under section 126, the applicable percentage is 100 percent. If section 126 property is disposed of more than 10 years after such date, the applicable percentage is 100 percent reduced (but not below zero) by 10 percent for each year or part thereof in excess of 10 years such property was held after the date of receipt of the payments.

(b) *Special Rules.*—Under regulations prescribed by the Secretary—

(1) rules similar to the rules applicable under section 1245 shall be applied for purposes of this section, and

(2) for purposes of sections 163(d), 170(e), 341(e)(12), 453B(d)(2), and 751(c), amounts treated as ordinary income under this section shall be treated in the same manner as amounts treated as ordinary income under section 1245.

C. Federal Regulations Under the 1954 Internal Revenue Code

§ 1.611-3. *Rules applicable to timber.* (a) *Capital recoverable through depletion allowance in case of timber.* In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 612 and the regulations thereunder. For the method of determining fair market value and quantity of timber, see paragraphs (d), (e), and (f) of this section. For capitalization of carrying charges, see section 1016(a)(1)(A). Amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances. Such amounts include, for example, expenditures made for the preparation of the timber site for planting or for natural seeding and the cost of seedlings. The apportionment of deductions between the several owners of economic interests in standing timber will be made as provided in paragraph (c) of § 1.611-1.

(b) *Computation of allowance for depletion of timber for taxable year.* (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. To the extent that depletion is allowable in a particular taxable year with respect to timber the products of which are not sold during such year, the depletion so allowable shall be included as an item of cost in the closing inventory of such products for such year.

(2) The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the

estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. Such amount shall be charged to a depletion account which shall be credited as the timber, with respect to which the charge was made, is sold. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on such basis, in which case the amount allowable on account of depletion for a given month will be determined in the manner outlined herein for a given year. The total amount of the allowance for depletion in any taxable year shall be the sum of the amounts allowable for the several timber accounts. For a description of timber accounts, see paragraphs (c) and (d) of this section.

(3) When a taxpayer has elected to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 631(a), he shall reduce the timber account containing such timber by an amount equal to the adjusted depletion basis of such timber. In computing any further gain or loss on such timber, see paragraph (e) of § 1.631-1.

(c) *Timber depletion accounts on books.* (1) Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 1012 of the property and land together with subsequent allowable capital additions in each account and all other adjustments provided by section 1016 and the regulations thereunder.

(2) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth. See paragraph (d) of this section. The timber accounts shall be credited each year with the amount of the charges to the depletion accounts computed in accordance with paragraph (b) of this section or the amount of the charges to the depletion accounts shall be credited to depletion reserve accounts. When the sum of the credits for depletion equals the cost or other basis of the timber property, plus subsequent allowable capital additions, no further deduction for depletion will be allowed.

(d) *Aggregating timber and land for purposes of valuation and accounting.* (1) With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one "block." A block may be an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. Blocks may also be established by geographical or political boundaries or by logical management areas. Timber acquired under cutting contracts should be carried in separate accounts and shall not constitute part of any block. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the district director on audit, the taxpayer may divide the timber in a given block into two or more accounts. For example, timber owned on February 28, 1913, and that purchased subsequently

may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts. Individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts. Blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or scattered tracts may be included in separate accounts. If such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(2) The timber accounts mentioned in subparagraph (1) of this paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in subparagraph (1) of this paragraph, the land in a given "block" may be carried in a single land account or may be divided into two or more accounts on the basis of its character or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(3) The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively. In cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber, and when the timber becomes merchantable such value or cost shall be recoverable through depletion allowances.

(4) Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

(5) For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.

(e) *Determination of quantity of timber.* Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, whichever date is applicable in determining the basis for cost depletion. This estimate shall state as nearly as possible the number of units which would have been found present by careful estimate made on the specified date with the object of determining 100 percent of the quantity of timber which the area covered by the specific account would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the district director that there remain on the ground, available for utilization, more or less units of timber at the close of the taxable year (or at the close of the month if the taxpayer keeps his depletion accounts on a monthly basis) than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised. The depletion unit shall be changed

when such revision has been made. The annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which the revision is made and all subsequent taxable years until a change in facts requires another revision.

(f) *Determination of fair market value of timber property.*

(1) If the fair market value of the property at a specified date is the basis for depletion deductions, such value shall be determined, subject to approval or revision by the district director upon audit, by the owner of the property 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, and methods of exploitation, in degree of utilization, etc. Such factors as the following will be given due consideration:

- (i) Character and quality of the timber as determined by species, age, size, condition, etc.;
- (ii) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;
- (iii) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation and the climate and the state of industrial development of the locality); and
- (iv) The freight rates by common carrier to important markets.

(2) The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned in this paragraph, will be consistent with that of other similar timber in the region. The district director will give weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors.

(g) *Revaluation of timber property not allowed.* No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit shall be revised when such a revaluation of a timber property has been made and the annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which such revision is made and for all subsequent taxable years.

(h) *Information to be furnished by taxpayer claiming depletion of timber.* A taxpayer claiming a deduction for depletion of timber and for depreciation of plant and other

improvements shall attach to his income tax return a filled-out Form T-Timber for the taxable year covered by the income tax return, including the following information:

- (1) A map where necessary to show clearly timber and land acquired, timber cut, and timber and land sold;
- (2) Description of, cost of, and terms of purchase of timberland or timber, or cutting rights, including timber or timber rights acquired under any type of contract;
- (3) Profit or loss from sale of land, or timber, or both;
- (4) Description of timber with respect to which claim for loss, if any, is made;
- (5) Record of timber cut;
- (6) Changes in each timber account as a result of purchase, sale, cutting, reestimate, or loss;
- (7) Changes in improvements accounts as the result of additions to or deductions from capital and depreciation, and computation of profit or loss on sale or other disposition of such improvements;
- (8) Operation data with respect to raw and finished material handled and inventoried;
- (9) Statement as to application of the election under section 631(a) and pertinent information in support of the fair market value claimed thereunder;
- (10) Information with respect to land ownership and capital investment in timberland; and
- (11) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

§ 1.612-1. Basis for allowance of cost depletion. (a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, adjusted as provided in section 1016, relating to adjustments to basis, and the regulations under such sections. In the case of the sale of a part of such property, the unrecovered basis thereof shall be allocated to the part sold and the part retained.

(b) *Special rules.* (1) The basis for cost depletion of mineral or timber property does not include:

(i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion, and

(ii) The residual value of land and improvements at the end of operations.

In the case of any mineral property the basis for cost depletion does not include amounts representing the cost or value of land for purposes other than mineral productions. Furthermore, in the case of certain mineral properties, such basis does not include exploration or development expenditures which are treated under section 615(b) or 616(b) as deferred expenses to be taken into account as deductions on a ratable basis as the units of minerals benefited thereby are produced and sold. However, there shall be included in the basis for cost depletion of oil and gas property the amounts of capitalized drilling and development costs which, as provided in § 1.612-4, are recoverable through depletion deductions. In the case of timber property, the basis for cost depletion does not include amounts representing the cost or value of land.

(2) Where a taxpayer elects to treat the cutting of timber as a sale or exchange of such timber, the basis for cost depletion shall be the fair market value of such timber as of the first day of the taxable year in which such timber is cut and such value shall be considered for such taxable year and all subsequent taxable years as the cost of such timber for all purposes for which such cost is a necessary factor. See section 631(a).

(c) *Cross references.* In cases where the valuation, revaluation, or mineral content of deposits is a factor, see paragraphs (c), (d), (e), and (f) of § 1.611-2. In cases where the valuation, revaluation, or quantity of timber is a factor, see paragraphs (e), (f), and (g) of § 1.611-3. For definitions of the terms "property," "fair market value," "mineral enterprise," "mineral deposit," and "minerals," see paragraph (d) of § 1.611-1. For rules with respect to treatment of depletion accounts on taxpayers' books, see paragraph (b) of § 1.611-2 in the case of mineral property and paragraph (c) of § 1.611-3 in the case of timber property.

§ 1.631-1. Election to consider cutting as sale or exchange.

(a) *Effect of election.* (1) Section 631(a) provides an election to certain taxpayers to treat the difference between the actual cost or other basis of certain timber cut during the taxable year and its fair market value as standing timber on the first day of such year as gain or loss from a sale or exchange under section 1231. Thereafter, any subsequent gain or loss shall be determined in accordance with paragraph (e) of this section.

(2) For the purposes of section 631(a) and this section, timber shall be considered cut at the time when in the ordinary course of business the quantity of timber felled is first definitely determined.

(3) The election may be made with respect to any taxable year even though such election was not made with respect to a previous taxable year. If an election has been made under the provisions of section 631(a), or corresponding provisions of prior internal revenue laws, such election shall be binding upon the taxpayer not only for the taxable year for which the election is made but also for all subsequent taxable years, unless the Commissioner on showing by the taxpayer of undue hardship permits the taxpayer to revoke his election for such subsequent taxable years. If the taxpayer has revoked a previous election, such revocation shall preclude any further elections unless the taxpayer obtains the consent of the Commissioner.

(4) Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut, for a period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to when such timber is cut for sale or for use in the taxpayer's trade or business, irrespective of whether such timber or contract right was acquired before or after the election. (For purposes of the preceding sentence, the rules with respect to the holding period of property contained in section 1223 shall be applicable.) However, timber which is not cut for sale or for use in the taxpayer's trade or business (for example, firewood cut for the taxpayer's own household consumption) shall not be considered to have been sold or exchanged upon the cutting thereof.

(b) *Who may make election.* (1) A taxpayer who has owned, or has held a contract right to cut, timber for a period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to when the timber is cut may elect under section 631(a) to

consider the cutting of such timber during such year for sale or for use in the taxpayer's trade or business as a sale or exchange of the timber so cut. In order to have a "contract right to cut timber" within the meaning of section 631(a) and this section, a taxpayer must have a right to sell the timber cut under the contract on his own account or to use such cut timber in his trade or business.

(2) For purposes of section 631(a) and this section, the term "timber" includes evergreen trees which are more than six years old at the time severed from their roots and are sold for ornamental purposes, such as Christmas decorations. Section 631(a) is not applicable to evergreen trees which are sold in a live state, whether or not for ornamental purposes. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(a). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

(c) *Manner of making election.* The election under section 631(a) must be made by the taxpayer in his income tax return for the taxable year for which the election is applicable, and such election cannot be made in an amended return for such year. The election in the return shall take the form of a computation under the provisions of section 631(a) and section 1231.

(d) *Computation of gain or loss under the election.* (1) If the cutting of timber is considered as a sale or exchange pursuant to an election made under section 631(a), gain or loss shall be recognized to the taxpayer in an amount equal to the difference between the adjusted basis for depletion in the hands of the taxpayer of the timber which has been cut during the taxable year and the fair market value of such timber as of the first day of the taxable year in which such timber is cut. The adjusted basis for depletion of the cut timber shall be based upon the number of units of timber cut during the taxable year which are considered to be sold or exchanged and upon the depletion unit of the timber in the timber account or accounts pertaining to the timber cut, and shall be computed in the same manner as is provided in section 611 and the regulations thereunder with respect to the computation of the allowance for depletion.

(2) 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 the factors and the principles involved in the determination of the fair market value of timber as described in the regulations under section 611.

(3) The fair market value as of the beginning of the taxable year of the standing timber cut during the year shall be considered to be the cost of such timber, in lieu of the actual cost or other basis of such timber, for all purposes for which such cost is a necessary factor. See paragraph (e) of this section.

(4) For any taxable year for which the cutting of timber is considered to be a sale or exchange of such timber under

section 631(a), the timber so cut shall be considered as a property used in the trade or business for the purposes of section 1231, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether the gain or loss considered to have resulted from the cutting of the timber will be considered to be gain or loss resulting from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) depends upon the application of section 1231 to the taxpayer for the taxable year. See section 1231 and the regulations thereunder.

(e) *Computation of subsequent gain or loss.* (1) In case the products of the timber are sold after cutting, either in the form of logs or lumber or in the form of manufactured products, the income from such actual sales shall be considered ordinary income. When the election under section 631(a) is in effect, the cost of standing timber cut during the taxable year is determined as if the taxpayer had purchased such timber on the first day of the taxable year. Thus, in determining the cost of the projects so sold, the cost of the timber shall be the fair market value on the first day of the taxable year in which the standing timber was cut, in lieu of the actual cost or other basis of such timber.

(2) This is also the rule in case the products of the timber cut during one taxable year, with respect to which an election has been made under section 631(a), are sold during a subsequent taxable year, whether or not the election provided in section 631(a) is applicable with respect to such subsequent year. If the products of the timber cut during a taxable year with respect to which an election under section 631(a) was made were not sold during such year and are included in inventory at the close of such year, the fair market value as of the beginning of the year of the timber cut during the year shall be used in lieu of the actual cost of such timber in computing the closing inventory for such year and the opening inventory for the succeeding year. With respect to the costs applicable in the determination of the amount of such inventories, there shall be included the fair market value of the timber cut, the costs of cutting, logging, and all other expenses incident to the cost of converting the standing timber into the products in inventory. See section 471 and the regulations thereunder. The fact that the fair market value as of the first day of the taxable year in which the timber is cut is deemed to be the cost of such timber shall not preclude the taxpayer from computing its inventories upon the basis of cost or market, whichever is lower, if such is the method used by the taxpayer. Nor shall it preclude the taxpayer from computing its inventories under the last-in-first-out inventory method provided by section 472 if such section is applicable to, and has been elected by the taxpayer.

§ 1.631-2. Gain or loss upon the disposal of timber under cutting contract. (a) *In general.* (1) If an owner disposes of timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The

difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year. Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e)(2) of this section for definition of "owner." For the purpose of determining whether or not the timber disposed of was held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal, the rules with respect to the holding period of property contained in section 1223 shall be applicable.

(2) In the case of such a disposal, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) *Determination of date of disposal.* (1) For purposes of section 631(b) and this section, the date of disposal of timber shall be deemed to be the date such timber is cut. However, if payment is made to the owner under the contract for timber before such timber is cut the owner may elect to treat the date of payment as the date of disposal of such timber. Such election shall be effective only for purposes of determining the holding period of such timber. Neither section 631(b) nor the election thereunder has any effect on the time of reporting gain or loss. See subchapter E, chapter 1 of the Code and the regulations thereunder. See paragraph (c)(2) of this section for the effect of exercising the election with respect to the payment for timber held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. See paragraph (d) of this section for the treatment of payments received in advance of cutting.

(2) For purposes of section 631(b) and this section, the "date such timber is cut" means the date when in the ordinary course of business the quantity of timber felled is first definitely determined.

(c) *Manner and effect of election to treat date of payment as of the date of disposal.* (1) The election to treat the date of payment as the date of disposal of timber shall be evidenced by a statement attached to the taxpayer's income tax return filed on or before the due date (including extensions thereof) for the taxable year in which the payment is received. The statement shall specify the advance payments which are subject to the election and shall identify the contract under which the payments are made. However, in no case shall the time for making the election under section 631 (b) expire before the close of March 21, 1958.

(2) Where the election to treat the date of payment as the date of disposal is made with respect to a payment made in advance of cutting, and such payment is made 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less from the date the timber dis-

posed of was acquired, section 631(b) shall not apply to such payment, irrespective of the date such timber is cut, since the timber was not held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to disposal.

(d) *Payments received in advance of cutting.* (1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631(b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Such amounts will be so treated irrespective of whether or not an election has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if no election has been made under paragraph (c) of this section, amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the date of acquisition of such timber.

(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631(b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

(3) (i) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(b) as amounts realized from the sale of timber to the extent attributable to timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(ii) The adjusted depletion basis attributable to the bonus shall be determined under the provisions of section 612 and the regulations thereunder. This subdivision may be illustrated as follows:

Example. Taxpayer A has held timber having a depletion basis of \$90,000 for two months when he enters into a contract of disposal with B. B pays A a bonus of \$5,000 upon the execution of the contract and agrees to pay X dollars per unit of timber to A as the timber is cut. A does not exercise the election to treat the date of payment as the date of disposal. It is estimated that there are 50,000 units of timber subject to the contract and that the total estimated royalties to be paid to A will be \$95,000. A must report the bonus in the taxable year it is received or accrued by him. The portion of the basis of the timber attributable to the bonus is determined by the following formula:

<u>Bonus</u>	×	Basis of timber	=	Basis attributable to bonus
Bonus + amount of expected royalties				
<u>\$ 5,000</u>	×	\$90,000	=	\$4,500
\$100,000				

(iii) To the extent attributable to timber not held for more than 1 year (6 months for taxable years beginning before

1977; 9 months for taxable years beginning in 1977), such bonuses shall be treated as ordinary income subject to depletion. In order to determine the amount of the bonus allocable to timber not held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the bonus shall be apportioned ratably over the estimated number of units of timber covered by the contract of disposal. This subdivision may be illustrated as follows:

Example. Assume under the facts stated in the example in subdivision (ii) of this subparagraph that B cuts 10,000 units of timber that have been held by A for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. The amount of the bonus (as well as the royalties) attributable to these units must be reported as ordinary income subject to depletion. The amount of bonus attributable to these units is determined by the following formula:

Number of units cut held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less	×	Amount of bonus	=	Amount of bonus treated as ordinary income subject to depletion
Total units covered by the contract				
<u>\$10,000</u>	×	\$5,000	=	\$1,000
\$50,000				

The amount of bonus attributable to the portion of the bonus received for timber held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less is determined by the following formula:

Amount of bonus attributable to timber held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less	×	Adjusted basis for depletion of bonus	=	Depletion allowance on timber held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less
Total bonus				
<u>\$1,000</u>	×	\$4,500	=	\$900
\$5,000				

The amount of the bonus attributable to timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and which is treated under section 631(b) as realized from the sale of timber would be \$4,000. The gain on such amount is \$400 (\$4,000 - \$3,600).

(iv) If the right to cut timber under the contract of disposal expires, terminates, or is abandoned before any timber is cut, the taxpayer shall treat the bonus received under such

contract as ordinary income not subject to depletion. Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such bonus was received. The recomputation shall be made in the form of an amended return where necessary.

(e) *Other rules for application of section.* (1) Amounts paid by the lessee for timber or the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor.

(2) The provisions of section 631(b) apply only to an owner of timber. An owner of timber means any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber. Such owner of timber must have a right to cut timber for sale on his own account or for use in his trade or business in order to own an interest in timber within the meaning of section 631(b).

(3) For purposes of section 631(b) and this section, the term "timber" includes evergreen trees which are more than 6 years old at the time severed from their roots and are sold for ornamental purposes such as Christmas decorations. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(b). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

§1.1231-1 Gains and losses from the sale or exchange of certain property used in the trade or business. (a) *In general.* Section 1231 provides that, subject to the provisions of paragraph (e) of this section, a taxpayer's gains and losses from the disposition (including involuntary conversion) of assets described in that section as "property used in the trade or business" and from the involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall be treated as long-term capital gains and losses if the total gains exceed the total losses. If the total gains do not exceed the total losses, all such gains and losses are treated as ordinary gains and losses. Therefore, if the taxpayer has no gains subject to section 1231, a recognized loss from the condemnation (or from a sale or exchange under threat of condemnation) of even a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is an ordinary loss. Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The noncapital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), other than stock in trade and certain copyrights and artistic property and, in the case of sales and other dispositions occurring after July 25, 1969, other than a letter, memorandum, or property similar to a letter or memorandum; (2) timber, coal, and iron ore, but only to the extent that section 631 applies thereto; and (3) certain livestock and unharvested crops. See paragraph (c) of this section.

(b) *Treatment of gains and losses.* For the purpose of applying section 1231, a taxpayer must aggregate his recognized gains and losses from—

(1) The sale, exchange, or involuntary conversion of property used in the trade or business (as defined in section 1231(b)), and

(2) The involuntary conversion (but not sale or exchange) of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

If the gains to which section 1231 applies exceed the losses to which the section applies, the gains and losses are treated as long-term capital gains and losses and are subject to the provisions of parts I and II (section 1201 and following), subchapter P, chapter 1 of the Code, relating to capital gains and losses. If the gains to which section 1231 applies do not exceed the losses to which the section applies, the gains and losses are treated as ordinary gains and losses. Therefore, in the latter case, a loss from the involuntary conversion of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is treated as an ordinary loss and is not subject to the limitation on capital losses in section 1211. The phrase "involuntary conversion" is defined in paragraph (e) of this section.

(c) *Transactions to which section applies.* Section 1231 applies to recognized gains and losses from the following:

(1) The sale, exchange, or involuntary conversion of property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and used in the taxpayer's trade or business, which is either real property or is of a character subject to the allowance for depreciation under section 167 (even though fully depreciated), and which is not—

(i) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of business;

(ii) A copyright, a literary, musical, or artistic composition, or similar property, or (in the case of sales and other dispositions occurring after July 25, 1969) a letter, memorandum, or property similar to a letter or memorandum, held by a taxpayer described in section 1221 (3); or

(iii) Livestock held for draft, breeding, dairy, or sporting purposes, except to the extent included under subparagraph (4) of this paragraph, or poultry.

(2) The involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(3) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) The sale, exchange, or involuntary conversion of livestock if the requirements of § 1.1231-2 are met.

(5) The sale, exchange, or involuntary conversion of unharvested crops on land which is (i) used in the taxpayer's trade or business and held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and (ii) sold or exchanged at the same time and to the same person. See paragraph (f) of this section.

For purposes of section 1231, the phrase "property used in the trade or business" means property described in this paragraph

(other than property described in subparagraph (2) of this paragraph). Notwithstanding any of the provisions of this paragraph, section 1231(a) does not apply to gains and losses under the circumstances described in paragraph (e)(2) or (3) of this section.

(d) *Extent to which gains and losses are taken into account.* All gains and losses to which section 1231 applies must be taken into account in determining whether and to what extent the gains exceed the losses. For the purpose of this computation, the provisions of section 1211 limiting the deduction of capital losses do not apply, and no losses are excluded by that section. With that exception, gains are included in the computations under section 1231 only to the extent that they are taken into account in computing gross income, and losses are included only to the extent that they are taken into account in computing taxable income. The following are examples of gains and losses not included in the computations under section 1231:

(1) Losses of a personal nature which are not deductible by reason of section 165(c) or (d), such as losses from the sale of property held for personal use;

(2) Losses which are not deductible under section 267 (relating to losses with respect to transactions between related taxpayers) or section 1091 (relating to losses from wash sales);

(3) Gain on the sale of property (to which section 1231 applies) reported for any taxable year on the installment method under section 453, except to the extent the gain is to be reported under section 453 for the taxable year; and

(4) Gains and losses which are not recognized under section 1002, such as those to which sections 1031 through 1036, relating to common nontaxable exchanges, apply.

(e) *Involuntary conversion*—(1) *General rule.* For purposes of section 1231, the terms “compulsory or involuntary conversion” and “involuntary conversion” of property mean the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition, or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money and whether or not the property is uninsured, partially insured, or totally insured. For example, if a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), with an adjusted basis of \$400, but not held for the production of income, is stolen, and the loss which is sustained in the taxable year 1956 is not compensated for by insurance or otherwise, section 1231 applies to the \$400 loss. For certain exceptions to this subparagraph, see subparagraphs (2) and (3) of this paragraph.

(2) *Certain uninsured losses.* Notwithstanding the provisions of subparagraph (1) of this paragraph, losses sustained during a taxable year beginning after December 31, 1957, and before January 1, 1970, with respect to both property used in the trade or business and any capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and held for the production of income, which losses arise from fire, storm, shipwreck, or other casualty, or from theft, and which are not compensated for by insurance in any amount, are not losses to which section 1231(a) applies. Such losses shall not be taken into account in applying the provisions of this section.

(3) *Exclusion of gains and losses from certain involuntary conversions.* Notwithstanding the provisions of subparagraph (1) of this paragraph, if for any taxable year beginning after December 31, 1969, the recognized losses from the involuntary conversion as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) exceed the recognized gains from the involuntary conversion of any such property as a result of fire, storm, shipwreck, or other casualty, or from theft, such gains and losses are not gains and losses to which section 1231 applies and shall not be taken into account in applying the provisions of this section. The net loss, in effect, will be treated as an ordinary loss. This subparagraph shall apply whether such property is uninsured, partially insured, or totally insured and, in the case of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), whether the property is property used in the trade or business, property held for the production of income, or a personal asset.

(f) *Unharvested crops.* Section 1231 does not apply to a sale, exchange, or involuntary conversion of an unharvested crop if the taxpayer retains any right or option to reacquire the land the crop is on, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). The length of time for which the crop, as distinguished from the land, is held is immaterial. A leasehold or estate for years is not “land” for the purpose of section 1231.

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses for 1957 of the kind described in section 1231 are as follows:

	Gains	Losses
1. Gain on sale of machinery used in the business and subject to an allowance for depreciation, held for more than 6 months	\$4,000	
2. Gain reported in 1957 (under sec. 453) on installment sale in 1956 of factory premises used in the business (including building and land, each held for more than 6 months) . .	6,000	
3. Gain reported in 1957 (under sec. 453) on installment sale in 1957 of land held for more than 6 months, used in the business as a storage lot for trucks	2,000	
4. Gain on proceeds from requisition by Government of boat, held for more than 6 months, used in the business and subject to an allowance for depreciation	500	
5. Loss upon the destruction by fire of warehouse, held for more than 6 months and used in the business (excess of adjusted basis of warehouse over compensation by insurance, etc.) . .		\$3,000
6. Loss upon theft of unregistered bearer bonds, held for more than 6 months. . .		5,000

	Gains	Losses
7. Loss in storm of pleasure yacht, purchased in 1950 for \$1,800 and having a fair market value of \$1,000 at the time of the storm.....		1,000
8. Total gains	\$12,500	
9. Total losses		\$9,000
10. Excess of gains over losses	\$3,500	

Since the aggregate of the recognized gains (\$12,500) exceeds the aggregate of the recognized losses (\$9,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. For any taxable year beginning after December 31, 1957, and before January 1, 1970, the \$5,000 loss upon theft of bonds (item 6) would not be taken into account under section 1231. See paragraph (e)(2) of this section.

Example (2). If in example (1), A also had a loss of \$4,000 from the sale under threat of condemnation of a capital asset acquired for profit and held for more than six months, then the gains (\$12,500) would not exceed the losses (\$9,000 plus \$4,000, or \$13,000). Neither the loss on that sale nor any of the other items set forth in example (1) would then be treated as gains and losses from the sale or exchange of capital assets, but all of such items would be treated as ordinary gains and losses. Likewise, if A had no other gain or loss, the \$4,000 loss would be treated as an ordinary loss.

Example (3). A's yacht, used for pleasure and acquired for that use in 1945 at a cost of \$25,000, was requisitioned by the Government in 1957 for \$15,000. A sustained no loss deductible under section 165(c) and since no loss with respect to the requisition is recognizable, the loss will not be included in the computations under section 1231.

Example (4). A, an individual, makes his income tax return on a calendar year basis. During 1970 trees on A's residential property which were planted in 1950 after the purchase of such property were destroyed by fire. The loss, which was in the amount of \$2,000 after applying section 165 (c)(3), was not compensated for by insurance or otherwise. During the same year A also recognized a \$1,500 gain from insurance proceeds compensating him for the theft sustained in 1970 of a diamond brooch purchased in 1960 for personal use. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses exceed the recognized gains from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than six months, neither the gain nor the loss are included in making the computations under section 1231.

Example (5). The facts are the same as in example (4), except that A also recognized a gain of \$1,000 from insurance proceeds compensating him for the total destruction by fire of a truck, held for more than six months, used in A's business and subject to an allowance for depreciation. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses (\$2,000) do not exceed the recognized gains (\$2,500) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than six months, such gains and losses are included in making the computations under section 1231. Thus, if A has no other gains or losses for 1970 to

which section 1231 applies, the gains and losses from these involuntary conversions are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than six months.

Example (6). The facts are the same as in example (5) except that A also has the following recognized gains and losses for 1970 to which section 1231 applies:

	Gains	Losses
Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months.....		\$ 4,000
Gain reported in 1970 (under sec. 453) on installment sale in 1969 of factory premises used in the business (including building and land, each held for more than 6 months)		6,000
Gain reported in 1970 (under sec. 453) on installment sale in 1970 of land held for more than 6 months, used in the business as a storage lot for trucks		2,000
Loss upon the sale in 1970 of warehouse, used in the business and subject to an allowance for depreciation, held for more than 6 months		\$5,000
Total gains.....	\$12,000	_____
Total losses.....		\$5,000

Since the aggregate of the recognized gains (\$14,500) exceeds the aggregate of the recognized losses (\$7,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than six months.

Example (7). B, an individual, makes his income tax return on the calendar year basis. During 1970 furniture used in his business and held for more than six months was destroyed by fire. The recognized loss, after compensation by insurance, was \$2,000. During the same year B recognized a \$1,000 gain upon the sale of a parcel of real estate used in his business and held for more than six months, and a \$6,000 loss upon the sale of stock held for more than six months. B has no other gains or losses for 1970 from the involuntary conversion, or the sale or exchange of property. The \$6,000 loss upon the sale of stock is not loss to which section 1231 applies since the stock is not property used in the trade or business, as defined in section 1231(b). The \$2,000 loss upon the destruction of the furniture is not a loss to which section 1231 applies since the recognized losses (\$2,000) exceed the recognized gains (\$0) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than six months. Accordingly, the \$1,000 gain upon the sale of real estate is considered to be gain from the sale or exchange of a capital asset held for more than six months since the gains (\$1,000) to which section 1231 applies exceed the losses (\$0) to which such section applies.

Example (8). The facts are the same as in example (7) except that B also recognized a gain of \$4,000 from insurance proceeds compensating him for the total destruction by fire of a freighter, held for more than six months, used in B's business

and subject to an allowance for depreciation. Since the recognized losses (\$2,000) do not exceed the recognized gains (\$4,000) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than six months, such gains and losses are included in making the computations under section 1231. Since the aggregate of the recognized gains to which section 1231 applies (\$5,000) exceeds the aggregate of the recognized losses to which such section applies (\$2,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than six months. The \$6,000 loss upon the sale of stock is not taken into account in making such computation since it is not a loss to which section 1231 applies.

D. Revenue Rulings

56-434. Sales of Tops and Limbs. *Applicability of Section 631(a) and (b) of the Internal Revenue Code of 1954 to income received by a timber owner from pulpwood cut by an independent contractor from (1) tops and limbs of sawtimber trees felled by the owner and (2) from standing trees.*

Advice has been requested (1) concerning the proper tax treatment of income received by a taxpayer from pulpwood cut from the tops and limbs of sawtimber trees by an independent contractor under the circumstances set forth below, and (2) as to the determination of the fair market value of sawtimber and cut tree tops and limbs under the provisions of section 631(a) of the Internal Revenue Code of 1954.

The timber owner (taxpayer), who is in the business of manufacturing lumber, severed certain trees of sawlog size, owned by him for more than six months prior to the beginning of the taxable year in which cut, and converted the sawlogs to his business, leaving the tree tops and limbs lying in place as felled. Under a cutting contract with an independent pulpwood contractor, the latter was licensed to cut pulpwood at certain rates per cord from the tops and limbs of sawtimber trees lying upon the ground and also to cut certain designated standing trees for conversion into pulpwood. The owner claimed the benefits of section 631(b) for income from the cutting of standing trees by the contractor and, with respect to income received for pulpwood cut from the tops and limbs of the sawtimber trees, he claimed either section 631(b) benefits or, if denied additional fair market value under section 631(a) upon the standing sawtimber trees, cut by him, to the extent of the income received from pulpwood produced from the tops and limbs.

Section 631(b) of the Code provides, in part, that if a taxpayer disposes of timber, owned by him and held for more than six months before disposal, under a contract whereby he retains an economic interest in the timber, such disposal shall in effect be considered a sale or exchange of timber. Any gain or loss realized would then be subject to the provisions of section 1231 providing for capital gains treatment in case the aggregate gains exceed the losses. It is held that section 631(b) benefits apply only with respect to the standing trees cut by the contractor and not to the pulpwood cut by the contractor from the tops and limbs of the trees felled by the taxpayer, since in the latter case there has not been a disposal of standing trees (timber).

Under the provisions of section 631(a) of the Code, a taxpayer, who has owned timber or has held a contract right to cut timber for more than six months prior to the beginning of the taxable year in which it is cut, may elect to treat his cutting of such timber as a sale or exchange thereof. Gain for this purpose is the excess of the fair market value of the timber over its adjusted basis. Fair market value is determined as of the first day of the taxable year in which the timber is cut. This fair market value is thereafter considered the taxpayer's cost of such cut timber for all purposes for which cost is a necessary factor, including the determination of gain or loss on any subsequent sale of the timber products. The gain or loss on such subsequent sale is treated as an ordinary gain or loss.

Ordinarily, fair market value of standing timber is determined upon the basis of current transactions in similar timber expressed in unit value per 1,000 board feet for sawtimber. In the usual transaction, all of the purchase price is allocated to the sawtimber content of the standing tree and nothing to the tops and limbs, which may be usable for pulpwood. When fair market value of timber cut under section 631(a) is determined by using the sawtimber unit value arrived at from such transactions in which all of the value has been allocated to the sawtimber, no additional value is allowable for the pulpwood in the tops and limbs. Therefore, in such cases, a taxpayer would not be entitled to increase the fair market value for purposes of section 631(a) with respect to any part of the amount he receives from a pulpwood contractor for pulpwood in the cut tops and limbs.

When the amount determined for the sawtimber content does not reflect the full fair market value of the tree and such tree value cannot be determined from comparative transactions, the additional fair market value of the tops and limbs in the standing tree can be determined by appraisal. In such appraisal, it is to be recognized that the selling price of the top and limbs on the ground represents principally a converted cost. Such cost is properly measured by an analysis which attributes to the top and limbs a fair share of all expenses incurred in felling and processing the tree, including road construction costs, to the stage where the top and limbs are available for the extraction and hauling of the pulpwood, plus a fair allowance for operating profit up to that point. Therefore, any additional fair market value assignable to the tree with respect to the top and limbs would be represented only by the excess of the proceeds from their sale over the amount determined by the above computation.

In view of the foregoing, it is held that section 631(b) benefits are applicable only to the disposal of standing trees (timber) held for more than six months before disposal. Under a contract whereby the economic interest is retained, and that the section does not apply to income received from the sale of tree tops and limbs lying on the ground. It is further held that section 631(a) benefits are applicable to the entire standing tree cut by an owner or holder of a contract right to cut, since a tree top and the limbs are an integral part of the standing tree. However, the total fair market value of such tree, which must be determined for the purposes of section 631(a), is not represented by the sum of the fair market value of the standing tree for sawtimber and the amount received for the pulpwood after the tree was felled, but is merely the value of the standing tree. Therefore, the total amount received from the sale of the tops

and limbs should be included in income as amounts received from the sale of goods.

57-9. Outright Sale of Stumps. *Income from the sale of tree stumps from land held by an investment company which is not in the timber or stump business, either as a buyer, seller or processor, is taxable as a capital gain where the land was acquired in a cutover state as a real estate investment and the stumps were sold in one lot.*

Advice has been requested whether the sale of stumps by an investment company is taxable as a capital gain or as ordinary income.

The sale involves all of the stumps on a large tract of land for an agreed total consideration, payable in one lump sum. The seller is not in the timber or tree stump business, either as a buyer, seller or processor, but acquired the property years before in a cutover condition, with some young timber growth present. The property was acquired and held for its enhancement in value either as a new crop of timber developed or for sale as land values increased.

In the usual case the sale of tree stumps has been considered to be ordinary income. Such sales ordinarily occur either in the case of taxpayers engaged in buying and selling timber or from timber properties used in the trade or business.

Section 1221 of the Internal Revenue Code of 1954 provides, in part, that the term "capital assets" means property held by the taxpayer, whether or not connected with his trade or business, but does not include property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Whether property is held for sale to customers in the ordinary course of a taxpayer's trade or business is a question of fact to be determined in the light of all the circumstances of each particular case. However, the difference is recognized between a sale of tree stumps in one lot by a taxpayer who is not in the timber or stump business, either as a buyer, seller, or processor, such as the one in this case, and a sale of tree stumps as a byproduct, either by lot or on a tonnage basis by timber operators after the merchantable standing timber has been cut and removed, in which case the stumps are considered to be property held by the taxpayer for sale to customers in the ordinary course of his trade or business and income from their sale is considered to be ordinary income.

Accordingly, it is held that gain realized from the sale of stumps from land held by a taxpayer who is not in the timber or tree stump business, but who acquired the cutover property some years before as an investment, constitutes gain from the sale of "capital assets." Since no cost basis was allocated to the stumps, the entire amount received, less expenses of sale, constitutes capital gain.

58-295. "Contract Right to Cut" for Purposes of Section 631(a) Requires Proprietary Interest. To be entitled to the benefits of section 631(a) of the Internal Revenue Code of 1954 as the holder of a "contract right to cut," a taxpayer must have acquired under such contract a proprietary interest in the timber which he cuts. Compare *Helga Carlem v. Com-*

missioner, 220 Fed. (2d) 338. Whether a taxpayer has a proprietary interest in timber cut by him depends upon the substance of the grant to him as determined in the light of all of the pertinent facts. Where a taxpayer is granted a contractual right to cut and remove all or a described part of the merchantable timber on a particular tract of land, he has a proprietary interest in the timber cut by him if at the time of the cutting he has an unrestricted right to sell the logs or to use them in his trade or business. If the circumstances are such that the grantor in fact takes for his own use or for sale on his own account substantially all of the logs cut, whether or not in the exercise of a right in the form of an option to purchase, the taxpayer-grantee will not be deemed to have an unrestricted right to sell the logs or to use them in his trade or business.

62-81. Tax Treatment of Payments Received Under Long-Term Cutting Contract. The owner of a tract of timber land entered into a contract with a paper company whereby the latter was granted, for a term of 60 years, the right to grow timber and to cut timber growing and to be grown on the tract. The company is obligated to make payments in each year of the term of the contract. The obligation to pay is not contingent upon the quantities of timber which are cut. At the time of execution of the contract, there was a stand of timber upon the tract having a known fair market value. *Held*, the transaction is not a "disposal" of timber under section 631(b) of the Internal Revenue Code of 1954. Payments equal to the fair market value of the timber existing at the execution of the contract constitute proceeds of sale of timber. Any gain included in the above amount is capital gain provided the conditions described in sections 1221 and 1231 of the Code are met. Any excess of such payments over the fair market value of the timber existing at the execution of the contract is ordinary income.

Advice has been requested as to the manner in which the owner of timber land, who enters into a long-term contract, under the circumstances described below, should treat the income therefrom for Federal income tax purposes.

The contract entered into between the owner of the timber land and a paper company is to extend for 60 years. The contract provides that for the stated term the owner agrees to "sell" and the company to "buy" all timber growing and to be grown upon the tract. The paper company, during the first ten years of the contract, must pay for and may cut 4M cords of wood per year, and during the next ten years must pay for and may cut 8M cords of wood per year. During the succeeding 40 years, timber cruises are to be made at specified intervals and quantities of annual growth of timber are to be estimated. Over this period of 40 years, the company must make annual payment for 8M cords or the quantity of estimated annual growth, whichever is greater, but cutting in any year may not exceed the estimated annual growth. However, with respect to the entire contract term, timber permitted to be cut, which is not cut in any year, may be cut in any of the succeeding twelve years, but not later than the expiration date of the contract, provided the quantity permitted to be cut in the later year is first cut.

The contract payment is at the rate of 3x dollars per cord, subject to periodic adjustment to reflect changes in the Wholesale Commodity Price Index of all commodities from that prevailing at the execution of the contract, but in no event shall

the adjusted payment be at a rate of less than 2x dollars per cord.

The company is required, at its own expense, at all times during the term of the contract, to manage and operate the land and timber thereon in accordance with good forestry practices in such manner that the average annual growth of timber shall not be less than the amount of timber cut and removed or otherwise utilized annually. The contract provides for the assumption by the company of ad valorem taxes, the use by the company of existing improvements, the right to construct additional improvements, and the right of the company to the full beneficial possession of the surface to an extent not detrimental to timber growth.

Title to the timber was to pass to the purchaser as cut. In the event of fire beyond a specified magnitude, the permissible annual cut could, at the seller's option, be reduced in proportion to the acreage affected, but purchaser was obligated to continue paying under the original schedule. In the event performance of any part of the agreement was prevented by specified factors beyond the control of the parties (including infestation of timber but not including fire) purchaser's obligation to pay was to be reduced in proportion to the extent and duration of such factors.

The fair market value of the timber existing at the date of the contract (merchantable timber of cutting size and smaller young growth of appraisable value) exceeds the landowner's adjusted basis for such timber.

Capital gain treatment of any portion of the landowner's receipts under the contract would be available to the landowner only to the extent that the transaction constituted either (1) a "sale" of timber, within the purview of sections 1221 or 1231 of the Internal Revenue Code of 1954, or (2) a "disposal" of timber within the purview of section 631(b). If the timber is held by the landowner "primarily for sale to customers in the ordinary course of trade or business," the provisions of sections 1221 or 1231 are not applicable. However, the fact that the timber is so held does not preclude the application of section 631(b). *Ah Pah Redwood Company v. Commissioner*, 251 Fed. (2d) 163 (1957); and Rev. Rul. 57-90, C.B. 1957-1, 199.

A "disposal of timber," to qualify under section 631(b), must be under a contract by virtue of which the owner retains an economic interest in such timber. An essential condition is that recovery of the capital investment of the owner must be conditioned upon severance of the timber. *Estate of James M. Lawton v. Commissioner*, 33 T.C. 47 (1959). See also section 1.611-1(b)(1) of the Income Tax Regulations; *Joe S. Ray v. Commissioner*, 32 T.C. 1244 (1959), affirmed 283 Fed. (2d) 337 (1960); and Rev. Rul. 56-542, C.B. 1956-2, 327.

The fact that the original unit price is subject to periodic adjustment for changes in the Wholesale Commodity Price Index of all commodities does not give the landowner a retained economic interest in the timber. The provision merely assures the landowner a return which will reflect changes in the general purchasing value of the dollar.

The possibility of a reduction of the purchaser's obligation to pay, to the extent that performance is prevented by specified

factors other than fire does not create a retained economic interest in the timber; despite such possibility, the landowner still looks to payments which are not conditioned upon the severance of timber for the recovery of his investment.

By the contract the landowner is to be paid stipulated amounts which are not conditioned on the quantities of timber which the paper company cuts. The landowner is assured of a fixed return, and the paper company is committed to a fixed obligation, neither of which is dependent upon, or governed by, the time or degree of severance of the timber. Thus, the landowner does not possess a "retained economic interest" in the timber. Accordingly, the transaction is not a "disposal" of timber under section 631(b) of the Code.

The contract, however, accomplishes a "sale" of the timber existing at the time of its execution. The contract shifts to the paper company the significant benefits and burdens incident to beneficial ownership of the timber during its term. The retention by the landowner of legal title to the timber until cut is merely a security device.

The agreement can accomplish a "sale" only of timber existing at the date of the contract since only timber in existence can be the subject of a present sale. See Williston on Sales (Rev'd Ed.), sections 62 and 258.

The landowner has parted with all control of the timber and of the land itself so far as it pertains to timber growth; growth occurring during the term of the contract is attributable to the possession and management of the property by the paper company. This would apply both to the subsequent growth of trees existing at the making of the contract and to timber grown in its entirety during the contract term. Payments under the contract not attributable to timber existing at the execution of the contract are not proceeds of sale of timber by the landowner but are consideration for the use of land by the paper company and, therefore, constitute ordinary income. *Estate of James M. Lawton*.

Accordingly, payments under the contract equal to the fair market value of the timber existing at the execution of the contract constitute proceeds of sale of timber. Any gain included in the above amount is capital gain, provided the conditions specified in section 1221 or 1231 of the Code are met. Any excess of such payments over the fair market value of the timber existing at the execution of the contract is ordinary income.

(Amplified by Rev. Rul. 78-267, p. 67)

62-82. Tax Treatment of Lump Sum Payment Received Under Long-Term Lease. *Lump sum payment under a contract for the lease of land and the grant of the right to cut timber therefrom constitutes proceeds of the sale of timber to the extent of the fair market value of the timber then existing; the resulting gain or loss is subject to the treatment described in Subchapter P of the Internal Revenue Code of 1954, provided the provisions thereof are met. Any excess of such payments over the fair market value of the existing timber is ordinary income.*

Advice has been requested as to the treatment for Federal income tax purposes of income received by an owner, or lessor,

pursuant to a long-term contract under the circumstances described below.

In the case under consideration, the owner (taxpayer) of timberland, in consideration of 2x dollars per acre per year or a total of 198x dollars (received in a lump sum upon the execution of the contract), leased, let and rented to a paper company for 99 years the surface rights, the rights of future operation and the right to cut and remove any and all timber, trees, wood and other forest products standing, growing or being situated and to be situated during the life of the contract on the described land.

The taxpayer retained ownership of all minerals rights and remained liable for taxes on such retained rights. The paper company was obligated to pay all taxes assessed against the leased property, including severance tax on the timber. The paper company may relieve itself of future liability for taxes with respect to such acreage as it may designate, but there is no provision for the rebate under such circumstances of any of the consideration originally paid for the use of such acreage.

The paper company has the exclusive right to recover for damages to the timber caused by mineral operations of the taxpayer or his lessees. The paper company's reimbursed for any land used in sand and gravel operations at a specified rate and for any damage to timber from such operation.

The taxpayer warrants title to the property, including timber thereon. In the event of loss of title by the taxpayer, or loss of possession by the paper company, the taxpayer will refund to the paper company the original consideration paid per acre for the lands so affected. The paper company has the right to recover and keep any awards, or damage payments resulting from trespasses or from condemnation of the property for public use, with respect to the value of the timber and the value of its rights with reference to future operations under the contract.

For reasons more fully set forth in Revenue Ruling 62-81 (page 56 of this publication), there has been under this contract, no "disposal" of timber within the meaning of section 631(b) of the Internal Revenue Code of 1954.

The question remains whether any portion of the lump-sum payment under the instant contract is consideration for a transfer of property in a transaction amounting to a present sale of timber. The transaction could properly be such only if some portion of the consideration was paid for timber having, at the time of the execution of the contract, a determinable fair market value (merchantable timber of cutting size and smaller young growth of appraisable value). Timber that is not in existence at the time of the contract cannot be the subject of a present sale. See Williston on Sales (Rev'd Ed.), sections 62 and 258.

The rights and privileges conferred upon the paper company comprehended both the possession of land and the disposition of timber. There is no provision of the contract which relates any portion of the payment specifically to timber. Despite the absence of such a reference, however, some portion of the payment received by the landowner may, in fact, be attributable to timber. This would be true if the timber existing on the tract

at the execution of the contract possessed a determinable fair market value. If the taxpayer establishes the fair market value of such existing timber, the payment to the extent of such fair market value constitutes proceeds from the sale of timber. The portion of the payment in excess of the value so established is in the nature of consideration for the use of land over a period of time and, therefore, ordinary income.

The position here is consistent with the conclusion by the Tax Court of the United States in *Estate of James M. Lawton v. Commissioner*, 33 T.C. 47 (1959), dealing with the tax treatment of receipts under a lease agreement. In that case capital gain treatment had been allowed by the Commissioner of Internal Revenue with respect to receipts by the taxpayer, the landowner, for a described quantity of existing timber. The controversy related to succeeding receipts by the taxpayer which, from the evidence before the court, could not be identified as attributable to timber existing at the execution of the lease contract. The court held that such succeeding receipts were ordinary income to the landowner, describing these receipts as "in the nature of rent for the right to use and occupy acreage for 'pine tree farming' and other independent forestry activities." In the instant case, the taxpayer may establish that there was an existing stand of timber to which a determinable portion of the consideration could be attributed.

Accordingly, it is held that the lump sum payment received under the instant contract constitutes proceeds from the sale of timber to the extent of the fair market value of the timber existing at the execution of the contract; that the resulting gain or loss is subject to the treatment described in Subchapter P of the Code, provided the provisions thereof are met; and that any excess of the payment over the amount of such fair market value is ordinary income.

(Amplified by Rev. Rul. 78-267, p. 67)

66-9. Casualty Loss Deduction Limited to Basis of Timber Destroyed. *The amount allowable as a deduction for a casualty loss due to destruction of timber by hurricane may not exceed the adjusted basis for determining loss from the sale or other disposition of the quantity of timber which by fair and reasonable estimates is found to be unfit for use because of the hurricane.*

Advice has been requested concerning the amount allowable for a casualty loss due to destruction of timber by a hurricane.

A taxpayer owns several tracts of timberland which he holds for investment. Some of the tracts were acquired by gift or inheritance. The taxpayer acquired other tracts by occasional purchases and exchanges over a period of years. The timberland was not acquired for resale in the course of any business.

A hurricane destroyed or damaged some of the timber on five different tracts of the taxpayer's land. The damage included breakage and uprooting of standing timber varying in severity from tract to tract. Some of the damaged timber was salvaged and some of it was unfit for salvage.

Section 165(a) of the Internal Revenue Code of 1954 provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Under section 165(c)(2) of the Code in the case of an individual a deduction is allowed for losses incurred in any transaction entered into for profit.

Section 1.165-7 of the Income Tax Regulations outlines the manner of determining the amount of a casualty loss allowable as a deduction. Section 1.165-7(b) of the regulations provides:

(b) *Amount Deductible.*—(1) *General Rule.*—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 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 § 1.1011-1 for determining the loss from the sale or other disposition of the property involved.

However, if the property used in a trade or business or held for the production of income is totally destroyed by casualty, and if the fair market value of such property immediately before the casualty is less than the adjusted basis of such property, the amount of the adjusted basis of such property shall be treated as the amount of the loss for purposes of section 165(a).

(2) *Aggregation of Property for Computing Loss.*—(f) A loss incurred in a trade or business or in any transaction entered into for profit shall be determined under subparagraph (1) of this paragraph by reference to the single, identifiable property damaged or destroyed. * * *

In the case of a casualty loss to timber, the “property involved” and the “single, identifiable property” destroyed is the quantity of timber which is rendered unfit for use by reason of the casualty. The amount of the casualty loss allowable is limited to the adjusted basis prescribed in section 1.1011-1 of the regulations for determining the loss from the sale or other disposition of that quantity of timber. The adjusted basis of the quantity of timber destroyed is determined by multiplying the unit adjusted basis by the quantity of timber destroyed.

In *Oregon Mesabi Corporation v. Commissioner*, 39 B.T.A. 1033 (1939), acquiescence, C.B. 1944, 22, the United States Board of Tax Appeals (now the Tax Court of the United States) held that timber killed by a fire was not thereby made worthless. Deduction for loss was allowed for the quantity of timber found by fair and reasonable estimates to have been destroyed. The court pointed out that timber which may be salvaged is not destroyed, but will present the usual problems of depletion when it is salvaged.

Gain or loss from the sale or other disposition of the timber which was not destroyed by the hurricane should be determined by deducting at the time of sale or other disposition the adjusted basis of the quantity of timber involved from the amount received for that timber. The adjusted basis of the quantity of timber rendered worthless for practical purposes is allowable as a deduction for casualty loss by hurricane if the loss is not compensated for by insurance or otherwise.

Accordingly, the amount allowable as a deduction for casualty loss due to destruction of timber by hurricane may not exceed the adjusted basis for determining loss from the sale or other

disposition of the quantity of timber which by fair and reasonable estimates is found to be unfit for use by reason of the hurricane. Such adjusted basis does not include any portion of the basis (or adjusted basis) attributable to the land, other improvements, or to any timber not rendered worthless by the hurricane.

66-18. Cost of Shearing and Pruning Christmas Trees Must be Capitalized. *In connection with the cultivation, as a trade or business, of Christmas trees for purposes of sale when they are more than six years old, the expenditures incurred for planting, basal pruning, stump culture and shearing must be capitalized. Expenditures incurred for silvicultural practices such as weeding, or cleaning, and noncommercial thinning are deductible as ordinary and necessary trade or business expenses. The cost of land improvements is capitalized in the land account or depreciated, depending on whether the useful life of such improvements is determinable. The cost of equipment purchased and other depreciable assets, such as culverts and fences, should be capitalized and recovered through the allowance for depreciation.*

(However, see page 28 of text and Rev. Rul. 71-228, page 61, for treatment of shearing and pruning costs.)

Advice has been requested relative to the Federal income tax treatment of certain expenditures incurred in connection with the cultivation of Christmas trees as a trade or business.

The taxpayer grows and sells Christmas trees. In some areas he plants the trees, in other areas he cultivates and cuts trees that have been naturally seeded. The taxpayer in all instances sells only those trees more than six years old, whether planted or naturally seeded trees. In planting seedlings, the taxpayer usually prepares the land prior to the actual planting. However, there are instances when the seedlings may be planted in one year and competing hardwood brush removed a year or two later to prevent suppression of seedlings.

In connection with the cultivation of both planted and naturally seeded trees, the taxpayer incurs certain expenditures before the cutting of such trees; for example, expenditures for basal pruning, stump culture, shearing and silvicultural practices, such as weeding, or cleaning, and noncommercial thinning. Basal pruning involves the removal of the lower limbs to stimulate heavier growth on the remainder of the top portion of the tree. It is more commonly applied in natural stands and in many cases makes a marketable tree of one which otherwise would be too thin at the top. Stump culture involves careful pruning of the stump to promote the growth of additional trees from the same stump. Hormones are sometimes used on the stump to stimulate sprouting. The pruning operation may be repeated each time a tree is cut from the stump. Shearing is a practice in which the terminal leader and the side branches are pruned to shape the tree. It is done primarily in planted stands and is usually done more than once to improve the shape and proportions of the tree.

Weeding, or cleaning, is a silvicultural operation employed in young established stands to free small trees from weeds, vines, etc., and to provide better growing conditions by liberating crop trees from other trees of a similar age but of less desirable species. It is sometimes done, especially in plantations, by cultivating between the rows or sometimes by spraying with

selective herbicides. Noncommercial thinning is the removal of excess trees in immature stands to give the remaining trees room to grow.

In addition to the above, the taxpayer incurs other expenditures for road grading, ditching, fire breaks, culverts and fences.

The general rules regarding capital expenditures, as set forth in section 1.446-1(a)(4)(ii) and (iii) of the Income Tax Regulations, provide (1) that expenditures shall be properly classified as between capital and expense and (2) that in any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditure (other than ordinary repairs) made to restore the asset or to prolong its useful life shall be added to the asset account.

Section 1.263(a)-1 (w) and (b) of the regulations provides, in part, that no deduction shall be allowed for amounts paid or incurred to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use.

Therefore in general, it may be said that expenditures, paid or incurred in the business of growing Christmas trees for purposes of sale when they are more than six years old, must be capitalized when they (1) are for the acquisition of property having a useful life of more than one year; (2) add to the value of property owned by the taxpayer; (3) prolong the useful life of property owned by the taxpayer; or (4) adapt property to a new or different use.

Such capital expenditures are to be treated in one of the following ways: (1) As an increase in the basis of the trees, recoverable through allowance for depletion as the trees are cut or as adjusted basis if the standing trees are sold; or (2) as part of the cost of depreciable property, recoverable through allowance for depreciation as provided in section 167 of the Internal Revenue Code of 1954; or (3) as not subject to depletion or depreciation.

Section 1.162-1(a) of the regulations provides that the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or credit under provisions of the law other than section 162 of the Code, may be deducted from gross income as business expenses.

Section 1.611-3(a) of the regulations provides that amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances.

Revenue Ruling 55-252, C.B. 1955-1, 319, holds that direct costs incurred in connection with reforestation by planting are capital expenditures. The ruling enumerates the following planting costs: (a) Preparation of the site, including any girdling or brush removal work to afford good growing conditions; (b) cost of seedlings; and (c) labor and tool expense, including depreciation of equipment used in planting, such as trucks, tree planters, etc.

Brush removal work performed a year or two after planting is considered to be proximately related to the establishment of the seedlings. Such work is essentially a part of the planting operation, and its cost should be capitalized. The cost of seedlings includes the amount expended for those purchased and those planted and raised by the taxpayer. The labor and tool expense includes all costs involved in planting the seedlings, including all amounts expended for transportation, supervision and labor, equipment rental and depreciation of owned equipment and tools used in connection with the planting. The portion of the depreciated cost of equipment thus added to the basis of the seedlings should be proportionate to the use of the equipment or tools in planting as compared with the use of such equipment or tools in other activities of the taxpayer.

Other expenditures that are capital in character include expenditures for basal pruning, stump culture and shearing. Capitalized costs, such as the aforementioned attributable to the planting and cultivation of Christmas trees, are recoverable (1) as adjusted basis when the standing trees are sold or (2) through allowances for depletion as the trees are cut.

The cost of land improvements which have a useful life substantially beyond the taxable year, such as road grading, ditching and fire breaks, should be capitalized. If such improvements do not have a determinable useful life, then the cost should be added to the basis of the land, to be recovered when the land is disposed of, as in a sale. If they do have a determinable useful life, then the cost should be recovered through annual depreciation. In no case should their cost be added to the basis of the trees.

The cost of equipment purchased and other assets having a limited and determinable life such as culverts and fences, should be capitalized and recovered through annual allowances for depreciation. But compare Revenue Ruling 55-252 for the rule concerning the treatment of depreciation of equipment used in planting as a planting cost and therefore a capital expenditure to be added to the basis of the seedlings.

The expenditures for silvicultural practices such as weeding and noncommercial thinning are incurred after the trees become established and before they are ready to be cut. Such expenditures are in the nature of maintenance charges and are deductible as ordinary and necessary trade or business expenses. In the case of a thinning operation which produces marketable trees, any amount received from the sale of the trees so removed is includible in gross income.

Accordingly, in planting and cultivation of Christmas trees as a trade or business the expenditures incurred for planting, basal pruning, stump culture, and shearing must be capitalized and added to the basis of the standing trees. These expenditures are recoverable as adjusted basis when the standing trees are sold or through depletion allowances as the trees are cut. Expenditures incurred for silvicultural practices, such as weeding, or cleaning, and noncommercial thinning are deductible expenses. The cost of land improvements is capitalized in the land account or depreciated, depending on whether the useful life of such improvements is determinable. The cost of equipment purchased and other depreciable assets (to the extent not used in connection with the planting of Christmas

trees) such as culverts and fences, should be capitalized and recovered through allowances for depreciation.

71-228. Cost of Basal Pruning Christmas Trees May Be Deductible Business Expense. *Costs incurred in taxable years ending after May 24, 1971, for shearing and basal pruning of trees grown for the Christmas tree market are deductible business expenses; Revenue Ruling 66-18 modified.*

The Internal Revenue Service has reconsidered Revenue Ruling 66-18, C.B. 1966-1, 59, insofar as it relates to the treatment of costs incurred for the shearing and basal pruning of trees grown for the Christmas tree market. Revenue Ruling 66-18 holds that such costs represent capital expenditures under section 263(a) of the Internal Revenue Code of 1954.

In *Daniel D. Kinley v. Commissioner*, 51 T.C. 1000 (1969), affirmed per curiam—F.2d—(1970), the Tax Court of the United States held that the cost incurred by the petitioner for the annual shearing of Christmas trees was an ordinary and necessary business expense deductible under section 162 of the Code. The court's holding is in accord with *Ransburg v. United States*, 281 F. Supp. 324 (1967).

The decision in *Kinley* is premised upon the Tax Court's findings of the unique conditions present in the Christmas tree industry. The Tax Court found that the sole use of the trees grown by the petitioner was for ornamental Christmas trees and that the seedlings planted by the petitioner were planted as Christmas trees. Under this view of the facts, the shearing did not adapt the trees to any use other than their use as Christmas trees. The court found that shearing, rather than improving or increasing the value of the trees, simply maintained and preserved the marketability of the trees as ornamental Christmas trees.

Upon reconsideration of the issue, the Service accepts the court's characterization of the ultimate facts involved.

Accordingly, based on the trees being planted and grown as Christmas trees rather than being converted into Christmas trees, the costs incurred for the shearing and basal pruning of trees grown for the Christmas tree market are deductible business expenses under section 162 of the Code.

Revenue Ruling 66-18, insofar as it relates to the treatment of costs incurred for the shearing and basal pruning of trees grown for the Christmas tree market is hereby modified.

Pursuant to the authority contained in section 7805(b) of the Code, the conclusions of this Revenue Ruling will not be applied for taxable years ending on or before May 24, 1971, the date the Revenue Ruling is published in the Internal Revenue Bulletin, to require an adjustment to basis where such costs were capitalized for prior taxable years.
(*Modifying Rev. Rul. 66-18, p. 59*)

71-334. Timber Sale Expenses. *Expenditures directly attributable to a disposal of timber under Section 631(b) of the Code are reductions of the "amount received" for purposes of computing gain or loss from such disposal.*

Advice has been requested as to the Federal income tax treatment of expenditures directly attributable to the disposal of timber under the provisions of section 631(b) of the Internal Revenue Code of 1954.

In connection with a disposal of timber, so as to produce the maximum income therefrom, the taxpayer expended certain amounts directly attributable to the disposal for:

- (1) advertising the timber for disposal;
- (2) cruising to determine the quantity and quality of timber to be disposed of;
- (3) marking or otherwise designating the timber for cutting;
- (4) marking seed trees to be retained;
- (5) scaling, measuring, or otherwise determining the quantity of timber cut;
- (6) fees paid to consulting foresters, selling agents, and others for services directly related to the timber disposal;
- (7) supervising or checking performance under the contract; and
- (8) other expenses directly attributable to the disposal.

Section 631(b) of the Internal Revenue Code of 1954 provides, in part:

In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber.

The specific question in the instant case is whether the words "amount realized" as used in section 631(b) of the Code mean the gross amount received or whether these words are to be interpreted to mean the gross amount reduced by the direct expenses incident to the transaction.

In considering an amendment to section 117 of the Internal Revenue Code of 1939, now section 631 of the Internal Revenue Code of 1954, Senate Report No. 627, 78th Cong., First Session, C.B. 1944, 973 at 993, on the Revenue Act of 1943, P.L. 235, C.B. 1944, 757, states:

Your committee is of the opinion that various timber owners are seriously handicapped under the Federal income and excess profits tax laws. The law discriminates against taxpayers who dispose of timber by cutting it as compared with those who sell timber outright. The income realized from the cutting of timber is now taxed as ordinary income at full income and excess profit tax rates and not at capital gain rates. In short, if the taxpayer cuts his own timber he loses the benefit of the capital gain rate which applies when he sells the same timber outright to another. Similarly, owners who sell their timber on a so-called cutting contract under which the owner retains an economic interest in the property are held to have leased their property and are therefore not accorded under present law capital-gain treatment of any increase in value realized over the depletion basis.

It is apparent that, in the above statement, a comparison was being made of economic income from sale versus economic

income from cutting or lease. The impact of income tax upon a taxpayer deriving income from cutting or lease discriminated against such taxpayer as compared with the impact of the lower capital gain rate applicable to a taxpayer deriving income from a sale.

It has been the consistent position of the Internal Revenue Service, in connection with transactions qualifying for capital gain or loss treatment, that selling expenses are treated as an offset to the selling price. (*Mrs. E. A. Giffin v. Commissioner*, 19 B.T.A. 1243, (1930); *Therese C. Johnson v. Commissioner*, 7 T.C. 465, acquiescence C.B. 1946-2, 3. Since the selling expenses in a sale of a capital asset are considered in arriving at income subject to a capital gain tax, it is reasonable to give like consideration to direct expenses in connection with income from leases. The comparison set forth in the above Committee Report constitutes a comparison of like concepts and affords a basis for a sound determination as to a finding of discrimination between similarly situated taxpayers. The fact that selling expenses may be of a recurring nature has been held not to affect their treatment as an adjustment to the selling price. *General Spring Corporation v. Commissioner*, Tax Court Memorandum Opinion, entered July 27, 1953.

It has been held that expenditures for the construction of access roads that are directly related to a disposal of timber under section 631(b) of the Code should be offset against capital gains realized on the disposal. *Dorothy C. Regan v. United States*, 410 F.2d 744 (1969).

Accordingly, it is held that expenditures directly attributable to a disposal of timber subject to the provisions of section 631(b) of the Code are reductions of the "amount received" for the purpose of computing gain or loss from such disposal. Whether any expenditure is directly attributable to a disposal of timber is to be determined largely on the strength or persuasiveness of the facts of each particular case and how closely related are the activities in connection with which the expenditure is incurred to the disposal of the timber.

73-51. Casualty Loss Resulting from Ice Storm. *Ice storm damage to merchantable trees that reduces the rate of growth or quality of subsequent timber increment but does not render the existing timber unfit for use is not a deductible casualty loss.*

Advice has been requested whether, under the circumstances described below, physical damage to surviving merchantable trees, arising from an ice storm, results in a deductible loss under section 165(a) of the Internal Revenue Code of 1954.

A taxpayer owns a large tract of timberland which it manages for the continuous production of wood for use in its business of manufacturing paper pulp. At the time of acquisition the total acquisition costs were allocated to the timber and land accounts, respectively.

An ice storm struck portions of the timberland causing physical damage to many of the "merchantable trees." "Merchantable trees" are those trees contributing to the quantity of timber determined according to section 1.611-3(e) of the Federal income tax regulations for the purpose of claiming a deduction for depletion.

The taxpayer claimed a casualty loss for the taxable year the damage occurred. The amount of the claimed loss was the estimated value of the "measurable damage" (physical damage) to the surviving merchantable trees. None of the claimed loss was compensated for by insurance or otherwise.

The taxpayer described the "measurable damage" as:

1. Broken top or limbs affecting at least 20 percent of the tree's crown, thereby slowing the tree's rate of growth.
2. Observable root damage that would probably weaken the tree, thereby reducing the rate of growth and leaving the tree more susceptible to attack from insects and disease.
3. Leaning or bending of the tree that will cause the formation of compression wood in subsequent timber increment, thereby reducing the quality of such increment.

Damaged areas were classified as heavy, medium, and light according to the percentage of surviving merchantable trees estimated to have suffered damage. For each class of damage the percent of the reduction in the rate of growth and the number of units of subsequent timber increment that would be downgraded in quality were estimated. From these estimates the projected economic loss at the time of future timber harvest was computed and discounted at six percent per annum to the date of the casualty. The amount determined in this manner was claimed as a casualty loss.

Section 1.165-7(b)(1) of the regulations 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 such loss is the lesser of either (1) the difference in the fair market value of the property immediately before and immediately after the casualty, or (2) the property's adjusted basis. Section 1.165(b)(2) of the regulations provides that in the case of property used in a trade or business or in any transaction entered into for profit, the amount of such loss is the lesser of either (1) the difference in the fair market value of the property immediately before and immediately after the casualty, or (2) the property's adjusted basis. Section 1.165-7(b)(2) of the regulations further provides that in the case of such property, any casualty loss to such property must be determined by reference to the single, identifiable property damaged or destroyed.

Section 1.611-3(d)(3) of the regulations provides that the total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively.

Section 1.611-3(e) of the regulations provides in pertinent part that each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, whichever date is applicable in determining the basis for cost depletion.

Revenue Ruling 66-9, 1966-1 C.B. 39, provides that in the case of a casualty loss to timber the "property involved" and

the "single, identifiable property" destroyed is the quantity of timber which is rendered unfit for use by reason of the casualty. Accord. *Rosenthal v. Commissioner*, 461 F.2d 491 (1969), affirming 48 T.C. 515 (1967); *Harper v. United States*, 396 F.2d 233 (1968), affirming per curiam, 274 F. Supp. 809 (D.S.C. 1967).

In denying a claim for the loss of future profits under section 165(a) of the Code the Tax Court of the United States held that it is vital to a loss that something of value be parted with. The Code contemplates only a loss of capital, or, in other words, actual loss of tangible or measurable property. This does not encompass a failure of profits or the loss of potential income. *Squirt Company v. Commissioner*, 51 T.C. 543 at 548 (1968), affirmed per curiam, 423 F.2d 710 (1970).

In the instant case the total quantity of timber on the tract was determined in accordance with section 1.611-3(e) of the regulations, and the total acquisition costs were allocated to the depletable timber account and the nondepreciable land account in accordance with section 1.611-3(d)(3) of the regulations. Therefore, there are two separately identifiable assets, timber and land, either of which may be the subject of a casualty loss. See *Estate of Sam E. Broadhead v. Commissioner*, T.C. Memo. 1966-26 (appealed on other issues).

The physical damage, described in 1, 2, and 3 above, suffered by the merchantable trees because of the ice storm did not result in any of the existing timber being damaged or rendered unfit for use, and therefore the damage was not measurable in units of timber destroyed. Any loss resulting from such physical damage would be in the nature of contemplated loss of future profits or potential income due to a reduction in the rate of growth or the quality of subsequent timber increment. Therefore, such physical damage suffered by the merchantable trees is not a deductible loss. Revenue Ruling 66-9.

Since the existing timber suffered no physical damage and none was rendered unfit for use because of the casualty, if any deductible loss occurred it would have been the result of damage to the land. To determine if the land suffered a deductible loss it must be viewed as if devoid of merchantable trees because timber and land are separately identifiable accounts under section 1.611-3(d)(3) of the regulations.

Accordingly, under the facts of this case, it is held that physical damage to the surviving merchantable trees arising from an ice storm, does not result in a deductible loss under section 165(a) of the Code.

75-59. Basis for Depletion of Long-Term Timber Contract.

The fair market value of the timber existing at the time of the execution of a long-term timber purchase contract constitutes the basis for depletion of the timber and payments in excess of the fair market value are consideration for the use of the land deductible as a business expense.

Advice has been requested as to the manner in which a taxpayer, a paper company, should treat the payments made under a long-term contract under the circumstances described below.

The contract entered into between the paper company and an owner of timberland provides that for the term of 60 years the owner agrees to "sell" and the paper company to "buy" all timber growing and to be grown upon the described tract of timberland. The paper company must pay for and may cut 4y cords of wood per year during the first ten years of the contract, and must pay for and may cut 8y cords of wood per year during the next ten years. During the remaining 40 years, quantities of annual growth of timber are to be estimated at specified intervals based on timber cruises. Over this period of 40 years, the company must make annual payments for 8y cords or the quantity of estimated annual growth, whichever is greater, but cutting in any year may not exceed the estimated annual growth. However, with respect to the entire contract term, timber permitted to be cut, which is not cut in any year, may be cut in any of the succeeding twelve years, but not later than the expiration date of the contract.

The contract payment is at the rate of 3x dollars per cord, subject to periodic adjustments to reflect changes in the Wholesale Commodity Price Index of all commodities from that prevailing at the execution of the contract, but in no event shall the adjusted payment be at a rate of less than 2x dollars per cord.

During the term of the contract, the paper company is required to manage and operate the land and timber thereon in accordance with good forestry practices in such manner that the average annual growth of timber shall not be less than the amount of timber cut and removed or otherwise utilized annually. The contract provides that the company will assume the ad valorem taxes, have the use of existing improvements, have the right to construct additional improvements and have the right to the full beneficial possession of the surface to an extent not detrimental to timber growth.

According to the contract, title to the timber passes to the company as it is cut. In the event of fire beyond a specified magnitude, the permissible annual cut could, at the seller's option, be reduced in proportion to the acreage affected, but the company is obligated to continue paying under the original schedule. In the event performance of any part of the agreement is prevented by specified factors beyond the control of the parties (including infestation of timber but not including fire), the company's obligation to pay is to be reduced in proportion to the extent and duration of such factors.

Rev. Rul. 62-81, 1962-1 C.B. 153 considers the question of treatment by the owner of the payments received under the type of contract in the instant case and holds that, for Federal income tax purposes, the contract accomplishes a sale of the timber existing at the time of the execution of the contract rather than a disposal of timber with a retained economic interest under section 631(b) of the Internal Revenue Code of 1954, and that payments under the contract in excess of the fair market value of the existing timber are not proceeds of sale of timber by the landowner but are consideration received for the use of the land by the paper company.

Where, in accordance with the contract, the landowner sells the existing timber and leases the land, the consideration paid

by the purchaser is for the purchase of the same timber and the lease of the same land.

Accordingly, in the instant case, the amounts paid under the contract equal to the fair market value of the timber existing at the time of the execution of the contract are capital costs of timber to the purchaser, recoverable through allowance for depletion as the trees are cut, or as adjusted basis of the standing trees in the case of sale, exchange, or other disposition. Any excess of such payments over the fair market value of the timber existing at the time of the execution of the contract is consideration for the use of the land and is deductible under section 162(a) of the Code.

(Amplified by Rev. Rul. 78-267, p. 67)

75-467. Capitalization of Reforestation Expenses. Generally, direct costs incurred in connection with reforestation by planting and artificial or natural seeding are capital expenditures, recoverable through the allowance for depletion when the timber is cut, or as adjusted basis if the timber is sold. See section 1.611-3(a) and section 1.1011-1 of the Income Tax Regulations. Such planting or seeding costs include:

(a) preparation of the site, including any girdling, herbicide applications, baiting of rodents, or brush removal work to afford good growing conditions;

(b) cost of seed or seedlings; and

(c) labor and tool expense, including depreciation of equipment such as tractors, trucks, tree planters and similar machines used in planting or seeding.

Indirect expenditures, such as interest paid on money borrowed to satisfy a state law requiring a deposit to guarantee natural reforestation over a specified period of years in lieu of planting, or a service charge on a performance bond in lieu of a cash deposit, may be treated as current deductions for the year in which incurred or capitalized cumulatively in accordance with a proper election by the taxpayer under the provisions of section 266 of the Internal Revenue Code of 1954.

Rev. Rul. 55-252, 1955-1 C.B. 319, is hereby superseded, since the position stated therein is set forth under the current statute and regulations in this Revenue Ruling. (See Sec. 194 of the Internal Revenue Code, page 42, and page 10 of the text.)

76-6. Reimbursements Under the Forestry Incentives Program. Cost sharing payments received from the Federal government under the forestry incentives program of the Agriculture and Consumer Protection Act of 1973 are includible in income, and the total costs of reforestation (not diminished by such payments) are to be capitalized as a cost of timber.

Advice has been requested regarding the treatment for Federal income tax purposes of a cost sharing payment received from the Federal government under the forestry incentives program (F.I.P.) of the Agriculture and Consumer Protection Act of 1973, Pub. L. No. 93-86.

The taxpayer reforested his non-industrial private forest land by planting tree seedlings and paid the total costs of such reforestation. Under the cost sharing provisions of F.I.P., the taxpayer received a reimbursement from the Federal government equal to 75 percent of his total reforestation costs.

Section 61 of the Internal Revenue Code of 1954 provides, in general, that gross income means all income from whatever source derived, unless excludable by law.

Section 263 of the Code provides, in pertinent part, that no deduction from income is allowable for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 1.611-3(a) of the Income Tax Regulations provides, in pertinent part, that amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances.

Government payments and cost sharing benefits received by farmers and ranchers under soil conservation and similar programs have been held to be income. *Baboquivari Cattle Co. v. Commissioner*, 135 F. 2d 114 (9th Cir. 1943), 1943 C.B. 1013; *Roy L. Harding*, 29 CCH Tax Ct. Mem. 789 (1970); *Clara Driscoll*, 3 CCH Tax Ct. Mem. 73 (1944).

Similarly, in the instant case, the F.I.P. payment is includible in the taxpayer's gross income in the year received, and the total costs of reforestation (not diminished by the F.I.P. payment) are to be capitalized as a cost of timber, recoverable through allowances for depletion as the timber is cut, or as adjusted basis for gain or loss in the event of sale or other disposition of the timber by the taxpayer. (See Sec. 126 of the Internal Revenue Code, p. 42, and p. 23 of the text.)

76-290. Depletion; Reforestation Expenditures. The expenditures for destroying undesirable hardwood trees and brush in naturally reforested stands of southern pine young growth are related to the seeding and establishment of the pine seedlings and are capital expenditures recoverable through depletion.

Advice has been requested whether, under the circumstances described below, expenditures for control of unwanted hardwood trees in naturally regenerated (reforested) stands of southern pine young growth must be capitalized in accordance with section 1.611-3(a) of the Income Tax Regulations.

A taxpayer owns extensive areas of timberlands in the south and manages them for the continuous production of wood. Much of the land supports forest stands of the loblolly-shortleaf pine type. The species composition of these stands, other than the predominating loblolly pine (*Pinus taeda*) and shortleaf pine (*Pinus echinata*), includes a number of hardwoods. The hardwood species, because they are more shade tolerant than the pines, often form dense understories in the mature pine stands. The pine stands are considered by the taxpayer to be mature and ready for harvesting at age 40 years.

Most of the hardwood trees have little or no market value because of their defectiveness, poor form, or small size. When the merchantable trees in such stands are cut (harvested), the residual undesirable hardwoods soon dominate the site so that regeneration of the valuable loblolly-shortleaf pine forest is prevented unless effective measures are taken to control the hardwoods, either by eliminating them or reducing their growth and vigor.

The taxpayer's method of providing for the reforestation of an area is to harvest all the merchantable timber except for an average of six pine seed trees per acre. The expectation is that the seed trees will drop enough seeds to achieve an adequate stocking of pine reproduction (seedlings) within a period of 3 to 5 years. Although the taxpayer recognizes at the time that the merchantable timber is harvested that the hardwood trees and brush then existing will have to be controlled in order to allow the new pine seedlings to grow to a commercially salable size, the performance of control activities is deferred by the company until after the adequacy of the stocking of pine seedlings can be determined.

If the taxpayer finds, within 3 to 5 years after the harvest cut, that the stocking of pine seedlings is inadequate for the regeneration of the loblolly-shortleaf forest, the taxpayer resorts to artificial reforestation. This is accomplished by first harvesting the pine seed trees, and then preparing the site for planting by eliminating or controlling the undesirable hardwood trees through the use of fire or chemicals, or by mechanical means. Finally, nursery grown pine seedlings are planted. The costs of such site preparation and planting of seedlings are capitalized by the taxpayer in accordance with the provisions of section 1.611-3(a) of the regulations.

If, however, the taxpayer finds that within 3 to 5 years after the harvest cut, an adequate stocking of pine seedlings has been achieved, the natural regeneration of the loblolly-shortleaf forest is considered to be feasible. The pine seed trees are then harvested and the taxpayer inspects the stand of young seedlings to determine the nature and extent of the work that must be done to control the undesirable hardwood trees so that they will not dominate the area to the exclusion of the more valuable pines. Implementation of the control procedures in the naturally reforested areas is usually undertaken by the taxpayer when the pine young growth is from 3 to 7 years old.

Various procedures may be used to accomplish the hardwood control. Mechanical or chemical methods are generally used to destroy or weaken the undesirable hardwoods. On the larger undesirable hardwood trees, a manually operated poison injector may be used. Regardless of the procedure used the objective is the same, to prevent the undesirable residual hardwood trees from dominating the site at the expense of the pine young growth. Such control procedures are a one-time endeavor with respect to each new stand of pine seedlings rather than a recurring type of activity.

Section 1.611-3(a) of the regulations provides, in part, that amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recovered through depletion allowances. Such amounts include, for example, expenditures made for preparation of the timber site for planting or for natural seedling and the cost of seedlings.

Rev. Rul. 66-18, 1966-1 C.B. 59, provides that brush removal work performed a year or two after the planting of Christmas tree seedlings is considered to be proximately related to the establishment of the seedlings. Such work is essentially a part of the planting operation, and its cost is to be capitalized.

Rev. Rul. 75-467, 1975-2 C.B. 93, holds that direct costs incurred in connection with reforestation by planting are capital expenditures. That Revenue Ruling provides specifically that one category of such expenditures is preparation of the site, including any girdling or brush removal work to afford good growing conditions. The term "girdle" means to encircle the stem of a living tree with cuts that completely sever bark and cambium and often are carried well into the outer sapwood, for the purpose of killing the tree.

The taxpayer's hardwood control activities accomplish the same purpose as the girdling referred to in Rev. Rul. 75-467, and are comparable to the site preparation work referred to in that Revenue Ruling and in Rev. Rul. 66-18.

Accordingly, in the instant case, the expenditures made for control of unwanted hardwood trees and brush in naturally regenerated stands of southern pine young growth are proximately connected with the seeding and establishment of the pine seedlings and must be capitalized in accordance with section 1.611-3(a) of the regulations.

77-229. Christmas Trees Sold on "Choose and Cut" Basis. *Income realized from the sale of Christmas trees that are selected and cut on the taxpayer's land by individual purchasers in ordinary income. However, the taxpayer may elect to treat the cutting of trees as sales or exchanges of timber as prescribed by section 1.631-1 of the regulations.*

Advice has been requested whether, for Federal income tax purposes, income realized from the following described transaction is taxable as long-term capital gain.

The taxpayer is in the business of growing evergreen trees and selling them to customers on a "choose and cut" basis for use as Christmas trees. The trees are more than 6 years old when severed from their roots.

In early December, the taxpayer advertises the Christmas trees for sale at its farm on a "choose and cut" basis. Customers, usually families, drive to the taxpayer's farm where the taxpayer shows them the growing trees, and explains that each customer may cut down one or more trees of the customer's choosing and, upon leaving the farm, must pay at specified rates per tree for each tree cut. Rates of payment vary, depending upon the height and shape of the tree. The customers are under no obligation to cut a tree but must pay for all trees actually cut. The transactions are not complete until the customers accept the taxpayer's standing offer by cutting a tree, thereby incurring a liability to pay at the specified rate.

In a typical situation, the taxpayer lends a hand saw to the customer who, upon having cut the chosen tree, returns the saw, pays for the tree at the agreed upon rate, loads it in the car and leaves the farm.

Section 611(a) of the Internal Revenue Code of 1954 provides that in the case of timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion.

Section 631(a) of the Code provides that if on the return the taxpayer so elects for a taxable year, then the cutting of timber (for sale or for use in the taxpayer's trade or business) during the year by the taxpayer who owns, or has a contract right to cut the timber (providing he has owned the timber or has held the contract right for a period of more than the applicable holding period before the beginning of the year) is considered a sale or exchange of the timber cut during the year. If the election has been made, gain or loss to the taxpayer is recognized in an amount equal to the difference between the fair market value of the standing timber as of the first day of the taxable year in which the timber is cut, and the adjusted basis for depletion of the timber in the hands of the taxpayer. For purposes of section 631, the term "timber" includes evergreen trees that are more than 6 years old at the time they are severed from the roots and are sold for ornamental purposes.

Section 631(b) of the Code provides that in the case of the disposal of timber held for more than 9 months (one year for taxable years after 1977) before disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in the timber, the differences between the amount realized from the disposal of the timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of the timber.

Section 1.631-1(d)(4) of the Income Tax Regulations provides that for any taxable year for which the cutting of timber is considered to be a sale or exchange under section 631(a) of the Code, the timber cut shall be considered as property used in the trade or business for the purposes of section 1231, along with other property the taxpayer used in the trade or business as defined in section 1231 (b), regardless of whether the timber is property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

Section 1.631-1(e)(1) of the regulations provides that in case the products of the timber are sold after cutting, either in the form of logs or lumber or in the form of manufactured products, the income from these actual sales shall be considered ordinary income.

Section 631(b) of the Code does not apply to the transactions in the instant case because there was no contract between the parties by virtue of which the customer had both a right and an obligation to cut timber. *Ah Pah Redwood Co. v. Commissioner*, 251 F.2d 163 (9th Cir. 1957); *Jantzer v. Commissioner*, 284 F.2d 348 (9th Cir. 1960); and *Patterson v. Belcher*, 302 F.2d 289 (5th Cir. 1962), *opinion amended and reh. den.*, 305 F.2d 557, *cert. den.* 371 U.S. 921 (1962).

In the instant case, the taxpayer retained all rights and interest in the standing timber. Consequently, the customer never acquired title to, an economic interest in, or a contract right to cut any timber. By the act of cutting a tree, the customer acquires both the right and the obligation to purchase the cut tree. The transaction between the taxpayer and the customer is, therefore, a present sale of a cut Christmas tree rather than a sale of standing timber.

Accordingly, income from the sale of the Christmas trees is ordinary income to the taxpayer.

However, the cutting of the trees is treated as a sale or exchange of timber in the manner prescribed by section 1.631-1 of the regulations provided the taxpayer makes the election under section 631(a) of the Code. The gain or loss on such sale (cutting of the trees) is subject to the tax treatment prescribed by section 1231(a) of the Code. Gain or loss on the actual sale of the cut Christmas trees is determined in accordance with section 1.631-1(e)(1) of the regulations.

78-104. Timber Cutting Contract; Payment for Failure to Cut. *Amounts received under a timber cutting contract for cut timber, the quantity of which is based upon a "cruise" rather than scaling, qualifies for treatment under section 631(b) of the Code. A penalty payment received for failure to cut the "cruised" or marked trees during the term of the contract is ordinary income.*

Advice has been requested whether, under the circumstances described below, the amounts received under a timber cutting contract will qualify for treatment under the provisions of section 631(b) of the Internal Revenue Code of 1951.

W is the fee owner of several thousand acres of timberland. *W* had owned the timberland for more than 1 year when it decided to dispose of selected timber growing on a portion of its timberland.

W marked each tree with paint that was to be included under the contract. At the time each tree was marked it was measured (cruised) to determine the number of merchantable units of timber in the tree. The right to cut the marked timber was offered for sale. *X*, an unrelated corporation, and *W* entered into a contract under the terms of which *W* agrees to sell only the marked timber and *X* agrees to purchase and cut only the marked timber located on a certain described tract of land. The term of the contract is 1 year. *W* retains title to all timber included under the contract until the timber is severed. Title then passes to *X*. *W* is responsible for any loss or damage to the marked timber prior to severance unless the loss or damage is caused by *X*.

The terms of the contract do not require *X* to scale (measure) the logs cut from the timber to determine the quantity of timber cut as is the usual procedure in the timber industry. Instead the contract provides that if all the marked trees are cut, the cruised quantity of timber must be paid for by *X*. The contract also specifies the quantity of hardwood and softwood (as determined by the cruise), the price per unit of hardwood and softwood, and the total consideration to be paid if all the marked timber is cut.

If only part of the timber has been cut when the 1 year term of the contract expires, a forestry consultant designated in the contract will measure (cruise) the uncut marked trees to determine the quantity of uncut hardwood and softwood timber remaining. These quantities will be subtracted from the originally measured (cruised) total quantities of hardwood and softwood timber and the difference will establish the quantities of timber cut. The quantities of hardwood and softwood cut multiplied by their respective unit rates will determine the amount to be paid by *X* for timber cut.

The contract also provides that *X* must pay a penalty of $\frac{1}{2}$ of the bid rate multiplied by the quantities, if any, of marked hardwood and softwood left uncut when the contract term expires.

Section 631(b) of the Code provides that in the case of the disposal of timber held for more than 9 months for taxable years beginning in 1977, or for more than 12 months for taxable years beginning after December 31, 1977, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber.

Section 1.611-1(b)(1) of the Income Tax Regulations provides that an economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in standing timber and secures, by any form of legal relationship, income derived from the severance of the timber, to which he must look for a return of his capital.

Rev. Rul. 61-56, 1961-1 C.B. 243, holds that an actual disposal of timber, under the facts described, would qualify for treatment under section 631(b) of the Code. However, in the event of the grantee's default by reason of which the grantor would receive payment of an amount under the the cash performance bond, such amount would not constitute payment for the disposal of timber and would be taxable as ordinary income to the grantor.

Under the terms of the contract, *W*, the owner of timber, gives *X* the right to enter on the described lands to cut and remove only certain specified timber from those lands. *X* is required to pay *W*, at bid rates, for the cruised quantity of timber if such timber is cut. If all the marked timber is not cut, the uncut marked timber is cruised and *X* must pay the bid rates only for the difference between the cruised quantity listed in the contract and the cruised quantity of uncut marked timber.

If all the marked timber is not cut by the contract termination date, *X* is also required to pay an amount determined by multiplying the cruised quantity of marked uncut timber by $\frac{1}{2}$ of the bid rate for timber. Therefore the amount is not attributable to the disposal of the timber, but is a form of damages. Any amount so received is not for timber cut. See Rev. Rul. 61-56.

Because the amount received by *W* for timber is dependent solely upon the quantity of timber cut, *W* has retained an economic interest in the timber in accordance with section 1.611-1(b)(1) of the regulations. *W* is the owner of the timber, as the term "owner" is defined in section 1.631-2(e)(2), and has held the timber for more than the requisite holding period provided in section 631(b) of the Code.

In this instance the marked timber has little defect, each tree is cruised when marked, the term of the contract is only one year and the transaction is between unrelated parties. Under these conditions the cruise is considered to be an accurate determination of the quantity of timber cut and paid for by *X* for Federal income tax purposes. The fact that the quantity of

timber cut is determined by a cruise, rather than by scaling, has no bearing on whether *W* has retained an economic interest in the timber included under the contract.

Accordingly, amounts received by *W* as payment for timber cut under the terms of the contract qualify for treatment under section 631(b) of the Code. Any amount received by *W* as a penalty for *X*'s failure to cut marked timber is ordinary income and does not qualify for treatment under section 631(b).

78-267. Unstated Interest; Long-Term Timber Contracts. *The application of the unstated interest provisions of section 483 of the Code to long-term timber contracts is described in situations in which the taxpayer is (1) a landowner who receives the entire consideration under the contract in a lump sum on the date the contract is signed, (2) a landowner who is to receive payments over a period of 60 years under a contract for the sale of timber and the lease of the land on which the timber is growing, and (3) a paper company that makes payments under a contract similar to that in situation 2; Rev. Ruls. 62-81, 62-82, and 75-59 amplified.*

Advice has been requested whether the provisions of section 483 of the Internal Revenue Code of 1954 apply to the timber transactions described in Rev. Rul. 62-82, 1962-1 C.B. 155; Rev. Rul. 62-81, 1962-1 C.B. 153; and Rev. Rul. 75-59, 1975-1 C.B. 177.

Under the provisions of section 483 of the Code a portion of the payments under a deferred payment sales contract that does not call for any interest or calls for an inadequate rate of interest shall be treated as interest income rather than as part of the sales price. Section 483 applies to any payment received by the seller on account of the sale or exchange of property, provided that: (1) all or part of the gain, if any, on the sale is considered capital gain, (2) the selling price, determined at the time of sale, is more than \$3,000, (3) the payment constitutes part or all of the sales price, (4) under the contract of sale, the payment is due more than 6 months after the date of sale or exchange, (5) some or all of the payments under the contract are due more than 1 year after the date of the sale or exchange, and (6) under the terms of the contract, there is "total unstated interest" as the term is defined in section 483(b).

Section 483(b) of the Code defines "total unstated interest," with respect to a contract for the sale or exchange of property, as an amount equal to the excess of, (1) the sum of the payments to which this section of the Code applies which are due under the contract, over (2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

Situation 1:

Under the terms of the long-term timber contract described in Rev. Rul. 62-82, the landowner receives a lump-sum payment of 198x dollars on the date the contract is signed. This payment is the only payment received by the landowner. No payments are due more than 6 months after the date of the execution of the contract.

Accordingly, the provisions of section 483 of the Code do not apply under the circumstances described in Rev. Rul. 62-82

because there are no deferred payments provided for under the terms of the contract.

Rev. Rul. 62-82 is amplified.

Situation 2:

Rev. Rul. 62-81 describes the manner in which an owner of timberland should treat the payments received from a long-term timber contract for Federal income tax purposes.

In that Revenue Ruling, the landowner was to receive payments over a period of 60 years under a contract for the sale of timber and the lease of the land on which the timber was growing. The fair market value of the timber existing on the date of the execution of the contract exceeded the landowner's adjusted basis for the timber. The contract did not designate any part of the payments as interest. It is assumed for purposes of the present ruling that under the contract the sales price, determined as of the time of sale, exceeded \$3,000.

Rev. Rul. 62-81 holds that payments under the contract equal to the fair market value of the timber existing on the date of execution of the contract constitute proceeds from the sale of timber. Any gain included in the above amount is capital gain, provided the conditions specified in section 1221 or 1231 of the Code are met. Any excess of such payments over the fair market value of the timber existing on the date of the execution of the contract is ordinary income.

Section 1.483-1(b)(1) of the Income Tax Regulations provides that a sale or exchange of property under section 483 of the Code includes any transaction treated as a sale or exchange for Federal income tax purposes.

Section 483(d) of the Code provides a separate rule for imputing interest when the payments under a contract for the sale or exchange of property are indefinite as to time, liability, or amount.

If there are indefinite payments, section 1.483-1(e)(1) of the regulations provides that section 483 of the Code shall be separately applied to each such indefinite payment as if it (and any amount of interest attributable to such indefinite payment) was the only payment due under the contract. The effect of the application of section 483 is determined at the time such payment is made.

Under the facts described in Rev. Rul. 62-81, if the timber in the hands of the landowner is a capital asset or if the gain from the sale of the timber is characterized as capital gain under section 1231 of the Code, the provisions of section 483 apply to the payments that are attributable to the sale of timber because (1) the gain on the sale would be capital gain from the sale of a capital asset or property described in section 1231, (2) the sale price, determined as of the time of sale, is more than \$3,000, (3) the payments constitute all or part of the sale price, (4) under the contract of sale, payments are due more than 6 months after the date of sale, (5) one or more payments are due more than 1 year after the date of sale, and (6) under the terms of the contract there is "total unstated interest" as that term is defined in section 483(b).

Accordingly, each payment, less that portion of the payment considered to be interest under the provisions of section 483 of the Code, is treated as received for the sale of timber until the aggregate of such payments, less imputed interest, equals the fair market value of the timber in existence on the date the contract is executed. The amount considered to be interest and any amount paid in excess of the sum of the fair market value of the timber plus imputed interest, constitutes ordinary income. However, if the timber in the hands of the landowner is neither a capital asset nor property used in a trade or business any gain realized from the sale of the timber is ordinary income to the landowner and the provisions of section 483 do not apply.

Rev. Rul. 62-81 is amplified.

Situation 3:

Rev. Rul. 75-59 describes the manner in which a paper company should treat the payments it makes under a long-term timber contract that is similar to the contract described in Rev. Rul. 62-81.

In *Situation 2* the provisions of section 483 of the Code apply to the amounts received by the landowner for the sale of the timber only if the timber is a capital asset or a section 1231 asset in the hands of the landowner. In *Situation 3*, however, under the provisions of section 1.483-2(b)(3)(ii) of the regulations, the amounts paid for timber receive section 483 treatment by the paper company regardless of whether the timber is a capital asset or a section 1231 asset in the hands of the landowner.

Accordingly, each payment by the paper company under the contract described, less that portion of the payment considered to be interest under the provisions of section 483 of the Code, is a capital cost of timber to the paper company until the aggregate of such payments, less imputed interest, equals the fair market value of the timber existing on the date of the execution of the contract. The amounts considered to be interest are deductible by the paper company under the provisions of section 163.

All amounts paid by the paper company under the contract in excess of an amount equal to the sum of the fair market value of the timber on the date of the execution of the contract plus imputed interest, are consideration for the use (rental) of the land and are deductible by the paper company under section 162(a) of the Code.

Rev. Rul. 62-81, Rev. Rul. 62-82, and Rev. Rul. 75-59 are amplified.

79-174. Losses; Casualty; Trees Destroyed by Onslaught of Beetles. *The death of ornamental trees 5 to 10 days following massive southern pine beetle attack in an area not known for such massive attacks results in an allowable casualty loss deduction to the extent provided by Section 165(c) of the Internal Revenue Code.*

ISSUE

Under the circumstances described below, is a loss from the

death of trees as a result of attack by insects a casualty loss within the meaning of section 165(c) of the Internal Revenue Code of 1954?

FACTS

In 1976, a taxpayer owned a residential lot on which 40 ornamental pine trees were growing. The trees were in healthy condition on July 1, 1976. By July 10, 1976, all of the trees were dead. Death was attributable to a mass attack of southern pine beetles. Beetle attacks in epidemic proportions were unknown in the vicinity of the taxpayer's residential lot prior to the attack that killed the trees.

The southern pine beetle is a flying insect that normally attacks living pine trees. The female beetle bores into a tree and enters the cambium tissue beneath the bark. It then emits an attractant that leads other beetles to the tree in a mass attack. The beetles construct tunnels in the cambium tissue and deposit their eggs. These tunnels intersect and in a short time completely girdle the tree. This cuts off the food supply to the higher parts of the tree and kills the tree. In the instant case, the cambium layer of each tree was completely girdled within 5 to 10 days after the arrival of the female beetle.

LAW AND ANALYSIS

Section 165(a) of the Code provides the general rule that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(c) of the Code provides that in the case of an individual, the deduction is limited to (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business, and (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. In respect of property not connected with a trade or business, a loss shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds \$100.

Court decisions and revenue rulings have established standards for the application of the above provisions, and have developed the overall concept that the term "casualty" as used in such provisions refers to an identifiable event of a sudden, unexpected, or unusual nature. Damage or loss resulting from progressive deterioration of property through a steadily operating cause would not be a casualty loss. See *Matheson v. Commissioner* [2 USTC ¶ 830], 54 F. 2d 537 (2nd Cir. 1931), XI-2 C. B. 392 (1932) and Rev. Rul. 76-134, 1976-1 C. B. 54.

Revenue Ruling 57-599, 1957-2 C. B. 142, holds in part that a loss arising from the death of trees as a result of an attack by insects does not constitute an allowable deduction as a casualty loss within the meaning of section 165(c)(3) of the Code. The loss was denied on the grounds that the death of the trees resulted from progressive deterioration, and, therefore, the element of suddenness was lacking.

To be sudden, an event must be of a swift and precipitous nature and not gradual or progressive. See Rev. Rul. 75-592, 1972-2 C. B. 101. Whether an event is sudden must be determined from all the surrounding facts and circumstances. In the

instant case, the cambium layers of the ornamental trees were completely girdled within 5 to 10 days after the arrival of the female beetle. Once the girdling occurred the trees were dead and their value as ornamentals was lost at that point. On the basis of these facts the element of suddenness is satisfied. See *Nelson v. Commissioner* [CCH Dec. 28,861 (M)], T. C. M. 1968-35, and *Black v. Commissioner* [CCH Dec. 34,665(M)], T. C. M. 1977-337.

In addition to being sudden in nature, the event must also be unusual or unexpected before it can qualify as a casualty within the meaning of section 165(c)(3) of the Code. Since there were no known attacks in epidemic proportions of southern pine beetles in the area of the taxpayer's residence, the event was both unusual and unexpected.

HOLDING

A casualty loss deduction is allowable to the taxpayer to the extent provided by section 165(c)(3) of the Code and the regulations thereunder.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 57-599 is modified to remove any implication that fatal damage to ornamental trees by insect infestation can never be of a sufficiently sudden nature to meet the required elements of a casualty loss under section 165(c)(3) of the Code.

80-175. Nonrecognition of Gain, Timber Damaged by Storm, Voluntary Sale. *The nonrecognition of gain provisions of section 1033(a) of the Code are applicable to proceeds received from the voluntary sale of timber downed by high winds, earthquake, or volcanic eruption when the proceeds are used to purchase other standing timber; Rev. Rul. 72-372 revoked.*

ISSUE

Reconsideration has been given to Rev. Rul. 72-372, 1972-2 C. B. 471, which deals with the application of the nonrecognition of gain provisions of section 1033(a) of the Internal Revenue Code with respect to the proceeds received from a sale of timber downed by high winds.

FACTS

In Rev. Rul. 72-372 the taxpayer was the owner of timberland. As a result of a hurricane, a considerable number of trees were uprooted. The timber was not insured, and once downed, was subject to decay or being rendered totally worthless by insects within a relatively short period of time. The taxpayer was, however, able to sell the damaged timber and realized a gain from such sale. The proceeds of the sale were used to purchase other standing timber.

Rev. Rul. 72-372 holds that a gain from a voluntary sale of such timber under these circumstances does not qualify for nonrecognition of gain under section 1033(a) of the Code because there was no direct conversion into money nor was such sale precipitated by the threat or imminence of requisition or condemnation.

LAW AND ANALYSIS

Section 1033(a)(1) of the Code provides rules under which no gain is to be recognized where property is compulsorily or involuntarily converted into property similar or related in service

or use to the property so converted. Section 1.1033(a)-1(a) of the Income Tax Regulations provides that an involuntary conversion may be, among other things, the result of the destruction of property in whole or in part.

Section 1033(a)(2)(A) of the Code provides for the nonrecognition of gain if property is involuntarily converted into money and that money is invested within a specified period of time, in other property similar or related in service or use to the property so converted.

Section 1033(a)(2)(B) of the Code states the time period within which converted property must be replaced. That time period commences with the date of the disposition of the converted property. The term "disposition of the converted property" is defined by section 1033(a)(2)(E)(ii) to mean the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation. Thus, the term "disposition of the converted property" is defined for the purpose of establishing the beginning of the replacement period and not for the purpose of defining the term "involuntary conversion." Section 1.1033(a)-1(a) of the regulations defines the latter term to include the destruction of property. In the present case, the taxpayer's property was destroyed by a hurricane.

In *S. H. Kress and Co. v. Commissioner* [CCH Dec. 26,084], 40 T. C. 142, 153 (1963), *acq.*, 1965-1 C. B. 4 the Tax Court of the United States stated that the basic purpose of section 1033 of the Code is to allow the taxpayer to replace his property without realization of gain "where he is compelled to give up such property because of circumstances beyond his control." In *S & B Realty Co. v. Commissioner* [CCH Dec. 30,073], 54 T. C. 863, 871 (1970), *acq.*, 1970-2 C. B. xxi the court stated that "When Congress enacted sections 214(a)(12) and 234(a)(14) of the Revenue Act of 1921 [the predecessors of section 1033] it obviously intended to grant a measure of tax relief to those who were compelled by the specified circumstances to convert their property into cash." The involuntary conversion provisions allow recognition of gain to be postponed on the theory that the taxpayer was compelled to dispose of property and had no economic choice in the matter. The taxpayer in the instant case was compelled by the destruction of the timber to sell it for whatever the taxpayer could or suffer a total loss. Consequently, the facts of this case place it within the ambit of those circumstances contemplated by the provisions of section 1033.

Both the Internal Revenue Service and the Tax Court have considered this application of section 1033(a) of the Code to sales of property not threatened by requisition or condemnation. Rev. Rul. 54-395, 1954-2 C. B. 143, holds that any gain from the sale of poisoned cattle at salvage value or in settlement of damage claims against manufacturers of contaminated feed pellets was subject to the involuntary conversion relief provisions. In *Masser v. Commissioner* [CCH Dec. 23,060], 30 T. C. 741 (1958), *acq.*, 1959-2 C. B. 5 the court considered this application of section 1033 to a sale of property that was part of an economic unit, a portion of which was sold under threat of condemnation. It found that the sale of both pieces of property constituted an involuntary conversion because it was

no longer practical to use the remaining property for the purpose intended.

The present case and *Masser* share three common features. First, an event specified by the statute as one that may result in an involuntary conversion occurred. Second, that event rendered the property unfit or impractical for its intended use. Third, the property was sold and the proceeds invested in similar property. Furthermore, the argument for applying section 1033 of the Code to the instant case is stronger than in *Masser*. In the instant case, the property sold was the very property directly affected by the casualty while in *Masser* the property sold was only indirectly affected by the condemnation.

In *C. G. Willis, Inc. v. Commissioner* [CCH Dec. 26,608], 41 T. C. 468 (1964), the court considered the application of section 1033 of the Code to the proceeds from the sale of a partially damaged ship. The ship was repairable; however, the owners chose to sell the ship (at a gain) rather than make the necessary repairs. The proceeds from the sale, along with the insurance proceeds for the repair cost, were invested in a barge that would cover the same ports and carry the same kind of cargo as the damaged ship. The ship owners claimed nonrecognition treatment for this transaction under the provisions of section 1033(a).

In denying the claim for nonrecognition treatment, the court stated that "Involuntary conversion, within the meaning of section 1033(a) of the Code, means that the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes." The court concluded that "It cannot be said that the sale of the unrepaired ship was a result of its partial destruction. The sale was the result of a business decision by the owner that the money equivalent of the unrepaired ship would serve its business interests better."

In the present case, the downed timber was not repairable and was generally no longer useful to the taxpayer in the context of its original objective. The destruction caused by the hurricane forced the taxpayer to sell the downed timber for whatever price it could get. Unlike the situation in *Willis*, the sale of the downed timber was dictated by the damage caused by the hurricane.

HOLDING

Upon reconsideration of Rev. Rul. 72-372, and in light of the court decisions cited above, it is now the Service's position that the nonrecognition of gain provisions of section 1033(a) of the Code are applicable with respect to the proceeds received from the sale of timber downed by high winds. The same treatment would be accorded if, for example, the timber in question was downed as a consequence of an earthquake or a volcanic eruption.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 72-372 is revoked.

81-2. Losses, Death of Tree Seedlings, Timber Producer. *A timber producer sustains no deductible loss on the death, not due to casualty, of tree seedlings planted to reforest land from which it has harvested the mature timber. Amounts paid or*

incurred in replanting to replace the lost seedlings must be capitalized in accordance with section 1.611-3(a) of the regulations.

ISSUE

Does the death of planted tree seedlings, under the circumstances described below, give rise to a deductible loss under section 165 of the Internal Revenue Code, and must the costs incurred as a result of the death of the seedlings be capitalized and recovered through the depletion allowance under section 611?

FACTS

The corporate taxpayer owns forested lands which it manages for the continuous production of timber for use in its business of manufacturing lumber.

After harvesting the mature timber on a portion of its lands by clear-cutting, the taxpayer reforested the clear-cut area by planting nursery grown tree seedlings at a cost of 30x dollars. In reforesting areas that have been clear-cut, the taxpayer attempts to grow 600 well spaced seedlings per acre. If 300 well spaced seedlings per acre survive, the area has enough trees growing on it to produce a satisfactory stand of mature timber. If less than 300 seedlings survive the reforestation is unsatisfactory and the understocked portion of the area has to be replanted to utilize the productive capability of the land economically.

Generally, the first two growing seasons are critical to seedling survival. It is, therefore, the taxpayer's practice to examine planted areas at the end of the second growing season to determine the number and spacing of the surviving seedlings. The examination of the reforested area in question showed that many of the seedlings had died and that portions of the area were not satisfactorily reforested. Later in 1979 the taxpayer replanted the understocked portions of the tract.

The seedling deaths were not due to a casualty and were not covered by any type of insurance. The taxpayer continued to use the area for growing timber for eventual use in its lumber mill.

LAW AND ANALYSIS

Section 1.165-1(a) of the Income Tax Regulations provides that any loss actually sustained during the taxable year and not made good by insurance or some other form of compen-

sation shall be allowed as a deduction subject to any provision of the Code which prohibits or limits the amount of the deduction.

Section 1.165-1(b) of the regulations provides that, to be allowable as a deduction under section 165(a) of the Code, a loss must be fixed by identifiable events. Only a bona fide loss is allowable. Substance, not mere form, shall govern in determining a deductible loss.

Section 1.611-3(a) of the regulations provides that amounts paid or incurred for the planting of timber shall be capitalized and recovered through a depletion allowance.

Rev. Rul. 61-206, 1961-2 C. B. 57, holds that when a test hole or holes are drilled to determine the existence of water and a well is thereafter drilled to accommodate the tax-payer's business needs, the mere abandonment of the test hole or holes does not give rise to a deductible loss when the drilling of the test hole or holes is an integral part of the development of the water well in a particular area.

Section 1.611-3(a) of the regulations applies to replanting costs as well as the cost of the original planting. Rev. Rul. 75-467, 1975-2 C. B. 93. Whether the taxpayer is successful in its initial reforestation effort or whether it must replant in order to achieve satisfactory stocking, all amounts paid or incurred are capital costs incurred in connection with the planting of timber. The aggregate of these costs becomes part of the taxpayer's adjusted basis in the timber grown on the tract. Gain or loss on the timber grown on the tract is generally determined at the time the timber is cut and depletion takes place or when the tract is abandoned for the purpose of growing timber.

HOLDING

The taxpayer did not sustain any deductible loss attributable to the seedlings that died even though portions of the tract had to be replanted. Furthermore, the cost of replanting must be capitalized in accordance with the provisions of section 1.611-3(a) of the regulations. However, if such additions to the capital account are made after December 31, 1979, all or a portion of such cost may be subjected to an allowance for amortization under the provisions of section 194 of the Code and to investment credit under section 48(a)(1)(F).

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