ARTHUR W. PETERSON
29 T.C.M. 802; P-H T.C. Memo ¶70,181 (1970)

Editor's Summary

Key Topics
• Operating expenses
• • Farming status
• • • Land clearance expenses

Facts

The taxpayers purchased a tract of land in 1943 and began cutting timber on the tract in 1945 and continued to do so up to and including the years in controversy. In 1945, the taxpayer began construction on a sawmill which when completed was used to process the timber from taxpayers' property. Although timber was cut during the years in issue, none was processed because of a lack of power at the sawmill. The taxpayer continued to cut and store timber during the years in issue with the intention of resuming the processing operation as soon as the power was restored. The taxpayers also engaged in other activities on this tract of land such as clearing and grass planting. The taxpayers' intention was to farm the land when it was finally cleared. The taxpayers claimed various expenditures as business expenses from their activities on this tract of land. Only those contentions relative to the timber tax issue will be discussed here. The taxpayers contended that the expenses were deductible under Section 162(a)[1] as expenses incurred in a trade or business or under Section 182[2] as expenditures incurred by a farmer in clearing his land. The Commissioner contended that the expenses related to the tract were nondeductible personal expenditures. The Commissioner argued alternatively that the expenses were nondeductible capital expenditures. The Commissioner also denied that any expenditures were deductible under Section 182.

Tax Court

HELD: FOR THE TAXPAYER (ON THE TIMBER TAX ISSUE). The taxpayers were engaged in the trade or business of cutting timber even though no timber was processed during the years in issue. The taxpayers intended to process the timber as soon as the power was restored to the sawmill. Since the taxpayers had been cutting timber for such a long period of time they were engaged in a trade or business even though the tong-term objective in cutting the timber was to clear the land for farming. The taxpayers were not entitled to the deduction of their expenses for activities other than logging, such as grass planting, stump blasting, brush clearing and river protection, since these activities were not incurred in the business of grass farming as the taxpayers claimed, but were part of the effort to clear the tract for eventual Operation as a farm. Certain expenses were allowed under Section 182 which provides that a person engaged in the business of farming may elect to deduct land-clearing expenses which are incurred for the purpose of making land suitable for farming. The taxpayers met this requirement as to certain "land-clearing" expenses for the years in which they properly elected under Section 182.

Case Text
[Timber Issue Only]

FORRESTER, Judge: Respondent has determined deficiencies in petitioners' income tax for the years 1962, 1963 and 1964, in the amounts of $3,445.41, $157.50, and $7,020.74, respectively. Respondent also has determined a penalty tax for each year under section 6653(a) of the Internal Revenue Code of 1954 in the amount of $172.27, $7.88 and $351.04, respectively.

Concessions having been made by the parties, the remaining issues are:

(1) Whether petitioners were engaged either in the business of logging or grass farming, or both, on their property located at Stehekin, Washington, and are therefore entitled to a business expense deduction under section 162 for expenses that are properly substantiated as relating to either or both operations.

(2) In the years 1963 and 1964, whether any expenses attributable to the Operation of the above-mentioned property that are held not to be deductible as a business expense under section 162 are deductible under section 182 as "land clearing expenses"; and if so, whether petitioners have properly elected to take a deduction for those expenses pursuant to the election provisions of section 182.

* * *

General Findings of Fact Applicable to All Issues

Some of the facts have been stipulated and are so found. The stipulations and exhibits attached thereto are incorporated herein by this reference.

Petitioners are Arthur W. Peterson (hereinafter sometimes referred to as Arthur) and his wife, Dorothy E. Peterson (hereinafter sometimes referred to as Dorothy), both presently residing at Manson, Washington. Their joint income tax returns were filed for the calendar years 1962, 1963, and 1964 with the district director of internal revenue at Tacoma, Washington. Petitioners are cash basis taxpayers.

During the years in issue, petitioners owned and operated a commercial apple orchard at Manson, Washington, that had produced its first commercial crop in 1945. The orchard consisted of two separate parcels of land, totaling 35 acres, with 48 trees per acre. Also located on the property are six buildings Which are used for bathing, laundry and storage, and a large workshop building.

The operation of the orchard is a year-round affair, requiring the permanent employment of five people and the hiring of at least twelve additional men during the harvest season, which extends from about September 25 to November 1 of each year. During the years in issue the laborers received hourly wages and, in addition, were provided with living quarters, electric power, and firewood as further compensation.

Both Arthur and his son, Dale Peterson (hereinafter sometimes referred to as Dale), managed the orchard. Dale was almost entirely in charge of the orchard business and paid most of its expenses

during the spring, summer and fall of each year, when Arthur was away managing the operation of his other property at Stehekin, Washington. In addition, part of the business expenses of the orchard each year was paid by the Lake Chelan Fruit Growers Association, a co-operative organization which sold petitioners' apple crop.

During the years in issue petitioners received the following income, actually or constructively, from their orchard operation:

Calendar Year	Amount
1962	$45,522.77
1963	65,745.72
1964	47,392.53

In 1962, 1963 and 1964, respectively, $17,019.24, $13,421.71, and $16,336.54 in orchard expenses were paid by Dale and $11,930.55, $26,731.73, and $21,745.35 in orchard expenses were paid by the Lake Chelan Fruit Growers Association. Respondent now agrees that those amounts are fully deductible business expenses of the orchard for the years in issue.

As noted above, during significant periods of the years in issue Arthur was not present at the orchard. At such times he was at petitioners' property at Stehekin, Washington, a 110 acre tract of land which was purchased in 1943 for $3,700. The property is approximately 45 miles from Manson, at the northwest end of Lake Chelan, borders on the Stehekin River, and is accessible only by boat or airplane.

When the property was purchased, all but eight to ten acres were covered with timber. Arthur began cutting the timber in 1945 and continued to do so up to and including the years in issue. In 1945 Arthur also began construction of a sawmill on the Stehekin property that commenced operation in 1947 but was not entirely completed till 1948. Electricity for the operation of the mill and for other electrical needs at Stehekin was supplied by a hydro-electric generating plant. During the years in issue, the plant consisted of two hydro-electric generators (one installed in 1945 and the other in 1955), and the attendant foundations, footings and water transmission facilities.

When the timber was cut, it was either processed into lumber in the sawmill and sold, or stored on the property for future processing. Timber was cut during the years in issue, but none was processed at the sawmill because of a lack of available power from the generating plant. The reason for this was that Arthur had entered into a contract with the local public utility district of Stehekin allowing the district to use the generating plant to supply electricity for the area in 1962 and 1963. Though the contract provided that Arthur was to receive power for the Stehekin property during these two years, the district refused to make it available. A dispute over the contract continued into 1964 which prevented the supply of electricity to the mill in that year.

Despite his inability to process the timber, Arthur continued to cut and store it during this period with the intention to resume the mill operation as soon as the electric power was restored. Approximately 200,000 board feet of timber was cut during this period when the mill was not in

operation.

During the years in issue and prior thereto, tree stumps were blasted and removed from the soil; the holes filled in with soil from the surrounding area and grass seed planted at the Stehekin property. Arthur's primary purpose for planting the grass seed was to enrich the soil. He also intended to produce and market both bluegrass seed and the stalks of bluegrass as hay, however, he never sold any hay because the grass crop was too dense for his mowing equipment. He did not sell any grass seed because its weed seed content had not yet been reduced to a level which met the requirements for sale of Washington State's Agricultural Department.

Other than timber cutting and clearing and grass planting, the only activities carried on at Stehekin during the years in issue were river protection work to prevent erosion and flooding of the land which consisted primarily of diversion of water routes; brush burning to comply with forestry regulations; mowing grass and "repairing" equipment.

By the time of trial herein, 60 acres of the Stehekin property had been cleared and about 50 acres were planted in bluegrass. The cleared: land, however, is not sufficiently extensive to justify the costs of a farming operator, which is Arthur's intent once sufficient land has been cleared. An underground sprinkler system is installed on the entire acreage, installation of which occurred prior to the years in issue, though some minor finishing work was done in 1962. Also located on the Stehekin property are two powerhouse buildings which house the hydro-electric generators, a planer building and a brick house. The buildings were built after 1946 and are presently used in connection with the logging and other activities. Among the equipment utilized at Stehekin is a sea mule barge which was purchased in either 1947 or 1948 and a flail mower, purchased on May 16, 1963 for $318.80.

From November 20 to April 15 for each of the years in issue, no employees work at the Stehekin property other than a caretaker, Mike Carragher (hereinafter sometimes referred to as Mike), because of the deep snows which make operations at the property impossible. Arthur usually leaves for Stehekin about April 15 and returns around November 20, though he does make some trips to Manson in this period.

In the income tax returns for 1962, 1963, and 1964, petitioners deducted various expenditures as expenses of their "business" at Stehekin and Manson without segregating the expenditures at either place. At trial, they sought to prove the amount of their expenditures to various activities on their properties through their own testimony and the introduction of innumerable checks. Since the legal contentions with regard to the deductibility of these expenses involve the same issues under sections 162 and 182, we shall at the outset deal with them and thereafter present our findings of fact as to the amounts and allocations of specific expenses, as well as certain subsidiary legal issues which relate to specific expenses. Other major issues concerning claimed depreciation and the negligence penalty will be treated subsequent thereto.

Issue 1. Deductibility of Expenses
at Stehekin and Manson

Petitioners deducted numerous expenses relating to the operation of their properties at Stehekin and Manson, Washington. They argue that they were engaged in two businesses on the Stehekin

property during the years in issue, that of logging and sawmilling (hereinafter sometimes referred to as logging) and grass seed farming (hereinafter sometimes referred to as grass farming); and that therefore, their expenses relating to such activities are deductible business expenses under section 162(a).[2] Moreover, petitioners contend that any Stehekin expenditures which are not deductible as business expenditures are capital expenditures for clearing the land to farm and deductible for the years t963 and 1964 under section 182.[3] Respondent, on the other hand, argues that all expenses relating to the Stehekin property are nondeductible personal expenditures because petitioners were not engaged in any trade or business there. Alternatively, respondent contends that the expenditures were nondeductible capital expenditures. Moreover, respondent argues that the expenditures are not deductible under section 182 in 1963 and 1964 because petitioners have not properly elected to take advantage of that section's provisions under section 1.182-6, Income Tax Regs. [4] and because they were not "engaged in the business of farming" under that section's provisions.

A. Deductibility of Expenses under Section 162

A taxpayer may be engaged in more than one business simultaneously. *M. A. Paul* [Dec. 19, 055], 18 T.C. 601 (1952); *John E. Good* [Dec. 18, 248], 16 T.C. 906 (1951). Petitioners, therefore, may have been engaged in both a logging and a grass farming business at Stehekin while, concededly, they were engaged in an apple farming business at Manson.

For almost 20 years, petitioners were engaged in cutting timber and sawmilling the timber into lumber at Stehekin. They built a sawmill, employed laborers to cut and process: timber and sold timber. During the years in issue, over 200,000 board feet of timber was cut. Though no timber was processed into lumber in 1962, 1963, or 1964, petitioners intended to process their timber and sell it as lumber as soon as they regained electric power to run their sawmill. We hold this activity, carried on for such an extensive length of time, is a trade or business and the expenses which are substantiated as relating thereto are deductible. To be sure, the expenses would not only produce a benefit from the profits of the sale of timber, but also a long-term benefit in that the land became *partially* cleared for farming. But the latter benefit, which required many more steps before its fruition-namely, blasting of the stumps, enriching the soil, etc.-does not detract from the fact that petitioners were independently engaged in a trade or business and the expenses attributable thereto, paid in the operation of that business, were deductible. Since petitioners were cash basis taxpayers they are entitled to a deduction for those expenses substantiated as relating to logging in the years in which the expenses were paid.

The activities, other than the logging, conducted on the Stehekin property, such as grass planting, stump blasting, brush clearing and river protection, are a different matter. We do not believe that petitioners' intent in engaging in these activities was to grass farm and reap a profit therefrom. Rather, the primary purpose was to replenish the soil in order to bring it into a productive capacity for the eventual operation of the property as a farm. No seed was ever sold, nor any attempt made to get approval for its sale from Washington State's Agricultural Department. This aspect of the operation at Stehekin was not a trade or business but rather preparation of the land for future farming. The *entire* benefit from the expenditures in these activities is to accrue in the future when the property is farmed. As such these are capital expenditures. *Cf. H. L. McBride*

[Dec. 20, 877] 23 T.C. 901 (t955); *J. H. Sanford* [Dec. 589], 2 B.T.A. 181 (1925). Thus these expenditures are nondeductible unless some other provision of the Internal Revenue Code allows a deduction.

B. Deductibility of Expenses under Section 182

Petitioners contend that any expenses in the years 1963 and 1964, which are not deductible under section 162, may be deducted pursuant to section 182. This section provides that a person who is engaged in the business of farming may elect to deduct land-clearing expenses, incurred for the purpose of making land suitable for use in farming, in the lesser amount of $5,000 or 25 percent of his taxable income from farming during the taxable year.

Respondent contends first that petitioners were not engaged in a trade or business of farming at Stehekin and, therefore, that section 182 is not applicable. However, section 182's requirement that the taxpayer must be engaged in the business of farming makes no indication that the farming operation must be part of or contiguous to the very property which is being prepared for farming, nor do the committee reports indicate that this is the case. *(Cf.* S. Rept. No. 1881, 1962-3, C.B. 703, 832-833.) In the absence of any contrary language in the statute or the legislative history, we give the ordinary meaning to this requirement, and construe the section's provision that the taxpayer be engaged in farming to mean that he may be so engaged on any property.

Petitioners also meet the requirement that their purpose be to make the land suitable for farming. Their intent was to farm once a sufficient acreage on the land was clear. Their preparation activity was to enrich soil, clear brush and otherwise put the land in a suitable condition so that it could be farmed. While it is true that they were engaging in their activity over an extended period of time, the section places no time limit within which the property must be ready for farming.

Finally, it is clear that many of the expenses, such as stump blasting, grass planting, and river protection, are "land clearing" expenses. We think it unnecessary to consider this point in detail at this time. We merely quote the applicable regulation which defines this term to show that many of the petitioners' activities fall within its terms.

> Sec. 1.I82-3 Definition, exceptions, etc., relating to deductible expenditures.
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> (a) "Clearing of land." (1) For purposes of section t82, the term "clearing of land" includes (but is not limited to)-
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> (i) The removal of rocks, stones, trees, stumps, brush or other natural impediments to the use of the land in farming through blasting, cutting, burning, dozing, plowing, or in any other way;
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> (ii) The treatment or moving of earth, including the construction, repair or removal of nondepreciable earthen structures, such as dikes or levees, if the purpose of such treatment or moving of earth is to protect, level, contour, terrace, or condition the land so as to permit its use as farming land; and
>
> (iii) The diversion of streams and watercourses, including the construction of nondepreciable drainage facilities, provided that the purpose is to remove or divert water from the land so as to make it available for use in farming.

* * *

(b) Expenditures not allowed as a deduction under section 182. (1) Section 182 applies only to expenditures for nondepreciable items. Accordingly, a taxpayer may not deduct expenditures for the purchase, construction, installation or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation under section 167 and the regulations thereunder. Expenditures in respect of such depreciable property include those for materials, supplies, wages, fuel, freight, and the moving of earth, paid or incurred with respect to tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps constructed of masonry, concrete, tile, metal, wood, or other nonearthen material.

The deductibility of these expenses depends on the, election requirements of section 182. Respondent contends that section 1.182-6, Income Tax Regs., adopted on January 25, 1965, has retroactive effect for 1963 and since petitioners did not elect according to its terms in their 1963 income tax returns, they are not entitled to the deduction in that year. As for 1964, respondent also contends that noncompliance with the provision of this regulation precludes qualification for that year.

Petitioners argue that for 1963 no election according to this regulation was required because the regulation was not promulgated until ,after the income tax return filing deadline for that year had passed. As we construe this argument, petitioners seem to contend (1)that in 1963 they may elect to take advantage of section 182 by merely returning the expense, and (2) that the regulation should be construed to be prospective only. As for 1964, petitioners point out that the government pamphlet, "Federal Income Tax Forms for 1964" states on its last page (unnumbered):

INSTRUCTIONS FOR SCHEDULE F
(FORM 1040)- 1964
* * *

EXPENSES AND OTHER DEDUCTIONS

Other farm expenses-* * *
You may deduct expenditures in clearing land to make it suitable for farming This deduction is limited to 25% of taxable income from farming, or $5,000 whichever is lesser.

Petitioners contend that they should not be precluded from taking the deduction for 1964 because this form affirmatively mislead them into believing that no set form of election was required.

According to section 7805(b):
SEC, 7805 * * *
(b) Retroactivity of Regulations or Rulings.-The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be

applied without retroactive effect.

Respondent argues that by virtue of the above-quoted section, all regulations are retroactive unless prescribed by the Commissioner to be otherwise and hence section 1.182-6, Income Tax Regs., must be given retroactive effect.

We think that section 1.182-6, Income Tax Regs., while not explicitly stated to be prospective, is implicitly so in application. The regulation states that the manner of election must be made by means of a statement filed "not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the taxable year for which the election is to apply." If this regulation is meant to have retroactive effect for the year 1963, it is tantamount to requiring that a taxpayer have the foresight in preparing his 1963 returns to know and specifically follow a manner of election that the Commissioner would state almost a year later. An election could not be made after the filing deadline. In effect, to construe the regulations to be retroactive would preclude any deduction in 1963 under section 182, because no taxpayer, except by the most improbable chance, would have elected in his 1963 returns in the manner prescribed by the regulation. We cannot give such an unreasonable interpretation to the regulation. We hold that this regulation was meant to apply only to taxable years after 1963, i.e., that its application is prospective only.

In the absence of a regulation *as to election* under section 182 for the year 1963, we think that a taxpayer was entitled to take advantage of this provision by means of any reasonable manner of election. Petitioners, in this instance, merely took the deduction and did not state that they were taking advantage of section 182 or segregate expenses on their returns. Nevertheless, we think that this is sufficient for 1963. In the absence of any regulation, the term "election" denotes to us that the taxpayer must make a choice and manifest that choice in some overt manner. By actually taking the deduction on the 1963 return, we hold that petitioners exhibited such a manifestation. Accordingly, petitioners are entitled to section 182 treatment for any expenses substantiated as clearing expenses in that year. *Cf. James River Apartments, Inc.* [Dec. 30, 024], 54 T.C. 618 (March 25,1970).

The question of election for 1964 poses an entirely different situation. The regulation was adopted before the deadline for filing a return for that year. Petitioners, in fact, did not file their return until April 9, almost three months after the promulgation of the regulation. We do not think the 1964 government pamphlet prescribing no particular manner of election for 1964 precludes the Commissioner from asserting that an election must be made according to this regulation. There was a ready means for petitioners to become aware of the new regulation by reference to its publication in the Federal Register. They must be held to know that the pamphlet "Federal Income Tax Forms" does not give the full details of the applicability of a particular deduction or section. For a full explanation the sections and regulations must be referred to, as well as additions and modifications thereto which are published in the Federal Register. If statements made in the "Federal Income Tax Forms" publication were binding on the Commissioner from an estoppel standpoint (which is in essence what petitioners argue) and publication in the Federal Register of changes or additions were not sufficient, then after the publication of the pamphlet there would be no way for the Commissioner to change or add to his position unless he mailed an adequate, timely notice to every taxpayer in the country. This is untenable. We hold that the regulation

applies to 1964 and since petitioners did not elect according to the regulation's provisions, no deduction under section 182 is allowed for that year. *See Adler v. Commissioner* [64-1 USTC ¶9388], 330 F.2d 91 (C.A. 9, 1964), affirming a Memorandum Opinion of this Court [Dec. 22,226(M)] .* * *

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1 Sec. 162. TRADE OR BUSINESS EXPENSES
(a) In General.-There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business ....

2 Sec. 182. EXPENDITURES BY FARMERS FOR CLEARING LAND.
(a) In General.--A taxpayer engaged in the business of farming may elect to treat expenditures which are paid or incurred by him during the taxable year in the clearing of land for the purpose of making such land suitable for use in farming as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

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1 All references are to the Internal Revenue Code of 1954.

2 SEC. 162. TRADE OR BUSINESS EXPENSES.
(a) In general.-There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including-
(I) a reasonable allowance for salaries or other compensation for personal services actually rendered;
(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

3 SEC. 182. EXPENDITURES BY FARMERS FOR CLEARING LAND.
(a) In General.-A taxpayer engaged in the business of farming may elect to treat expenditures which are paid or incurred by him during the taxable year in the clearing of land for the purpose of making such land suitable for use in farming as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.
(b) Limitation.-The amount deductible under subsection (a) for any taxable year shall not exceed whichever of the following amounts is the lesser:
(1) $5,000 or
(2) 25 percent of the taxable income derived from farming during the taxable year.
For purposes of paragraph (2), the term "taxable income derived from farming" means the gross income derived from farming reduced by the deductions allowed by this chapter (other than by this section) which are attributable to the business of farming.
(c) Definitions.-For purposes of subsection (a)-
(1) The term "clearing of land" includes (but is not limited to) the eradication of trees, stumps,

and brush, the treatment or moving of earth, and the diversion of streams and watercourses.

(2) The term "land suitable for use in farming" means land which as a result of the activities described in paragraph (1) is suitable for use by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

(d) Exceptions, etc-

(1) Exceptions.-The expenditures to which subsection (a) applies shall not include-

(A) the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation provided in section 167, or

(B) any amount paid or incurred which is allowable as a deduction without regard to this section.

(2) Certain Property Used in the Clearing of Land.-

(A) Allowance for Depreciation.-The expenditures to which subsection (a) applies shall include a reasonable allowance for depreciation with respect to property of the taxpayer which is used in the clearing of land for the purpose of
making such land suitable tot use in farming and which, if used in a trade or business, would be property subject to the allowance for depreciation provided by section 167.

(B) Treatment as Depreciation Deduction.-For purposes of this chapter, any expenditure described in subparagraph (A) shall, to the extent allowed as a deduction under subsection (a), be treated as an amount allowed under section 167 for exhaustion, wear and tear, or obsolescence of the property which is used in the clearing of land.

(e) Election.-The election under subsection (a) for any taxable year shall be made within the time prescribed by law (including extensions thereof) fox filing the return for such taxable year. Such election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. Such election may not be revoked except with the consent of the Secretary or his delegate.

4 Sec. 1.182-6 Election to deduct land clearing expenditures.

(a) Manner of making election. The election to deduct expenditures for land clearing provided by section 182(a) shall be made by means of a statement attached to the taxpayer's income tax return for the taxable year for which such election is to apply. The statement shall include the name and address of the taxpayer, shah be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the taxable year for which the election is to apply. The statement shall also set forth the amount and description of the expenditures for land clearing claimed as a deduction under section 182, and shall include a computation of "taxable income derived from farming", if the amount of such income is not the same as the net income from farming shown on Schedule F of Form 1040, increased by the amount of the deduction claimed under section 182.

(b) Scope of election. An election under section 182(a) shall apply only to the taxable year for which made. However, once made, an election applies to all expenditures described in §1.182-3 paid or incurred during the taxable year, and is binding for such taxable year unless the district director consents to a revocation of such election. Requests for consent to revoke an election under section 182 shall be made by means of a letter to the district director for the district in which the taxpayer is required to file his return, setting forth the taxpayer's name, address and

identification number, the year for which it is desired to revoke the election, and the reasons therefor. However, consent will not be granted where the only reason therefor is a change in tax consequences.