

THE TIMBER OWNER
And His
FEDERAL INCOME TAX



Agriculture Handbook No. 274

U.S. DEPARTMENT OF AGRICULTURE

FOREST SERVICE

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PREFACE

This publication was originally issued in 1953 as Agriculture Handbook 52 and was revised in 1964 and 1970. The Handbook was undertaken in the belief (1) that many forest owners pay more in income taxes on timber sold or harvested than the law requires; (2) that overpayment detracts from the economic incentive to practice forestry; and (3) that forest practices would be improved if the owners were informed of their actual income tax obligations and opportunities.

The present revision has been reviewed by the Internal Revenue Service with primary reference to changes brought about by the Tax Reform Act of 1969. The Act made no changes in the Internal Revenue Code provisions relating specifically to timber, but changes were made, among others, in the treatment of capital gains and losses generally.

Readers are cautioned that the Handbook is intended merely as a guide, based on law and regulations in effect at the date of publication and that each taxpayer must consider all of the facts and circumstances in applying the laws and regulations to his own particular situation.

The information in this book is current as of October 1974.

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INTRODUCTION

How should timber receipts and expenditures be reported when making out a Federal income tax return? Can a deduction be claimed when timber is damaged by fire or windstorm? How large a deduction will be allowed? The present handbook is designed to answer these questions and to present, in nontechnical language, other information that the timber owner needs to know in order to handle the Federal income tax aspects of his forest operations. The handbook is intended for the individual forest owner and also for those who may be called upon to advise him on his timber problems. Such persons will include consulting foresters, industry foresters, extension foresters, and service foresters; and in connection with income-tax matters, the taxpayers' attorney, banker, accountant, or other business consultant.

There are a number of reasons why a handbook such as this may serve a useful purpose. Provisions of the Internal Revenue Code are complex, and it is likely that many timber owners are not calculating their tax correctly. This may result from failure to use special tax provisions relating to timber, failure to take full advantage of deductions permitted by law, or, on the other hand, claiming as deductions certain expenditures which should be capitalized. It is unfortunate both for the timber owner and for the community if timberlands are not fully utilized because of a misunderstanding of tax liability.

A clearer understanding of income-tax procedures may benefit the taxpayer financially and should at the same time encourage better forest management. It is hoped that savings realized through use of correct procedures in reporting timber receipts and expenditures will act as incentives for timber owners to grow more timber, to protect it better, and to utilize it more wisely.

As the table of contents indicates, the discussion falls under three broad headings. First is the treatment of timber expenditures, not only those that may be deducted as operating expenses year by year, but also those that must be capitalized and recovered over a period of

years through depletion or depreciation. This section deals with money paid out by the timber owner. Second is the treatment of receipts from sales of timber and other forest products. This section deals with the money taken in by the timber owner. Third is the treatment of timber losses from fire, windstorm, or other casualties. Such losses do not necessarily involve cash transactions, but may constitute a deduction which the taxpayer can claim in his tax return.

The concluding section contains references to the self-employment Social Security tax, questions and answers, and problems illustrating specific income-tax situations. The appendix includes sample income tax forms, the text of the special timber provisions of the Internal Revenue Code, asset guideline classes and periods, asset depreciation ranges, and annual asset-guideline repair allowance percentages, and selected rulings of the Internal Revenue Service relating to timber and other forest products.

The field of Federal income taxation is extensive, and it has been practical to cover only the more usual questions of interest to the individual timber owner. Those with special tax problems may need to consult their Internal Revenue office or tax counsel.

In general, this publication does not include background information on the Federal income-tax system as a whole, on accounting periods and methods, or on the filing of returns. For treatment of these and similar topics not related specifically to forest operations, the following publications will be of assistance:

Your Federal Income Tax (Publication 17).

Tax Guide for Small Business (Publication 334).

Farmer's Tax Guide (Publication 225).

Single copies of these publications may be obtained without cost from most IRS offices.

A leaflet summarizing the contents of this booklet is available: *Federal Income-Tax Tips for the Timber Owner*. Issued periodically by the U.S. Department of Agriculture, Forest Service. Obtainable without charge from the Forest Service, Washington, D.C. 20250.

COSTS OF FOREST OWNERSHIP AND OPERATION

For income-tax purposes your expenditures as a forest owner may be classified as (a) additions to capital, such as the purchase of land or timber, (b) deductions from gross income, such as operating expenses, or (c) deductions from timber-sale proceeds, such as expenses of sale. Certain expenditures which are ordinarily deductible, such as taxes, interest on indebtedness, and other carrying charges may, at the election of the taxpayer, be capitalized.

In addition to out-of-pocket expenditures, you will have costs of an accounting nature that represent, in a sense, the "recovery" of capital expenditures previously incurred. Such items are timber depletion allowances on the one hand and depreciation and amortization allowances on the other. Timber depletion is closely related to treatment of timber-sale proceeds and is taken up with that topic at a later point.

The costs of forest ownership and operation are considered under the following five headings:

1. Capital expenditures.
2. Operating expenses.
3. Carrying charges.
4. Expenses of sale.
5. Depreciation.

CAPITAL EXPENDITURES

You may incur capital expenditures for either the acquisition of property or property rights, or permanent improvements that increase the value of property you already own. Examples of the former are purchases of timber and of equipment having a useful life of more than 1 year, or acquisition of rights-of-way or other easements extending more than 1 year. Examples of the latter are expenditures for bridges, roads, and firebreaks; for tree planting and seeding; and for major repair of equipment that prolongs its useful life.

Capital expenditures may not be deducted from gross income on the tax return year by year as paid or incurred but must be "capitalized." That is to say, they must be set up on the taxpayer's books through charges to one or more capital accounts. Whether for acquisition or improvement, capital expenditures are of three broad types: those relating to the land account, to the timber account, and to the equipment account.

The Land Account

Assets placed in the land account include the land itself, nondepreciable land improvements, and depreciable land improvements.

When timberland is purchased, you should make an allocation of the total purchase price including costs of timber cruising, appraisal, land survey, title search and insurance, recording fees, and legal services. The amount set up on your books for the land itself should be that portion of the total cost attributable to basic land value. For example, suppose you purchased timberland for \$3,000, of which one-third or \$1,000 was attributable to the land and two-thirds or \$2,000 was attributable to the timber. If in connection with the purchase you also paid \$300 for legal and appraisal fees, the \$300 must be allocated in the same manner: \$100 to the land and \$200 to the timber.

Nondepreciable land improvements include earthwork betterments of a permanent character, such as clearing, grading and ditching of roads with an indeterminable life. Depreciable land improvements include bridges, culverts, graveling, fences, fire towers, and other nonpermanent structures and improvements.

Roads may fall into either the fully depreciable or partly depreciable category, depending upon the use for which they are intended. *Permanent roads*, intended for general use including administration, fire access, or logging are regarded as partly depreciable to the extent that the bridges, culverts, and graveling may be depreciated over their physical life.

Temporary roads, for example, those that are completely abandoned after a logging operation has been completed, may be charged off through depreciation over the period of time in which they are in use. A logging road that is constructed to temporary-use standards and maintained for standby fire protection after the logging operation has been completed should generally not be charged off over a period shorter than the physical life of the bridges and culverts associated with it. Costs of firebreak construction are treated similarly to costs for temporary road construction.

Road grading and other annual maintenance costs are generally deductible as operating expenses, as discussed under that heading.

The Timber Account

Items included in the timber account are placed in one of three subaccounts: (1) Merchantable timber, (2) young growth, and (3) tree planting or seeding.

When tracts of timber are purchased, a reasonable part of the total cost should be allocated to the first two subaccounts, merchantable timber and young growth if it is of significant value. When making such allocation, the cost attributable to the land itself is excluded and is charged to the land account as explained above.

The part attributed to timber cannot exceed an amount which bears the same proportion to the total cost as the timber value at time of acquisition bears to the value of the entire property at that time. When timber alone is purchased, the timber account must likewise be charged with the costs of cruising and other costs related to the acquisition in addition to the purchase price.

Amounts paid or incurred in connection with the planting of timber, including planting for Christmas trees, are charged to the plantation (also known as deferred reforestation) subaccount. Such costs include, for example, expenditures for the preparation of the timber site for tree planting or seeding and for the cost of seedlings or tree seeds. Site preparation costs include those for tree girdling, brush or stump removal, and the leveling and conditioning of land to facilitate planting or seeding and to afford good growing conditions.

The costs of incidental replanting following tree mortality from natural causes, as in Christmas tree plantations, are generally capitalized. However, if timber is destroyed by fire or other casualty, the appropriate loss should be claimed as an income tax deduction and the cost of replacement must be capitalized. The deductibility of losses from casualty is described in the section "Casualties, Thefts, Condemnations," p. 19.

Among other items properly chargeable to the plantation account are tool expenses including depreciation of equipment used in planting, such as trucks, tractors, and tree planters. The cost of hired labor employed in tree planting or seeding must also be capitalized. The term "hired labor" includes members of the taxpayer's family who are actually paid for their

services; it does not include the taxpayer himself.

The young-growth and plantation subaccounts are reduced as timber becomes merchantable. Such amounts are then added to the merchantable timber subaccount for recovery through timber depletion, as explained under the heading "Determining the Amount of Gain or Loss."

The Equipment Account

This account includes the cost of durable equipment such as a sawmill, trucks, tractors, or powersaws. The owners of larger forests may need to establish subaccounts; for example, one to include sawmill and other processing machinery including motors and a second to include trucks, tractors, loaders, powersaws, and other mobile equipment. The equipment account, or the related depreciation reserve account, is increased by the amount of any major repair or reconstruction costs that materially increase the value or prolong the life of such equipment. The equipment account will be reduced by such costs in the account and the related reserve cleared when the equipment is disposed of.

The costs of equipment purchases, major repairs, and improvements are recoverable through depreciation allowances, as explained under the heading "Depreciation."

OPERATING EXPENSES

You may deduct from gross income the ordinary and necessary expenses paid or incurred during the year in carrying on a trade or business. Also, an individual, as contrasted with a corporate taxpayer, may deduct ordinary and necessary expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Under these broad provisions of the Internal Revenue Code, the forest owner has authority to deduct ("expense") operating costs provided they qualify as "ordinary and necessary."

Operating expenses are diverse and include expenditures for tools of short life (usually thought of as less than 1 year) or small cost, such as axes, handsaws, sledges, wedges, etc.;

Also operation and maintenance costs including incidental repairs of trucks, tractors, and other mechanical equipment used in your forest oper-

ations. Deductible also are salaries or other compensation for services actually rendered by others, such as hired labor, fees of consulting foresters, lawyers, accountants, etc., travel expenses including meals and lodging while away from home on business, and rentals or other payments for land, equipment, or other business property in which the taxpayer has no equity, provided these expenditures are not directly related to an activity, such as timberland purchase, reforestation project, or timber sale, in which case they are capital expenditures.

Treatment of taxes, interest, insurance premiums, and similar items in the nature of carrying charges depends upon the character of your operations. In the case of forest tracts producing current income, the interest charges, taxes, and insurance premiums are normally deducted year by year as operating expenses. In the case of properties not producing current income, such items are regarded as carrying charges which may be capitalized as taken up under the following heading.

Taxes, such as property taxes, forest yield, or severance taxes, State or local consumer-sales and gasoline taxes, and automobile-license fees for business vehicles, are for the most part deductible. Taxes that may not be deducted include Federal income taxes, estate, inheritance and gift taxes, and special assessments for local benefits tending to increase the value of the property assessed.

Interest payments include those on bank loans and other short-term credit and also those on long-term indebtedness such as mortgages. Interest charges may not be deducted when they are of an accounting character representing the cost of capital invested in the business ("implicit" interest) and not actual out-of-pocket expenditures.

Premiums for fire, windstorm, theft, or other insurance such as public liability and workman's compensation also come under the heading of deductible expenses.

The method of listing your operating expenses on the tax return depends on certain circumstances. If you are engaged in farming you may list your operating expenses on Schedule F, "Farm Income and Expenses"; if engaged in the timber business or your timber operations are related to another business, operating expenses should be listed on Schedule C, "Profit or (Loss) from Business or Profes-

sion." Forest owners incurring only occasional expenses and not filing Schedule C or F may, provided they itemize their deductions, list such expenses on Schedule A (Form 1040) itself under the heading "Miscellaneous deductions."

CARRYING CHARGES

Taxes, interest on a mortgage, and certain other carrying charges that are otherwise deductible but not deducted as expenses, may be capitalized at your election. Taxes, interest, and carrying charges thus represent in a sense a midway position between capital expenditures on the one hand and operating expenses on the other.

Taxes that come under the heading of carrying charges include annual property taxes, including taxes payable on forest lands subject to yield tax provisions. Yield or severance taxes payable only at time of timber harvest, on the other hand, may not be capitalized. The reference to mortgage interest is self-explanatory. "Other carrying charges" include premiums for insuring standing timber against loss by fire or other hazards, contributions to fire-protection organizations, and expenditures for labor, materials, and tools to be 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.

The question often arises how costs of non-commercial thinning of immature stands and timber stand improvement work (such as girdling or poisoning hardwood culls) should be handled. These are not, strictly speaking, activities involving carrying charges; they are rather in the nature of maintenance operations and are not covered by the strict language of the Statute or Regulations. Normally such work follows current timber harvesting, and these expenditures are deducted. Such expenditures, however, may be capitalized as carrying charges provided this practice is consistently followed from year to year.

Under ordinary circumstances, the small timber owner not engaged in current timber operations would probably not take advantage of the election to capitalize carrying charges, but would deduct such items as taxes and interest each year in computing his tax liability. However, an individual who acquires a stand of growing timber with the thought of cutting it in

some future year, and who uses the Standard Deduction or the Tax Table in computing his tax, instead of itemizing his deductions, would want to capitalize these expenses because they would otherwise be wasted.

EXPENSES OF SALE

Advertising and other costs such as timber cruising, marking, and scaling directly related to a specific sale of timber are treated as expenses of sale. Such items would also include fees of consulting foresters, appraisers, selling agents, lawyers, or other advisors for work directly relating to a sale of timber. If the transaction is reported as ordinary income on a business schedule, such as Schedule C or F, the expenses of sale will also be deducted on that schedule. In a transaction reported on Schedule D, either as a sale or exchange of a capital asset or as a disposal with an economic interest retained, selling expenses are treated as an offset to the selling price and are deducted on Schedule D. Schedule D transactions are discussed in greater detail under "Receipts from Sales of Timber and Other Forest Operations," beginning below.

DEPRECIATION

You are permitted a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in your trade or business or held for the production of income. This allowance takes the form of an annual depreciation deduction on your tax return. Moreover, you may elect to claim, as additional first-year depreciation, up to 20 percent of your cost of certain new or used tangible personal property

with a useful life of 6 years or more as depreciation for the year in which it is purchased. A detailed discussion of depreciation is contained in IRS Publication 534, *Tax Information on Depreciation*, which may be obtained free from your local Internal Revenue office.

Depreciation allowances represent a very real cost of ownership and operation. They reflect the portion of the cost or other basis of depreciable property that is written off during the current tax year. Your annual depreciation deduction is the amount set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) so that the aggregate of the allowable amounts set aside, plus salvage value, will at the end of the estimated useful life of the depreciable property equal the cost or other basis of the property. The effect of depreciation allowances is to reduce your taxable income by amounts sufficient to "recover," during the useful life of the property, the capital (less salvage value) invested in it.

The asset depreciation range guidelines for manufacturing and nonmanufacturing industries are shown by broad asset classes in IRS Publication 534, *Tax Information on Depreciation*, which may be obtained free from your local Internal Revenue Office. Asset depreciation ranges applicable to logging and sawmilling; lumber, wood products, and furniture manufacture; and paper and allied products are reproduced in Exhibit J in the appendix. Also reproduced are asset depreciation ranges for selected items of particular interest to forest owners, applicable to agriculture and to transportation equipment. The transportation equipment asset depreciation ranges apply to business in general and cut across industry lines.

RECEIPTS FROM SALES OF TIMBER AND OTHER FOREST OPERATIONS

When you report proceeds from the sale of timber or other forest products on your Federal income tax return, two questions arise. The first relates to the amount of gain or loss, the second to the type of gain or loss. Determination of the amount requires consideration of your cost or other "basis" for gain or loss and will be taken up first. Following this, the various kinds of timber transactions will be dis-

cussed. These result in different types of gain or loss and are reported differently on your return.

DETERMINING THE AMOUNT OF GAIN OR LOSS

Gain or loss on the sale or other disposition of timber, as in the case of property in general, is

the difference between the amount received and the cost or other basis of the property. Many forest owners overlook the fact that they may have a basis that can be attributed to the timber sold.

For the most part the determination of gain or loss from the sale of property causes no difficulty. In the simplest case, if you bought a vacant lot for \$1,000 and later sold it for \$1,200, your gain is the difference, or \$200. Similarly, if you acquire a timber tract for \$2,000, of which \$1,000 of the purchase price should be allocated to the timber, and you later sell all of the timber on the tract for \$1,200, your gain on the sale is the difference, or \$200. However, when you acquire timber and sell or otherwise dispose of it at intervals over a period of years an additional step is required. You must determine, with regard to each disposition, what part of your cost or other basis is to be offset against the proceeds to determine your gain or loss.

This means that you need to establish your basis or adjusted basis for the timber and divide this by the total quantity of merchantable timber in order to find the unit cost (depletion unit). The depletion unit multiplied by the quantity of timber sold during the year gives you the cost of the timber sold. The latter, plus expenses of sale, is then subtracted from the gross sales price to give the gain or loss for tax purposes.

Determination of the amount of gain or loss is described under the following six headings: The Cost or Other Basis for Gain or Loss, The Adjusted Basis, The Quantity of Merchantable Timber, The Depletion Unit, The Gain or Loss for Tax Purposes, and Record Requirements.

The Cost or Other Basis for Gain or Loss

The dollar amounts that you enter in your timber account when you acquire timber for the first time or when you acquire additional timber depend upon the manner of acquisition. If the timber was purchased, your basis is ordinarily its cost. But in the case of property purchased prior to March 1, 1913, special rules apply, and the basis may be its cost adjusted to March 1, 1913, or it may be its fair market value on that date. Special rules also apply in determining the basis of property acquired by gift, by inheritance or under a will, in a nontaxable or partially taxable exchange, and as a replacement for property involuntarily converted. If your timber property was acquired in

a manner other than by purchase on or after March 1, 1913, ask your local Internal Revenue office for a free copy of IRS Publication 544, *Sales and Other Dispositions of Assets*, which explains these special rules for determining the basis of property.

If at the time you acquired timberland no separate timber valuation (exclusive of land and improvements) was established, you will need to know whether a part of the total acquisition value of the property should have been allocated to the timber. If you acquired cutover land, or land with little or no merchantable timber on it, you probably would have no original basis to be entered in your timber account.

If the timber value was a significant part of the total but its quantity and value at date of acquisition are unknown, you will probably need the assistance of a forester to determine this information. Only timber that was merchantable as of the acquisition date should be included in the valuation. This means that present timber quantity must be reduced by the amount of timber growth since such basic date. Problem No. 3 in "Concluding Section" illustrates the calculation of merchantable timber quantity and its value as of a prior year.

Once the value of a timber property for purposes of determining gain or loss has been determined and approved by the Internal Revenue Service, no revaluation is allowed during the continuance of a given ownership except for misrepresentation, fraud, or gross error as to the facts known on the evaluation date. Revaluation by the taxpayer in such cases may not be made without the written approval of the Commissioner of Internal Revenue.

The Adjusted Basis

Your original basis for gain or loss will need to be adjusted from time to time to keep current the dollar amount shown in your merchantable timber account. The basis will need to be increased by the value allocated to additional timber purchases and by the amount of carrying charges that have been capitalized. Such adjustments should be made as the transactions take place in order that the dollar amount of your merchantable timber account, as brought forward at the start of the taxable year, will reflect the situation at that time. Adjustments may also include decreases to the account for timber sales made or casualty losses incurred during the preceding year.

In the year of timber cutting or sale additional adjustments may be needed. For example, there should be added the value of timber acquired since the beginning of the year, amounts transferred from the young growth or the plantation accounts (described on page 3) for timber reflected in such accounts which has become merchantable, and carrying charges incurred during the year which have been capitalized.

Adjustments to the basis for gain or loss are illustrated in the examples that follow under "The Gain or Loss for Tax Purposes."

The Quantity of Merchantable Timber

When timber is first acquired, the quantity to be entered in your timber account, expressed in board feet, cords, or other units, should be estimated on the basis of the total volume that the tract would have produced on the date of acquisition if all the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in the region at that time. An entry in your timber account, increasing the quantity of timber by the number of units purchased or otherwise acquired, should be made each time you acquire additional timber. Likewise, if you have cut or sold any of the timber in prior years, the quantity should have been decreased in such years by the number of units cut or sold. The quantity shown at the beginning of the year for which the depletion unit is determined should thus reflect the quantity of merchantable timber available for cutting, subject to the adjustments explained below.

The number of units shown in the merchantable timber account at the beginning of the tax year should be adjusted to correct inaccuracies or to reflect changed standards of utilization or 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 the young growth or deferred reforestation accounts of timber reflected in such accounts that has become merchantable, and (3) the number of units gained through growth since the last such adjustment. Periodic adjustments for growth should be made; however, the owner of a small timber holding who has infrequent transactions would generally be required

to make this determination only for a year in which he cuts, sells, or otherwise disposes of timber.

Adjustments to the merchantable timber account are illustrated in the examples that follow under "The Gain or Loss for Tax Purposes."

The Depletion Unit

The depletion unit, as stated earlier, is found by dividing your adjusted basis for depletion by the total quantity of timber. The unit is usually expressed in dollars per thousand board feet or per cord, but the individual tree may be the physical unit as in the case of Christmas tree plantations. The unit is determined for each timber account for the tax year in which timber is cut or sold, after making the adjustments already described. Further reference to calculation of the depletion unit will be found under the heading "Record Requirements," p. 8.

The Gain or Loss for Tax Purposes

The depletion unit multiplied by the number of units sold is the basis for determining gain or loss on the sale. This amount plus any expenses in connection with the timber disposal or sale, such as timber surveys, advertising, etc., is subtracted from the amount received, and the difference is the gain or loss to be reported on your return. This calculation is illustrated below.

Example.—Mr. Brown bought a farm for \$10,000 in 1940 and determined that \$1,500 of the purchase price should be allocated to standing timber located on a part of the farm. In 1956 he bought a 100-acre timber tract adjoining his farm. He paid \$2,500 for the second property, and in connection with the purchase he also paid \$60 for a timber cruise and boundary survey and \$40 for title search and recording the deed, bringing the total cost to \$2,600. He allocated \$600 (\$6 per acre) to the land and \$2,000 to the timber. At the time of purchase all of the timber on the two tracts was considered merchantable, and no part of the cost of timber was allocated to young growth. Mr. Brown did not make an election for any year to capitalize taxes or other carrying charges pertaining to the timber. The quantity of timber on the first tract at the time of purchase was 300,000 board feet, and that on the second tract at the time of purchase was 190,000 board feet.

In 1974 Mr. Brown decided to sell some of his timber. He had not cut or sold or otherwise

disposed of any of the timber in prior years. He determined that timber growth since he acquired the two tracts was 100,000 board feet. He sold 60,000 board feet in 1974 for \$35 per M, or \$2,100 and he paid \$100 for a timber cruise and other expenses in connection with the sale.

Mr. Brown's depletion unit for determining gain or loss on this disposition is \$5.93 per M board feet, the basis for gain or loss is \$355.80, and he has a gain on the sale of \$1,644.20 to report on his 1974 return.

	Timber invest- ment	Timber quantity (M bd. ft.)
First tract	\$1,500	300
Second tract	2,000	190
Timber growth since purchase		100
<hr/>		
Adjusted basis for depletion	3,500	
Total timber available for cutting		590
<hr/>		
Depletion unit (\$3,500 ÷ 590 M bd. ft.)		\$5.93
Basis for gain or loss on 60 M bd. ft. of timber sold (\$5.93 × 60 M bd. ft.)		\$355.80
<hr/>		
Proceeds from sale (60 M bd. ft. @ \$35 per M)		\$2,100.00
<i>Less:</i>		
Basis of timber sold	\$355.80	
Expenses	100.00	
<hr/>		
Total		455.80
Gain on sale		\$1,644.20

Timber depletion occurs when you cut standing timber. The determination of your depletion allowance is made in the same manner as determination of the basis for gain or loss when timber is sold. To illustrate, assume that in the first example Mr. Brown did not sell standing timber, but instead cut 60,000 board feet for sale or for use in his business. He would divide his adjusted basis, \$3,500, by the total quantity of merchantable timber, 590,000 board feet, to arrive at his depletion unit of \$5.93 per M board feet. His depletion allowance for the timber cut would be \$5.93 × 60 M board feet, or \$355.80.

Although timber depletion occurs when timber is cut, the depletion deduction is not claimed until the logs or wood is sold or otherwise disposed of. Thus, if you cut timber during the year but do not sell the logs until the following year, you may not claim a deduction for the depletion allowance, or for expenses in connection with the cutting, on your return for

the year of cutting. You must set up a cut timber (log) inventory at the end of the year and include the depletion allowance and cutting expenses in that account. In the following year, when you sell the logs, the amount in the inventory account is offset against the proceeds of sale to determine your gain or loss.

Example.—Mr. Masters cut 50,000 board feet of his timber in 1974. His depletion allowance on the cutting was \$150, and his expenses of cutting the timber totaled \$1,000. He sold 25,000 board feet of these logs in 1974. Since he sold only half of the timber cut, only half of the depletion allowance (\$75) and half of his cutting expenses (\$500), or a total of \$575, may be offset in determining the amount of gain. Since he did not sell the other 25,000 board feet in 1974, the balance of the depletion allowance and cutting expenses must be set up in a log inventory at the end of 1974. If the remaining logs were sold in 1975, the amount shown in this inventory account would be offset against sale proceeds to determine the gain or loss on the sale in that year.

No depletion allowance may be claimed in the case of timber cut for your own personal use such as firewood for your home, and no adjustment to the dollar amount in your timber account would be made when you cut timber for such use. However, if you cut large amounts of timber for this or similar purposes, it may be necessary to adjust the quantity shown in the timber account in order to reflect the decrease in timber available for cutting and sale.

Record Requirements

The Income Tax Regulations do not call for any specific type of timber account, but they do require that you keep accurate and complete records in order that depletion allowances and other amounts shown on your return in the computation of gain or loss on timber transactions may be supported.

Taxpayers claiming a depletion allowance or operating, buying, leasing, or selling timberlands are to file Form T (Timber), Forest Industries Schedule, which may be obtained from any local Internal Revenue office. Part F of this schedule, reproduced as Exhibit G of the appendix, illustrates the timber depletion calculation in detail including the basis used in connection with timber disposals and physical losses of timber from fire or other cause. The schedule may help you to determine what accounts you

should set up to record your timber transactions.

The timber accounts shown below, for example, might be sufficient in the case of Mr. Brown (*Example*, p. 7). Mr. Brown, who is primarily a farmer, acquired a small tract of timber as part of his farm when purchased, and several years later purchased another timber tract. His only entries to the accounts are for his two acquisitions and the single sale. Like Mr. Brown, owners of smaller tracts will usually find it simpler to establish one timber value and one timber quantity account for depletion purposes rather than to calculate depletion for each tract separately.

Had Mr. Brown elected to capitalize taxes or other carrying charges in prior years, or in the current year prior to the sale, such charges would have been added to "Timber account—Value" to increase the dollar amount of the adjusted basis for depletion. Had losses of tim-

ber been sustained such as from a fire or other casualty, the "Quantity" account would have been reduced by the number of board feet destroyed, and the "Value" account would have been reduced by the basis of the timber destroyed.

Once established, your timber account may be divided into two or more subaccounts only under exceptional circumstances subject to approval of the District Director of Internal Revenue upon audit of your tax return. This may be done, for example, by tree species or by special timber products, such as crosstie trees, pole and piling trees, and high-grade veneer-log trees. (See question 21 on p. 25.) Such a separation of accounts, known as species or value depletion as contrasted with average depletion, permits removal of low-value trees without reducing the basis for depletion disproportionately. A larger depletion allowance thus remains for use when the crop trees are harvested. In the same way,

Timber account—Value

	<i>Debit</i>	<i>Credit</i>
3/ 1/40 Tract No. 1 purchased:		
Total cost -----	\$10,000	
Less amount charged to land -----	8,500	
Charged to timber account -----		\$1,500.00
1/ 1/41 Adjusted basis for depletion carried forward -----		1,500.00
8/15/56 Tract No. 2 purchased:		
Total cost -----	\$2,600	
Less amount charged to land -----	600	
Charged to timber account -----		2,000.00
1/ 1/57 Adjusted basis for depletion carried forward -----		3,500.00
12/31/74 Basis for sale of 60 M bd. ft., July 1974 (\$3,500 ÷ 590 M bd. ft. = \$5.93 (depletion unit); \$5.93 × 60 M bd. ft.) -----		\$355.80
12/31/74 Adjusted basis for depletion to be carried forward -----		3,144.20
	3,500.00	3,500.00
1/ 1/75 Adjusted basis for depletion brought forward -----		\$3,144.20

Timber account—Quantity (bd. ft.)

	<i>Debit</i>	<i>Credit</i>
3/ 1/40 Tract No. 1, estimated merchantable quantity at purchase -----	300,000	
8/15/56 Tract No. 2, estimated merchantable quantity at purchase -----	190,000	
12/31/74 Growth, date of purchase to 1/1/74 -----	100,000	
	590,000	
12/31/74 60 M bd. ft. sold, July 1974 -----		60,000
12/31/74 Quantity to be carried forward -----		530,000
	590,000	590,000
1/ 1/74 Quantity brought forward -----		530,000

if high-value trees are removed first, a higher depletion allowance may be claimed and the recognized gain will be reduced accordingly. Many timber owners will not need to use species or value depletion but will find the average depletion method well suited to their needs.

DETERMINING THE TYPE OF GAIN OR LOSS

The tax treatment of gain or loss from the sale or other disposition of timber, and the manner of reporting it on your return, depend upon whether you have an "ordinary" gain or loss or "capital" gain or loss. Ordinary income is 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 result in a tax benefit to you. If your net gains from the sale or exchange or long-term capital assets (assets held more than 6 months) exceed your net losses from the sale or exchange of short-term capital assets (assets held 6 months or less), only one-half of the excess is subject to tax. Furthermore, the tax on your excess of net long-term capital gains cannot exceed 25 percent of that excess for gains not exceeding \$50,000.

If your capital gains exceed \$50,000 the first \$50,000 of net long-term capital gain is taxed at 25 percent and the balance is taxed at a higher rate. The capital gain deduction may be subject to the minimum tax on tax preference items. Examples of capital gain computations are contained in Internal Revenue Service Publication 544, *"Sales and Other Dispositions of Assets,"* and the minimum tax on tax preference items is discussed in Internal Revenue Service Publication 525, *"Taxable Income and Nontaxable Income."* Both publications are available free from your local Internal Revenue Office.

Whether your gains or losses from timber transactions are treated as ordinary or capital gains and losses will depend upon a number of factors including the purpose for which the timber was held, the length of time you owned the timber before disposal, the form of disposal, and the nature of the product. These factors are taken up below under the following headings:

Sale of standing timber for a lump sum

Disposal of standing timber with an economic interest retained.

Cutting of standing timber with election to treat as a sale.

Sale of forest products other than standing timber.

Agricultural program payments represent an additional form of receipt and are discussed under "Other Receipts, such as Agricultural Program Payments."

Sale of Standing Timber for a Lump Sum

A lump-sum sale is one in which you sell timber outright and are paid a fixed amount agreed upon in advance. The sale may cover all the timber standing on a given acreage or tract of land, or it may cover certain species, diameter classes, or marked trees only.

Whether a lump-sum sale of standing timber will result in ordinary or capital gain or loss depends upon whether the timber is considered to have been a capital asset in your hands. Timber is a capital asset in your hands if it is not considered to be property held primarily for sale to customers in the ordinary course of your trade or business and if it is not property used in your trade or business. Whether timber sold was held primarily for sale in the ordinary course of the taxpayer's trade or business is not always easy to determine. It depends on all the facts surrounding the particular transaction. Some of the factors that have a bearing have been listed by one writer as follows:

1. The purpose for which the timber was acquired, whether for sale or investment.
2. The number, continuity, and frequency of sales as opposed to isolated transactions.
3. The activity of the seller with reference to the sales or of those acting under his instructions or in his behalf.
4. The extent or substantiality of the transaction.
5. Any other facts tending to indicate that sales or transactions were in furtherance of an occupation of the taxpayer.

In general, if you make only an occasional sale of timber 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 proceeds of sale will be entitled to capital gains treatment. On the other hand, if you are a dealer in timber or timberland or make repeated sales of standing timber from properties assembled or held for

such purposes, or if other factors enumerated above cast doubt upon the nature of the transaction, you run the risk, upon audit of your return, of having the tax status of your timber transaction questioned.

Because uncertainty may exist in some situations as to eligibility of lump-sum sales for capital gains treatment, taxpayers making frequent sales of timber held for more than 6 months may dispose of it in such a manner as to retain an economic interest and thus avoid the problem. The latter situation is described below under "Disposal of Standing Timber with an Economic Interest Retained."

Assuming that your timber sale does qualify for capital gains treatment, the holding period becomes a consideration. Sale or exchange of a capital asset held more than 6 months at time of the transaction leads to a long-term capital gain or loss while sale or exchange of a capital asset held 6 months or less leads to short-term capital gain or loss. As mentioned earlier, if you have an excess of net long-term capital gains over net short-term capital losses, only one-half of the excess is subject to tax. Short-term gains do not have this advantage and are taxed in the same manner as ordinary income. They are, however, offset against long-term capital losses. If all of your capital transactions result in a net capital loss you may be limited as to the amount of the loss used to offset other income reported for that year, and you are permitted to carry over any unused loss to other years. Because of these special rules capital gains and losses are entered on your return in a manner different from ordinary income.

Capital gains and losses from sales or exchanges of timber that qualifies as a capital asset (or that is treated as a capital asset in the situations discussed later) are reported in separate Schedule D, "Sales or Exchanges of Property." In the case of timber held more than 6 months at the date of sale, you enter the transaction in Part II of Schedule D under "Long-term capital gains and losses—assets held more than 6 months." If the timber was held 6 months or less, the transaction would be entered in Part I under "Short-term capital gains and losses—assets held not more than 6 months."

Example.—Mr. Brown sold 60,000 board feet of standing timber in a lump-sum sale on August 15, 1974, for \$2,100. The timber was located on land acquired as part of his farm which he

purchased on March 1, 1940. His cost or other basis of the timber sold was \$355.80, computed as previously explained under "Determining Amount of Gain or Loss," and he paid \$100 for a timber cruise in connection with the sale. He is engaged primarily in farming, and the timber is considered to be a capital asset in his hands. Mr. Brown has a long-term capital gain of \$1,644.20 on the sale of the standing timber (sale proceeds of \$2,100 less \$455.80, which is the sum of his cost or other basis of the timber sold, \$355.80, and the \$100 expense of sale paid for the timber cruise). The transaction is entered in Part II of Schedule D (Form 1040) under "Long-term Capital Gains and Losses—Assets Held More Than 6 Months," as follows:

Col. a.	Kind of property and description	60,000 bd. ft. pine timber; lump-sum sale
Col. b.	Date acquired	3-1-40
Col. c.	Date sold	8-15-74
Col. d.	Gross sales price	\$2,100
Col. e.	Cost or other basis as adjusted and expense of sale	\$455.80 (attach explanation)
Col. f.	Gain (or loss) (d) less (e)	\$1,644.20

The gain is carried forward as indicated on Schedule D, and the net taxable gain or loss is transferred to the tax return (Form 1040). In the absence of other capital assets transactions, only 50 percent of \$1,644.20 or \$822.10 is includable in taxable income.

If the timber had been held 6 months or less at date of sale, the transaction would have been entered under the "short term" part of Schedule D (Part I) and the full \$1,644.20 (in the absence of offsetting long term capital losses) would have been includable in taxable income.

The explanation that follows may be of further assistance in providing the information called for in columns "a" to "f" inclusive of Schedule D.

a. *Kind of property and description.*—Indicate here only the nature of the property, the amount and type of property sold. For example: "60,000 bd. ft. pine timber."

b. *Date acquired.*—Show here the date upon which the timber came into your possession, whether by purchase, gift, inheritance, or in other manner.

c. *Date sold.*—Show here the date that title to the timber passed to the buyer.

d. *Gross sales price.*—Show here the full contract price.

e. *Cost or other basis as adjusted, ... and*

expense of sale.—Here you enter your cost basis of the timber sold and the expense of the timber cruise. A statement should be attached to the schedule showing the calculation of your cost basis in the timber sold, as illustrated earlier under “Determining Amount of Gain or Loss.” The statement should indicate the original cost of the tract as a whole, and the portion of the purchase price allocated to land, improvements (if any), and timber, respectively. Mention should also be made of the quantity and quality of merchantable timber present on the tract at time of acquisition, and the quantity of subsequent timber growth to date, reduced by prior sales and any sustained losses, as, for example, by fire. The expenses related directly to the sale should be itemized in your statement, and would include items such as advertising the timber for disposal, cost of timber survey or cruise, cost of marking trees to be cut, cost of travel, fees of consulting foresters, accountants, or attorneys, and other expenses of similar nature.

f. *Gain or (loss).*—Here will be entered the difference between the gross sales price (column d) less the sum of the cost or other basis and the expense of sale (column e).

In the event that you are paid in installments extending beyond the year of sale for timber sold on a lump-sum basis, the question arises as to the taxable year in which the gain should be reported. In general, if payments in the year of sale do not exceed 30 percent of the selling price, you may elect under the installment method to report the gain proportionately over the years in which collections are made. The election to use the installment method applies only to gains; if you have a deductible loss it must be deducted in full in your return for the year of the sale. The election to use the installment method of reporting gain must be shown in your timely filed return for the year of the sale, even though no payments are received in that year.

If your lump-sum sale does not qualify for capital gains treatment under facts that indicate the timber was “held for sale to customers in the ordinary course of your business,” the gain or loss from the sale is ordinary income or loss and the transaction must be reported on a business schedule filed with your income tax return. Ordinarily, such a sale would be reported on Schedule C (Form 1040), “Profit or (loss) from Business or Profession.” A farmer

could include the transaction in his Schedule F (Form 1040), “Farm Income and Expenses,” Part I.

Disposal of Standing Timber With an Economic Interest Retained

A disposal of timber with an economic interest retained occurs under a so-called pay-as-cut contract in which you are paid a stated amount per unit harvested and only for the units harvested. Due to the fact that you retain ownership of the timber until the trees are harvested by the purchaser, the title does not pass when the contract is made. You thus retain ownership until the trees are cut and your receipts depend upon the quantity of timber harvested. Sale of timber with provision merely for installment payments falling due, whether or not the timber is harvested, does not satisfy the requirements for retention of an economic interest.

Proceeds of timber disposal meeting the test of “economic interest retained” may qualify for treatment under the special provisions of Sections 631(b) and 1231 of the Internal Revenue Code, which are reproduced in the appendix, pages 50 and 51. Disposals of timber coming within the terms of Section 631(b) are sometimes referred to as “Section 631(b) transactions.”

You have an economic interest in timber in every case in which you have acquired by investment any interest in standing timber and secure, by any form of legal relationship, income derived from the severance of the timber to which you must look for a return of your capital. Thus, the special provisions apply not only to the actual owner of timberland, but also to a sublessor who subleases or subcontracts his right to cut.

The special provisions offer two important advantages. First, your timber is included within a special tax category of “business property” entitled to capital gains treatment when aggregate gains exceed aggregate losses of such property. This is explained more fully below. Second, the question of whether your timber is held for sale to customers in the ordinary course of business does not arise as it does under lump-sum sales. As a result your use of capital gains treatment is not subject to question on such grounds.

Only timber owned more than 6 months comes under the special provisions of Section

631(b) and 1231. If you owned timber more than 6 months at date of disposal under a cutting contract, three aspects of the special provisions require explanation. These relate to the definitions of ownership, timber, and date of disposal.

As respects ownership, Section 631(b) applies only to disposal of timber by an "owner," but this term is broadly defined, as explained above, to include any person, including a sublessor and the holder of a contract right to cut, who owns an interest in timber. An "interest in timber" results from possession of the right to cut timber for sale on one's own account or for use in one's trade or business.

The term "timber" for purposes of Section 631(b) includes the parts of standing trees usable or used for lumber, pulpwood, veneer, poles, piling, crossties, and other wood products; it includes also evergreen trees which are more than 6 years old when severed from the roots and which are sold for ornamental purposes, such as Christmas trees. The special provisions are not applicable to evergreen trees sold in a live state whether or not for ornamental purposes. Tops and other parts of standing timber likewise are not considered as "evergreen trees." The latter term is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

The date of disposal is the date the timber is cut. However, because it is not usually possible to measure the quantity of timber at the point in the woods where it is felled, timber is considered to be "cut" at the time when in the ordinary course of business the quantity of timber felled is first definitely determined. The date of disposal, therefore, will generally be the time when, in accordance with your common and consistent practice, the quantity of felled timber is first determined at a log landing, dump, or wood yard. This arbitrary definition of "cut" could have a favorable effect in determining whether your sale under a cutting contract comes under the special provisions, since you may not have owned timber more than 6 months when the timber was felled, but could have owned it more than 6 months prior to the date the quantity was actually determined in accordance with your usual practice. Taxpayers must hold to a consistent practice and may not shift the scaling point to obtain a tax advantage.

If payment under the contract is made before cutting, you may elect to treat the date of

payment as the date of disposal. This election must be evidenced by a statement attached to your return for the taxable year in which the payment is received. However, if the election is made and you did not hold the timber more than 6 months before the date of payment, the special provisions of Section 631(b) do not apply to the payment received. Further, if advance payments were included in your return as amounts realized from the sale of timber, and the cutting right expires, terminates, or is abandoned before the timber paid for is cut, you must recompute your income and file an amended return where necessary. Such payments are then treated as ordinary income not received from the disposal of timber under a cutting contract.

There are three steps in reporting your gain or loss from a disposal of timber under a cutting contract. First, you determine the amount of gain or loss; second, you group the gain or loss with certain other gains and losses that you may have sustained during the taxable year; third, if the result of the grouping is a net gain, you enter the transaction on Schedule D. These three steps are explained in the paragraphs and examples that follow.

Determination of the gain or loss consists simply of subtracting from the gross sales price the sum of your cost or other basis in the timber (depletion basis) and the expense of sale. The difference is your gain or loss.

The taxable gains and losses that must be grouped are those from the following sales, exchanges, or other dispositions of property held more than 6 months, and are known as "section 1231 gains or losses."

1. The disposal with an economic interest retained of timber, iron ore, or coal held more than 6 months.

2. Timber held more than 6 months before the beginning of the taxable year, with respect to which you have elected to treat the cutting as a sale (explained under the heading "Cutting of Timber with Election to Treat as a Sale").

3. An unharvested crop on land used in farming if the crop and land are sold, exchanged, or involuntarily converted at the same time and to the same person, and the land has been held more than 6 months.

4. Livestock (not including poultry) acquired before 1970 for draft, breeding, or dairy purposes, and held 12 months or more.

5. Cattle and horses acquired after 1969 for

draft, breeding, dairy or sporting purposes and held 24 months or more.

6. Livestock (except cattle, horses, and poultry) acquired after 1969 for draft, breeding, dairy, or sporting purposes and held 12 months or more.

7. Real property, depreciable personal property, and leaseholds used in your trade or business and held more than 6 months.

8. Property held for the production of rents or royalties if held more than 6 months.

9. Casualty and theft gains and losses of property held more than 6 months. These include casualty losses and thefts of property held for personal use (such as your car or residence, but in case of a loss only the excess over \$100), business property, property held for the production of rents and royalties, and investment property (such as notes and bonds). Insurance proceeds or other reimbursements must be taken into account in arriving at the net gains or losses. For a detailed description of how to compute and report casualty gains or losses see IRS Publication 547, *"Tax Information on Disasters, Casualty Losses, and Thefts."*

10. Property condemned for public use if held more than 6 months (this includes gains on business and investment property, and on property held for personal use, but only losses on business and investment property).

If gain or loss results from the disposition of a capital asset, or if it is treated as such, it is a capital gain or loss. If you hold a capital asset 6 months or less, the gain or loss from its sale or exchange is a short-term capital gain or loss. To determine the amount of your short-term capital gain or loss add the gains and the losses separately and subtract the smaller from the larger. The result is the net short-term capital gain or loss.

Long-term capital gains and losses result from the disposition of a capital asset, or an asset treated as such, held for more than 6 months and are merged in a similar manner to determine the net long-term capital gain or loss.

The total net gain or loss is determined by merging the net short-term capital gain or loss with the net long-term capital gain or loss and reported on line 14, Part III, Schedule D. For a detailed discussion of capital gains and losses see IRS Publication 544, *"Sales and Other Dispositions of Assets."*

Example 1. Mr. Black disposed of timber under a cutting contract during 1974. The contract called for payment at the rate of \$30 per thousand board feet as the timber was cut and scaled. During September, 60,000 board feet were cut as shown by scaling completed on September 23. Mr. Black received the amount due him, \$1,800 on October 1. The timber was standing on land purchased in 1940. His depletion basis for the timber disposed of (computed as explained under "Determining Amount of Gain or Loss," p. 5) was \$355.80, and he paid \$200 in connection with the sale for tree marking and log scaling, so that the transaction resulted in a gain of \$1,244.20 (\$1,800.00 less \$355.80 and \$200.00). He also had certain other gains and losses during the year, all of which were of the type required to be grouped for determining how they must be reported as follows:

(1) Gain on sale of timber under cutting contract	\$1,244.20
(2) Gain on sale of pastureland	500.00
(3) Loss on sale of livestock used for breeding purposes	(400.00)
(4) Deductible casualty loss from fire to personal residence (in excess of \$100)	(300.00)
(5) Total of items	<u>\$1,044.20</u>
(6) Total casualty and theft gains and losses	<u>\$(300.00)</u>
(7) Total of items less casualty and thefts	<u><u>\$1,344.20</u></u>

The casualty loss (Item 4) is listed in Section A, Part I, Form 4797. Since total casualty and theft losses exceed total casualty and theft gains, they are treated as ordinary gains or losses, and the total is entered in Part II, Form 4797. The personal casualty loss (Item 4) is deductible only on Schedule A (Form 1040).

The other "section 1231" gains and losses (Items (1), (2), and (3)) are entered in Section B, Part I, Form 4797. Since the total of these items is a gain, the net amount is treated as a capital gain. Enter the net amount (a gain of \$1,344.20) on line 4, Form 4797, and on line 8, Schedule D (Form 1040).

Example 2. Assume the facts in Example 1 above except that Mr. Black's loss on the sale of livestock was \$2,000 and that he realized a gain from insurance reimbursement for a stolen diamond ring. Comparison of the gains and losses showed an excess of losses as follows:

(1) Gain on sale of timber under cutting contract	\$1,244.20
(2) Gain on sale of pastureland	500.00
(3) Loss on sale of livestock used for breeding purposes	(2,000.00)
(4) Deductible casualty loss from fire to personal residence (in excess of \$100)	(300.00)
(5) Gain from insurance reimbursement for diamond ring	400.00
(6) Total of all items	<u>\$(155.80)</u>
(7) Total casualty and theft items	<u><u>\$100.00</u></u>

All the casualty and theft items (Items (4) and (5)) are first listed in Section A, Part I, Form 4797. Since the total casualty and theft gains exceed the total casualty and theft losses, the net gain (\$100) is entered in Section B, Part I, Form 4797 along with the other "section 1231" items (Items (1), (2), and (3)). Since the total of these items is a loss, each is treated as an ordinary gain or loss, and the total is listed in Part II, Form 4797, along with his other ordinary gains and losses, if any. The personal casualty loss (Item (4)) is deductible only on Schedule A (Form 1040), and only if Mr. Black itemizes his deductions, but the other "section 1231" items are combined and entered on line 30, Form 1040, regardless of his intention to itemize his deductions, take the standard deduction, or use a tax table.

Cutting of Standing Timber With Election to Treat as a Sale

If you cut timber for sale or for use in your business, you may, under certain conditions, be entitled to capital gains treatment under special provisions of the Internal Revenue Code. These provisions are found in Sections 631(a) and 1231 of the Code and are reproduced in the appendix.

Under the special provisions, if you cut timber which you owned more than 6 months before the first day of the tax year in which it was cut and such timber was cut for sale or for use in your business and you elect to use Section 631(a), you report your gain in two parts as follows:

1. The difference between the depletion basis of the standing timber cut during the taxable year and its fair market value as of the first day of the taxable year in which it was cut. This may be treated as a long term capital gain as explained below.

2. The difference between the fair market value of such standing timber on the first day of the tax year and the proceeds from sales of resulting products (less processing costs). This must in all cases be treated as ordinary income.

Six aspects of Section 631(a) require explanation. These relate to definitions of ownership, timber, intended timber use, holding period, fair market value used as the "sales price," and election to use the provision. It should be kept in mind that the special provisions apply only to timber that you had owned or held under contract for more than 6 months before the first day of your tax year.

1. *Definition of ownership.*—The special treatment is available to a taxpayer who has owned, or has held a contract right to cut, timber for the requisite period. In order to have a "contract right to cut timber," you must have an unrestricted right to sell the timber cut under the contract on your own account or to use such cut timber in your trade or business. This means that if you, as for example a sawmill operator, bought timber from another under a pay-as-cut contract, such timber qualifies the same as timber that you own.

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

2. *Definition of timber.*—The term "timber," as in disposals with economic interest retained, covers trees usable for lumber, pulpwood, veneer, poles, piling, crossties, or other wood products; it also includes evergreen trees that are more than 6 years old when severed from the roots and are sold for ornamental purposes, such as Christmas trees. It does not include living trees sold for transplanting whether or not for ornamental purposes. Standing timber is often referred to as "stumpage" by foresters and people in the timber business. The age of a tree is the total period from germination of the seed; for practical purposes the age of cut trees may be determined by counting the annual growth rings.

3. *Intended timber use.*—Only timber cut by the taxpayer for sale or for use in his trade or business qualifies for treatment under Section

631(a). This would include owned timber (see definition of ownership above) that you cut for sale as sawlogs, pulpwood, piling, crossties, fuelwood, etc., or for use in your business, such as sawmilling or other processing operation. "Timber cut by the taxpayer" includes that which you cut personally or which is cut by persons in your employ or under contract to you.

4. *Holding period.*—The "more than 6-months" holding period needed for qualification under Section 631(a) runs from the date you acquired the timber or the contract right to cut the timber to the first day of the taxable year in which it was cut. If you report your income on a calendar-year basis, you must have held the timber since before July 1 of the preceding year.

As explained on page 12 in connection with pay-as-cut contracts, timber is considered to be cut at the time when, in the ordinary course of business, the quantity felled is first definitely determined. This will generally be the date when the felled timber is scaled or otherwise measured for volume at a log landing, dump, mill site, or wood yard.

5. *Fair market value used as the "sales price."*—In the case of timber that you cut, you naturally have no cash proceeds from stumpage to use as the "gross sales price" since standing timber was not actually sold. For use as the "sales price," the fair market value of the timber must be estimated as of the first day of the taxable year in which it was cut. If you are on a calendar-year basis, this date will be January 1.

The "cutting" of the timber is regarded, for tax purposes, as a sale of such timber to yourself and the total gain, as indicated earlier, is reported in two parts. The fair market value as of the first day of the taxable year is then regarded not only as the "selling price" of the standing timber for use in determining the gain from cutting of timber, but also as the "cost" of the timber for use in determining the gain from the actual sale of the resulting products.

As a practical matter you are not likely to have great difficulty in placing a reasonable stumpage value on the timber that you have cut. The value sought will be the selling price assuming a transfer between a willing buyer and a willing seller. A public or private consulting forester normally can advise you as to the approximate price per thousand board feet, cord, or other unit for similar stumpage in your

area as of the first day of the taxable year. This average figure can then be adjusted as may be necessary to reflect the condition of your own timber. Among factors to be considered are the following: (a) The character and quality of the timber as determined by species, age, size, and condition; (b) the quantity of the timber per acre, the total quantity of timber under consideration, and its location with reference to available markets; (c) accessibility of the timber from the standpoint of probable cost of cutting and transportation; and (d) competition likely to develop from other buyers of stumpage.

The timber in each instance should be valued on its own merits and not on the basis of general averages for regions. In estimating fair market value, there are two especially useful guides. The first is original cost, adjusted for changing price levels, and changes in timber quantity and quality since acquisition. The second is so-called transactions evidence that considers recent sales and transfers of similar timber.

The determination of fair market value under Section 631(a) in the case of Christmas trees raises questions that differ from those applicable to timber in general. These questions are dealt with in problem 6 on page 30 under "Concluding Section."

6. *The election to use Section 631(a).*—Although the law gives you the choice of whether or not to use this provision, it will ordinarily be to your advantage to do so. A situation in which you might prefer not to make use of the elective provision relates to the self-employment Social Security tax which is discussed on page 23.

An election under Section 631(a) to adopt the optional method is binding with respect to all eligible timber that you cut in the year of election and subsequent years, and the consent of the Commissioner of Internal Revenue is required to discontinue it. This permission is ordinarily given where there is a showing of undue hardship; however, consent to resume the practice must also be obtained from the Commissioner and might be difficult to justify.

Election to use the optional method provided by Section 631(a) takes the form of a computation in your tax return. This computation may be accompanied by a statement such as: "I elect to consider the cutting of timber as a sale or exchange in accordance with Section 631(a)." The election should be made in the tax return

for the year to which it applies, and may not be made in an amended return for such year.

Determination of the gain or loss on the cutting of timber that you have elected to treat as a sale consists of subtracting the adjusted basis of the timber cut from fair market value used as the "sales price." It is important to remember that the latter does not reflect an actual stumpage sale, since the timber was not sold standing but was cut by the taxpayer. The figure represents rather an estimate of the value of the timber as it stood uncut in the woods on the first day of your taxable year. The difference between this fair market value and the basis of the timber cut is your gain from the cutting of timber.

Gains and losses from 631(a) transactions must be grouped with taxable gains and deductible losses from sales, exchanges, and other dispositions of certain assets held more than 6 months, in the same manner as gains and losses on timber sales under pay-as-cut contracts explained on page 12. The manner of reporting these gains and losses depends upon whether the total gains exceed total losses, and the rules are the same as explained in connection with sales of standing timber under pay-as-cut contracts.

Your gain or loss from actual sale or other disposition of the cut timber or the resulting product is always treated as ordinary income or loss. Generally, such gain or loss would be reported on business Schedule C, Form 1040. A farmer could include this gain or loss on Schedule F, Form 1040. He would then report the sale proceeds as part of farm income and deduct the "cost" (the fair market value used in computing gain or loss on cutting elected to be treated as a sale), and his expenses of cutting and sale, as part of farm expenses.

The following example illustrates the rules applying to the election to treat timber cutting as a sale. Problem 5, page 29 under "Concluding Section," also illustrates the application of this election. Part I of the following examples relates to the stumpage gain and Part II relates to the gain from processing products "beyond the stump."

Example.—Mr. Jenkins, who files his tax returns on a calendar year basis, cut 60,000 board feet of timber during 1974 from a tract which he had purchased in 1940. Also in 1974, he sold the resulting sawlogs at roadside for \$3,300. The fair market value of the standing timber

which he cut was determined to be \$30 per thousand board feet, or \$1,800, as of January 1, 1974. His basis of the timber cut (computed as explained under "Determining Amount of Gain or Loss," above) was \$355.80. His logging and skidding costs amounted to \$1,080. Mr. Jenkins had owned the timber for more than 6 months and he elected to treat the cutting as a sale. He also had other gains and losses during the year, all of which were of the type required to be grouped in the comparison of gains and losses discussed above.

Mr. Jenkins would determine the gain or loss on the cutting of the timber separately from the gain or loss from the sale of the sawlogs as follows:

Part I—Gain or loss on timber cutting treated as sale:

Fair market value, as of 1/1/74, of timber cut during year	\$1,800.00
Less: Cost or other basis (depletion allowance)	355.80
Gain from cutting of timber	<u>\$1,444.20</u>

Comparison of gains and losses required to be grouped:

(1) Gain on timber cutting treated as a sale	\$1,444.20
(2) Gain on sale of pastureland	500.00
(3) Loss on sale of livestock used for breeding purposes	(400.00)
(4) Deductible casualty loss from fire to personal residence (in excess of \$100)	(300.00)
(5) Total of items	<u>\$1,244.20</u>
(6) Total casualty and theft gains and losses	<u>(\$300.00)</u>
(7) Total of items less casualty and thefts	<u>\$1,544.20</u>

Since total casualty and theft losses exceed total casualty and theft gains ((6) above), each casualty and theft item is treated as ordinary gain or loss. The personal casualty loss ((4) above), is only deductible on line 29, Schedule A (Form 1040).

Since the total of all items less the casualty and thefts ((7) above) is a gain, these items ((1) through (3) above) are treated as capital gains and losses. The net amount (\$1,544.20 gain) goes on line 8, Part II, Schedule D. As explained in the example on page 11 a statement should be attached to Schedule D showing how the basis

of the timber was computed plus any other necessary information.

If total gains had not exceeded total losses, none of the gains or losses would have been treated as capital gains and losses. The gain on the cutting of timber treated as a sale, the gain on the sale of pastureland, and the loss from sale of livestock, would all be reported in Part III of Schedule D as ordinary gains and losses. The \$300 deductible casualty loss from fire damages to his personal residence would be deductible by Mr. Jenkins only on Schedule A (Form 1040) and only if he itemizes his deductions.

Part II—Gain or loss from sale of sawlogs at roadside:

Proceeds from sale of sawlogs		\$3,300
Less:		
Fair market value used as "sale price" in computing gain from cutting treated as sale	\$1,800	
Logging and skidding costs	1,080	
	2,880	
Gain on sale of sawlogs		\$420

As explained above, this is treated as ordinary income. Mr. Jenkins would report this part of the transaction on business Schedule C (or, if he files a farm return, he could include it on Schedule F).

Sale of Forest Products Other Than Standing Timber

Proceeds from sale of forest products other than standing timber are treated as ordinary income. This is true not only of products derived from harvested trees, such as logs, lumber, pulpwood, poles, mine timbers, crossties, fenceposts, fuelwood, chips, etc., but also of products derived from standing trees, such as gum naval stores, maple syrup, fruits, nuts, bark, and Christmas greens. Proceeds from sales of trees for landscaping purposes, such as balled nursery stock, are also treated as ordinary income.

An exception to the above rule should be noted. If you make a lump-sum sale of tree stumps from cutover land acquired for investment, you may be entitled to capital gains treatment with respect to such a sale. The sale

must be for all the stumps on the property. Repeated lump-sum sales do not qualify for capital gains treatment nor does the sale of stumps by the ton even though all the stumps are sold. Likewise, capital gains treatment does not apply to stumps sold by one in the timber or stump business either as buyer, seller, or processor. Thus proceeds from sale of tree stumps by timber operators after merchantable timber has been harvested, are considered to be ordinary income. Revenue Ruling 57-9 deals with this question and is reproduced in the appendix.

The cutting of sawtimber under Section 631(a) does not entitle the owner to capital gains treatment on proceeds from the sale of limbs and tops for pulpwood. See Revenue Ruling 56-434, reproduced in the appendix.

Other Receipts, Such as Agricultural Program Payments

Government payments made under the Forestry Incentives Program or related government cost-sharing programs, to cover the cost of approved conservation practices must be reported as ordinary income whether received in the form of cash, materials, or services. Such practices include forest tree planting; timber stand improvement such as thinning, cutting, girdling, or poisoning of cull trees or unwanted species; fencing as protection from cattle; fire-break construction.

Ordinary income treatment is applicable even though, as in tree planting, the related expenditures must themselves be capitalized for eventual recovery through the depletion allowance at such time as the planted trees become merchantable. The forest landowner would capitalize the entire cost of planting including that portion for which he is reimbursed. This treatment would also apply to fencing.

Ordinary income treatment also applies to payments received under the Naval Stores Conservation Program.

If you file the Schedule of "Farm Income and Expenses" (Schedule F), agricultural program payments should be entered opposite that item under "Other Farm Income." If you do not file Schedule F, agricultural program payments may be entered on page 2 of Form 1040 under Part I, line 37, "Other."

CASUALTIES, THEFTS, CONDEMNATIONS

If your timber has been destroyed in whole or in part during the year, or if you have sustained loss by timber theft or condemnation of forest land for public use, you may be entitled to claim a deduction on your income tax return. To do this, it is necessary to know what kinds of losses may be deducted, how to determine the amount of loss recognized for tax purposes, and how to determine the type of deduction; whether ordinary loss or capital loss. If, because of insurance recovery or other compensation, the destruction, theft, or condemnation results in a gain, the gain must be included in your income unless, as explained under the heading "Gains from Involuntary Conversions," you make an election to postpone reporting such gain.

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 to say 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 crash or war.

Two types of loss that differ from those just described, but which are treated in a similar manner, are those resulting from theft, frequently referred to as timber trespass, and condemnation of property for public use.

Death of trees from disease or insect infestation does not ordinarily result in a casualty loss. Losses resulting from a low level of pest incidence, usually present under normal conditions, are likewise not deductible. Also not deductible are indirect losses such as reduced timber growth rates following physical damage, site deterioration, or loss of prospective earnings. The same is true of losses that are of incidental or minor character.

Sometimes timber damage is the result of a combination of causes. Thus a nondestructive fire may be followed by insect attacks; trees weakened by interior rot or characterized by shallow roots may as a result of repeated windstorms be uprooted or broken off or may die as

a result of drought. The prudent owner will salvage the affected timber. When losses of this character are heavy but the timber is not salvaged, the books of account should nevertheless reflect the loss of timber volume as an adjustment against annual growth in computing the depletion unit.

Unless you have a cost or other basis in the timber destroyed, stolen, or condemned you do not have a deductible loss. For example, if your only timber consisted of trees that have reseeded naturally on an old field, and you have not capitalized development expenditures, taxes, or other carrying charges, you would have no basis and no loss would be recognized for tax purposes. This would hold true even though the value of the timber destroyed, based upon current market prices, was substantial. If you received insurance or other compensation, the entire amount received would be your gain.

Two Internal Revenue Service publications that provide additional information on the subject matter of this chapter are: IRS Publication 547, *Tax Information on Disasters, Casualty Losses, and Thefts*, and IRS Publication 549, *Condemnations of Private Property for Public Use*. Both of these pamphlets are available free from your local Internal Revenue office.

DETERMINING THE AMOUNT OF DEDUCTIBLE LOSS

Casualty Losses

If timber held for use in your business or for the production of income is destroyed by fire or other casualty, your deductible loss is the basis of the timber destroyed less any insurance or other compensation received or expected to be received. In the case of timber damaged but not rendered unmerchantable, gain or loss upon cutting, sale, or other disposal is determined as described on page 10 for timber sales in general.

The basis of timber destroyed is determined in the same manner as for a sale or other disposition, as explained under "Determining the Amount of Gain or Loss," page 10. You must first determine your depletion unit, expressed in physical units such as board feet, cords, etc., by dividing the adjusted depletion basis as shown in your timber account by the quantity of merchantable timber in the account. The

depletion unit multiplied by the number of units destroyed is your basis to be used in computing the loss.

The quantity of timber destroyed will need to be established to the satisfaction of the Internal Revenue Service if a deduction is to be claimed. You may wish to employ a consulting forester to cruise the timber if the area is extensive and a substantial amount of work is involved. In many cases, however, the local district forester, forest fire warden, or other representative of the State forestry department will be able to furnish you with an estimate of the quantity destroyed.

Insurance recoveries on standing timber are relatively infrequent as yet because insurance of this nature has been slow to develop. Insurance of timber against loss by fire and lightning is currently available in selected areas, however, and such insurance may be expected to grow in the future. As forest insurance becomes more general, possibly in connection with expanding forest credit facilities, and as insurance coverage is broadened to include windstorm and other hazards, proceeds from insurance loss adjustments will become increasingly important in determining gain or loss following timber damage or destruction.

The year of deduction for a loss arising from casualty is generally the year in which the casualty occurred. But where a claim for reimbursement exists, and there is a reasonable prospect of recovery of all or part of the loss, the amount that you anticipate will be recovered must be used to reduce your loss for the year of the casualty, even though you do not receive payment until a subsequent tax year. If you subsequently recover less than the amount you estimated, you may deduct the difference for the year in which it is determined that no more reimbursement or recovery can reasonably be expected.

Example.—Timber that you owned was destroyed by fire in 1974. The basis of the timber destroyed was \$800 and you expected to recover \$600 of your loss from fire insurance on the timber. Even though the insurance company does not make any payment to you in 1974 your loss for 1974 is limited to \$200, the difference between your loss and the amount you expect to recover. If the company makes an offer in 1975 to settle your claim for \$500, and you accept the offer, the \$100 difference between this amount and the \$600 you expected to

receive may be claimed as a casualty loss on your return for 1975.

If, after you have claimed a deduction for the loss, you receive reimbursement in excess of the amount you estimated that you would recover (but not more than the total amount of the loss computed), you must include such excess in your income on your return for the year received. You do not recompute the tax for the year in which you claimed the deduction.

Example.—In 1974 timber that you owned was destroyed by fire. Your loss from the casualty for tax purposes was \$1,000 and you estimated that insurance would cover \$750 of the loss. You therefore claimed a loss of \$250 on your 1974 return. In 1975 the insurance company pays you \$850, or \$100 more than you estimated in computing your deductible loss for 1974. The \$100 is included as income in your return for 1975.

In the event of destruction of unmerchantable timber, whether a plantation or young growth of natural regeneration, you may have a deductible casualty loss provided you (1) keep separate accounts under these headings as explained under "The Timber Account," on page 3, (2) have costs allocated to such accounts, and (3) have not already transferred such amounts into the merchantable timber account. If these requirements are satisfied, your basis of the unmerchantable timber destroyed may be computed by dividing the total cost shown in the account by the number of acres in plantation or young growth, and multiplying the amount so determined by the area of young growth destroyed.

Buildings or equipment used in timber operations may be partially or totally destroyed by casualty. If there is a total destruction of property used in your business or held for the production of income, your deductible casualty loss is the adjusted basis of the property destroyed, less salvage value and less insurance or other compensation received or expected to be received. In the case of partial destruction of such property, your deductible loss is limited to the lesser of your adjusted basis or the decrease in fair market value of the property just before and just after the casualty, reduced by insurance or other compensation received or expected to be received.

Example 1.—Your sawmill was completely destroyed by a fire and you carried no insurance on the property. The adjusted (depre-

ciated) basis of the sawmill at the time of the fire was \$2,500 and the value of equipment following the fire was only scrap value, amounting to \$25. Your deductible casualty loss is \$2,475, the adjusted basis of \$2,500 less salvage value of \$25.

Example 2.—Assume that the sawmill in Example 1 above was damaged by the fire but not totally destroyed. Just before the fire the sawmill had a fair market value of \$2,650 and immediately following the fire its fair market value was \$1,500. Under these facts, your loss is limited to \$1,150, the decrease in fair market value, since this amount is less than your adjusted basis of \$2,500. Had the fair market value of the sawmill been \$3,000 just before the fire and \$200 just afterward, then the decrease in fair market value would be \$2,800 and your deductible casualty loss would be limited to your adjusted basis of the property, or \$2,500.

The extent of decrease in fair market value caused by a casualty is sometimes difficult to determine. In such case, the costs of restoring and cleaning up after the casualty may be acceptable as evidence of the decrease in the value of the property if (1) they are necessary to restore the property to its precasualty condition, (2) the amount spent for restoration is not excessive, (3) they 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. Amounts spent for protection against future casualties, such as dikes to prevent future flooding or a sprinkler system to prevent fire damage, are not deductible but should be capitalized.

Theft Losses

The deductible loss arising from a theft of timber, frequently referred to as "timber trespass," is determined in much the same manner as losses arising from casualty. In the case of timber held for use in a business or for the production of income, the deductible loss is your basis of the timber stolen, that is, your depletion unit multiplied by the number of units stolen, less insurance or other recoverable amounts. Theft losses, however, are generally deductible only in the year of discovery. Therefore, the quantity of timber to be used in determining your depletion unit is the quantity at the time the theft was discovered. For the purpose of establishing a theft loss, you do not have to prove when timber was stolen, but only

that the theft occurred and when the theft was discovered.

As in the case of casualty losses, your loss from theft must be reduced by the amount of anticipated recovery, even though you do not receive payment until a subsequent year. Also, if you receive reimbursement in excess of the amount anticipated (but not more than the amount of loss) in computing your deductible theft loss for a prior year, you include the excess as ordinary income in your return for the year such excess is received. See the explanations and examples regarding these situations in the discussion above.

Condemnations

Condemnation means taking private property for public use without consent of the owner but upon award and payment of just compensation. The tax consequences are the same if you sell the property under threat or imminence of condemnation. Thus, if the public condemning authority notifies you of its intent to acquire your property by negotiation or if necessary by condemnation, and you sell the property to the authority at a mutually agreed upon price, the sale is treated in the same manner as if your property had actually been condemned and you were granted an award.

The computation of loss when your forest land is condemned or sold under threat or imminence of condemnation will in all cases involve the land, but may or may not involve standing timber, depending upon whether you are permitted to harvest such timber. The basis of your timber is determined in the same manner as in an ordinary sale or in a casualty or theft, by determining your depletion unit and multiplying this by the number of units involved in the condemnation. As discussed earlier in this pamphlet, your land account should show the part of the original cost or other basis of timber property allocated to land exclusive of standing timber. The basis of the land condemned or sold under threat or imminence of condemnation is the proportion of the cost or other basis of that land as shown in your land account.

Example.—You purchased a 50-acre timber tract and allocated \$25 an acre, or \$1,250 to the land exclusive of timber. 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 loss (or gain) on the condemnation is 5/50 of \$1,250 or \$125. The basis for computing loss (or gain) on the timber is your depletion unit multiplied by the number of units standing on the 5 acres condemned. However, if the condemning authority allowed you to harvest the timber before the land was taken over, and you did in fact cut and sell the timber, only the land would be involved in the computation. The gain or loss on the cutting and sale of the timber would be treated under the general rules discussed earlier for voluntary sales and exchanges.

Condemnation of property for public use can raise many specialized questions. For example, in addition to receiving an award for your property, a condemnation might also result in your receiving 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 special assessments being charged to you because of resulting improvements to your property. A detailed explanation of the treatment of these and other special problems is contained in IRS Publication 549, *Condemnations of Private Property for Public Use*, which may be obtained free from your local Internal Revenue office.

GAINS FROM INVOLUNTARY CONVERSIONS

When forest or other property is destroyed, stolen, or condemned for public use, and insurance, condemnation award, or other recovery is received in cash or in the form of other property, the situation is known as an involuntary conversion. This occurs, for example, when damages are awarded by court order, or a voluntary settlement is made by parties responsible for causing damage to your timber, as by a railroad following a forest fire caused by locomotive sparks.

If the insurance, condemnation award, or other compensation that you receive to indemnify you for property involuntarily converted is greater than your basis of that property, you have a realized gain on the conversion. Ordinarily, the gain on an involuntary conversion is includable in your income for the year it is realized. Under certain circumstances, however, such gain (or a portion of it) will not need

to be reported for the year in which realized, but may be postponed until a later time.

No part of the gain is taxed following an involuntary conversion if three conditions are met. These are that you (1) purchase as replacement for the property destroyed, stolen, or condemned either property which is similar or related in use to the property converted, or the controlling interest in a corporation owning such property, at a cost which equals or exceeds the amount you received by way of compensation; (2) make the replacement within a specified time, normally 2 years following the close of the tax year in which you first realized any part of the gain, if the involuntary conversion occurred after December 31, 1969. If the property was involuntarily converted before January 1, 1970 the replacement period ends 1 year after the close of the first tax year in which any part of the gain upon the conversion is realized; and (3) make an election to postpone reporting the gain by filing a statement with your return stating that the election is being made and including all pertinent information concerning the involuntary conversion and the replacement property.

If you make the election, only that part of your gain which is not expended for replacement property is included in the comparison of gains and losses, listed on page 12, to determine whether each gain and each loss in the group is reported as long-term capital gain or loss or as ordinary gain or loss.

A more detailed explanation of the election to postpone reporting gain on an involuntary conversion is contained in the two free pamphlets mentioned previously, IRS Publication 547, concerning casualties and thefts, and IRS Publication 549, concerning condemnations. These two pamphlets can be obtained from your local Internal Revenue office.

REPORTING GAINS AND LOSSES FROM CASUALTIES, THEFTS, AND CONDEMNATIONS

The manner of reporting gains and losses from casualties, thefts, or condemnations of timber or forest land held for use in business or for the production of income, will depend upon the length of time the property was held. (See IRS Publications 547 and 549.)

CONCLUDING SECTION

SELF-EMPLOYMENT SOCIAL SECURITY TAX

The self-employment tax is imposed upon individuals engaged in a trade or business as a sole proprietorship or as a partnership, for the purpose of providing them with Social Security coverage. If your income from timber operations is considered as received in the course of a trade or business, it may be subject to self-employment tax even though your timber transactions are infrequent and you are primarily engaged in some other business. For example, a farmer whose property includes a stand of timber, or a person employed in the city and owning a timber tract outside of town, who occasionally cuts and sells his timber for firewood may be liable for self-employment tax on his income. However, gains from sales of timber which is a capital asset in your hands, and gains from timber transactions falling under Section 631 of the Internal Revenue Code, are not included in income subject to the self-employment tax. Capital assets and Section 631 transactions are discussed in an earlier chapter, "Receipts From Sales of Timber and Other Forest Operations," page 5.

Since 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 in the case of sales by a dealer, or repeated sales by a timber owner as contrasted with an occasional sale. A Christmas tree grower selling uncut trees on a specified area for a lump sum would derive ordinary income on the sale in the ordinary course of his business, and the self-employment tax would apply to income from the sale. On the other hand, if you are not a timber dealer or timber operator and you make an occasional sale of standing timber which you own, you normally would be entitled to capital gain treatment and thus would not be liable for self-employment tax on gain from the sale.

Receipts from timber disposed of with an economic interest retained, if held for more than 6 months and otherwise meeting the conditions of Section 631(b) of the Code, would not be subject to the self-employment tax. This

situation results when timber is disposed of under cutting contract for a stated sum per unit harvested. The disposal under a cutting contract of timber held less than 6 months is not subject to Section 631(b), and therefore would lead to ordinary income treatment and liability for self-employment tax.

Gain on the cutting of timber treated as a sale, under the election provided by Section 631(a) where timber was held more than 6 months prior to the beginning of the year in which cut, is the difference between the fair market value of the timber on the stump as of the beginning of the year and its basis at the time of cutting. This gain is not included in income subject to self-employment tax, even though you are a timber operator and your only or principal source of income is derived from cutting and selling timber. However, any profit derived from the ultimate sale of the cut timber or timber product is subject to the self-employment tax.

The sale of forest products other than standing timber leads to ordinary income treatment and hence receipts from this source are subject to self-employment tax. The same is true also of agricultural program payments received in connection with forest operations.

The maximum amount subject to social security during your tax year is \$14,000 for 1975. The maximum amount may change for later years. This maximum includes both self-employment earnings subject to the tax and wages subject to social security withholding. If you work for wages subject to withholding which 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 self-employment tax, your gains from the timber operations will be taxed to the extent of the difference between your wages and the maximum.

A farmer who cuts and sells his timber may, for the sake of obtaining Social Security benefits, prefer not to make an election under Sec-

tion 631(a) to treat cutting of timber as a sale. In such event he would include his timber income and expenses, and the basis of the timber sold, as farm income and expenses in Schedule F, Form 1040. Such income would be subject to self-employment tax and would be reported in the self-employment tax section of his business return. It should be remembered, however, that if this election has been made in a prior year, you may not forego that election in any following year without the permission of the Internal Revenue Service.

For further information on the subject of self-employment tax, including the tax rate, the computation of the tax and changes in the maximum amount, ask your local Internal Revenue office for a free copy of IRS Publication 533, *Information on Self-Employment Tax*. Farmers see IRS Publication 225, *Farmer's Tax Guide*.

QUESTIONS AND ANSWERS

State Foresters and State Extension Foresters were given an opportunity to list the income-tax questions most frequently asked of their field representatives. The material that follows is based in part upon the responses.

Costs of Forest Ownership and Operation

1. *What are the two ways of treating costs of forest ownership and operation?*

Costs represent either expense or capital items; with respect to certain ones such as carrying charges you have a choice as to method of treatment.

2. *What is meant by "expensing" costs?*

Costs that are expensed are deducted from gross income for the year in which they were paid or incurred.

3. *What is meant by "capitalizing" costs?*

Costs that are capitalized are added to the basis or adjusted basis of the property and are recovered through depletion (in the case of timber), through depreciation (in the case of equipment and other depreciable assets), or upon sale (as in the case of land).

4. *What costs may be "expensed"?*

Ordinary and necessary expenses if reasonable in amount and if paid or incurred during the taxable year in carrying on a trade or business.

5. *What costs must be capitalized?*

Those incurred for the acquisition of timber

or timberland and of other property having a useful life of more than 1 year and for permanent improvements or betterments to such property; also the cost of seeding and planting, including expenditures for site preparation to afford good growing conditions.

6. *Can a landowner obtain a tax deduction for reforesting idle land?*

Not at the time of planting. Costs of seeding and planting including labor must be capitalized and may be recovered through depletion at such time as the timber becomes merchantable; such costs cannot be expensed.

7. *May land, on which timber has been cut, be depreciated?*

Land is not subject to depreciation at any time, although some land improvements such as bridges or fences may be depreciated.

8. *If depreciation is not taken in a given year may it be taken later?*

No. Depreciation not taken for the year when allowable is in effect forfeited and allowances claimed in later years may not be increased to compensate for the forfeited amount.

Receipts From Sale of Timber and Other Forest Operations

9. *How do you determine the amount of gain or loss resulting from disposal of timber?*

The gain or loss, generally speaking, is the difference between what was received for the timber at time of disposal (less expense of sale) and its cost or other "basis" for depletion.

10. *How is gain or loss on the sale of land computed when land and timber are sold together?*

The basis of the land is combined with the adjusted basis of any improvements on the land and the basis of the standing timber sold with the land. The sale price for the entire property less the combined basis of land, improvements, and timber, and less expenses of sale is your gain or loss on the sale.

11. *What is the difference between depletion and depreciation?*

Depletion is the reduction or exhaustion of an asset such as timber or other natural resource. Depreciation results from the wearing-out of an asset due to service or from its becoming obsolete by reason of changing technology.

12. *How is depletion related to capital gains treatment?*

There is no direct relationship. Depletion af-

fects the amount of gain or loss whereas capital gains treatment has to do with the type of gain or loss.

13. *What is meant by the "basis" of a timber holding? What is meant by the adjusted basis?*

The basis in the case of timber purchased on or after March 1, 1913, represents the original cost of the timber excluding the value of land and improvements. If timber is acquired by inheritance or gift and not by purchase, special rules apply. The adjusted basis will reflect increases in the timber investment (as for example those resulting from acquisition of additional timber) or decreases (as for example those resulting from timber disposal).

14. *How should the purchase cost be allocated among timber, land, and buildings acquired in a "lump sum purchase"? How is the allocation made when the property was brought substantially below (or above) fair market value?*

The total cost of acquiring the property is allocated over the merchantable timber, young growth, land, and buildings in the same proportions that the fair market value of each as of the date of purchase, bore to the fair market value of the property as a whole as of the date of purchase. If the property was purchased for an amount substantially above or below fair market value, the allocation would be made in the same proportion of actual cost as it would have been had the purchase been for fair market value.

15. *How do you place a value upon timber as of its acquisition date?*

The quantity of merchantable timber standing on the tract as of its acquisition date should be determined and a fair unit stumpage value applied.

16. *What is the basis for depletion of a plantation?*

The actual cost to the taxpayer of establishing the plantation plus any carrying charges that have been properly capitalized.

17. *What is the basis for depletion of a timber stand that has resulted from natural reseeding of an idle field?*

Unless carrying charges or other costs have been capitalized and if you have no other timber, you will have no basis for depletion.

18. *What is the depletion unit and what is the depletion allowance?*

The depletion unit is found by dividing the basis or adjusted basis of the timber by the total number of units (board feet, cords, or

other unit) in the timber account. The depletion allowance is found by multiplying the depletion unit by the number of units cut during the year.

19. *In determining the unit depletion, do you revise the basis for depletion from time to time to reflect current timber values? Do you revise the timber quantity shown on your books to reflect current changes including those resulting from timber growth?*

Revaluation of timber is not permitted except in cases of misrepresentation, fraud, or gross error as to facts known at the date of valuation, and then only upon written approval of the Commissioner of Internal Revenue. Timber quantity on the other hand, must be revised from time to time (see Depletion Schedule in Form T, reproduced in the appendix, p. 49).

20. *What is selective depletion by products?*

The calculation of the depletion allowance separately for particular product classes rather than for the timber stand as a whole; for example use of separate depletion rates for sawtimber, pulpwood, veneer timber, etc.

To illustrate, assume that your tract averages 20 cords per acre having an average cost or other basis (excluding land) of \$9.50 per cord or \$190 per acre. If the stand consists in part of sawtimber-size trees and in part of pulpwood-size trees and if you plan to harvest the sawtimber trees first and make a pulpwood cut at a later time, it will be to your advantage to calculate the depletion unit separately for the two size classes.

You might find, for example, that the sawtimber trees average 4,000 board feet per acre, the equivalent in the case of your particular stand to 10 cords, and that a basis of \$35 per thousand board feet or \$140 per acre should be allocated to such trees. In the case of the pulpwood-size trees a basis of \$5 per cord or \$50 per acre is allocated. Your taxable gain upon disposal of the sawtimber trees will be substantially less, by reason of the higher basis, than if an average depletion unit of \$9.50 per cord had been used.

21. *How can one calculate the depletion allowance when cutting fenceposts, pulpwood, or dogwood bolts?*

The depletion allowance is calculated in the same way, irrespective of the nature of the forest products harvested. Selective depletion may, however, be adopted as pointed out in the answer to the preceding question. Timber vol-

umes should be converted to the same unit (such as board feet or cords) used in the timber account. If necessary your local public or private consulting forester can be asked to supply converting factors.

22. *Is the depletion allowance calculated differently in the case of selective cutting than in the case of clear cutting a portion of a tract?*

The same method applies in either situation.

23. *Are you allowed to claim a depletion allowance when your basis for depletion has been fully recovered?*

No. Once the cost or other basis has been fully recovered, the taxpayer has obtained a return of his capital investment in the timber and no further depletion may be taken. However, with the proper application of adjustments for timber growth, there will be a diminishing but never completely recovered depletion balance under sustained-yield cutting.

24. *Is income from forest land taxed at the same rate as income from farmland?*

Income from the cutting or sale of timber may in effect be taxed at a lower rate than certain types of farm income because of the capital gains provisions applying to timber sales.

25. *Does the income tax favor an owner who practices sustained-yield operation?*

Not in specific terms but the capital gains provisions and those for expensing or capitalizing costs of forest ownership and operation do, in effect, encourage sustained-yield forest operation.

26. *Is timber growth taxable?*

Timber growth is not taxable as such.

27. *Do you need to report on your return the fair-market value of timber cut for home use?*

Timber cut for your own household consumption, as for example firewood, need not be reported. (Gains from sales of firewood to others, however, are taxable.)

28. *What factors determine the way in which gains are taxed?*

Such factors include the nature of the products sold, the length of time owned before disposal, and the form of disposal.

29. *What is meant by a lump-sum sale of timber?*

A lump-sum sale is one in which you sell stumpage outright and are paid a fixed amount agreed upon in advance.

30. *Are gains from lump-sum sales of timber*

entitled to capital gains treatment in all situations?

No. Capital gains treatment is available only if the timber sold on a lump-sum basis is not held for sale to customers in the ordinary course of business. Whether timber in a given case is regarded as being "held for sale to customers" depends upon the number, continuity, and frequency of sales and other factors as discussed in the text.

31. *What is meant by disposal of timber with economic interest retained?*

Such a disposal occurs under the so-called pay-as-cut contract in which you are paid a stated amount per unit harvested, as for example per cord or per thousand board feet, and the amount you receive depends upon the quantity of timber cut.

32. *Does disposal of timber with an economic interest retained lead to capital gains treatment?*

Yes, provided the timber has been held for more than 6 months before such disposal and the disposal otherwise meets the requirements of Sections 631(b) and 1231 of the Internal Revenue Code.

33. *Is it possible to have prior agreements to sell timber on a scale basis, receiving payments as the timber is cut, and still use the capital gains treatment?*

Yes. This is the situation covered by Section 631(b).

34. *Does the question whether timber is "held primarily for sale to customers" affect the tax treatment of income from timber disposed of with an economic interest retained?*

No.

35. *Is capital gains treatment available to a forest owner who does not dispose of standing timber but cuts it for sale or for use in his business?*

Yes, provided (1) the owner so elects, (2) the timber has been held for more than 6 months before the beginning of the tax year in which it was cut, and (3) the requirements of Sections 631(a) and 1231 of the Internal Revenue Code are otherwise met.

36. *How is the capital gain or loss determined in the case of timber cut by an owner who makes the election under Section (631(a))?*

The difference between the (1) basis of the timber harvested and (2) its fair market value on the first day of the taxable year in which it is cut, is usually eligible for capital gains treat-

ment. The increase in value from processing less cost of processing must be treated as ordinary income.

37. *If timber is felled and the resulting logs are sold during the same year, must the transaction be reported in full in that year? If the logs are sold in a later year, what would be the status of the sale as well as of the inventory?*

Under Section 631(a) the gain or loss on standing timber is reported in the taxable year in which the timber is cut. If the resulting logs are sold during the same year, the sales price minus the sum of the fair market values of the timber cut and processing and other costs is reported as ordinary income for that year. If the logs are not sold by the end of the tax year, the stumpage value as of the first day of the tax year (used in determining the gain or loss up to that point) is taken as the "cost" of the timber cut. This cost plus processing costs already incurred will then be the year-end inventory value of the logs and may not be taken as a deduction until the year in which the logs are sold.

38. *Are Christmas trees regarded as "timber" under Section 631?*

Yes, if such trees are more than 6 years old when severed from the roots and sold for ornamental purposes.

Casualties, Thefts, Condemnations

39. *Are casualty losses of timber deductible on your income tax return?*

Such losses and also those resulting from theft or condemnation may be recognized for tax purposes.

40. *Is the recognized loss of timber from fire or other casualty, theft, or condemnation based on its sound value before the loss?*

No. The loss recognized for tax purposes in the case of timber cannot be greater than the cost or other basis of the timber destroyed, less any insurance or other recoveries.

41. *How do you determine the amount of loss to your timber from fire or other cause?*

Get an accurate estimate of the quantity destroyed and multiply it by the depletion unit; see answer to preceding question. A local public or private consulting forester can be asked to estimate the volume of the timber before and after the loss.

42. *Can a tax deduction be claimed for loss of future growth following a fire?*

No.

43. *If damaged timber is sold for more than its basis for depletion can you claim a loss?*

No. You will have a gain for tax purposes even though a smaller one than had no damage occurred.

Self-Employment Social Security Tax

44. *Do proceeds from disposal of timber qualify as self-employment income for Social Security purposes?*

Under certain circumstances; see discussion in text on page 23.

PROBLEMS

Number 1

A young forest owner incurs certain management costs during the year such as new fencing, maintenance of firebreaks, taxes, etc. Twenty-five years from now he may clear cut. When and how should he report his expenses over the 25-year period?

Answer

Fencing is regarded as a capital investment and the cost should accordingly be capitalized. The cost should, however, be "recovered" by means of depreciation allowances.

The cost of maintaining firebreaks, and other necessary expenditures of a maintenance character are normally expensed (that is, deducted from gross income year by year as paid or incurred). Such expenditures, however, may be capitalized provided this practice is consistently followed from year to year.

In the case of nonincome producing properties, annual taxes, mortgage interest, and other true carrying charges may be expensed or capitalized at the election of the taxpayer from year to year. Once the property becomes income-producing, such charges are expensed.

Number 2

Smith made an outright sale of timber (lump sum basis) for \$1,200 in 1974. This was the first income that he had received from his timber since he purchased the property in 1930. The original purchase price did not include a timber value since there was no merchantable timber on the tract when acquired. No value has been allocated to young growth. Smith paid general property taxes varying from 5 to 20 cents per acre from the time of purchase and deducted these year by year from his ordinary income

when filing his income tax return. He had incurred no other carrying charges and had made no expenditures for development of his timber. How much of the \$1,200 that Smith received is taxable? Should it be treated as ordinary income or as a capital gain?

Answer

The entire amount should be reported as a long-term capital gain. Since Smith can allocate no part of the original purchase price to his timber and since he has not capitalized any timber costs, he has no basis for depletion and can claim no cost. If Smith had elected to capitalize his property taxes rather than to expense them year by year, he could deduct from his \$1,200 proceeds such part of the capitalized taxes as related to the timber sold. If he had allocated a cost to young growth, he would have a basis for the merchantable timber.

Number 3

A widow acquired two timber tracts by inheritance from her husband in 1956 and there was no appraisal of the timber made at that time. She owned no other timber. In 1974 the timber, amounting to 250,000 board feet of hardwoods, was sold outright (lump sum basis) for \$3,750, or the equivalent of \$15 per thousand board feet. The basis for determining gain will depend upon the value of the timber for estate tax purposes at the date of death. How should the 1956 value be determined?

Answer

Ordinarily the determination of timber value as of a prior date requires the services of a forester. Otherwise the taxpayer must have sufficient background and data to support his own computation. The procedure would be essentially as follows:

1. Estimate the volume of timber which would have been present at date of death in the trees which were cut in 1974.
2. Determine what the fair market value per unit of similar timber was at date of death.
3. Multiply the volume of timber by the unit value.
4. The resulting figure is the fair market value of the timber at date of death.

For example, assume that the purchaser-logger finds that the trees comprising the sale average about 17 inches in diameter at breast height. A forester advises that trees of this size

usually yield about two 16-foot logs and would have a volume of 182 board feet by the Scribner log rule. On this basis the total timber volume sold, 250,000 board feet log scale, would have been represented in 1,374 trees.

Roughly half the trees harvested were sugar maple and the remainder red oak, basswood, and soft elm. Applying estimated average annual growth rates per diameter inch for the species in question, the forester determined that the growth between 1956 and 1974 amounted to 23,324 board feet for sugar maple and 30,881 board feet for the remaining species, a total of 54,205 board feet.

By subtraction the volume of timber which would have been present in 1956 in the trees which were cut in 1974 amounted to 195,795 board feet:

	<i>Board feet</i>
1974 volume -----	250,000
Less: Growth -----	54,205
1956 volume -----	195,795

The estimated fair market value per unit in 1956 for similar timber was determined by the forester to have been \$8 per thousand board feet. Multiplying 195,795 board feet by \$8 per thousand gives a total value of \$1,566.36. This represents the fair market value of the timber in 1956 and is the basis for gain or loss.

The taxable gain on the timber sale amounts to the difference between \$3,750 (the gross sales price) and \$1,566.36 (the basis for gain or loss) or \$2,183.64. This should be reported as a long-term capital gain.

Number 4

Jones disposed of timber under a pay-as-cut contract for \$30 per M board feet. In 1974 a total of 26,500 board feet was cut. Fee for timber cruise and other expenses of sale brought the net proceeds down to \$740. The farm had been bought in 1940 for \$6,500. The farm had a total of 104 acres of which 23 acres were in timber. The buildings were in poor condition at time of purchase. How should Jones calculate the recognized gain on the timber sale?

Answer

In order to determine his "basis" for gain or loss, Jones must allocate a reasonable portion of the original purchase price to his timber. A reasonable allocation was made as follows after

taking into consideration sales of similar properties in the same general area:

Buildings and improvements	\$1,500
Land	3,000
Timber	2,000
	<hr/>
	\$6,500

The timber sold was estimated to represent roughly 25 percent of the total merchantable volume at time of sale, so that a basis for determining gain of \$500 (one-quarter of \$2,000) was claimed. The recognized gain was then:

Gross sales price	\$795
Less: Expenses of sale	55
	<hr/>
	\$740
Less: Basis for determining gain	500
	<hr/>
Recognized gain	\$240

The \$240 should be compared with other gains and losses, as shown in the list on page 13 and should then be entered on Schedule D as explained in the text.

Number 5

An elderly couple had a choice of selling the stumpage from their woodland or operating the timber themselves and selling the products. They chose to harvest the timber. Being unable to work in the woods themselves, they had the work done at a total cost of \$1,109.67 made up as follows:

Felling and bucking—	
32,695 board feet at \$4.25 per M	\$138.95
1,781 tie cuts at 26¢ per tie	463.06
950 board feet of aspen at \$4.25 per M	4.04
Skidding—	
32,695 board feet at \$4 per M	130.78
1,781 tie cuts at 15¢ per tie	267.15
950 board feet at \$4 per M	3.80
Reskidding for loading	29.13
Telephone calls	5.15
Insurance	67.61
	<hr/>
	\$1,109.67

Proceeds from sale of products harvested amounted to \$3,416.87 made up as follows:

21,990 board feet veneer logs at \$65 per M ..	\$1,429.35
10,705 board feet sawlogs at \$35 per M	374.68
1,781 tie cuts at 85¢ per cut	1,513.85
950 board feet aspen logs at \$25.25 per M ..	23.99
Fuel from tops	75.00
	<hr/>
	\$3,416.87

How should the owners' recognized gain be calculated?

Answer

The couple elected to use the optional method under Section 631(a) of the Internal Revenue Code. The total gain is thus calculated in two parts: (a) The increase in value of the stumpage up to the beginning of the year in which the cut was made, and (b) the net increase in value from time of cutting to sale of products.

(a) The increase in value of the stumpage up to the first day of taxable year in which it was cut.

The fair market value of the stumpage cut as of the first day of the tax year was determined to be as follows:

32,695 bd. ft. veneer logs and sawlogs at \$25 per M	\$817.38
1,781 tie cuts at 45¢ per cut	801.45
950 board feet aspen at \$5 per M	4.75
	<hr/>
	\$1,623.58

The basis for gain (depletion allowance) was calculated as follows:

32,695 board feet veneer logs and sawlogs.
71,240 board feet tie cuts (at 40 bd. ft. per cut).
950 board feet aspen.
<hr/>
104,885 board feet total cut.

It is assumed that the owners had an average depletion unit of \$5 per M board feet. (For illustration of a depletion calculation see example, p. 8). The depletion allowance amounts to 104,885 board feet times \$5 per M, or \$524.43.

Fair market value of stumpage as of first day of taxable year	\$1,623.58
Less: Depletion allowance	524.43
	<hr/>
Gain in value of stumpage	\$1,099.15

(b) The net increase in value from time of cutting to sale of products.

Revenue from products sold	\$3,416.87
Less:	
"Cost" of products (the fair stumpage value)	\$1,623.58
Expenses for felling, bucking, skidding, etc.	1,109.67
	<hr/>
	2,733.25
	<hr/>
Gains from processing	\$683.62

The effect of using the optional method, as shown in the summary below, has been to obtain the advantage of capital gains treatment

on \$1,099.15 (assuming that aggregate gains exceed aggregate losses in the comparison of gains and losses as listed on p. 13 and to pay income tax at ordinary income rates on only \$683.62.

Revenue received from products sold	-----	\$3,416.87
<i>Less:</i>		
Basis for determining gain		\$524.43
Expenses	-----	1,109.67
		1,634.10
Total gain	-----	\$1,782.77

Taxed as capital gain	-----	\$1,099.15
Taxed as ordinary income	-----	683.62

		\$1,782.77

Number 6

A taxpayer has established five Christmas tree plantations in five successive years, each comprising 10 acres and each containing 12,000 trees of fast-growing pine species. Two-year-old nursery stock had been used, hence 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.

The cost of establishing the first plantation was \$150 for planting stock and planting. There was subsequently incurred \$1,060 as capital cost representing (a) certain carrying charges for which an election to capitalize had been made; and (b) the cost of replanting lost trees. The total capitalized cost just prior to the first cutting thus amounted to \$1,210. An inventory showed that there were now present 11,000 well-formed salable trees. Of these 11,000, 6,000 were of sizes to be cut this year and 5,000 to be left for further growth. A depletion unit of 11 cents per tree was derived by dividing the \$1,210 adjusted basis for depletion by 11,000 trees.

The taxpayer elected to treat the cutting of the trees as a sale under Section 631(a) of the Internal Revenue Code. How does he determine (1) the fair market value of the trees as of the first day of the taxable year and (2) the taxable gain (assuming his costs of cutting and delivery to be \$900)?

Answer

(1) Determination of the fair market value, as

of the first day of the taxable year, of the trees harvested.

A recognized method of pricing Christmas trees, both in the wholesale and retail market, makes use of the "value per foot of height." Assuming that an independent jobber-cutter would pay 20c per foot at the plantation and would receive 25c per foot delivered to the wholesaler, his net return for buying, cutting, and delivering the trees, including his profit, would be 5c per foot. If his trees averaged 6 feet in height, he would receive \$1.50 per tree for which he paid the owner \$1.20. Under this assumption, the owner would have received a fair price at the plantation for the trees cut by the jobber. However, to convert this value to one as of the first day of the taxable year requires discounting for the time element, the risks borne during the growing season, and the lump-sum purchase factor.

Assuming that during the last season before harvest the trees averaged 1 foot of growth in height, then each tree would have had a value on the first day of the taxable year (assumed as January 1) of 20c less than at time of cutting in November or December. Accordingly, a 6-foot tree worth \$1.20 for harvesting in November or December would have been a 5-foot tree worth \$1 on January 1. As an alternative to using current prices as a basis, those prevailing during the previous season (about 1 month before January 1) could be used and the corresponding "per foot of height" values applied to the trees as standing on January 1. If there has been no change in market prices, the result would be the same.

(2) Determination of the taxable gain.

It will be assumed that the trees are harvested by the taxpayer and sold to a wholesaler; as indicated above, election was made to treat the cutting as a sale.

6,000 trees harvested at fair-market value of \$1 per tree	-----	\$6,000
Basis for determining gain (depletion allowance) at 11¢ per tree	-----	660

Gain on the stump (taxed as capital gain)	----	\$5,340

6,000 trees sold for \$1.50 per tree delivered	--	\$9,000
<i>Less:</i>		
"Cost" (fair market value)	-----	\$6,000
Cutting and delivering	-----	900

Gain from harvesting and delivery (taxed as ordinary income)	-----	\$2,100

If the taxpayer had not harvested the trees but had entered into a cutting contract with a jobber, the gain (assuming selling expense of \$100) would have been calculated as follows:

6,000 trees sold for \$1.20 per tree ----- \$7,200
Less:

Basis for determining gain (depletion) at 11¢ per tree -----	\$660	
Expenses of sale -----	100	
	<hr/>	
Total deductions -----		760
		<hr/>
Capital gain -----		\$6,440
		<hr/> <hr/>

1040

U.S. Individual Income Tax Return

1040

1	NAME (Last, first, middle initial)	
2	RESIDENCE (Street, P.O. box, or other mailing address)	
3	CITY, TOWN, OR VILLAGE	
4	STATE	
5	ZIP CODE	

APPENDIX

6. **EXEMPTIONS** (See instructions for limitations.)

7. **DEPENDENTS** (See instructions for limitations.)

8. **CHARITABLE CONTRIBUTIONS** (See instructions for limitations.)

9. **STATE AND LOCAL TAXES** (See instructions for limitations.)

10. **RENTAL EXPENSES** (See instructions for limitations.)

11. **SAVINGS BOND INTEREST** (See instructions for limitations.)

12. **UNEMPLOYMENT COMPENSATION** (See instructions for limitations.)

13. **WARRANTY PAYMENTS** (See instructions for limitations.)

14. **RETIRED ANNUITIES** (See instructions for limitations.)

15. **IRAs** (See instructions for limitations.)

16. **529 COLLEGE SAVINGS PLANS** (See instructions for limitations.)

17. **529 EDUCATION SAVINGS PLANS** (See instructions for limitations.)

18. **529 PREPAID TuITION PLANS** (See instructions for limitations.)

19. **529 UGMA/UTMA PLANS** (See instructions for limitations.)

20. **529 LIFE INSURANCE CONTRACTS** (See instructions for limitations.)

21. **529 FUTURE EDUCATION FUNDS** (See instructions for limitations.)

22. **529 EDUCATION INVESTMENT FUNDS** (See instructions for limitations.)

23. **529 EDUCATION SAVINGS PLANS** (See instructions for limitations.)

24. **529 EDUCATION SAVINGS PLANS** (See instructions for limitations.)

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79. **529 EDUCATION SAVINGS PLANS** (See instructions for limitations.)

80. **529 EDUCATION SAVINGS PLANS** (See instructions for limitations.)

EXHIBIT A

Form 1040

US

Department of the Treasury—Internal Revenue Service Individual Income Tax Return

1974

For the year January 1–December 31, 1974, or other taxable year beginning 1974, ending 19.....

Name (If joint return, give first names and initials of both) Last name COUNTY OF RESIDENCE Your social security number Present home address (Number and street, including apartment number, or rural route) Spouse's social security no. City, town or post office, State and ZIP code Occupation Yours Spouse's

Filing Status (check only one)

- 1 Single
2 Married filing joint return (even if only one had income)
3 Married filing separately. If spouse is also filing give spouse's social security number in designated space above and enter full name here
4 Unmarried Head of Household (See instructions on page 5)
5 Widow(er) with dependent child (Year spouse died 19)

Exemptions

- Regular / 65 or over / Blind
6a Yourself
b Spouse
c First names of your dependent children who lived with you
d Number of other dependents (from line 27)
7 Total exemptions claimed

8 Presidential Election Campaign Fund

Do you wish to designate \$1 of your taxes for this fund? Yes No
If joint return, does your spouse wish to designate \$1? Yes No

Table with columns for Income (9-15) and Taxable Income (9-15). Includes rows for Wages, Dividends, Interest, and Adjustments to income.

- If you do not itemize deductions and line 15 is under \$10,000, find tax in Tables and enter on line 16.
If you itemize deductions or line 15 is \$10,000 or more, go to line 44 to figure tax.
CAUTION. If you have unearned income and can be claimed as a dependent on your parent's return, check here and see instructions on page 7.

Table for Tax, Payments and Credits (16-22). Includes rows for Tax, Total credits, Income tax, Other taxes, Total Federal income tax withheld, and Total (add lines 21a, b, c, and d).

Table for Balance Due or Refund (23-26). Includes rows for Balance Due IRS, Overpaid, Amount of line 24 to be refunded to you, and Amount of line 24 to be credited on 1975 estimated tax.

Sign here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which he has any knowledge.
Your signature Date
Preparer's signature (other than taxpayer) Date
Spouse's signature (if filing jointly, BOTH must sign even if only one had income)
Address (and ZIP Code) Preparer's Emp. Ident. or Sec. Sec. No.

Other Dependents	(a) NAME	(b) Relationship	(c) Months lived in your home. If born or died during year, write B or D.	(d) Did dependent have income of \$750 or more?	(e) Amount YOU furnished for dependent's support. If 100% write ALL.	(f) Amount furnished by OTHERS including dependent.
					\$	\$
27 Total number of dependents listed in column (a). Enter here and on line 6d ▶						

Part I Income other than Wages, Dividends, and Interest

28 Business income or (loss) (attach Schedule C)	28		
29 Net gain or (loss) from sale or exchange of capital assets (attach Schedule D)	29		
30 Net gain or (loss) from Supplemental Schedule of Gains and Losses (attach Form 4797)	30		
31 Pensions, annuities, rents, royalties, partnerships, estates or trusts, etc. (attach Schedule E)	31		
32 Farm income or (loss) (attach Schedule F)	32		
33 Fully taxable pensions and annuities (not reported on Schedule E—see instructions on page 8)	33		
34 50% of capital gain distributions (not reported on Schedule D—see instructions on page 8)	34		
35 State income tax refunds (does not apply if refund is for year in which you took the standard deduction—others see instructions on page 8)	35		
36 Alimony received	36		
37 Other (state nature and source—see instructions on page 8) ▶	37		
38 Total (add lines 28, 29, 30, 31, 32, 33, 34, 35, 36, and 37). Enter here and on line 12 ▶	38		

Part II Adjustments to Income

39 "Sick pay." (From Forms W-2 and W-2P. If not shown on Forms W-2 or W-2P, attach Form 2440 or statement.)	39		
40 Moving expense (attach Form 3903)	40		
41 Employee business expense (attach Form 2106 or statement)	41		
42 Payments as a self-employed person to a retirement plan, etc.—see instructions on page 9	42		
43 Total adjustments (add lines 39, 40, 41, and 42). Enter here and on line 14 ▶	43		

Part III Tax Computation (Do not use this part if you use Tax Tables 1-12 to find your tax.)

44 Adjusted gross income (from line 15)	44		
45 (a) If you itemize deductions, check here <input type="checkbox"/> and enter total from Schedule A, line 41 and attach Schedule A	45		
(b) If you do not itemize deductions, check here <input type="checkbox"/> and enter 15% of line 44, but do NOT enter more than \$2,000. (\$1,000 if line 3 checked)			
46 Subtract line 45 from line 44	46		
47 Multiply total number of exemptions claimed on line 7, by \$750	47		
48 Taxable income. Subtract line 47 from line 46	48		

(Figure your tax on the amount on line 48 by using Tax Rate Schedule X, Y, or Z, or if applicable, the alternative tax from Schedule D, income averaging from Schedule G, or maximum tax from Form 4726.) Enter tax on line 16.

Part IV Credits

49 Retirement income credit (attach Schedule R)	49		
50 Investment credit (attach Form 3468)	50		
51 Foreign tax credit (attach Form 1116)	51		
52 Credit for contributions to candidates for public office—see instructions on page 9	52		
53 Work Incentive (WIN) credit (attach Form 4874)	53		
54 Total credits (add lines 49, 50, 51, 52, and 53). Enter here and on line 17 ▶	54		

Part V Other Taxes

55 Self-employment tax (attach Schedule SE)	55		
56 Tax from recomputing prior-year investment credit (attach Form 4255)	56		
57 Tax from recomputing prior-year Work Incentive (WIN) credit (attach schedule)	57		
58 Minimum tax. Check here <input type="checkbox"/> , if Form 4625 is attached	58		
59 Social security tax on tip income not reported to employer (attach Form 4137)	59		
60 Uncollected employee social security tax on tips (from Forms W-2)	60		
61 Total (add lines 55, 56, 57, 58, 59, and 60). Enter here and on line 19 ▶	61		

Part VI Other Payments

62 Excess FICA tax withheld (two or more employers—see instructions on page 9)	62		
63 Credit for Federal tax on special fuels, nonhighway gasoline and lubricating oil (attach Form 4136)	63		
64 Credit from a Regulated Investment Company (attach Form 2439)	64		
65 Total (add lines 62, 63, and 64). Enter here and on line 21d ▶	65		

Foreign Accounts Did you, at any time during the taxable year, have any interest in or signature or other authority over a bank, securities, or other financial account in a foreign country (except in a U.S. military banking facility operated by a U.S. financial institution)? Yes No
If "Yes," attach Form 4683. (For definitions, see Form 4683.)

EXHIBIT B

**Schedules A & B—Itemized Deductions AND
(Form 1040) Dividend and Interest Income**

1974

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

Name(s) as shown on Form 1040

Your social security number

Schedule A—itemized Deductions (Schedule B on back)

Medical and Dental Expenses (not compensated by insurance or otherwise) (See instructions on page 10.)	Contributions (See instructions on page 11 for examples.)
<p>1 One half (but not more than \$150) of insurance premiums for medical care. (Be sure to include in line 10 below)</p> <p>2 Medicine and drugs</p> <p>3 Enter 1% of line 15, Form 1040</p> <p>4 Subtract line 3 from line 2. Enter difference (if less than zero, enter zero)</p> <p>5 Enter balance of insurance premiums for medical care not entered on line 1</p> <p>6 Enter other medical and dental expenses:</p> <p style="padding-left: 20px;">a Doctors, dentists, nurses, etc.</p> <p style="padding-left: 20px;">b Hospitals</p> <p style="padding-left: 20px;">c Other (Itemize—include hearing aids, dentures, eyeglasses, transportation, etc.) ▶</p> <p>.....</p> <p>.....</p> <p>.....</p> <p>.....</p> <p>7 Total (add lines 4, 5, 6a, b, and c)</p> <p>8 Enter 3% of line 15, Form 1040</p> <p>9 Subtract line 8 from line 7 (if less than zero, enter zero)</p> <p>10 Total (add lines 1 and 9). Enter here and on line 35 ▶</p>	<p>21 a Cash contributions for which you have receipts, cancelled checks, etc.</p> <p>b Other cash contributions. List donees and amounts. ▶</p> <p>.....</p> <p>.....</p> <p>.....</p> <p>22 Other than cash (see instructions on page 11 for required statement)</p> <p>23 Carryover from prior years</p> <p>24 Total contributions (add lines 21a, b, 22, and 23). Enter here and on line 38 ▶</p> <p>Casualty or Theft Loss(es) (See instructions on page 12.) Note: If you had more than one loss, omit lines 25 through 28 and see instructions on page 12 for guidance.</p> <p>25 Loss before insurance reimbursement</p> <p>26 Insurance reimbursement</p> <p>27 Subtract line 26 from line 25. Enter difference (if less than zero, enter zero)</p> <p>28 Enter \$100 or amount on line 27, whichever is smaller</p> <p>29 Casualty or theft loss (subtract line 28 from line 27). Enter here and on line 39 ▶</p>
<p>Taxes (See instructions on page 10.)</p> <p>11 State and local income</p> <p>12 Real estate</p> <p>13 State and local gasoline (see gas tax tables)</p> <p>14 General sales (see sales tax tables)</p> <p>15 Personal property</p> <p>16 Other (Itemize) ▶</p> <p>.....</p> <p>.....</p> <p>17 Total (add lines 11, 12, 13, 14, 15, and 16). Enter here and on line 36 ▶</p>	<p>Miscellaneous Deductions (See instructions on page 12.)</p> <p>30 Alimony paid</p> <p>31 Union dues</p> <p>32 Expenses for child and dependent care services (attach Form 2441)</p> <p>33 Other (Itemize) ▶</p> <p>.....</p> <p>.....</p> <p>34 Total (add lines 30, 31, 32, and 33). Enter here and on line 40 ▶</p>
<p>Interest Expense (See instructions on page 11.)</p> <p>18 Home mortgage</p> <p>19 Other (Itemize) ▶</p> <p>.....</p> <p>.....</p> <p>.....</p> <p>20 Total (add lines 18 and 19). Enter here and on line 37 ▶</p>	<p align="center">Summary of Itemized Deductions A</p> <p>35 Total medical and dental—line 10</p> <p>36 Total taxes—line 17</p> <p>37 Total interest—line 20</p> <p>38 Total contributions—line 24</p> <p>39 Casualty or theft loss(es)—line 29</p> <p>40 Total miscellaneous—line 34</p> <p>41 Total deductions (add lines 35, 36, 37, 38, 39, and 40). Enter here and on Form 1040, line 45 ▶</p>

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side)

Your social security number

Part I Dividend Income

Note: If gross dividends (including capital gain distributions) and other distributions on stock are \$400 or less, do not complete this part. But enter gross dividends less the sum of capital gain distributions and non-taxable distributions, if any, on Form 1040, line 10a (see note below).

1 Gross dividends (including capital gain distributions) and other distributions on stock. (List payers and amounts—write (H), (W), (J), for stock held by husband, wife, or jointly)

Table with 3 columns for listing dividend payers and amounts. Includes rows for line 1 and line 2.

2 Total of line 1

3 Capital gain distributions (see instructions on page 13. Enter here and on Schedule D, line 7). See note below

4 Nontaxable distributions (see instructions on page 13)

5 Total (add lines 3 and 4)

6 Dividends before exclusion (subtract line 5 from line 2). Enter here and on Form 1040, line 10a

Part II Interest Income

Note: If interest is \$400 or less, do not complete this part. But enter amount of interest received on Form 1040, line 11.

7 Interest includes earnings from savings and loan associations, mutual savings banks, cooperative banks, and credit unions as well as interest on bank deposits, bonds, tax refunds, etc. Interest also includes original issue discount on bonds and other evidences of indebtedness (see instructions on page 13). (List payers and amounts)

Table with 3 columns for listing interest payers and amounts. Includes rows for line 7 and line 8.

8 Total interest income. Enter here and on Form 1040, line 11

Note: If you received capital gain distributions and do not need Schedule D to report any other gains or losses or to compute the alternative tax, do not file that schedule. Instead, enter 50 percent of capital gain distributions on Form 1040, line 34.

B

EXHIBIT C

SCHEDULE C
(Form 1040)
Department of the Treasury
Internal Revenue Service

Profit or (Loss) From Business or Profession
(Sole Proprietorship)
Partnerships, Joint Ventures, etc., Must File Form 1065.
▶ Attach to Form 1040. ▶ See Instructions for Schedule C (Form 1040).

1974

Name(s) as shown on Form 1040 _____ Social security number _____

- A** Principal business activity (see Schedule C Instructions) _____; product _____
- B** Business name _____ **C** Employer identification number _____
- D** Business address (number and street) _____
City, State and ZIP code _____
- E** Indicate method of accounting: (1) Cash (2) Accrual (3) Other _____
- F** Were you required to file Form W-3 or Form 1096 for 1974? (See Schedule C Instructions) _____
If "Yes," where filed _____
- G** Was an Employer's Quarterly Federal Tax Return, Form 941, filed for this business for any quarter in 1974? _____
- H** Method of inventory valuation _____ Was there any substantial change in the manner of determining quantities, costs, or valuations between the opening and closing inventories? (If "Yes," attach explanation) _____

Income			Balance ▶
1	Gross receipts or sales \$	Less: returns and allowances \$	
2	Less: Cost of goods sold and/or operations (Schedule C-1, line 8)		
3	Gross profit		
4	Other income (attach schedule)		
5	Total income (add lines 3 and 4)		

Deductions			Balance ▶
6	Depreciation (explain in Schedule C-3)		
7	Taxes on business and business property (explain in Schedule C-2)		
8	Rent on business property		
9	Repairs (explain in Schedule C-2)		
10	Salaries and wages not included on line 3, Schedule C-1 (exclude any paid to yourself)		
11	Insurance		
12	Legal and professional fees		
13	Commissions		
14	Amortization (attach statement)		
15	(a) Pension and profit-sharing plans (see Schedule C Instructions)		
	(b) Employee benefit programs (see Schedule C Instructions)		
16	Interest on business indebtedness		
17	Bad debts arising from sales or services		
18	Depletion		
19	Other business expenses (specify):		
	(a)		
	(b)		
	(c)		
	(d)		
	(e)		
	(f)		
	(g)		
	(h)		
	(i)		
	(j)		
	(k)	Total other business expenses (add lines 19(a) through 19(j))	
20	Total deductions (add lines 6 through 19)		

21 Net profit or (loss) (subtract line 20 from line 5). Enter here and on Form 1040, line 28. **ALSO** enter on Schedule SE, line 5(a)

SCHEDULE C-1.—Cost of Goods Sold and/or Operations (See Schedule C Instructions for Line 2)

1	Inventory at beginning of year (if different from last year's closing inventory, attach explanation)	
2	Purchases \$	Less: cost of items withdrawn for personal use \$
		Balance ▶
3	Cost of labor (do not include salary paid to yourself)	
4	Materials and supplies	
5	Other costs (attach schedule)	
6	Total of lines 1 through 5	
7	Less: Inventory at end of year	
8	Cost of goods sold and/or operations. Enter here and on line 2 above	

Part IV Capital Loss Limitation—Where Losses Are Shown on Both Lines 12(a) AND 13

17 Enter loss from line 5; if line 5 is zero or a gain, enter a zero		17
18 Enter loss from line 13		18
19 Enter gain, if any, from line 5; if line 5 is zero or a loss, enter a zero		19
20 Reduce loss on line 18 to the extent of the gain, if any, on line 19		20
21 Combine lines 3 and 11 and if gain, enter gain; if zero or a loss, enter a zero	21	
NOTE: If the entry on line 21 is zero, OMIT lines 22 through 28, and enter on line 29 the loss shown on line 12(a).		
22 Enter gain, if any, from line 11	22	
23 Enter smaller of amount on line 21 or line 22	23	
24 Enter excess of gain on line 21 over amount on line 23	24	
25 Enter loss from line 4(a); if line 4(a) is blank, enter a zero	25	
26 Reduce gain, if any, on line 24 to the extent of loss, if any, on line 25 (see Instruction I)	26	
27 Enter loss from line 12(a)	27	
28 Add the gain(s) on line(s) 23 and 26	28	
29 Reduce the loss on line 27 to the extent of the gain, if any, on line 28 (see Instruction J)		29
30 Enter smaller of amount on line 29 or line 20 (if line 29 is zero, enter a zero)		30
31 Subtract amount on line 30 from the loss on line 20		31
32 Enter 50% of the amount on line 31		32
33 Add lines 17, 30, and 32		33
34 Enter here and enter as a (loss) on Form 1040, line 29, the smallest of: (a) Amount on line 33; (b) \$1,000 (\$500 if married and filing a separate return—see Instruction L for a higher limit not to exceed \$1,000); or, (c) Taxable Income, as adjusted (see Instruction K)		34 ()

Part V Complete Part V if You are Married Filing a Separate Return and Losses are Shown on Lines 4(a) and 14. (See Instruction L).

35 Combine lines 3 and 11 and if gain, enter gain; if zero or a loss, enter a zero		35
NOTE: If the entry on line 35 is zero, OMIT lines 36 through 42, and enter on line 43 the loss shown on line 4(a).		
36 Enter gain, if any, from line 3		36
37 Enter smaller of amount on line 35 or line 36		37
38 Enter excess of gain on line 35 over amount on line 37		38
39 Enter loss from line 12(a); if line 12(a) is blank, enter a zero		39
40 Reduce the gain, if any, on line 38 to the extent of the loss, if any, on line 39 (see Instruction I)		40
41 Enter loss from line 4(a)		41
42 Add the gain(s) on line(s) 37 and 40		42
43 Reduce the loss on line 41 to the extent of the gain, if any, on line 42 (see Instruction J)		43

Part VI Computation of Alternative Tax (See Instruction U to See if the Alternative Tax Will Benefit You)

44 Enter amount from Form 1040, line 48		44
45 Enter amount from line 15(a)		45
46 Subtract amount on line 45 from amount on line 44 (but not less than zero)		46
47 Enter smaller of amount on line 13 or line 14		47
If line 47 does not exceed \$50,000 (\$25,000 if married filing separately), check here <input type="checkbox"/> and omit lines 48 through 54.		
48 Enter long-term gains recognized on amounts received before January 1, 1975, from certain contracts and installment sales referred to as "certain subsection (d) gains" (see Instruction U)		48
49 Enter amount from line 48 or \$50,000 (\$25,000 if married filing separately), whichever is larger		49
If line 49 is equal to or greater than line 47, check here <input type="checkbox"/> and omit lines 50 through 54.		
50 Multiply amount on line 49 by 50%		50
51 Add amounts on lines 46 and 50		51
52 Tax on line 44 or 45, whichever is greater (use Tax Rate Schedule in instructions)		52
53 Tax on the amount on line 51 (use Tax Rate Schedule in instructions)		53
54 Subtract amount on line 53 from amount on line 52		54
55 Tax on the amount on line 46 (use Tax Rate Schedule in instructions)		55
56 If the block on line 47 or 49 is checked, enter 50% of line 45; otherwise enter 25% of line 49		56
57 Alternative Tax—add amounts on lines 54 (if applicable), 55, and 56. If smaller than the tax figured on the amount on Form 1040, line 48, enter this alternative tax on Form 1040, line 16		57

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side)

Your social security number

If you received earned income in excess of \$600 in each of any 10 calendar years before 1974, you may be entitled to a retirement income credit. If you elect to have the Service compute your tax (see Form 1040 instructions, page 4), answer the question for columns A and B below and fill in lines 2 and 5. The Service will figure your retirement income credit and allow it in computing your tax. Be sure to attach Schedule R and write "RIC" on Form 1040, line 17. If you compute your own tax, fill out all applicable lines of this schedule.

Married residents of Community Property States see Schedule R instructions.

Joint return filers use column A for wife and column B for husband. All other filers use column B only.

Did you receive earned income in excess of \$600 in each of any 10 calendar years before 1974? (Widows or widowers see Schedule R instructions.) If "Yes" in either column, furnish all information below in that column. Also furnish the combined information called for in column C for both husband and wife if joint return, both 65 or over, even if only one answered "Yes" in column A or B.

	A		B		C Alternative Computation (Combined information of husband and wife if joint return and both 65 or over)
	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Yes	<input type="checkbox"/> No	
1 Maximum amount of retirement income for credit computation			\$1,524 00	\$1,524 00	\$2,286 00
2 Deduct:					
(a) Amounts received as pensions or annuities under the Social Security Act, the Railroad Retirement Acts (but not supplemental annuities), and certain other exclusions from gross income					
(b) Earned income received (does not apply to persons 72 or over):					
(1) If you are under 62, enter the amount in excess of \$900					
(2) If you are 62 or over but under 72, enter amount determined as follows:					
if \$1,200 or less, enter zero					
if over \$1,200 but not over \$1,700, enter 1/2 of amount over \$1,200; or if over \$1,700, enter excess over \$1,450					
3 Total of lines 2(a) and 2(b)					
4 Balance (subtract line 3 from line 1) If column A, B, or C is more than zero, complete this schedule. If all of these columns are zero or less, do not file this schedule.					
5 Retirement income:					
(a) If you are under 65: Enter only income received from pensions and annuities under public retirement systems (e.g. Fed., State Govts., etc.) included on Form 1040, line 15					
(b) If you are 65 or older: Enter total of pensions and annuities, interest and dividends included on Form 1040, line 15, and gross rents from Schedule E, Part II, column (b). Also include your share of gross rents from partnerships and your proportionate share of taxable rents from estates and trusts					
6 Line 4 or line 5, whichever is smaller					
7 (a) Total (add amounts on line 6, columns A and B)					
(b) Amount from line 6, column C, if applicable					
8 Tentative credit. Enter 15% of line 7(a) or 15% of line 7(b), whichever is greater					
9 Amount of tax shown on Form 1040, line 16					
10 Retirement income credit. Enter here and on Form 1040, line 49, the amount on line 8 or line 9, whichever is smaller. Note: If you claim credit for foreign taxes or tax free covenant bonds, skip line 10 and complete lines 11, 12, and 13, below					
11 Credit for foreign taxes or tax free covenant bonds					
12 Subtract line 11 from line 9 (if less than zero, enter zero)					
13 Retirement income credit. Enter here and on Form 1040, line 49, the amount on line 8 or line 12 whichever is smaller					

EXHIBIT F

**SCHEDULE F
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Farm Income and Expenses

(Compute social security self-employment tax on Schedule SE)
▶ Attach to Form 1040. ▶ See Instructions for Schedule F (Form 1040).
▶ If rental income, see Instruction C before using this schedule.

1974

Name(s) as shown on Form 1040	Social security number
Business name and address	Employer identification number (See instructions)
Location of farm(s) and number of acres in each farm	

Part I Farm Income—Cash Receipts and Disbursements Method
Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report such sales on Form 4797.

Sales of Purchased Livestock and Other Items Purchased for Resale		
a. Description	b. Amount received	c. Cost or other basis
1 Livestock:	\$	\$
2 Other items:		
3 Totals	\$	\$
4 Profit or (loss), subtract line 3, column c from line 3, column b ▶		\$

Sales of Market Livestock and Produce Raised and Held Primarily for Sale and Other Farm Income

Kind	Quantity	Amount
5 Cattle		\$
6 Calves		
7 Sheep		
8 Swine		
9 Poultry		
10 Dairy products		
11 Eggs		
12 Wool		
13 Cotton		
14 Tobacco		
15 Vegetables		
16 Grain		
17 Fruits and nuts		
18 Other (specify):		

OTHER FARM INCOME

19 Machine work	
20 (a) Patronage dividends (See Sch. F instructions)	
(b) Per-unit retains (See Sch. F instructions)	
21 Nonpatronage distributions from exempt cooperatives	
22 Agricultural program payments:	
(1) Cash	
(2) Materials and services	
23 Commodity credit loans under election (or forfeited)	
24 Federal gasoline tax credit	
25 State gasoline tax refund	
26 Other (specify):	
27 Add lines 5 through 26 ▶	\$
28 Gross profit *(add lines 4 and 27) ▶	\$

Part II Farm Deductions—For Cash and Accrual Method Taxpayers

Do not include personal or living expenses not attributable to production of farm income, such as taxes, insurance, repairs, etc., on your dwelling.

Items	Amount
29 Labor hired	\$
30 Repairs, maintenance	
31 Interest	
32 Rent of farm, pasture	
33 Feed purchased	
34 Seed, plants purchased	
35 Fertilizers, lime	
36 Machine hire	
37 Supplies purchased	
38 Breeding fees	
39 Veterinary, medicine	
40 Gasoline, fuel, oil	
41 Storage, warehousing	
42 Taxes	
43 Insurance	
44 Utilities	
45 Freight, trucking	
46 Conservation expenses	
47 Land clearing expenses	
48 Pension and profit-sharing plans (see Sch. F instructions)	
49 Employee benefit programs other than line 48 (see Sch. F instructions)	
50 Other (specify):	
51 Add lines 29 through 50 ▶	\$
52 Depreciation (from line 59, Part III) ▶	
53 Total deductions. Add lines 51 and 52 ▶	\$

54 Net farm profit or (loss) (subtract line 53 from 28). Enter here and on Form 1040, line 32. ALSO enter on Schedule SE, Part I, line 1(a) ▶

* Use amount on line 28 for optional method of computing net earnings from self-employment. (See Schedule SE, Part I, line 3.) 16-N3227-1

EXHIBIT G

Form **4797**
Department of the Treasury
Internal Revenue Service

Supplemental Schedule of Gains and Losses
Sales, Exchanges and Involuntary Conversions under
Sections 1231, 1245, 1250, 1251, and 1252
To be filed with Form 1040, 1041, 1065, 1120, etc.—See Separate Instructions

1974

Name _____ Identifying number as shown on page 1 of your return _____

Part I Sales or Exchanges of Property Used in Trade or Business, and Involuntary Conversions
(Section 1231)

SECTION A.—Involuntary Conversions Due to Casualty and Theft (See Instruction D)

a. Kind of property (If necessary, attach additional descriptive details not shown below)	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price	e. Depreciation allowed (or allowable) since acquisition	f. Cost or other basis, cost of subsequent improvements (if not purchased, attach explanation) and expense of sale	g. Gain or (loss) (d plus e less f)
1						

2 Combine the amounts on line 1. Enter here, and also on the appropriate line as follows

- (a) For all except partnership returns:
 - (1) If line 2 is zero or a gain, enter such amount in column g, line 3.
 - (2) If line 2 is a loss, enter the loss on line 5.
- (b) For partnership returns: Enter the amount shown on line 2 on Schedule K (Form 1065), line 6.

SECTION B.—Sales or Exchanges of Property Used in Trade or Business and Certain Involuntary Conversions (Not Reportable in Section A) (See Instruction D)

3						

4 Combine the amounts on line 3. Enter here, and also on the appropriate line as follows

- (a) For all except partnership returns:
 - (1) If line 4 is a gain, enter such gain as a long-term capital gain on the Schedule D (Form 1040, 1120, etc.) that is being filed. See instruction D.
 - (2) If line 4 is zero or a loss, enter such amount on line 6.
- (b) For partnership returns: Enter the amount shown on line 4 on Schedule K (Form 1065), line 7.

Part II Ordinary Gains and Losses

a. Kind of property (If necessary, attach additional descriptive details not shown below)	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price	e. Depreciation allowed (or allowable) since acquisition	f. Cost or other basis, cost of subsequent improvements and expense of sale	g. Gain or (loss) (d plus e less f)
5 Amount, if any, from line 2(a)(2)						
6 Amount, if any, from line 4(a)(2)						
7 Gain, if any, from line 21						
8						

9 Combine lines 5 through 8. Enter here, and also on the appropriate line as follows

- (a) For all except individual returns: Enter the gain or (loss) shown on line 9, on the line provided for on the return (Form 1120, etc.) being filed. See instruction E for specific line reference.
- (b) For individual returns:
 - (1) If the gain or (loss) on line 9, includes losses which are to be treated as an itemized deduction on Schedule A (Form 1040) (see instruction E), enter the total of such loss(es) here and include on Schedule A (Form 1040), line 29—identify as "loss from Form 4797, line 9(b)(1)"
 - (2) Redetermine the gain or (loss) on line 9, excluding the loss (if any) entered on line 9(b)(1). Enter here and on Form 1040, line 30

Form **4797** (1974)

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1251, 1252—Assets Held More than Six Months (See Separate Instructions)

Disregard lines 18 and 19 if there are no dispositions of farm property or farmland, or if this form is filed by a partnership.

10 Description of sections 1245, 1250, 1251, and 1252 property:	Date acquired (mo., day, yr.)	Date sold (mo., day, yr.)
(A)		
(B)		
(C)		
(D)		
(E)		

Relate lines 10(A) through 10(E) to these columns ▶▶▶▶▶	Property (A)	Property (B)	Property (C)	Property (D)	Property (E)
11 Gross sales price					
12 Cost or other basis and expense of sale					
13 Depreciation allowed (or allowable)					
14 Adjusted basis, line 12 less line 13					
15 Total gain, line 11 less line 14					
16 If section 1245 property:					
(a) Depreciation allowed (or allowable) after applicable date (see instructions)					
(b) Enter smaller of line 15 or 16(a)					
17 If section 1250 property:					
(a) Enter additional depreciation after 12/31/63 and before 1/1/70					
(b) Enter additional depreciation after 12/31/69					
(c) Enter smaller of line 15 or 17(b)					
(d) Line 17(c) times applicable percentage (see instruction F.4)					
(e) Enter any excess of line 15 over line 17(b)					
(f) Enter smaller of line 17(a) or 17(e)					
(g) Line 17(f) times applicable percentage (see instruction F.4)					
(h) Add lines 17(d) and 17(g)					
18 If section 1251 property:					
(a) If farmland, enter soil, water, and land clearing expenses for current year and the four preceding years					
(b) If farm property other than land, subtract line 16(b) from line 15; OR, if farmland, enter smaller of line 15 or 18(a) (see instruction F.5)					
(c) Excess deductions account (see instruction F.5)					
(d) Enter smaller of line 18(b) or 18(c)					
19 If section 1252 property:					
(a) Enter soil, water, and land clearing expenses made after 12/31/69					
(b) Enter amount from line 18(d), if none enter a zero					
(c) Enter any excess of line 19(a) over line 19(b)					
(d) Line 19(c) times applicable percentage (see instruction F.5)					
(e) Line 15 less line 19(b)					
(f) Enter smaller of line 19(d) or 19(e)					

Summary of Part III Gains (Complete Property columns (A) through (E) through line 19(f) before going to line 20)

20 Total of Property columns (A) through (E), line 15	
21 Total of Property columns (A) through (E), lines 16(b), 17(h), 18(d), and 19(f). Enter here and on line 7	
22 Subtract line 21 from line 20. Enter here and in appropriate Section in Part I (see instructions D and F.2)	

EXHIBIT H

Form T (Timber) (Revised August 1965) U.S. Treasury Department Internal Revenue Service	FOREST INDUSTRIES SCHEDULES (Supplemental to the income tax return form for taxpayers operating, buying, leasing, or selling timber lands)	Submit in duplicate (only one set of maps is required)
For taxable year ended	Name	
Check form of organization: <input type="checkbox"/> Corporation. <input type="checkbox"/> Partnership. <input type="checkbox"/> Fiduciary. <input type="checkbox"/> Individual.	Number and street	
	City or town, state and postal ZIP code	

SCHEDULE F.—CAPITAL RETURNABLE THROUGH DEPLETION

The data indicated, 41 to 56, inclusive, should be given separately for each timber account covering the changes, if any, which have taken place during the taxable year. Insert as many additional pages of the same form as may be necessary. Taxpayers depleting on the block basis must combine new purchases with the opening balances and use the average depletion rate shown on line 48 for all timber cut or sold, regardless of how long held.

	(1) Quantity in M feet board measure, log scale, or other unit ¹	(2) Cost or other basis (dollars)
41. Title of account (name of block or tract)		
42. Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding taxable year.....		
43. Increase or decrease of quantity of timber required by way of correction ²		
44. (a) Addition for growth (period covered years).....		
(b) Transfers from young growth account.....		
(c) Transfers from deferred reforestation account.....		
45. Acquired during year.....		
46. Addition to capital during year ³		
47. Total at end of year, before depletion (sum of lines 42 to 46, inclusive, in each column).....		
48. Unit rate returnable through depletion; or basis of sales or losses (47(2) divided by 47(1)).....		
49. Quantity of timber cut during year ⁴		
50. Depletion sustained (48 multiplied by 49) ⁴		
51. Quantity of timber sold or otherwise disposed of during year.....		
52. Allowable as basis of sale (48 multiplied by 51).....		
53. Quantity of timber lost by fire or other cause during year.....		
54. Allowable as basis of loss (48 multiplied by 53).....		
55. Total reductions during year: (a) Sum of 49(1) plus 51(1) plus 53(1).....		
(b) Sum of 50(2) plus 52(2) plus 54(2).....		
56. Net quantity and value at end of year (47(1) minus 55 (a)(1) and 47(2) minus 55(b)(2)).....		

¹ Give name of log rule. If M feet, log scale, is not the unit used, state what unit was used and explain the unit of measure.
² The quantity in M feet, log scale, or other unit remaining at the end of the year should be adjusted for changes in standards of utilization, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as the basis for depletion in prior years. If such a change is made, the basis upon which it is made should be clearly stated.
³ Such an addition should be analyzed to show the items included. Here are included expenditures for taxes, administration, protection, interest actually paid, etc., if such expenditures have not been treated as expense deductions in the return. Expenditures for reforestation, such as site preparation, planting, seeding, etc., should ordinarily be carried in a separate deferred account.
⁴ If an election is made to claim gain or loss from the cutting of timber under section 631(a), as covered under items 58 to 65, inclusive, all timber acquired during the current taxable year as well as timber acquired within 6 months prior to the beginning of the taxable year should be reported separately both as to the quantity cut and the amount of depletion, with the average unit rate applicable to both.

EXHIBIT I

Internal Revenue Code of 1954

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 or his delegate. 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.

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 6 months before the beginning of such 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 or his delegate, 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 or his delegate. 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.

(b) DISPOSAL OF TIMBER WITH A RETAINED ECONOMIC INTEREST.—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. 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.

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 6 months 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 6 months. 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 compen-

sated 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 6 months 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 6 months, 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 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) 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,

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

(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.

(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 6 months, 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."

EXHIBIT J

Federal Regulations Under 1954 Internal Revenue Code

§ 1.611-1. Allowance of deduction for depletion.—(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

(2) See § 1.611-5 for methods of depreciation relating to improvements connected with mineral or timber properties.

(3) See paragraph (d) of this section for definition of terms.

(b) *Economic interests.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensa-

tion for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

(2) No depletion deduction shall be allowed the owner with respect to any timber or coal that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber or coal, if such disposal is considered a sale of timber or coal under section 631 (b) or (c).

(c) *Special rules*—(1) *In general.* For the purpose of the equitable apportionment of depletion among the several owners of economic interests in a mineral deposit or standing timber, if the value of any mineral or timber must be ascertained as of any specific date for the determination of the basis for depletion, the values of such several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral or timber as a whole.

(2) *Leases.* In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interest in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations thereunder.

(3) *Life tenant and remainderman.* In the case of property held by one person for life with remainder to another person, the deduction for depletion under section 611 shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(4) *Mineral or timber property held in trust.*

If a mineral property or timber property is held in trust, the allowable deduction for depletion is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depletion in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(i) If under the trust instrument or local law the income of a trust computed without regard to depletion is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(ii) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depletion in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depletion reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depletion deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion.

(5) *Mineral or timber property held by estate.* In the case of mineral property or timber property held by an estate, the deduction for depletion under section 611 shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate which is allocable to each.

(d) *Definitions.* As used in this part, and the regulations thereunder, the term—

(1) "Property" means—(i) in the case of minerals, each separate economic interest

owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614 (b), (c), (d), or (e); and (ii) in the case of timber, an economic interest in standing timber in each tract or block representing a separate timber account (see paragraph (d) of § 1.611-3). For rules with respect to waste or residue of prior mining, see paragraph (c) of § 1.614-3. When, in the regulations under this part, either the word "mineral" or "timber" precedes the word "property", such adjectives are used only to classify the type of "property" involved. For further explanation of the term "property", see section 614 and the regulations thereunder.

(2) "Fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(3) "Mineral enterprise" is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) "Mineral deposit" refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition.

(5) "Minerals" includes ores of the metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to depletion based upon a percentage of gross income from the property under section 613 and the regulations thereunder.

§ 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 (1) 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. 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 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, re-estimate, 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.

§ 1.631-1. 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 stand-

ing 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 six months prior to the beginning of the taxable year in which 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 six months before the beginning of the taxable year 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 refer-

ence 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 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 six months depends upon the application of section 1231 to the taxpayer for the taxable year. See section 1231 and the regulation 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 products 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, and 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 six months 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 al-

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 six months 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 six months 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 six months 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.

(e) *Manner and effect of election to treat date of payment as 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 six months or less from the date the timber disposed 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 six months 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 six months 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 six months.

(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:

$$\frac{\text{Bonus}}{\text{Bonus} + \text{amount of expected royalties}} \times \text{Basis of timber} = \text{Basis attributable to bonus}$$

$$\frac{\$5,000}{\$100,000} \times \$90,000 = \$4,500$$

(iii) To the extent attributable to timber not held for more than six months, 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 six months, 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 six months 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 the bonus attributable to these units is determined by the following formula:

$$\frac{\text{Number of units cut held for six months or less}}{\text{Total units covered by the contract}} \times \text{Amount of bonus} = \text{Amount of bonus treated as ordinary income subject to depletion.}$$

$$\frac{10,000}{50,000} \times \$5,000 = \$1,000$$

The amount of the depletion attributable to the portion of the bonus received for timber held for six months or less is determined by the following formula:

$$\frac{\text{Amount of bonus attributable to timber held for six months or less}}{\text{Total bonus}} \times \text{Adjusted basis for depletion of bonus} = \text{Depletion allowance on timber held for six months or less.}$$

$$\frac{\$1,000}{\$5,000} \times \$4,500 = \$900$$

The amount of the bonus attributable to timber held for more than six months, 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 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 6 months 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 6 months is an ordinary loss. Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The non-capital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 6 months, other than stock in trade and certain copyrights and artistic property; (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 6 months. 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 6 months 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 6 months 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) Livestock held for draft, breeding, dairy, or sporting purposes, except to the extent included under paragraph (4) of this paragraph, or poultry.

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

(2) The involuntary conversion of capital assets held for more than 6 months.

(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 6 months, 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)). Notwithstanding any of the provisions of this paragraph, section 1231(a) does not apply to losses described in paragraph (e)(2) 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 recog-

nized 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 unless subparagraph (2) of this paragraph applies. For example, if a capital asset held for more than 6 months, with an adjusted basis of \$400, but not held for the production of income, is stolen, and the loss is not compensated for by insurance or otherwise, section 1231 applies to the \$400 loss.

(2) *Certain uninsured losses.* Notwithstanding the provisions of subparagraph (1) of this paragraph, losses sustained during a taxable year beginning after December 31, 1957, with respect to both property used in the trade or business and any capital asset held for more than 6 months 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.

(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
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 six months. For any taxable year ending after December 31, 1957, 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 1957 at a cost of \$25,000, was requisitioned by the Government in 1955 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. [Reg. § 1.1231-1.]

Asset guideline class	Description of assets included	Asset depreciation range (in years)			Annual asset guideline repair allowance percentage
		Lower limit	Asset guideline period	Upper limit	
01.0	DEPRECIABLE ASSETS USED IN THE FOLLOWING ACTIVITIES: ¹				
to					
79.0					
01.0	Agriculture:				
	Includes only such assets as are identified below and that are used in the production of crops or plants, vines and trees (including forestry); the keeping, grazing, or feeding of livestock for animal products (including serums), for animals increase, or value increase; the operation of dry lot or farm dairies, nurseries, greenhouses, sod farms, mushroom cellars, cranberry bogs, apiaries, and fur farms; the production of bulb, flower, and vegetable seed crops;				

	and the performance of agricultural, animal husbandry and horticultural services.				
01.1	Machinery and equipment, including grain bins and fences but no other land improvements -----	8	10	12	11.0
01.2	Animals:				
01.21	Cattle, breeding or dairy -----	5.5	7	8.5	-----
01.22	Horses, breeding or work -----	8	10	12	-----
01.23	Hogs, breeding -----	2.5	3	3.5	-----
01.24	Sheep and goats, breeding -----	4	5	6	-----
01.3	Farm buildings -----	20	25	30.0	5.0
24.0	Manufacture of lumber and wood products:				
24.1	Cutting of Timber:				
	Includes logging machinery and equipment and road building equipment used by logging and sawmill operators and pulp manufacturers on their own account -----	5	6	7	10.0
24.2	Sawing of dimensional stock from logs:				
	Includes machinery and equipment installed in permanent or well-established sawmills -----	8	10	12	6.5
24.3	Sawing of dimensional stock from logs:				
	Includes machinery and equipment installed in sawmills characterized by temporary foundations and a lack, or minimum amount, of lumber-handling, drying, and residue disposal equipment and facilities -----	5	6	7	10.0
24.4	Manufacture of lumber, wood products, and furniture:				
	Includes assets used in the production of plywood, hardboard, flooring, veneers, furniture and other wood products, including the treatment of poles and timber -----	8	10	12	6.5
26.0	Manufacture of paper and allied products:				
26.1	Manufacture of pulps from wood and other cellulose fibers and rags:				
	Includes assets used in the manufacture of paper and paperboard, but does not include the assets used in pulpwood logging nor the manufacture of hardboard -----	13	16	19	4.5
26.2	Manufacture of paper and paperboard:				
	Includes assets used in the production of converted products such as paper coated off the paper machines, paper bags, paper boxes, and envelopes -----	9.5	12	14.5	5.5

00.0 DEPRECIABLE ASSETS USED IN ALL BUSINESS ACTIVITIES, EXCEPT AS NOTED:

00.2	Transportation Equipment:				
00.22	Automobiles, taxis -----	2.5	3	3.5	16.5
00.23	Buses -----	7	9	11.0	11.5
00.24	General purpose trucks, including concrete ready-mix trucks and ore trucks for use over-the-road:				
00.241	Light (actual unloaded weight less than 13,000 pounds) -----	3	4	5	16.5
00.242	Heavy (actual unloaded weight 13,000 pounds or more) -----	5	6	7	10.0

¹ All asset classes defined below include subsidiary assets within the meaning of section 109(e)(2) of the Revenue Act of 1971 whenever such assets are used in the economic activities specified. However, in accordance with the provisions of that section of the Act, during the period beginning on January 1, 1971 and ending January 1, 1974 or such earlier date as of which asset classes incorporating the subsidiary assets are represcribed or modified, taxpayers may exclude from an election all subsidiary assets in a specified class provided that at least 3 percent of all the assets placed in service in the class during the taxable year are subsidiary assets. See section 1.167(a)-11(b)(5)(vii) of the Income Tax Regulations for application of the 3 percent test.

It should be noted that these lives are applicable when the class life asset depreciation range has been elected in accordance with section 1.167(a)-11 of the Income Tax Regulations. If this election is not made the lives are subject to determination based on the experienced life of the same or similar assets in the hands of the taxpayers.

EXHIBIT K

INTERNAL REVENUE SERVICE SELECTED RULINGS—TIMBER AND OTHER FOREST PRODUCTS

Revenue Ruling 55-252

SECTION 24(a).—PLANTING

Generally, direct costs incurred in connection with reforestation by planting are capital expenditures, recoverable through depletion as the timber subsequently becomes merchantable and is cut or sold. Compare *Mim. 6030, C.B. 1946-2, 45; G.C.M. 6544, C.B. VIII-2, 118 (1929)*. Such planting costs include:

- (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.

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 39.24(a)-6 of Regulations 118.

Revenue Ruling 56-434

SECTION 631.—TOPS AND LIMBS

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 cer-

tain 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 sec-

tion 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.

Revenue Ruling 57-9

SECTION 1221.—STUMPS

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.

Revenue Ruling 71-334

SECTION 631(b).—EXPENSE OF SALE

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.

Revenue Ruling 58-295

SECTION 631.—CONTRACT RIGHT TO CUT

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. Commissioner*, 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 contrac-

tual 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.

Revenue Ruling 62-81

SECTION 1221.—CAPITAL ASSET DEFINED

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 the 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.

Revenue Ruling 62-82

SECTION 1221.—CAPITAL ASSET DEFINED

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 mineral 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.

Revenue Ruling 66-9

SECTION 165.—LOSSES

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.

Revenue Ruling 66-18

SECTION 263.—CAPITAL EXPENDITURES

(Cultivation of Christmas Trees)

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 (a) 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 the 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 capi-

talized 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.

Revenue Ruling 71-228

SECTION 162.—BUSINESS EXPENSES

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.

Revenue Ruling 73-51

SECTION 165.—LOSSES

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 probable 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 1.165-7(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 (1969), 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 non-depreciable 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 a 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.