

BRATTON V. ROUNTREE
76-1 U.S.T.C. ¶9198, 37. AFTR 2d 76-762 (1976)

Editor's Summary Key Topics

DEPLETION ALLOWANCE

- Basis on which depletion allowed
- Definitions relating to timber depletion
- Fair market value
- Growth factor
- Immature timber account

CUTTING AS A SALE OR EXCHANGE

- Fair market value of timber cut under election
- How determined

Facts

Taxpayer as a member of a partnership which, in 1956, purchased the leased timber rights to 2,959,000 board feet of timber on a 1,360 acre tract, at a cost of approximately \$25.35 per thousand board feet. In the same year, the partnership purchased in fee 8,246 acres of land and timber adjacent to the first tract, and containing 21,896,000 board feet of timber, for \$737,747.39.

Issue No. 1

The taxpayer determined the cost depletion basis of the timber purchased in fee by allocating to the timber an amount of the purchase price equal to \$25 per thousand board feet and then allocating the remainder of the purchase price to the land. The taxpayer made no allocation to immature timber.

The Government contended that substantial adjustments should be made in the timber's depletion basis, including allocation of part of the purchase price to immature timber. In its computation of the depletion basis, the Government established values for three components of the tract -- open land, standing fee timber and land with young growth. It accepted the taxpayer's value of standing timber, but separately valued open land and land with young growth based on sales from the first tract. The purchase price of the entire tract was only 79% of the total of the component parts as valued by the Government. Therefore, the Government allocated the purchase price among the three components by giving each a basis equal to 79% of its value as estimated by the Government.

Issue No. 2

In calculating the timber available for cost depletion in the three taxable years following the purchase, the partnership did not provide for an annual growth factor for the standing timber.

The government, referring to Treasury Regulations adopted in 1960, applied a five percent annual growth rate to the partnership's timber depletion account, thereby reducing the unit rate of depletion and the amount of timber depletion. The Commissioner used a U.S. Forest Service publication and the report of a timber cruise to determine the growth rate factor.

Issue No. 3

In computing the gains from timber cut in 1958 under a Section 631(a) election, the partnership valued its timber at \$35 per thousand board feet. The partnership made no distinction in value on the basis of size of the timber. The Government reduced the value of "small timber" to \$15 per thousand board feet, citing the testimony of the expert witness that such a distinction was appropriate and the fact that the report of the cruise divided the timber into "small" and "large" classes for purposes of merchantability.

District Court

Issue No. 1

Held: For the taxpayer. The Court held that an allocation to immature timber was not required under the facts of this case. The Court rejected the Government's contention that immature and young growth must always receive an allocated value. The Court found that an allocation to immature timber was not required in this case since it was of unknown quantity with no tangible value, the timber cruise did not mention immature timber in its timber estimate tables, and it was a common practice of the timber industry at that time not to assign a value to such timber. The testimony of the Government's witness carried little weight since his opinions were arrived at ten years after the purchase.

The Court also rejected the Government's valuation of the tract primarily because the Government's valuation exceeded the tract's purchase price. The Court found no reason in this case to vary the general rule that fair market value is determined by what a willing buyer would pay to a willing seller. The Court felt that it was reasonable for the taxpayer to value the standing timber based on what it had paid per thousand board feet for the leased timber rights on the adjacent tract.

Issue No. 2

Held: For the Government. The Court held that Section 611 of the Internal Revenue Code, as explained by the Treasury Regulations, required the application of a "reasonably ascertainable" growth factor in determining the amount of allowable timber depletion. While not certain of the propriety of applying Treasury Regulations adopted in 1960 to a purchase occurring in 1956, the Court found that the regulations were among the first promulgated under Section 611 and were substantially similar to earlier regulations in the same area. The Court held that an annual growth factor should be taken into consideration in computing the timber depletion account.

Issue No. 3

Held: In part for the taxpayer and in part for the Government. The Court held that there was no basis for the Government's distinguishing between small and large timber in determining Section 631(a) gain. The determination of fair market value for purposes of Section 631(a) gain requires a determination of the facts and circumstances of the particular case. The testimony of the Government's expert witness carried little weight since he had not made an investigation of timber operations in the area for the period involved in the case. Therefore, the Court rejected the Government's valuation of the "small" timber at \$15 per thousand board feet. However, it also disagreed with the taxpayer's \$35 per thousand board feet valuation. The Court found it inconsistent for the taxpayer to value timber on the basis of the value of the leased timber for purposes of determining timber depletion, but to distinguish their values for determining Section 631(a) gain.

Case Text

[Timber issues only]

GRAY, JR., District Judge:

This is an action by the plaintiff taxpayer ¹ for refund of income taxes and assessed interest paid as a result of certain adjustments made by the defendants to the plaintiff's income tax returns for the years 1955, 1956, 1957, 1958, and 1959. The adjustments and resultant tax deficiency arose from the disallowance of certain business expenses claimed by the taxpayer in the years 1955 through 1959; ² the redetermination of the income received in 1957, 1958, and 1959 by the Pemiscot Land and Timber Company ["Pemiscot"], a partnership in which the taxpayer was a partner; the classification of rental income received by the taxpayer as ordinary income and not capital gains; and the taxation in 1958 as a capital gain of insurance proceeds received by the taxpayer in that year.

I. Income From the Pemiscot Partnership

On July 2, 1956, the taxpayer, together with four other persons, formed the Pemiscot Land and Timber Company, a partnership in which each partner owned a twenty percent (20%) interest. In August, 1956, the partnership acquired a timber deed from Alvin Wunderlich under which the partnership purchased for \$75,000 the leased timber rights on a 1,360-acre tract. The leased timber purchased amounted to 2,959,000 board feet, thus costing the partnership approximately \$25.35 per thousand board feet. Also, in August, 1956, the partnership purchased in fee from Wunderlich, for \$737,747.39, 8,246 acres of land and timber, which acreage adjoined the 1,360 acres and which acreage contained 21,896,000 board feet of timber ["fee timber"]. During the tax years in question, the partnership cut and sold various amounts of the timber on the two tracts, thus realizing income which it reported in timely filed tax returns.

The Commissioner of Internal Revenue [the "Commissioner"] made several adjustments ³ to the partnership returns for the years 1957, 1958, and 1959, which adjustments had the ultimate effect of increasing the ordinary income tax liability of the partnership and thus of the plaintiff taxpayer.

A. Allocation of the Purchase Price Between Land and Timber

The partnership allocated \$593,939.39 of the \$737,747.39 purchase price of the 8,246-acre tract to the cost of the fee timber and the remaining \$143,808 to the cost of the land. This timber cost allocation was, according to the plaintiff's evidence, made by valuing the fee timber at approximately \$25 per thousand board feet, substantially the same value as the \$25.35 per thousand board feet cost of the leased timber. The partnership multiplied the 21,896,000 board feet of fee timber by the \$25 figure, thereby arriving at its timber cost allocation figure, and then allocated the remainder of the purchase price to the land.⁴

The Commissioner adjusted the partnership's cost allocation as follows:

Type of Property	Acreage	Quantity Board Feet	Recommended Allocation of Cost
Farm land	130		\$12,782.42
Nonproductive low woodland, lakes, etc.	500		4,916.31
Cypress Land	645		9,513.06
Productive woodland	6,971.15		171,361.87
Young growth timber	7,616.15		74,886.78
Timber		21,896,000	464,286.95
Total			

As indicated, the Commissioner allocated only \$464,286.95 to the cost of the fee timber, and, in addition, allocated a part of the purchase price to immature or young timber growth, which growth the partnership did not consider in its allocation.

In valuing the 8,246 acres, the defendants propose three value components--open land, standing fee timber and land with young growth ["timberland"]. Using a sale of allegedly comparable land as the best indication of the open land value, the defendants have assigned a value of \$9,100 to the open land. As regards the standing fee timber, defendants have accepted as the timber value the partnership's figure of \$593,939.39. Finally, to the land with young growth, defendants have assigned a value of \$321,245. This value was derived from values associated with the sales of several parcels of the 1,360-acre tract, which tract defendants cite as comparable to the timberland on the 8,246 acres and as the best evidence of the value of land with young growth. Adding together these three values and arriving at a value of approximately \$924,000, defendants then allocate the purchase price 5 by figuring that the purchase price is approximately seventy-nine percent (79%) of the total value of the tract and then computing seventy-nine percent (79%) of each value component. Defendants thus allocate \$472,357 to the fee timber and \$262,643 to the land and timberland with small growth.

The significance of this conflict in allocation is that the timber cost allocation figure provides, for purposes of cost depletion, the basis of the timber subject to depletion, the thereby affecting the amount of allowable depletion to which the partnership is entitled, and the amount of partnership income.

As indicated, the primary dispute regarding the allocation of the purchase price between land and timber involves the propriety of allocating a value to the immature, scrub timber growth. Assigning appropriate, reasonable values to the land and timber requires the making of the factual determinations of what elements of the 8,246 acres have allocable values and what those

values are. The resolution of these factual issues necessarily depends upon the particular facts and circumstances of the case, as indicated by the evidence presented. The parties refer for guidance to the Treasury Regulations promulgated pursuant to Section 611 of the Internal Revenue Code of 1954. The court is not certain, however, of the propriety of applying these regulations in this case, since the tax years in question cover 1955 through 1959 and the regulations referred to did not become effective until 1960. Even assuming, however, that the regulations do apply, making the proper allocation still involves the resolution of fact issues, and the regulations are, therefore, instructive.

In determining the basis of timber for purposes of cost depletion, the partnership must allocate the purchase price of the 8,246 acres between timber and land, the proper basis being the cost applicable to the timber alone, exclusive of land and improvements. Internal Revenue Code of 1954, 612; 4 Mertens, *Law of Federal Income Taxation*, ¶24.41 (Rev. ed. 1973). Section 1.611-3(c) of the Treasury Regulations provides that, in setting up the allocation accounts, proper provision should be made for "immature timber growth." In addition, Section 1.611-3(d)(3) of the Treasury Regulations states that, in cases in which immature growth is a factor, a reasonable portion of the total cost of a tract shall be allocated to such immature timber. In the opinion of the court, these regulations indicate that whether immature growth is a factor requiring allocation depends upon the facts and circumstances of each particular case; and thus they do not require, as the defendants argue, that such growth must always receive an allocated value.

After careful consideration, the court is of the opinion that the evidence adduced in this case does not warrant the allocation of part of the purchase price for the 8,246-acre tract to immature growth. First, the trial testimony indicates that the scrub or stump growth on the tract has no tangible worth, in that, if the large standing timber were removed, there would exist no market in which to sell the remaining stumpage. This scrub growth is, in a sense, an unknown quantity whose only value lies in its potential. See *Drey v. United States*, 61-1 USTC ¶9116, 7 AFTR 2d 333 (E. D. Mo. 1960). Also, the cruise performed by C. D. Shy and Company makes no mention of any immature growth in its timber estimate tables, and this fact, while not in and of itself determinative of the immature growth valuation issue, does indicate that such growth is not necessarily a valuation factor.⁶ In addition, the evidence indicates that the common practice in the timber industry at the relevant times was to assign no value to immature growth. This industry practice is certainly not determinative of the allocation issue, but it does indicate, *inter alia*, that few, if any, persons having some knowledge of the timber industry believed stump growth to be of any recognizable value.

Moreover, the evidence presented on behalf of the defendants does little to negate the conclusion that allocation of value to immature growth is improper. Defendants argue that the 8,246-acre and the 1,360-acre tracts are comparable, both having young growth, and that it is reasonable to assume that the prices paid by the buyers of parcels of the 1,360-acre tract included a value for stump growth. Assuming that the evidence establishes the comparability of the two tracts, the defendants' conclusion remains only an assumption unsupported by the evidence. Further, the testimony of defendants' witness, Huff, that there existed appraisable young growth on the tract carries only minimal weight, since his conclusion was based on an opinion arrived at approximately ten years after the purchase and since he applied without any apparent basis a figure of ten dollars per acre as a value for such growth.

Moreover, while agreeing that allocation of the purchase price must be made on the basis of fair market values, the court is not satisfied from the evidence that, as defendants contend, the fair market value of the 8,246 acres equals approximately \$924,000, which is almost a full \$200,000 more than the purchase price paid by the partnership. Fair market value is generally determined by what a willing buyer would pay to a willing seller in ordinary circumstances, and the partnership purchase of the 8,246 acres from Wunderlich seems to come within this principle.

The court finds, therefore, that the fair market value of the 8,246 acres for allocation purposes is equal to the purchase price of \$737,747.39 paid to Wunderlich by the partnership. Since the immature growth is not a factor in this case, the court is of the opinion that the partnership can allocate the purchase price by valuing the timber and assigning the remaining value to the land. The court is of the opinion, however, that the partnership erred in its computation which produced a \$593,939.39 value for the timber. Adopting the partnership's method of multiplying the 21,896,000 board feet of timber on the 8,246-acre tract by the \$25 per thousand board feet figure derived from the cost per thousand board feet of the timber on the 1,360-acre tract, the court finds that \$547,400⁷ should be allocated to the cost of the fee timber and \$190,347.39 should be allocated to the cost of the land.

B. Application of an Annual Growth Factor

In calculating the quantity of timber available for cost depletion in 1957, 1958, and 1959, the partnership did not provide for any annual growth factor. The Commissioner adjusted the partnership returns for those years by applying a five percent annual growth factor to the partnership's timber depletion account; the effect of this application was to increase the amount of board footage on the tract in each year, thereby decreasing the unit rate of depletion and the amount of allowable timber depletion.

The court is of the opinion that Section 611, Internal Revenue Code of 1954, as explained by the Applicable Treasury Regulations, requires that a reasonably ascertainable growth factor be considered in computing the amount of timber subject to depletion.

Section 1.611-3(e) of the Treasury Regulations provides that, if, during the time a taxpayer owns timber property it is ascertained that, due to the growth of timber, the number of timber units remaining on the ground at the close of the taxable year differs from the number supposed to be remaining according to the original estimate of the quantity of timber, then the original estimate, but not the basis, of the timber shall be revised; the revised estimate is then used to figure the charge to the depletion account for the year. Again, while not certain of the propriety of applying this regulation, since it became effective in 1960, the court recognizes that it was among the first set of regulations promulgated under Section 611, Internal Revenue Code of 1954, and is substantially similar to the earlier regulations governing the same problem area. 4 Mertens, Law of Federal Income Taxation, 24.42, n. 62 (rev. ed. 1973). In addition, in *Belcher v. Patterson*, 60-2 USTC ¶9733, 6 AFTR 2d 5697 (N. D. Ala. 1960), affirmed in part, reversed in part, with discussion of the point for which the case is cited [62-1 USTC ¶9426], 302 F. 2d 289 (5th Cir. 1962), cert. denied, 371 U. S. 921 (1962), the district court, apparently ruling on the basis of the Internal Revenue Codes of 1939 and 1954, held that a reasonably ascertainable growth factor

should be taken into account in determining the amount of timber subject to the depletion allowance.

The court is further of the opinion that the evidence establishes the propriety of the five percent growth factor employed by the Commissioner. The use of the United States Forest Service Publication and the C. D. Shy and Company cruises to compute the growth rate was proper.

The court finds, therefore, that a five percent annual growth rate should be applied in calculating the charge to the timber depletion account for each of the years 1957, 1958, and 1959.

C. Fair Market Value of Timber for Purposes of Section 631(a)

Section 631(a), Internal Revenue Code of 1954, allows a taxpayer who cuts timber, which is owned by the taxpayer for more than six months prior to the beginning of the taxable year in which the taxpayer elects to have Section 631(a) apply, to treat the cutting as a sale or exchange of the timber cut, and thereby receive capital gains treatment under Section 1231, Internal Revenue Code of 1954.

The amount of gain or loss recognized shall equal the difference between the fair market value of the timber cut and the adjusted basis for depletion of such timber. The fair market value shall be determined as to the first day of the taxable year in which the timber is cut.

For the 1958 tax year,⁸ the Commissioner allowed the partnership to elect treatment under Section 631(a),⁹ but reduced the fair market value of the "small timber" from \$35 per thousand board feet to \$15 per thousand board feet. The partnership had assigned a \$35 per thousand board feet fair market value to all the timber, making no distinction between small and large timber. The effect of the Commissioner's adjustment was to reduce the cost of timber sold by the partnership, thereby reducing the Section 1231 capital gain and increasing the ordinary income of the partnership.

Assigning a proper fair market value involves an examination of various factors, and necessarily depends upon the facts and circumstances of a particular case. See: Treasury Regulation 1.611-3(f) (1960).

From an examination of the evidence in this case, the court is of the opinion that no distinction should be made between small and large timber for purposes of determining fair market value under Section 631(a). First, the court has been unable to find sufficient evidence to indicate that the Commissioner did in fact assign values on the basis of timber size, or, if he did so, the bases he used for making such a distinction. The testimony of defendants' expert witness, Hull, carries little, if any, weight, since this witness made no investigation of the 1956 timber operations in Pemiscot County, Missouri, which are involved in this case. Moreover, the fact that the C. D. Shy and Company cruise divided the timber into small and large for purposes of merchantability is not, in and of itself, evidence sufficient to require the same distinction for Section 631(a) fair market value purposes. Secondly, the court believes it somewhat inconsistent for the defendants to argue for a small versus large timber distinction for purposes of Section 631(a), having made

no such contention regarding the fair market value of the timber when attempting to allocate properly the purchase price of the 8,246 acres.

Although finding that no distinction between small and large timber should be made, the court cannot agree with the \$35 per thousand board feet value which the partnership assigned to all the timber. The court finds it inconsistent and unacceptable for the taxpayer to base the fair market value of the fee timber on the value of the leased timber at the time of purchase, and then turn around and attempt to distinguish the leased timber when assigning a fair market value under Section 631(a). Moreover, it appears to the court that the values of the leased and fee timber are substantially the same in this case. Finally, while recognizing that timber values can increase, the court does not find evidence in this case sufficient to support such an increase.

The court is, therefore, of the opinion that the timber cut shall be assigned a fair market value of \$25 per thousand board feet for the tax years 1958 and 1959.

1 Plaintiff, Dorothy Bratton, the now deceased wife of plaintiff O. D. Bratton, is a named plaintiff in this action solely because the Brattons filed joint returns during the tax years in question.

2 The parties have now agreed to a settlement as to the amount of business expenses which the taxpayers are entitled to deduct, and, accordingly, the business expense issues are no longer before the court.

3 The Commissioner's adjustment dealt only with the land and fee timber on the 8,246 acre tract, he having accepted the partnership's computations as to the leased timber.

4 The partnership has apparently treated the \$737,747.39 purchase price as also being the total value of the land, so that its cost allocation figures are viewed by the Court as being derived from an allocation on the basis of fair market values.

5 Defendants actually use a \$735,000 purchase price/cost figure, apparently as a rounded off approximation of the original purchase price.

6 The introduction to the cruise does refer to a "reproduction stand" of species smaller than those considered in the report, but the court does not consider such a reference as evidence sufficient to require a value allocation to the scrub growth.

7 Interestingly, this cost of timber value closely approximates the values assigned to the timber by the defendant's expert witness, Sizemore.

8 The election for the 1958 tax year is binding on the taxpayer for all subsequent years unless the taxpayer receives permission from the Secretary of the Treasury or his delegate to revoke the election. Thus, the election in this case also applies for the 1959 tax year.

9 Prior to the trial, the defendants moved to amend their answer to allege that the partnership had erroneously used Section 631(a) and that the Commissioner had erred in allowing a Section 631(a) election. The court denied the motion.