

ROGERS V. COMMISSIONER
46 T.C.M. 789
Tax Ct. Mem. Dec. (CCH) 40,290(M), (P-H) ¶83,420
(Timber issues only)

Editor's summary

Key Topics

CUTTING AS A SALE OR EXCHANGE

- Fair market value of timber cut under the election
- how determined

VALUATION

- Fair market value of timber
- how determined

Facts

The taxpayers were stockholders of a Subchapter S corporation which was engaged in the manufacture and sale of timber products. The corporation purchased from private persons, timberland within a four county area of New York State and, after holding the land for a minimum of six months, harvested the timber pursuant "to a unique harvesting practice": It hauled to its mill a greater length of each tree than was customary in the region. Additionally, the company sought to maximize lumber production with little regard to the quality of lumber produced, and thus used unique milling practices--such as sawing only two rather than the customary four sides from a log before sawing it into boards. After the timber was milled, the resulting lumber was graded, weighed, and the daily volume calculated by multiplying the weight of the lumber by a factor that varied according to species and quality. From these figures, the annual lumber production was calculated and used for purposes of Section 631(a) as the volume of timber cut during the year. The Commissioner determined that the fair market value of the standing timber cut by the company was lower than that which was claimed by the taxpayer.

Tax Court

HELD: Fair market value determined. The Tax Court found flaw in the government's experts report which based their fair market value estimates on the volume of *lumber* produced by the company rather than the estimated volume of standing timber it cut. Also, the government's experts failed to properly account for the appreciation realized from holding the timber before cutting. Nevertheless, the Court also found flaw with petitioner's experts who had included in their comparables sales of federal and state timber--timber of a higher quality than that cut by the

taxpayers. Additionally, the petitioner's experts used comparables which contained a greater percentage of higher value species than was cut by the company, and improperly included in such comparables the estimated cost of roads, drainage ditches, and cutting the trees.

Based upon all the testimony and experts' reports, as well as the unique facts and circumstances of the case, the court determined the fair market value of the timber.

Case Text
Memorandum Findings of Fact and Opinion

WILES, Judge: In these consolidated cases, respondent determined the following deficiencies in petitioners' Federal income taxes:

Petitioner	Docket No.	Year	Amount
Earl Rogers, Jr. and Mildred Rogers	2001-78	1974	\$36,748.00
		1976	34,774.00
Frank H. Aloï and Francine Aloï	2002-78	1973	1,287.00
		1974	2,510.00
		1976	2,091.00
Joseph E. Riehle and Janyce L. Riehle	2003-78	1973	959.56
		1974	1,269.40
		1976	1,990.00
Lewis C. Jenkins and Janet R. Jenkins	2004-78	1973	5,025.00
	8093-78	1974	11,172.00
	4147-80	1976	8,285.00
David P. Rogers and Margaret K. Rogers	2005-78	1973	2,320.00
		1974	5,020.00
		1976	4,715.00

After concessions, the issues for decisions are: (1) the fair market value, for purposes of section 631 (a),² of timber held by petitioners' Subchapter S corporation on October 1, 1972, October 1, 1973, and October 1, 1975; (2) whether petitioners' Subchapter S corporation is entitled to deduct \$324, 343.00 in state sales taxes in the taxable year ending September 30, 1976.

Findings of Fact

ISSUE 1: Fair Market Value of Timber. Some of the facts have been stipulated and are found accordingly.

During the years in issue, Earl Rogers, Jr. (hereinafter Rogers), Frank H, Aloï, Joseph E. Riehle, Lewis C. Jenkins, and David P. Rogers (hereinafter collectively referred to as petitioners) were the sole shareholders in Portville Forest Products, Inc. (hereinafter PFP), a Subchapter S corporation with its principal place of business in Portville, New York. At all relevant times herein, Rogers was the President and Manager of PFP, and Frank Aloï was the Secretary-Treasurer, In 1974, Lewis Jenkins became Vice-President. PFP was owned in approximately the

following proportions during the years in issue:

Name	Approximate Percentage Interest
Earl Rogers, Jr.	59%
David P. Rogers	15%
Lewis C. Jenkins	15%
Frank H. Aloï	6%
Joseph E. Riehle	2%

In 1965, PFP elected to be taxed as a small business corporation under Subchapter S, and thus during the years in issue, PFP was not subject to the income taxes imposed by Chapter 1 of Subtitle A. The petitioners, as shareholders of PFP, were taxed on the income generated by PFP's operations. PFP reported income on an accrual basis with a fiscal year running from October 1 through September 30.

At all relevant times herein, PFP was engaged in the manufacture and sale of timber products. For use in its business, PFP cut timber which it either owned, or had a contract right to cut, for a period of more than six months before the beginning of each fiscal year. PFP duly elected to treat the cutting of its timber under the provisions of section 631(a) for Federal income tax purposes.

The timberland that PFP purchased was located on scattered tracts within a four county area surrounding PFP's mill in Portville, New York. Generally, PFP's timberland purchases were made through real estate agents, local farmers, and other individuals who advertised their land for sale in newspapers; no purchases were made from state or federal lands.

After land was acquired and held for a minimum of six months, PFP harvested the timber. Pursuant to a unique logging practice, PFP cut and hauled to its mill a greater length of each tree than was customary in the region. The additional length consisted entirely of narrow tree tops that other mills left in the woods because they produced low quality lumber. Thus, PFP generally obtained a greater volume of raw timber from a given tract than would a competitor.

PFP's unique logging practice was a direct outgrowth of a business philosophy which sought maximum lumber production with little regard for the quality of lumber produced. A second and more significant consequence of this business philosophy was a milling policy which sought to produce the largest amount of lumber in the least amount of time.³ The result was a high speed process that produced a significant quantity of the lowest quality "pallet" lumber.

After the timber was milled, the resulting lumber was graded and weighed and the daily volume of lumber was calculated by multiplying the weight of the lumber by a factor that varied according to species and quality. From these figures Rogers calculated the annual lumber production and used it, for purposes of section 631(a), as the volume of timber cut during the year.

To value the timber, Rogers used a modified net back to stump method. Under this procedure, Rogers calculated the fair market value of the standing timber by deducting from lumber sale

gross receipts all selling costs, logging and manufacturing costs, and a 10 percent profit and risk factor. Rogers then averaged this fair market value figure with the fair market value figure obtained by performing the same calculation but using in place of the actual lumber sale gross receipts the hypothetical gross receipts that would have been obtained had PFP sold its lumber at the prices listed in the Hardwood Marketing Bulletin, a weekly national trade journal. The resulting average was the fair market value of standing timber cut during the taxable year claimed by PFP on its tax returns during the years in issue.

In the notices of deficiency, respondent determined that the fair market value of the standing timber cut by PFP during each year in issue was lower than that claimed by PFP. The following chart reflects the fair market value of harvested timber claimed by petitioners, and the lower fair market value determined by respondent for each of the taxable years in issue:

PFP's taxable Year Beginning	Petitioners' ⁴ FMV/MBF Timber ⁵	Respondent's FMV/MBF Timber
October 1, 1972	\$105.00	\$31.00
October 1, 1973	105.00	36.00
October 1, 1975	105.00	37.00

As a result of these lower fair market values respondent decreased the long-term capital gains that PFP claimed, pursuant to section 631(a), from the cutting of its timber and increased the company's ordinary income by a proportionate amount. Since PFP is a Sub-chapter S corporation, these changes resulted in increases in petitioners' Federal Income tax liabilities.

Opinion

ISSUE 1: Fair Market Value of Timber. We must determine the fair market value, for purposes of section 631(a), of timber cut by petitioners' Subchapter S corporation on October 1, 1972, October 1, 1973, and October 1, 1975.

Section 631(a) provides that a taxpayer may elect to treat the cutting of timber during a taxable year as a sale or exchange of a capital asset, provided that he has owned the timber or held the contract right to cut such timber for more than six months before the beginning of the taxable year. ⁶ Capital gain or loss is recognized by the taxpayer in an amount equal to the difference between (1) the fair market value of the timber as of the first day of the taxable year in which the timber is cut, and (2) the taxpayer's adjusted basis for depletion of the timber, Section 631 (a), section 1.631-1 (d)(1), Income Tax Regs, Since PFP uses a fiscal year ending on September 30, the relevant valuation dates are October 1 of 1972, 1973, and 1975.

The normal standard for valuing timber eligible for section 631(a) treatment is the hypothetical selling price in a transaction between a willing seller and a willing buyer, both of whom have the most reliable and accurate information available on the valuation date. Section 1.631-1 (d)(2), Income Tax Regs. *Buse v. Commissioner*, 71 T.C. 1129, 1135:1136 (1979). Among the factors to be considered in determining the fair market value of timber on a given date are the character, quality, quantity, location, and accessibility of the timber. Disinterested expert appraisals may also

be considered. Section 1.611-3(f), Income Tax Regs.

Generally, when using expert reports, the comparable sales method⁷ is preferred over the conversion return method. *Buse v. Commissioner, supra* at 1136-I 137; *Peek v. Commissioner, T.C. Memo. 1983-224*. The conversion return method is, however, a valuable check on results derived from the comparable method. *Buse v. Commissioner, supra* at 1137.

In determining the fair market value of PFP's timber we have the opinions of three experts, Donald F. Beach and Shag Taynton for respondent, and Curtis H. Bauer for petitioner. The appraisers for both parties used the comparable sales approach; however, inasmuch as choice of comparables is a value judgment, the parties' experts disagreed as to the appropriate comparables. Respondent's experts conclude that no "true" comparables exist for PFP on the premise the PFP purchases timber of lower quality and smaller size than most other mills in the area.⁸ Consequently, they used PFP's own purchases to establish the fair market value.⁹ Petitioners' expert, on the other hand, used timber sales from public and private lands in the four county area that included few, if any, of PFP's purchases. We find varying degrees of weakness in the methods of analysis used by each of the witnesses and conclude that none of their opinions is totally dispositive of the value of this timber.

The fundamental flaw in respondent's experts' response is that they based their fair market value estimates on the volume of *lumber* produced by PFP rather than on the estimated volume of *standing timber* cut by PFP,¹⁰ as required by the statute and regulations. Section 631 (a) and section 1.631-1 (a)(1), Income Tax Regs. This error resulted in a significant undervaluation of PFP's timber for two reasons. First, lumber yield is generally higher than estimated timber volume,¹¹ and using the larger timber yield figure in the denominator of the fraction,

$$\frac{\text{fair market value}}{\text{estimated timber volume}}$$

results in a lower value per unit of timber. Moreover, the under valuation is exaggerated because PFP obtained a higher lumber yield per unit of timber than was common in the industry. Respondent's experts thus reached an artificially low fair market value.

Second, respondent's experts used PFP's historic timber cost as the starting point for their calculations. PFP typically held timber anywhere from six months to several years, and the historic cost does not reflect the growth and appreciation of timber which normally occurs between the date it is purchased and the date it is cut. *Pope & Talbot, Inc. v. Commissioner, 60 T.C. 74, 79 (1973), affd., 515 F.2d 155 (9th Cir. 1975)*. Respondent's experts were careful to base their estimates on the cost of timber purchases six months before and six months after each applicable valuation date in an effort to provide the closest estimate of the fair market value of the timber purchased. However, this still does not properly account for the appreciation which PFP obtained from holding the timber before cutting. In other words, although PFP's purchases may be a good indication of the value of the timber when purchased, they are not determinative of the value of the timber when it was harvested after additional growth.

Petitioners' expert's report, on the other hand, contained several flaws which rendered the values therein excessive. Although the comparables used were properly based on the fair market value of standing timber, approximately half involved higher value Federal and state timber. PFP never purchased Federal or state timber and use of these sales figures is inapposite. In addition, the comparables Bauer used contained a greater percentage of higher value species than was cut by PFP during the years in issue. Finally, Bauer improperly included in his estimates the costs of putting in roads, drainage ditches, and cutting the trees. As a result of these problems, the values Bauer obtained were too high.

Since we have been called upon to determine the value of timber we will do so. However, there is no mathematical formula that can provide the necessarily speculative value to be placed on a hypothetical sale between willing buyers and sellers. Having considered all of the testimony and experts' reports in light of the unique facts and circumstances of this case, we conclude the fair market values on the appropriate valuation dates were as follows:

Valuation Date	Fair Market Value per MBF Timber
October 1, 1973	\$51.00
October 1, 1974	59.00
October 1, 1976	54.00

Decisions will be entered under Rule 155.

2 All statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

3 For example, contrary to the normal practice of sawing four sides from a log to produce a square cant from which lumber could be sawed, PFP would remove only two sides of a log before sawing it into boards. In addition, PFP would not turn the logs being sawed to maximize the quality of the lumber produced.

4 The figures shown for petitioners are unreduced by the tree cutting costs claimed by PFP in reporting the fair market value of timber on its return for each year in issue.

5 MBF is an abbreviation for thousand board feet.

6 During the years in issue, the holding period for long-term capital gains was six months,

7 The comparable sales approach to valuation (also known as the market data approach) involves selecting sales of property similar to the property being valued and adjusting the sale price to account for all materially different facts and circumstances existing between the two properties. See *Peek v. Commissioner* [20 TTJ 105].

8 The conflicting evidence regarding the quality and size of PFP's timber purchases precludes us from determining whether respondent's experts' premise was, in fact, correct. We note, however, that since PFP maximized lumber production at the expense of lumber quality, it is logical that they would buy less expensive (i.e., lower quality) timber.

9 Respondent's experts maintain the PFP purchased timber from different sellers and thus the prices paid accurately reflect the fair market value of PFP's timber,

10 Both experts estimated fair market value by dividing the annual cost of all of PFP's timber purchases by the total volume of lumber actually produced from that timber. In other words, respondent's experts improperly used the formula,

$$\frac{\text{acquisition cost}}{\text{lumber production}}$$

instead of,

$$\frac{\text{fair market value first day of taxable year}}{\text{estimated timber volume}}$$

mandated by section 631(a). The formula utilized by respondent's experts merely provides the average annual acquisition cost per unit of lumber rather than the fair market value of the standing timber cut by PFP.

11 This is a consequence of the assumptions regarding timber size, tree taper, milling techniques, etc., built into the Doyle rule which is commonly used to estimate timber in the area around PFP's mills.