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THE TIMBER OWNER

And His

FEDERAL INCOME TAX

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Agriculture Handbook No. 274

UNITED STATES DEPARTMENT OF AGRICULTURE

Forest Service

THE TIMBER OWNER

And His

FEDERAL INCOME TAX

ELLIS T. WILLIAMS

Division of Forest Economics and Marketing Research
Forest Service

Agriculture Handbook No. 274

U.S. DEPARTMENT OF AGRICULTURE FOREST SERVICE

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PREFACE

A COMMITTEE of the Society of American Foresters appointed in 1949 to study the effect of taxation on forest practices had an important part in the conception and development of Agriculture Handbook 52, published in 1953. The members of this committee believed (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. Members of the committee were helpful in proposing the publication, assisting in its organization, and reviewing the manuscript. The committee was composed of Ralph W. Marquis, chairman, Upper Darby, Pa.; Lloyd P. Blackwell, Ruston, La.; W. D. Hagenstein, Portland, Oreg.; E. G. Wiesehuegel, Norris, Tenn.; and E. T. F. Wohlenberg, Ukiah, Calif.

The present publication has been reviewed by the Internal Revenue Service. Readers are cautioned, however, that it 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.

Published current as of November 1964.

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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 taxpayer's 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, guideline lives for depreciable assets, 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 District Director of Internal Revenue 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.—Issued annually by the U.S. Treasury Department, Internal Revenue Service. For sale by local offices of the Internal Revenue Service and by the Superintendent of Documents, Washington, D.C., 20402, price 50 cents.

Tax Guide for Small Business.—Issued annually by the U.S. Treasury Department, Internal Revenue Service. For sale by local offices of the Internal Revenue Service and by the Superintendent of Documents, Washington, D.C., 20402, price 50 cents.

Farmer's Tax Guide.—Issued annually by the U.S. Treasury Department, Internal Revenue Service. Obtainable without charge from local offices of the Internal Revenue Service and from county agricultural agents.

Federal Income-Tax Tips for the Small Timber Owner.—An eight-page leaflet summarizing the contents of this booklet. 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 exepnditures 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 improvements, and depreciable 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 represent that portion of the total cost attributable to bare land value. For example, suppose you purchased timberland for $3,000, of which one-third or $1,000 was paid for the land and two-thirds or $2,000 was paid for the timber. If in connection with the purchase you also paid $300 for legal fees and other services, 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 which 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 charged to 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. 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. Included in the merchantable timber and young-growth subaccounts are costs of timber cruising and other expenses directly associated with the timber purchase. 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, may ordinarily be capitalized or expensed at the taxpayer's election. 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. 16.

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 credited as timber becomes merchantable. Such amounts are then charged 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 will be charged with 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 in lieu thereof the related depreciation reserve account, is charged also with any major repair or reconstruction costs that materially increase the value or prolong the life of such equipment. The equipment account will be credited for 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 operations. 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.

Payments under a lease for land held to grow timber are considered as capital expenditures against the present or future timber crop and may not be expensed.

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 severence 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 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 Profession." Forest owners incurring only occasional expenses and not filing Schedule C or F may, provided they itemize their deductions, list such expenses on Form 1040 itself under the heading "Other Deductions."

CARRYING CHARGES

Taxes, interest on a mortgage, and certain other carrying charges which 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 and also acreage (bare land) taxes payable on forest tracts subject to yield tax provisions. Yield or severance taxes payable only at time of timber harvest, on the other hand, do not qualify for such treatment. 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 noncommercial 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 on page 5.

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 depreciation, up to 20 percent of your cost of certain property as depreciation for the year in which it is purchased. A tax credit (investment credit) may also be allowed, based on your investment in certain depreciable property. A detailed discussion of the depreciation and the investment credit is contained in IRS Document No. 5050, *Depreciation, Investment Credit, Amortization, Depletion,* 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.

Depreciation guidelines for manufacturing and nonmanufacturing industries are shown by broad asset classes in IRS Publication No. 456, *Depreciation Guidelines and Rules*, which may be obtained from the Superintendent of Documents, Washington, D.C., 20402, for 30 cents. Guideline classes applicable to logging and sawmilling; lumber, wood products, and furniture manufacture; and paper and allied products are reproduced in Exhibit H in the appendix. Also reproduced are selected items of particular interest to forest owners, as listed in the guideline classes applicable to agriculture and to transportation equipment. The latter class applies to business in general and cuts 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 forms of timber disposal will be discussed. 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 Document No. 5516, *Cost or other Basis 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

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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 volume 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 volume 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 disposal 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 shown 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 disposition, 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 in log rule. 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 which 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 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 1964 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 1964 for $15 per M, or $900, and he paid $50 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 $494.20 to report on his 1964 return.

	Timber investment	*Timber quantity (M bd. ft.)*
First tract	$1, 500	300
Second tract	2, 000	190
Timber growth since purchase	--------	100
Adjusted basis for depletion	3, 500	-----
Total timber available for cutting	--------	590

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
Proceeds from sale (60 M bd. ft. @ $15 per M)		900. 00
Less:		
Basis of timber sold	$355. 80	
Expenses	50. 00	
Total		405. 80
Gain on sale		494. 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 timber is sold or otherwise disposed of. Thus, if you cut timber for sale during the year but do not sell it 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 charge the depletion allowance and cutting expenses to 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 1964. His depletion allowance on the cutting was $150, and his expenses of cutting the timber totaled $500. He sold 25,000 board feet of these logs in 1964. Since he sold only half of the timber cut, only half of the depletion allowance ($75) and half of his cutting expenses ($250), or a total of $325, may be offset in determining the amount of gain. Since he did not sell the other 25,000 board feet in 1964, the balance of the depletion allowance and cutting expenses must be set up in a log inventory at the end of 1964. If the remaining logs were sold in 1965, 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

may be required 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 E 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.

As a matter of practice, Form T is not generally required of owners of relatively small nonindustrial forests. Their timber transactions normally are not frequent and do not ordinarily involve large amounts. Therefore, these taxpayers do not have to keep as complex or detailed records as does an industrial forest owner or someone who actively buys and sells timber. As a minimum, however, two of the records as indicated by the requirements of the depletion information part of Form T should be maintained. One of these, expressed in board feet, cords, or other physical unit, will reflect the adjusted quantity of your timber holdings. The other, expressed in dollars, will show the original cost or other basis of your timber adjusted from time to time as already described.

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 debited to "Timber account—Value" to increase the dollar amount of the adjusted basis for depletion. Had losses of timber been sustained such as from a fire or other casualty, the "Quantity" account would have been credited with the number of board feet destroyed, and the "Value" account would have been credited with 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,

Timber account—Value

			Debit	*Credit*
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	
12/31/64	Basis for sale of 60 M bd. ft., July 1964 ($3,500÷590 M bd. ft.=$5.93 (depletion unit); $5.93×60 M bd. ft.)			$355. 80
12/31/64	Adjusted basis for depletion to be carried forward			3, 144. 20
			3, 500. 00	3, 500. 00
1/ 1/65	Adjusted basis for depletion brought forward		$3, 144. 20	

Timber account—Quantity (bd. ft.)

		Debit	*Credit*
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	
12/31/64	Growth, date of purchase to 1/1/64	100, 000	
		590, 000	
12/31/64	60 M bd. ft. sold, July 1964		60, 000
12/31/64	Quantity to be carried forward		530, 000
		590, 000	590, 000
1/ 1/65	Quantity brought forward	530, 000	

and high-grade veneer-log trees. 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, 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 which apply to capital gains and losses, and to certain dispositions which are sometimes treated as capital gains and losses as explained later, will generally result in a tax benefit to you. If your net gains from the sale or exchange of 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.

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 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 stumpage 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 timber 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 or was not held 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 property 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 repeated sales of timber held for more than 6 months frequently 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 disposal 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 and the tax may not be more than 25 percent of such excess. Short-term gains do not possess 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 applying to capital gains and losses, they are entered on your return in a manner different from ordinary income.

Capital gains and losses from sales or exchanges of timber which qualifies as a capital asset (or which is treated as a capital asset in the situations discussed later) are reported in separate Schedule D, "Gains and Losses from 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 I 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, 1964, for $900. 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 $50 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 $494.20 on the sale of the standing timber (sale proceeds of $900 less $405.80, which is the sum of his cost or other basis of the timber sold, $355.80, and the $50 expense of sale paid for the timber cruise). The transaction is entered in Part I 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	60,000 bd. ft. pine stumpage; lump-sum sale
Col. b. Date acquired	3-1-40
Col. c. Date sold	8-15-64
Col. d. Gross sales price	$900
Col. e. Depreciation	(Leave blank)
Col. f. Cost or other basis and expense of sale.	$405.80 (Attach explanation).
Col. g. Gain or loss (col. d less col. f).	$494.20

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 $494.20 or $247.10 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, and the full $494.20 (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 g inclusive of Schedule D.

a. *Kind of property.*—As indicated in the column heading, a statement may be attached to the schedule giving additional details. These could well include the location and area of forest tract where sale was made and the quantity by leading species of the timber cut.

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. *Depreciation allowed.*—This heading does not apply to sales of timber and no entry need be made in this column.

f.—*Cost or other basis, . . . 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.

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

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 which indicate that 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), "Schedule of Farm Income and Expenses." If he used the cash method of accounting, sale proceeds would be included as income from "Wood and Lumber" in the farm income section, and his cost or other basis and expenses of sale would be itemized under "Other" farm expenses in that part of the Schedule.

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 sale 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, page 37 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) covers 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 mill pond. 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 sale of timber under a cutting contract.

There are three steps in reporting your gain or loss from disposal of timber under 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, 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 the cost or other basis and the expense of sale. The difference is your gain.

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.

1. The disposal with an economic interest retained of timber, iron, 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 sold with land, where the land has been held more than 6 months.

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

5. Sales or exchanges of real property, depreciable property, and leaseholds used in your trade or business, and held more than 6 months.

6. Business property or property held for the production of rents or royalties which was subjected to a casualty or theft if held more than 6 months and covered by insurance in any amount.

7. Notes, bonds, and other investment property subjected to a casualty or theft if held more than 6 months and covered by insurance in any amount.

8. Nonbusiness property subjected to a casualty or theft if held more than 6 months.

9. 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, upon grouping the gains and losses as listed above, the gains exceed the losses, each item is entered in Part I of Schedule D under the heading "Long-Term Capital Gains and Losses—Assets Held More Than 6 Months." But if the gains do not exceed the losses, each item is entered in Part III of Schedule D under the heading "Property Other Than Capital Assets."

This difference in treatment depending upon whether gains or losses predominate is generally to your advantage. When gains exceed losses, all are treated as capital items with consequent saving of tax resulting from capital gains treatment. On the other hand, when losses exceed gains, they are all treated as noncapital items and thus will usually result in a net deduction from ordinary income. The effect here also is to reduce your tax liability.

The entries in columns a to g inclusive of Schedule D are made in the same manner as shown following the example on page 10 and present no special problems.

Example 1.—Mr. Black disposed of timber under a cutting contract during 1964. The contract called for payment at the rate of $18 per thousand board feet. During September 60,000 board feet were cut as shown by scaling completed on September 23. Mr. Black received the amount due him, $1,080, on October 1. The timber was located on land purchased in 1940. His basis for the timber sold (computed as explained under "Determining Amount of Gain or Loss," p. 7) was $355.80, and he paid $100 in connection with the sale for a timber cruise, marking, and scaling, so that the disposition resulted in a gain of $624.20 ($1,080.00 less the sum of $355.80 and $100.00). He also had certain 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. Black's first step in determining how his gains and losses must be reported is to group and compare them, as follows:

	Gain	*Loss*
Gain on sale of timber under cutting contract	$624.20	-------
Gain on sale of pastureland	500.00	-------
Loss on sale of livestock used for breeding purposes	--------	$400.00
Deductible casualty loss from fire to personal residence (in excess of $100)	--------	300.00
	1,124.20	700.00

Since total gains exceed total losses, each of the above gains and losses is entered in Part I of Schedule D under "Long-Term Capital Gains and Losses—Assets Held More than 6 Months." Entries should be made on the return and a statement should be attached to Schedule D as explained in the example on page 10. This statement will show how the basis of the timber sold was computed plus other necessary information.

Example 2.—Assume the facts in Example 1 above except that Mr. Black's loss on the sale of livestock was $900. Comparison of the gains and losses showed an excess of losses as follows:

	Gain	*Loss*
Gain on sale of timber under cutting contract	$624. 20	--------
Gain on sale of pastureland	500. 00	--------
Loss on sale of livestock used for breeding purposes	--------	$900. 00
Deductible casualty loss from fire to personal residence (in excess of $100)	--------	300. 00
	1, 124. 20	1, 200. 00

Because gains do not exceed losses none of the transactions is reported as a long-term capital gain or loss. Mr. Black's gain on the sale of timber, the gain on the sale of pastureland, and his loss on the sale of livestock are all reported in Part III of Schedule D as a sale or exchange of "Property Other Than Capital Assets," and treated as ordinary gains and losses. The $300 deductible casualty loss from fire to his personal residence, however, is deductible only on page 2 of Form 1040 and only if Mr. Black itemizes his deductions.

CUTTING OF 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 usually 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 held more than 6 months before the first day of your tax year, and that if you harvest timber held 6 months or less on such date, you cannot use the elective method described below.

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 or used for lumber, pulpwood, veneer, poles, piling, crossties, and other wood products; it also includes 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 trees likewise are not considered as evergreen trees under the definition. The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees. 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.

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4. *Holding period.*—The 6-month 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 before July 1 of the preceding year.

As explained on page 11 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 for volume at a log landing, dump, or mill pond.

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 determined 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 establishing fair market value, there are two especially useful benchmarks. The first is original cost as adjusted for changing price levels and for changes in timber quantity and quality since acquisition. The second is so-called transactions evidence that reflects 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 25 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 19.

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 some such statement 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 11. 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 the 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 24 under "Concluding Section," also illustrates the application of this election. Part I of the following example 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 1964 from a tract which he had purchased in 1940. Also in 1964, he sold the resulting sawlogs at roadside for $1,800. The fair market value of the standing timber which he cut was determined to be $17 per thousand board feet, or $1,020, as of January 1, 1964. 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 $435. Mr. Jenkins had owned the timber for more than the required 6-months holding period 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 1/1/64, of timber cut during year	$1,020.00
Less: Cost or other basis (depletion allowance)	355.80
Gain from cutting of timber	664.20

Comparison of gains and losses required to be grouped:

	Gain	*Loss*
Gain on timber cutting treated as a sale	$664.20	-------
Gain on sale of pastureland	500.00	-------
Loss on sale of livestock used for breeding purposes	--------	$400.00
Deductible casualty loss from fire to personal residence (in excess of $100)	--------	300.00
	1,164.20	700.00

Since total gains exceed total losses, each of the above gains and losses is entered in Part I of Schedule D under "Long-term Capital Gains and Losses—Assets Held More Than 6 Months." As explained in the example on page 10, 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 sales or exchanges of "Property Other Than Capital Assets." The $300 deductible casualty loss from fire damages to his personal residence would be deductible by Mr. Jenkins only on page 2 of 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		$1,800
Less:		
Fair market value used as "sale price" in computing gain from cutting treated as sale	$1,020	
Logging and skidding costs	435	
		$1,455
Gain on sale of sawlogs		345

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 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; firebreak construction; and cost of dams for forest fire control including construction costs of access roads to such dams.

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.

Ordinary income treatment also applies to payments received under the Naval Stores Conservation Program and under the Soil Bank Act including annual rentals on acreage placed in the Conservation Reserve.

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 II, "8. Other sources."

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 allowable 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 result in a casualty. 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 Document No. 5174, *Casualties* (including storms, floods, other disasters, and thefts), and IRS Document No. 5383, *Condemnations*. 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 5 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 5. 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 1964. 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 1964 your loss for 1964 is limited to $200, the difference between your loss and the amount you expect to recover. If the company made an offer in 1965 to settle your claim for $500, and you accepted 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 1965.

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 1964 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 1964 return. In 1965 the insurance company paid you $850, or $100 more than you estimated in computing your deductible loss for 1964. The $100 is included as income in your return for 1965.

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 2, (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 (depreciated) 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 trepass," 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 received 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 totalling 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 Document No. 5383, *Condemnations*, 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 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 1 year following the close of the tax year in which you first realized any part of the gain; 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 gain 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 Document No. 5174, concerning casualties and thefts, and IRS Document No. 5383, concerning condemnations. These two pamphlets can be obtained from your local Internal Revenue office.

REPORTING GAINS AND LOSSES FROM CASUALTIES, THEFT, 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. In the case of casualty and theft losses of timber held more than 6 months, it will also depend upon whether the property was insured (See IRS Documents Nos. 5174 and 5383).

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 $4,800. 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 total $4,800 or more 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 $4,800, 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 $4,800 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 Section 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 and computation of tax, ask your local Internal Revenue office for a free copy of IRS Document No. 5047, *Self-employment Tax*. Farmers see IRS Publication No. 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. *Can the costs of noncommercial thinning be deducted from taxable income?*

Yes.

6. *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 ex-

penditures for site preparation to afford good growing conditions.

7. *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.

8. *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.

9. *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.

RECEIPTS FROM SALE OF TIMBER AND OTHER FOREST OPERATIONS

10. *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.

11. *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.

12. *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.

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

There is no direct relationship. Depletion affects the amount of gain or loss while capital gains treatment has to do with the type of gain or loss.

14. *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).

15. *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 bought 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.

16. *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.

17. *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.

18. *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.

19. *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.

20. *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. 39).

21. *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

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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 $5 per cord or $100 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 $20 per thousand board feet or $80 per acre should be allocated to such trees. In the case of the pulpwood-size trees a basis of $2 per cord or $20 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 $5 per cord had been used.

22. *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 volumes 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.

23. *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.

24. *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.

25. *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.

26. *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.

27. *Should a timber owner stagger his sales in order to keep down his income tax?*

This is not likely to be a serious problem when capital gains treatment applies. The tax applicable to net long-term capital gains cannot exceed 25 percent.

28. *Is timber growth taxable?*

Timber growth is not taxable as such.

29. *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.)

30. *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.

31. *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.

32. *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.

33. *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.

34. *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.

35. *Is it possible to have prior agreement 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).

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

No.

37. *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 be-

fore 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.

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

39. *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 up to the beginning of the year in which it is cut is reported for that year. 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.

40. *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

41. *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.

42. *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.

43. *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.

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

No.

45. *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

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

Under certain circumstances; see discussion in text on page 19.

PROBLEMS

NUMBER 1

A young forest owner is making a precommercial thinning in his 30-year-old stand. He has other 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 precommercial thinning, maintenance of 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 1964. 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 had 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 1950 and there was no appraisal of the timber made at that time. She owned no other timber. In 1964 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 1950 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 1964.
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 1950 and 1964 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 1950 in the trees which were cut in 1964 amounted to 195,795 board feet:

	Board feet
1964 volume	250,000
Less: Growth	54,205
1950 volume	195,795

The estimated fair market value per unit in 1950 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 1950 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 1964 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
	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
	740
Less: Basis for determining gain	500
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
	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
	3,416.87

How should the owner's 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
	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.

104,885 board feet total cut.

It is assumed that the owner 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
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	
		2,733.25
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
Less:		
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; (b) the cost of replanting lost trees; and (c) the cost of shearing and shaping the 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 20¢ per foot at the plantation and would receive 25¢ per foot delivered to the wholesaler, his net return for buying, cutting, and delivering the trees, including his profit, would be 5¢ 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 20¢ 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
Less:		
"Cost" (fair market value)	$6,000	
Cutting and delivering	900	
		6,900
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	
Total deductions		760
Capital gain		6,440

APPENDIX

EXHIBIT A

FORM 1040
U.S. Treasury Department
Internal Revenue Service

U.S. INDIVIDUAL INCOME TAX RETURN—1964

or taxable year beginning _____, 1964, ending _____, 19____

Your social security number (Husband's if joint return)

Occupation

Wife's number, if joint return

Occupation

Please Print or Type

First name and initial (If joint return, use first names and middle initials of both) | Last name

Home address (Number and street or rural route)

City, town or post office, and State | Postal ZIP code

Enter the name and address used on your return for 1963 (if the same as above, write "Same"). If none filed, give reason.

NOTE.—Married taxpayers: If you are changing from filing separate returns to a joint return or from a joint return to separate returns, enter names and addresses from the 1963 joint or separate returns.

See instructions before completing your return.

FILING STATUS—check one:

1a. ☐ Single
b. ☐ Married filing joint return (even if only one had income)
c. ☐ Married filing separately. If your husband or wife is also filing a return give his or her first name and social security number.
d. ☐ Unmarried Head of Household
e. ☐ Surviving widow(er) with dependent child

EXEMPTIONS

2a. Regular . . . . . ☐ Yourself ☐ Wife
b. Age 65 or over . . ☐ Yourself ☐ Wife
c. Blind . . . . . ☐ Yourself ☐ Wife

Enter number of boxes checked →

3a. Number of your dependent children *who lived with you* . .
b. Number of other dependents (from line 3, Part I, page 2) . .
4. Total exemptions claimed . . . . . →

INCOME—If joint return, include all income of both husband and wife

5. Wages, salaries, tips, etc. If not shown on attached Forms W-2 attach explanation . . . . . $
6. Other income (from line 9, Part II, page 2) . . . . . .
7. Total (add lines 5 and 6) . . . . . .
8. Adjustments (from line 5, Part III, page 2). . . . . .
9. Total income (subtract line 8 from line 7) . . . . . .

FIGURE TAX BY USING EITHER 10 OR 11

TAX COMPUTATION

10. Tax Table—If you do not itemize deductions and line 9 is less than $5,000, find your tax from tables in instructions. Do not use lines 11 a, b, c, or d. Enter tax on line 12.
11. Tax Rate Schedule—
a. If you itemize deductions, enter total from Part IV, page 2 . . . . . .
If you do not itemize deductions, and line 9 is $5,000 or more enter the larger of:
(1) 10 percent of line 9 or;
(2) $200 ($100 if married and filing separate return) plus $100 for each exemption claimed on line 4, above.
The deduction computed under (1) or (2) is limited to $1,000 ($500 if married and filing separate return).
b. Subtract line 11a from line 9 . . . . . .
c. Multiply total number of exemptions on line 4, above, by $600 . . . . . .
d. Subtract line 11c from line 11b. (Figure your tax on this amount by using tax rate schedule on page 10 of instructions. Enter tax on line 12.). . . . . .

TAX—CREDITS—PAYMENTS

12. Tax (from either Tax Table, line 10, or Tax Rate Schedule, line 11) . . . . . .
13. Total credits (from line 5, Part V, page 2). . . . . .
14. Income tax (subtract line 13 from line 12). . . . . .
15. Self-employment tax (Schedule C-3 or F-1) . . . . . .
16. Total tax (add lines 14 and 15) . . . . . .
If either you or your wife worked for more than one employer, see page 5 of instructions.
17a. Total Federal income tax withheld (attach Forms W-2) . . . . . .
b. 1964 Estimated tax payments _____
(Include 1963 overpayment allowed as a credit) **(Office where paid)**
c. Total (add lines 17a and 17b). . . . . .

TAX DUE OR REFUND

18. If payments (line 17c) are less than tax (line 16), enter **Balance Due.** **Pay in full with this return.** →
19. If payments (line 17c) are larger than tax (line 16), enter **Overpayment** →
20. Amount of line 19 you wish credited to 1965 Estimated Tax . . . . . .
21. Subtract line 20 from 19. Apply to: ☐ U.S. Savings Bonds, with excess refunded; or ☐ Refund only .

• Attach Copy B of Form W-2 Here •

• Attach Check or Money Order 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. If prepared by a person other than taxpayer, his declaration is based on all information of which he has any knowledge.

SIGN HERE → _____ If joint return, BOTH HUSBAND AND WIFE MUST SIGN even if only one had income. Date

Sign here _____ Signature of preparer other than taxpayer _____ Address _____ Date

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PART I.—EXEMPTIONS—Complete only for dependents claimed on line 3b, page 1

(a) NAME (If more space is needed attach schedule)	(b) Relationship	(c) Months lived in your home. If born or died during year write "B" or "D"	(d) Did dependent have income of $600 or more?	(e) Amount YOU furnished for dependent's support. If 100% write "ALL"	(f) Amount furnished by OTHERS including dependent
1.				$	$
2.					

3. Total number of dependents listed above. Enter here and on line 3b, page 1 . . . . . → [ ]

PART II.—INCOME FROM ALL SOURCES OTHER THAN WAGES, SALARIES, ETC.

Dividends and Other Distributions

A. Gross amount . . . . . .

B. Nontaxable and capital gain distributions . .

C. Subtract item B from item A. Give details in lines 1a through 1d .

Explanation of Item C (Write (H), (W), (J) for stock held by husband, wife, or jointly)

1a. Qualifying dividends (Name of payer)

Total . . .

b. Subtract $100. If joint return see instructions .

c. Balance . . . . . .

d. Nonqualifying dividends (Name of payer)

Total . . .

2. Total (add lines 1c and 1d) . . . →

3. Interest (Name of payer)

Total interest income . . . →

4. Pensions and annuities, rents and royalties, partnerships, and estates or trusts (Schedule B) .

5. Business income (Schedule C) . . . . . •

6. Sale or exchange of property (Schedule D) . .

7. Farm income (Schedule F) . . . . . •

8. Other sources (state nature)

Total other sources . . . →

9. Add lines 2 through 8. Enter here and on line 6, page 1 . . . . . →

PART III.—ADJUSTMENTS

1. "Sick pay" if included in line 5, page 1 (Attach Form 2440 or other required statement) . .

2. Moving expenses (attach Form 3903) . . . .

3. Employee business expense (attach Form 2106 or other statement) . . . . . .

4. Payments by self-employed persons to retirement plans, etc. (Attach Form 2950SE) . . .

5. **Total adjustments** (lines 1 through 4). Enter here and on line 8, page 1 . . . . . .

EXPENSE ACCOUNT INFORMATION—If you had an expense allowance or charged expenses to your employer, check here ☐ and see page 7 of instructions.

PART IV.—ITEMIZED DEDUCTIONS—Use only if you do not use tax table or standard deduction.

Medical and dental expense.—Attach itemized list. Do not enter any expense compensated by insurance or otherwise. NOTE: If you or your wife are 65 or over, or if either has a dependent parent 65 or over, see page 8 of instructions for possible larger deduction.

1. Enter excess, if any, of medicine and drugs over 1% of line 9, page 1 . . . . . .

2. Other medical, dental expenses (include hospital insurance premiums) . . . . . .

3. Total (add lines 1 and 2) . . . . . .

4. Enter 3% of line 9, page 1 (see note above) .

5. Subtract line 4 from line 3; see page 8 of instructions for maximum limitation . . . . .

Contributions.—If other than money, attach required statement—see instructions.

Total (see instructions for limitations) →

Interest: Home mortgage

Other (Specify)

Total interest expense →

Taxes—Real estate

State and local gasoline

General sales

State and local income

Personal property

Total taxes →

Other deductions (see page 9 of instructions)

Total other deductions →

TOTAL DEDUCTIONS (For line 11a, page 1) →

PART V.—CREDITS

1. Dividends received credit: Enter smallest of (a) 2% of line 1c, Part II, (b) tax shown on line 12, page 1, less foreign tax credit, or (c) 2% of taxable income (see instructions).

2. Retirement income credit (Schedule B) . . .

3. Investment credit (Form 3468) . . . . .

4a. Foreign tax credit (Form 1116)

b. Tax-free covenant bonds credit

5. **Total credits** (add lines 1 through 4b). Enter here and on line 13, page 1 . . . . . .

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EXHIBIT B

SCHEDULE C
(Form 1040)
U.S. Treasury Department
Internal Revenue Service

PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION

(Sole Proprietorships)

(Compute social security self-employment tax on Schedule C-3 (Form 1040))

1964

Attach this schedule to your income tax return, Form 1040 — **Partnerships, joint ventures, etc., must file on Form 1065**

Name and address as shown on page 1, Form 1040

A. Principal business activity ..... ; product .....
(See separate instructions) (For example: retail—hardware; wholesale—tobacco; services—legal; manufacturing—furniture; etc.)

B. Business name ..... **C. Employer Identification Number** .....

D. Business location .....
(Number and street or rural route) (City or post office) (State)

E. Indicate method of accounting: ☐ cash; ☐ accrual; ☐ other.

1. Gross receipts or gross sales $..... Less: Returns and allowances $.....		$.....	
2. Inventory at beginning of year (If different than last year's closing inventory attach explanation)			
3. Merchandise purchased $....., less cost of any items withdrawn from business for personal use $.....			
4. Cost of labor (do not include salary paid to yourself)			
5. Material and supplies			
6. Other costs (explain in Schedule C-1)			
7. Total of lines 2 through 6			
8. Inventory at end of this year			
9. Cost of goods sold (line 7 less line 8)			
10. Gross profit (subtract line 9 from line 1)			
OTHER BUSINESS DEDUCTIONS			
11. Depreciation (explain in Schedule C-2)			
12. Taxes on business and business property (explain in Schedule C-1)			
13. Rent on business property			
14. Repairs (explain in Schedule C-1)			
15. Salaries and wages not included on line 4 (exclude any paid to yourself)			
16. Insurance			
17. Legal and professional fees			
18. Commissions			
19. Amortization (attach statement)			
20. Retirement plans, etc. (other than your share—see instructions)			
21. Interest on business indebtedness			
22. Bad debts arising from sales or services			
23. Losses of business property (attach statement)			
24. Depletion of mines, oil and gas wells, timber, etc. (attach schedule)			
25. Other business expenses (explain in Schedule C-1)			
26. Total of lines 11 through 25			
27. Net profit (or loss) (subtract line 26 from line 10). Enter here; on line 1, Schedule C-3; and on line 5, Part II, page 2, Form 1040			

SCHEDULE C-1. EXPLANATION OF LINES 6, 12, 14, AND 25 **C**

Line No.	Explanation	Amount	Line No.	Explanation	Amount
		$.....			$.....

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SCHEDULE C–2. EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED ON LINE 11

This schedule is designed for taxpayers using the alternative guidelines and administrative procedures described in Revenue Procedure 62–21 as well as for those taxpayers who wish to continue using procedures authorized prior to the revenue procedure. Where double headings appear use the first heading for the new procedure and the second heading for the older procedure.

1. Group and guideline class — OR — Description of property	2. Cost or other basis at beginning of year — OR — Cost or other basis	3. Asset additions in year (amount) — OR — Date acquired	4. Asset retirements in year (amount) (applicable only to Rev. Proc. 62–21)	5. Depreciation allowed or allowable in prior years	6. Method of computing depreciation	7. Class life — OR — Rate (%) or life	8. Depreciation for this year
1. Total additional first-year depreciation (do not include in items below) →							
2. Totals							
3. Less: Amount of depreciation claimed elsewhere in Schedule C							
4. Balance—Enter here and on line 11, page 1							
5. Cost or other basis of fully depreciated assets still in use							

INVENTORY QUESTIONS

1. Was inventory valued at—Cost ☐; lower of cost or market ☐; other ☐. If other, attach explanation.
2. Have write-downs been made to inventory? Yes ☐ No ☐. If "Yes," were the write-downs computed on the basis of:
   (a) ☐ Percentage reductions from parts of the inventory
   (b) ☐ Percentage reductions from the total inventory
   (c) ☐ Valuation of individual items.
   If "a" or "b" is checked, enter the percentage of write-downs ..... %. For "a," "b," or "c" enter the dollar amount of write-downs $.....
   (If not available, estimate and indicate that the figure is an estimate.)
3. Was the inventory verified by physical count during the year?
   Yes ☐ No ☐. If "No," attach explanation of how the closing inventory was determined.
4. Was there any substantial change in the manner of determining quantities, costs or valuations between the opening and closing inventories? Yes ☐ No ☐. If "Yes," attach explanation.

NOTE: If a direct answer cannot be given to a question, attach explanation.

EXPENSE ACCOUNT INFORMATION

Enter information with regard to yourself and your five highest paid employees. In determining the five highest paid employees, expense account allowances must be added to their salaries and wages. However, the information need not be submitted for any employee for whom the combined amount is less than $10,000, or for yourself if your expense account allowance plus line 27, page 1, is less than $10,000. See separate instructions for Schedule C, for definition of "expense account."

Name	Expense account	Salaries and Wages
Owner		XXXXXXXXXXXXXX
1.		
2.		
3.		
4.		
5.		

Did you claim a deduction for expenses connected with: (If answer to any question is "YES," check applicable boxes within that question.)

F. A hunting lodge ☐, working ranch or farm ☐, fishing camp ☐, resort property ☐, pleasure boat or yacht ☐, or other similar facility ☐? (Other than where the operation of the facility was your principal business.) ☐ YES ☐ NO

G. Vacations for you or members of your family, or employees or members of their families? (Other than vacation pay reported on Form W–2.) ☐ YES ☐ NO

H. The leasing, renting, or ownership of a hotel room or suite ☐, apartment ☐, or other dwelling ☐, which was used by you, your customers, employees, or members of their families? (Other than use by yourself or employees while in business travel status.) ☐ YES ☐ NO

I. The attendance of members of your family or your employees' families at conventions or business meetings? ☐ YES ☐ NO

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EXHIBIT C

SCHEDULE D (Form 1040)	U.S. Treasury Department—Internal Revenue Service **GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY** Attach this schedule to your income tax return, Form 1040	1964

Name and address as shown on page 1 of Form 1040

Part I—CAPITAL ASSETS

Short-term capital gains and losses—assets held not more than 6 months

a. Kind of property and how acquired (if necessary, attach statement of 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 (attach schedule)	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. Enter your share of net short-term gain (or loss) from partnerships and fiduciaries .....
3. Enter unused capital loss carryover from 5 preceding taxable years (attach statement) .....
4. Net short-term gain (or loss) from lines 1, 2, and 3 ..... •

Long-term capital gains and losses—assets held more than 6 months

5. Enter gain from line 3, Part II .....

			Total long-term gross sales price..			

6. Enter the full amount of your share of net long-term gain (or loss) from partnerships and fiduciaries .....
7. Capital gain dividends .....
8. Net long-term gain (or loss) from lines 5, 6, and 7 ..... •

9. Combine the amounts shown on lines 4 and 8, and enter the net gain (or loss) here .....

10a. If line 9 shows a GAIN—Enter 50% of line 8 or 50% of line 9, whichever is smaller. (Enter zero if there is a loss or no entry on line 8.) **(See reverse side for computation of alternative tax)** .....

b. Subtract line 10a from line 9. Enter here and on line 1, Part IV .....

11. If line 9 shows a LOSS—Enter here and on line 1, Part IV the **smallest** of the following: (a) the amount on line 9; (b) the amount on line 11b, page 1 of Form 1040 computed without regard to capital gains and losses; or (c) $1,000 . •

Part II—GAIN FROM DISPOSITION OF DEPRECIABLE PROPERTY UNDER SECTIONS 1245 AND 1250—assets held more than 6 months

D

Where double headings appear, use the first heading for section 1245 and the second heading for section 1250.

a. Kind of property and how acquired (if necessary, attach statement of descriptive details not shown below)	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price	e. Cost or other basis, cost of subsequent improvements (if not purchased, attach explanation) and expense of sale
1.				

f. Depreciation allowed (or allowable) since acquisition (attach schedule)		g. Adjusted basis (e less sum of f-1 and f-2)	h. Total gain (d less g)	i. Ordinary gain (lesser of f-2 or h) (see instructions)	j. Other gain (h less i)
f-1. Prior to January 1, 1962 —OR— Prior to January 1, 1964	f-2. After December 31, 1961 —OR— After December 31, 1963				

2. Total ordinary gain. Enter here and on line 2, Part IV ..... •
3. Total other gain. Enter here and on line 5, Part I; however, if the gains do not exceed the losses when this amount is combined with other gains and losses from section 1231 property enter the total of column j on line 1, Part III..

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Part III—PROPERTY OTHER THAN CAPITAL ASSETS

a. Kind of property and how acquired (if necessary, attach statement of 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 (attach schedule)	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. Enter gain from line 3, Part II						
2. Enter your share of non-capital gain (or loss) from partnerships and fiduciaries						
3. Net gain (or loss) from lines 1 and 2. Enter here and on line 3, Part IV ●						

Part IV—TOTAL GAINS OR LOSSES FROM SALE OR EXCHANGE OF PROPERTY

1. Net gain (or loss) from either line 10b or 11, Part I	
2. Total ordinary gain from line 2, Part II	
3. Net gain (or loss) from line 3, Part III	
4. Total net gain (or loss), combine lines 1, 2, and 3. Enter here and on line 6, page 2, Part II, Form 1040	

COMPUTATION OF ALTERNATIVE TAX

It will usually be to your advantage to use the alternative tax if the net long-term capital gain exceeds the net short-term capital loss, or if there is a net long-term capital gain only, and you are filing (a) a separate return with taxable income exceeding $20,000, or (b) a joint return, or as a surviving husband or wife, with taxable income exceeding $40,000, or (c) as a head of household with taxable income exceeding $32,000.

1. Enter the amount from line 11d, page 1, Form 1040	
2. Enter amount from line 10a, Part I on reverse side	
3. Subtract line 2 from line 1	
4. Enter tax on amount on line 3 (use applicable tax rate schedule on page 10 of Form 1040 instructions)	
5. Enter 50% of line 2	
6. Alternative tax (add lines 4 and 5). If smaller than the tax figured on the amount on line 11d, page 1 of Form 1040, enter this alternative tax on line 12, page 1, Form 1040 and write "Alternative" to left of entry	

INSTRUCTIONS (Continued from reverse side of original)

tion prior to July 1, 1963, and in column f-2 depreciation after June 30, 1963.

Column i of Part II, section 1250 property only.—If held for more than 6 months, but not more than 1 year, enter the smaller of
(1) column h, or
(2) column f-2

If held for more than 1 year, enter the result of multiplying the smaller of
(1) column h, or
(2) column f-2 less the amount of depreciation computed for the same period using the straight line method,

by the percentage obtained by subtracting from 100%, one percentage point for each full month the property was held in excess of 20 months. Where substantial improvements have been made within the preceding 10 years, see section 1250(f).

Basis.—In determining gain or loss use cost, except as specially provided. The basis of property acquired by gift after December 31, 1920, is the cost or other basis to the donor in the event of gain, but, in the event of loss, it is the lower of either such donor's basis or the fair market value on date of gift. If a gift tax was paid with respect to property received by gift, see section 1015(d). Generally, the basis of property acquired by inheritance is the fair market value at the date of death. For special cases involving property acquired from a decedent, see section 1014.

Installment sales.—If you sold personal property for more than $1,000 or real property regardless of amount, you may be eligible to report any gain under the installment plan if (1) there is no payment in the year of sale, or (2) the payments in the year of sale do not exceed 30 percent of the selling price. The election must be made in the year of sale even though no payment was received in that year. Contact any Internal Revenue Service office for more complete information. See section 453.

For treatment of a portion of payments as "unstated interest" on deferred payment sales, see section 483.

Sale of personal residence.—Tax on a portion or all of the gain from the sale of your principal residence may be deferred if:
(a) within 1 year after (or before) the sale, you purchase another residence and use it as your principal residence; or
(b) within 1 year after (or before) the sale, you begin construction of a new residence and use it as your principal residence not later than 18 months after the sale.

If you sold property for $20,000 or less on or after your 65th birthday which was owned and used by you as your principal residence for at least 5 of the last 8 years any gain on the sale need not be included in income. If the property was sold for more than $20,000 part of the gain must be taken into income.

Contact your nearest Internal Revenue Service office for full details or to obtain Form 2119 which may be used to report the sale or exchange or to figure your new basis.

Nonbusiness debts.—If a debt, such as a personal loan, becomes totally worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. Enter such loss in column (g) and describe in column (a), Part I. This does not apply to: (a) a debt evidenced by a corporate security with interest coupons or in registered form and (b) a debt acquired in your trade or business.

Limitation on allowable capital losses.—If line 9, Part I, shows a net loss, the loss shall be allowed as a deduction, only to the extent of the smaller of (1) line 11b (or line 9 if tax table is used), page 1, Form 1040 computed without capital gains (losses), or (2) $1,000. The excess of such allowable loss over the lesser of items (1) and (2) above is called "capital loss carryover." Any such carryover loss may be carried forward indefinitely. Short-term losses and long-term losses are to be carried over by category. In computing the carryover, short-term losses must be considered first.

Losses in transactions between certain persons.—No deduction is allowable for losses from sales or exchanges of property directly or indirectly between (a) members of a family, (b) a corporation and an individual (or a fiduciary) owning more than 50 percent of the corporation's stock (liquidations excepted), (c) a grantor and fiduciary of any trust, (d) a fiduciary and a beneficiary of the same trust, (e) a fiduciary and a fiduciary or beneficiary of another trust created by the same grantor, or (f) an individual and a tax-exempt organization controlled by the individual or his family. Partners and partnerships see section 707(b).

Long-term capital gains from regulated investment companies.—Include in income as a long-term capital gain the amount you are notified on Form 2439 which constitutes your share of the undistributed capital gains of a regulated investment company. You are entitled to a credit of 25 percent of this amount which should be included with the amount claimed on line 17a, page 1, Form 1040. The remaining 75 percent should be added to the basis of your stock.

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EXHIBIT D

SCHEDULE F (Form 1040)
U.S. Treasury Department
Internal Revenue Service

SCHEDULE OF FARM INCOME AND EXPENSES

(Compute social security self-employment tax on Schedule F–1 (Form 1040))
Attach this schedule to your income tax return, Form 1040

1964

Name and address as shown on Form 1040.

Business name and address

Location of farm(s) and number of acres in each farm

Employer identification number

FARM INCOME FOR TAXABLE YEAR—CASH RECEIPTS AND DISBURSEMENTS METHOD

PART I. Report receipts from sale of livestock held primarily for sale in the applicable column below. (Do not include other sales of livestock held for draft, breeding, or dairy purposes; report such sales on Schedule D (Form 1040))

SALES OF MARKET LIVESTOCK AND PRODUCE RAISED AND HELD PRIMARILY FOR SALE						OTHER FARM INCOME	
Kind	Quantity	1. Amount	Kind	Quantity	2. Amount	Items	3. Amount
Cattle		$	Eggs		$	Mdse. rec'd for produce	$
			Meat products			Machine work	
Sheep			Poultry, dressed			Breeding fees	
Swine			Wool			Wood and lumber	
Poultry			Honey			Other forest products	
Bees			Sirup and sugar			Patronage dividends, rebates or refunds	
Grain			Other (specify):			Agricultural program payments	
Hay						Other (specify):	
Cotton							
Tobacco							
Vegetables							
Fruits and nuts							
Dairy products							

Total of columns 1, 2, and 3. Enter here and on line 1 of Part IV below $

PART II. SALES OF PURCHASED LIVESTOCK AND OTHER ITEMS PURCHASED FOR RESALE

a. Description	b. Date acquired	c. Amount received	d. Cost or other basis	e. Profit (or loss)
		$	$	$
Totals (enter amount from column e, on line 2 of Part IV below)		$	$	$

PART III. **FARM EXPENSES FOR TAXABLE YEAR (see instructions)** **F**

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

Items	1. Amount	Items	2. Amount	Items	3. Amount
Labor hired	$	Veterinary, medicine	$	Retirement plans, etc. (other than your share—See instructions)	$
Repairs, maintenance		Gasoline, fuel, oil		Other (specify):	
Interest		Storage, warehousing			
Feed purchased		Taxes			
Seed, plants purchased		Insurance			
Fertilizers, lime		Utilities			
Machine hire		Rent of farm, pasture			
Supplies purchased		Freight, trucking			
Breeding fees		Conservation expenses			

Total of columns 1, 2, and 3. Enter here and on line 4 of Part IV below (cash method) or line 6, Part VII (accrual method) $

PART IV. **SUMMARY OF INCOME AND DEDUCTIONS—CASH RECEIPTS AND DISBURSEMENTS METHOD**

1. Sale of livestock and produce raised and other farm income	$	4. Farm expenses (from Part III)	$
2. Profit (or loss) on sale of purchased livestock and other purchased items		5. Depreciation (from Part V)	
		6. Other farm deductions (specify):	
3. Gross profits*	$	7. Total deductions	$

8. Net farm profit (or loss) (subtract line 7 from line 3). Enter here and on line 7, Part II, page 2, Form 1040. Make your computation of self-employment income and the self-employment tax on Schedule F–1 $

*Use this amount for optional method of computing net earnings from self-employment. (See line 3, Schedule F-1 (Form 1040))

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PART V. DEPRECIATION (see instructions) (Do not include property you and your family occupy as a dwelling, its furnishings, and other items used for personal purposes)

This schedule is designed for taxpayers using the alternative guidelines and administrative procedures described in Revenue Procedure 62-21 as well as for those taxpayers who wish to continue using procedures authorized prior to the revenue procedure. Where double headings appear use the first heading for the new procedure and the second heading for the older procedure.

1. Group and guideline class — OR — Description of property	2. Cost or other basis at beginning of year — OR — Cost or other basis	3. Asset additions in year (amount) — OR — Date acquired	4. Asset retirements in year (amount) (applicable only to Rev. Proc. 62-21)	5. Depreciation allowed or allowable in prior years	6. Method of Computing Depreciation	7. Class life — OR — Rate (%) or life	8. Depreciation for this year
1. Total additional first-year depreciation (do not include in items below →							
Total cost or other basis..							

2. Total depreciation (enter on line 5 of Part IV (cash method) or line 7, Part VII (accrual method)) ..... $

3. Cost or other basis of fully depreciated assets still in use .....

PART VI. FARM INCOME FOR TAXABLE YEAR—ACCRUAL METHOD

(Do not include sales of livestock held for draft, breeding, or dairy purposes; report such sales on Schedule D (Form 1040), and omit them from "On hand at beginning of year" column)

Description (Kind of livestock, crops, or other products)	On hand at beginning of year		Purchased during year		Raised during year	Consumed or lost during year	Sold during year		On hand at end of year	
	Quantity	Inventory value	Quantity	Amount paid	Quantity	Quantity	Quantity	Amount received	Quantity	Inventory value
		$		$				$		$
Totals (enter here and in Part VII below).....		$ (Enter on line 3)		$ (Enter on line 4)				$ (Enter on line 1(b))		$ (Enter on line 1(a))

PART VII. SUMMARY OF INCOME AND DEDUCTIONS—ACCRUAL METHOD

1(a). Inventory of livestock, crops, and products at end of year.	$		6. Farm expenses (from Part III)	$
(b). Sales of livestock, crops, and products during year.....			7. Depreciation (from Part V)..	
(c). Other farm income (specify):			8. Other farm deductions (specify):	
Total of line 1(c).....			Total of line 8.....	
2. Total.....	$		9. Total deductions.....	$
3. Inventory of livestock, crops, and products at beginning of year	$			
4. Cost of livestock and products purchased during year				
5. Gross profits (subtract the sum of lines 3 and 4 from line 2)*.	$			

10. Net farm profit (or loss) (subtract line 9 from line 5). Enter here and on line 7, Part II, page 2, Form 1040. $

Make your computation of self-employment income and the self-employment tax on Schedule F-1 .....

* Use this amount for optional method of computing net earnings from self-employment. (See line 3, Schedule F-1 (Form 1040))

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EXHIBIT E

Internal Revenue Service Forest Industries Schedule Form T (Timber)

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.

41. Title of account (name of block or tract)	(1) Quantity in M feet board measure, log scale, or other unit [1]	(2) Cost or other basis (dollars)
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]		X X X
44. (a) Addition for growth (period covered ____ years)		X X X
(b) Transfers from young growth account		
(c) Transfers from deferred reforestation account		
45. Acquired during year		
46. Addition to capital during year [3]	X X X	
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 47(1))	X X X	
49. Quantity of timber cut during year [4]		X X X
50. Depletion sustained (48 multiplied by 49) [4]	X X X	
51. Quantity of timber sold or otherwise disposed of during year		X X X
52. Allowable as basis of sale (48 multiplied by 51)	X X X	
53. Quantity of timber lost by fire or other cause during year		X X X
54. Allowable as basis of loss (48 multiplied by 53)	X X X	
55. Total reductions during year:		
(a) Sum of 49(1) plus 51(1) plus 53(1)		X X X
(b) Sum of 50(2) plus 52(2) plus 54(2)	X X X	
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 F

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 ac-

count in computing taxable income, except that section 1211 shall not apply; and

(2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

In the case of any property used in the trade or business and of any capital asset held for more than 6 months and held for the production of income, this subsection shall not apply to any loss, in respect of which the taxpayer is not compensated for by insurance in any amount arising from fire, storm, shipwreck, or other casualty, or from theft.

(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, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(2) TIMBER, COAL, AND DOMESTIC IRON ORE.—Such term includes timber, coal, and iron ore with respect to which section 631 applies.

(3) LIVESTOCK.—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy 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 G

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 interest.* (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 compensation 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 tim-

ber account (see paragraph (d) of § 1.611–3). For rules with respect to waste or residue of prior mining, see paragraph (c) of § 1.1614–1. 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 (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. 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 standing timber on the first day of such year as gain or loss from a sale or exchange under section 1231.

Thereafter, any subsequent gain or loss shall be determined in accordance with paragraph (e) of this section.

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

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

(4) Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut for a period of more than 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 reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, methods of exploitation, degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of that particular day. Due consideration will be given to the factors and the principles involved in the determination of the fair market value of timber as described in the regulations under section 611.

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

(4) For any taxable year for which the cutting of timber is considered to be a sale or exchange of such timber under section 631(a), the timber so cut shall be considered as 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 regulations thereunder.

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

(c) *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 taxypayer 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 captial 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 noncapital 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 and coal, 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 captial 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 captial 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) A copyright, a literary, musical, or artistic composition, or similiar property, held by a taxpayer described in section 1221(3); or

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

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

(3) The cutting or disposal of timber, or the disposal of coal, 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 tax-

payer'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) of this paragraph). 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 recognized under section 1002, such as those to which sections 1031 through 1036, relating to common nontaxable exchanges, apply.

(e) *Involuntary conversion.*—(1) *General rule.* For purposes of section 1231, the terms "compulsory or involuntary conversion" and "involuntary conversion" of property mean the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money 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 1945 at a cost of $25,000, was requisitioned by the Government in 1957 for $15,000. A sustained no loss deductible under section 165(c) and since no loss with respect to the requisition is recognizable, the loss will not be included in the computations under section 1231.

EXHIBIT H

Guideline Classes for Depreciable Assets[1]

Logging and Sawmilling

Includes the cutting of timber and the sawing of dimensional stock from logs.

(a) Logging ..... 6 years

Includes logging machinery and equipment and road building equipment used by logging and sawmill operators on their own account; also pulpwood logging by pulp manufacturing companies.

(b) Sawmills ..... 10 years

Includes permanent or well-established sawmills.

(c) Portable Sawmills ..... 6 years

Includes sawmills characterized by temporary foundations, and a lack or minimum amount of lumber-handling, drying, and residue-disposal equipment and facilities.

Lumber, Wood Products, and Furniture ..... 10 years

Includes the manufacture of lumber, plywood, veneers, furniture, flooring, and other wood products; also manufacture of wooden prefabricated houses, windows, doors, hardboard and plywood, and the treating of poles and timber.

Excludes logging and sawmilling and the manufacture of pulp and paper.

Paper and Allied Products

(a) Pulp and Paper ..... 16 years

Includes the manufacture of pulp from wood, rags, and other fibers and the manufacture of paper and paperboard from pulp.

Excludes paper finishing and conversion into cartons, bags, envelopes, and similar products; also the manufacture of hardboard and pulpwood logging equipment used by manufacturers of pulp.

(b) Paper Finishing and Converting ..... 12 years

Includes paper finishing and conversion into cartons, bags, envelopes, and similar products.

Agriculture (selected items)

Includes commercial farms and ranches, agricultural and horticultural services, and forestry enterprises.

Excludes logging and sawmilling.

(a) Machinery and Equipment ..... 10 years

Includes machinery and equipment used in the production of crops and livestock and in the on-farm processing of feeds. Includes fences, but excludes other land improvements.

* * * * *

(c) Trees and Vines

Includes trees and vines producing nuts, fruits, and citrus crops.

Due consideration shall be given in each producing region to the geographic, climatic, genetic, economic, and other factors which determine depreciable life.

(d) Farm Buildings ..... 25 years

Transportation Equipment (selected items)

Includes the following types of transportation equipment:

* * * * *

(b) Automobiles, including taxis ..... 3 years

* * * * *

(d) General-purpose trucks:

Light (actual unloaded weight less than 13,000 pounds) ..... 4 years

Heavy (actual unloaded weight 13,000 pounds or more) ..... 6 years

* * * * *

(f) Tractor units (over-the-road) ..... 4 years

(g) Trailers and trailer-mounted containers ..... 6 years

* * * * *

[1] Depreciation Guidelines and Rules. U.S. Treasury Department, Internal Revenue Service Publication 456, revised 1964.

EXHIBIT I

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

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

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

Ordinarily, fair market value of standing timber is determined upon the basis of current transactions in similar timber expressed in unit value per 1,000 board feet for sawtimber. In the usual transaction, all of the purchase price is allocated to the sawtimber content of the standing tree and nothing to the tops and limbs, which may be usuable 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 ex-

traction and hauling of the pulpwood, plus a fair allowance for operating profit up to that point. Therefore, any additional fair market value assignable to the tree with respect to the top and limbs would be represented only by the excess of the proceeds from their sale over the amount determined by the above computation.

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

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 58–266

SECTION 117(k).—EXPENSE OF SALE

Advise has been requested as to the Federal income tax treatment of expenditures which are directly attributable to the disposal of coal or timber under the provisions of section 117(k)(2) of the Internal Revenue Code of 1939.

The taxpayer in this case is a corporation which is the owner and lessor of coal lands. Substantially all of its income is derived from the disposal of coal within the purview of section 117(k)(2) of the Code. In connection with and directly attributable to the disposal of coal so as to produce the maximum income therefrom, the taxpayer expends substantial amounts for checking the lessee's records for accounting and billing purposes, for mining engineers to insure that the maximum amount of coal will be mined by modern methods, for supervisory safety measures, etc.

Section 117(k)(2) of the Code, as amended by the Revenue Act of 1951, 65 Stat. 452, 26 U.S.C. 117, provides, in part, as follows:

> In the case of the disposal of timber or coal (including lignite), held for more than 6 months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber or coal, the difference between the *amount received* for such timber or coal and the adjusted basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber or coal. Such owner shall not be entitled to the allowance for percentage depletion provided for in section 114(b)(4) with respect to such coal. * * * (Italics supplied.)

The specific question, therefore, is whether the words "amount received," as used in section 117(k)(2) 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.

Section 117(k)(2) of the Code was orginally added to the Code by section 127(a) of the Revenue Act of 1943, C.B. 1944, 756 at 773, and, as enacted at that time, was applicable only with respect to the disposal of timber.

Senate Report No. 627, 78th Cong., First Session, C.B. 1944, 973 at 993, on the Revenue Act of 1943 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 profits 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 captial-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 captial gain or loss treatment, that selling expenses are treated as an offset to the selling price. I. T. 2305, C. B. V–2, 108 (1926); (*Mrs.*) *E. A. Griffin* v. *Commissioner*, 19 B.T.A. 1243; *Therese C. Johnson* v. *Commis-*

sioner, 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 capital gain tax, it would seem reasonable to give like consideration to direct expenses in connection with income from leases. In this way the comparison set forth in the above Committee Report would constitute a comparison of like concepts and afford 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.

Section 112(a) of the Code provides in general that, upon the sale or exchange of property, the entire amount of gain or loss determined under section 111 of the Code shall be recognized. Section 111 of the Code provides, in part:

> (a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
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> (b) AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

There is no essential difference between the words "amounts received" found in section 117(k)(2) of the Code and "money received" as used in section 111. Under section 117(k)(2), since the transaction is considered as though it were a gain or loss upon the sale of such timber or coal, and under appropriate circumstances, as provided by section 117(j), gain is considered as long-term capital gain, the direct expenses incident to the transaction should constitute a reduction of the "amount received" in the same manner that selling expenses reduce the sales price.

The words "amounts received" are found in section 117(f) of the Code. Section 117(f) of the Code provides:

> RETIREMENT OF BONDS, ETC.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidence of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

The effect of this section is to convert ordinary income or loss to capital gain or loss, without any reference however to section 117(j) of the Code. Section 117(f) has been a part of the Code since its enactment in 1939.

In the case of *Edward A. Atlas* v. *Commissioner*, Tax Court Memorandum Opinion, entered January 27, 1945, two of the questions in issue were whether the taxpayer realized taxable income in 1940 when he surrendered bonds purchased at a discount and whether the gain, if any, is taxable in part as a long-term capital gain. In accordance with the provisions of section 117(f) of the Code, the court held:

> We think that the surrender of the $61,000 bonds, Series M–1184, for the Fort Hubbard Apartments was the equivalent of the retirement of the bonds by the Bankers Trust Co. The gain to the petitioner upon such transaction was the difference between the cost of the bonds, $23,430.77, and the stipulated fair market value of the Fort Hubbard Apartments received $70,000, less the fees, commissions and expenses amounting to $1,795.50, or a net gain of $44,773.73.
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> "The amount of the gain attributable to each period is the difference between the cost of the bonds acquired in such period and an aliquot portion of the net amount received upon surrender of the bonds, $70,000 less $1,795.50, or $68,204.50."

In the case of a corporation deriving substantially all its income from coal or timber leases, to which section 117(k)(2) of the Code is applicable, the tax relief intended by the Congress in enacting this section would be largely lost if the direct expenses attributable to the lease were not considered in arriving at the gain which would be treated as long-term capital gain. Under such circumstances, the corporation would either derive no tax benefit from these expenses, if the alternative tax under section 117(c)(1) of the Code was applicable, or it would derive no tax benefit under section 117(k)(2) if its direct expenses were so large as to make the alternative tax under section 117(c)(1) inapplicable.

On the other hand, in the case of a corporation realizing appreciable ordinary income, as well as income from section 117(k)(2) leases, if the direct expenses are not considered in arriving at the gain computed under this section, the gross profit from the lease (gross amount received less cost depletion) will be subject to a maximum tax at substantially lower long-term capital gain rates, whereas the direct expenses will in turn offset the ordinary income subject to the higher corporate normal and surtax rates. There appears to be no basis for concluding that section 117(k)(2) was intended to operate in such a manner as to favor corporations deriving both ordinary income and section 117(k)(2) income as against corporations deriving only section 117(k)(2) income.

Accordingly, it is held that direct expenses incurred in connection with the disposal of coal or timber subject to the provisions of section 117(k)(2) of the Code reduce the amount received for the purpose of computing gain or loss from such disposal of coal or timber. Whether any expense is a "direct expense" is a matter to be determined largely on the strength of persuasiveness of the facts of each particular case and how closely related are the activities in connection with which the expense is incurred to the disposal of the coal or timber.

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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 Carlen* 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 contractual right to cut and remove all or a described part of the merchantable timber on a particular tract of land, he has a proprietary interest in the timber cut by him if at the time of the cutting he has an unrestricted right to sell the logs or to use them in his trade or business. If the circumstances are such that the grantor in fact takes for his own use or for sale on his own account substantially all of the logs cut, whether or not in the exercise of a right in the form of an option to purchase, the taxpayer-grantee will not be deemed to have an unrestricted right to sell the logs or to use them in his trade or business.

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