Tax Ramifications of the Ownership of Natural Resources by Farmers

by

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TAX RAMIFICATIONS OF THE OWNERSHIP OF NATURAL RESOURCES BY FARMERS

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The purpose of this article is to present an overview of natural resource taxation only from the farmer/landowner's perspective, with emphasis on the tax treatment of gain derived from an attempted sale of a natural resource, a general discussion of depletion including the economic interest concept, the depletability of resources such as ground water and soil and the taxation of resources, such as timber, which are subject to certain statutory exceptions to general rules.

Although the term "natural resources" has been defined statutorily as including "land, water, minerals, wildlife, and others,"[1] the term is not defined for federal income tax purposes in the Internal Revenue Code. Rather, the availability of the deduction for depletion is premised upon Code section 611, which allows depletion "[I]n the case of mines, oil and gas wells, other natural deposits, and timber. . . ."[2] However, the definition of "other natural deposits" is not so broad as to include minerals in a taxpayer's blood plasma. In *Green v. Commissioner*,[3] the Tax Court held that bodies and skills of taxpayers are not among the natural deposits contemplated by Congress in the depletion provisions.[4] The depletion provisions, according to the Tax Court, were enacted "to promote exploration and development of geological mineral resources."[5]

Conceptually, natural resource taxation revolves around depletion. The federal income tax system imposes a tax on income generated from the sale of property. It was recognized even prior to the establishment of the federal income tax in 1913 that certain enterprises exhausted their capital even as they sold the property. In other words, some of the gross proceeds from such a sale were not income, but a nontaxable return of capital. These enterprises were termed the "wasting asset" businesses.[6] The depletion allowance was codified on this premise in 1913 with a five percent limitation on the allowance available in the case of mines.[7] Depletion is important for

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1. 42 U.S.C. § 4231(a)(2) (1968), *repealed and revised by* 31 U.S.C. § 6506(b)(2) to substitute the words "all natural resources" for the quoted definition.

2. I.R.C. § 611 (West Supp. 1983).

3. Green v. Commissioner, 74 T.C. 1229 (1980).

4. *Id.* at 1238, *citing* Heisler v. United States, 463 F.2d 375 (9th Cir. 1972), *cert. denied* 410 U.S. 927 (1973).

5. *Green*, *citing* S. REP. No. 617, 65th Cong., 3d Sess. (1918), 1939-1 C.B. 117, 120-121.

6. *See* Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399 (1913) (discussing the use of the term "depreciation" under the Corporation Tax Act of 1909 as it related to mine owners); Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918).

7. Tariff Act of 1913, ch. 16, 38 Stat. 114 (1913).

the determination of (i) who is granted the deduction, especially in multi-party situations, (ii) how the income from the property will be treated, (iii) what income from the property will be denied depletion and (iv) if a sale or exchange occurs other than in a lump sum, whether capital gain treatment will be allowed or whether the gain will be ordinary income subject to depletion.

Percentage depletion and cost depletion are the only two types of depletion available to taxpayers, and by regulation, the taxpayer is allowed the higher of cost or percentage depletion.[8] Code section 613(b) grants a depletion allowance on a percentage of gross income from a lengthy listing of geological substances, in amounts ranging from twenty-two percent to five percent.[9] The percentage depletion allowance must not exceed fifty percent of the taxpayers' taxable income from the property computed without allowance for depletion.[10] A fourteen percent depletion allowance is granted the category of "all other minerals."[11] However, for percentage depletion purposes, the term "all other minerals" does not include soil, sod, dirt, turf, water or mosses, or minerals from sea water, the air or similar inexhaustible sources.[12] However, such exclusion from percentage depletion does not necessarily mean an accompanying denial of cost depletion so long as the fundamental requirements of a natural deposit,[13] exhaustibility[14] and severance of the resource[15] are met. Cost depletion is available for all of the depletable resources and is computed for the taxable year by dividing (i) the property's basis by (ii) the remaining units to arrive at the depletion unit, and by then multiplying the depletion unit by the number of units sold.[16] The "property's basis" is the cost or other basis of the property as determined under Code section 1012 and the regulations thereunder, adjusted as provided in

8. Treas. Reg. § 1.611-1(a)(1) (1960).

9. I.R.C. § 613(b) (West Supp. 1983). The Tax Reduction Act of 1975, except for (i) retaining percentage depletion at the specified percentage rate of 22% for domestic "fixed contract gas" and domestic "regulated gas", and (ii) retaining an independent producer and royalty owner per-day barrel exemption, repealed percentage depletion for all domestic and foreign oil and gas production effective January 1, 1975. *See* I.R.C. § 613A (West Supp. 1983).

10. I.R.C. § 613(a) (West Supp. 1983). In general, the taxpayer computes percentage depletion by multiplying the gross income from the property, reduced by an amount equal to any royalties paid or incurred by the taxpayer with respect to the property by the specified percentage, except that he shall substitute for the derived product an amount equal to 50% of the taxable income from the property computed without allowance for depletion if the latter amount is less than said derived product. The taxpayer must use tax costs in the computation of taxable income from the property even though book costs were used in the computation of gross income. Rev. Rul. 83-134, 1983-37 I.R.B. 10.

11. I.R.C. § 613(b)(7) (West Supp. 1983). Geothermal resources are granted a percentage depletion allowance of 16% for 1983 and 15% for 1984 and thereafter under Code § 613(e). This provision was added by the Energy Tax Act of 1978 in part to clarify the ambiguity regarding the applicable percentage for such deposits, the Tax Court and the Ninth Circuit having granted the "gas" allowance percentage in the case of Reich v. Commissioner, 52 T.C. 700 (1969), *aff'd*, 454 F.2d 1157 (9th Cir. 1972).

12. I.R.C. § 613(b)(7) (West Supp. 1983).

13. *See* Rev. Rul. 79-411, 1979-2 C.B. 246.

14. *See* Meyers v. Commissioner, 66 T.C. 235 (1976).

15. *See* A. Duda & Sons, Inc. v. United States, 560 F.2d 669 (5th Cir. 1977).

16. Treas. Reg. § 1.611-2(a)(1) (1960).

section 1016 and the regulations.[17] The property's basis does not include (i) "amounts representing the cost or value of the land for purposes other than mineral production," (ii) "the residual value of the land and improvements at the end of operations" or (iii) any amounts recoverable through depreciation deductions, deferred expenses and deductions other than depletion.[18] It does include however, the amount of capitalized drilling and development costs which are recoverable through depletion deductions as provided in section 1.612-4 of the Regulations.[19]

"Remaining units" are the number of units of the resource remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the number of units sold within the taxable year.[20] The "number of units sold within the taxable year" (for a taxpayer on the cash receipts and disbursements method of accounting) includes units for which payments were received within the taxable year although the units were produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year. For a taxpayer on the accrual method of accounting, the number of units sold is determined from the taxpayer's inventories kept in physical quantities and in a manner consistent with his method of inventory accounting.[21]

Depletion of Ground Water

In *United States v. Shurbet*,[22] the Fifth Circuit allowed cost depletion for ground water from the Ogallala aquifer used by a taxpayer in his irrigated farming operation. The decision was carefully limited to the depletion allowance for "ground water extracted from the Ogallala water reservoir of the Southern High Plains, 'according to the peculiar conditions of each case,' section 611 of the 1954 Internal Revenue Code."[23] The IRS announced that it would follow the decision in *Shurbet* in 1965[24] and in 1982 Revenue Ruling 82-214, the IRS amplified the 1965 ruling "to include taxpayers who extract ground water from areas of the Ogallala Formation other than the Southern High Plains."[25]

In *Nesmith v. Commissioner*,[26] a taxpayer attempted to take depletion for ground water located over the North Coyanosa irrigation area of the Pecos aquifer. The Tax Court denied the deduction because the taxpayer could not prove that (i) his particular supply of ground water was nonrechargeable and (ii) was being exhausted. The government's evidence showed the water tables had generally risen over the years. The Tax Court

17. Treas. Reg. §§ 1.61-2(a)(1) (1960) and 1.612-1(a) (1960).
18. Treas. Reg. § 1.612-1(b)(1) (1960).
19. *Id.*
20. Treas. Reg. § 1.611-2(a)(3) (1960).
21. Treas. Reg. § 1.611-2(a)(2)(i) and (ii) (1960).
22. United States v. Shurbet, 347 F.2d 103 (5th Cir. 1965).
23. *Id.* at 109.
24. Rev. Rul. 65-296, 1965-2 C.B. 181.
25. Rev. Rul. 82-214, 1982-2 C.B. 115.
26. Nesmith v. Commissioner, T.C.M. 1972-34 (P-H).

stated that "[t]he purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset. [Citation omitted]. Inherent in the allowance is the requirement that the natural resource must be exhaustible."[27]

In order to obtain a deduction for cost depletion of ground water, a taxpayer must establish (to the satisfaction of the district director) (i) the amount of water present at acquisition, (ii) the cost basis in the water and (iii) "the net amount of exhaustion of the water deposit beneath his land during the taxable year."[28] The cost of ground water at acquisition may be established by comparing differences between the fair market values of dry lands and lands containing water for irrigation. The determination of the amount of water present at acquisition is made by reference to the saturated thickness of that part of the formation containing water, measured in feet (the depletable saturated thickness).[29] The depletion unit for ground water is a per foot cost, computed by dividing the original basis in the water by the original number of feet. The depletion allowance equals the unit cost times feet decrease.[30]

Soil, Sod, Loam, Peat, Moss

Soil or sod is specifically denied a percentage depletion deduction in the Code.[31] However, soil and loam are natural deposits for cost depletion purposes.[32] Moreover, in order to claim depletion on soil or sod, the resource must be ultimately exhaustible[33] and depletion will be denied where the soil is partially replenished as a result of taxpayer's farming techniques.[34] Finally, the exhaustion must be due to severance and not exhaustion from wear and tear due to erosion, wind or loss of soil nutrients.[35] Exhaustion from severance includes loss of topsoil suffered in a sale of sod[36] or balled nursery stock.[37]

Code section 613(b) grants a five percent depletion allowance for peat.[38] For purposes of percentage depletion, the distinction between "peat" and "peat soil" is that peat means "an extractable deposit of partially carbonized vegetable matter which, when extracted, is sold as a separate product for use

27. *Id.* at 72-135.
28. Rev. Proc. 66-11, 1966-1 C.B. 624.
29. *Id.* at 625.
30. *Id.* at 626. The taxpayer must establish the net amount of exhaustion during the year. If a recharge of water increases the depletable saturated thickness over its level at the end of the prior year, no depletion will be allowed, and no further depletion will be allowed until the water table falls below the previously known lowest level. *Id.* at 625.
31. I.R.C. § 613(b)(7)(A) (West Supp. 1983).
32. Rev. Rul. 79-411, 1979-2 C.B. 246.
33. Meyers v. Commissioner, 66 T.C. 235, 238 (1976).
34. Rev. Rul. 79-267, 1979-2 C.B. 243.
35. Meyers v. Commissioner, 66 T.C. 235, 238.
36. *Id.*
37. Rev. Rul. 77-12, 1977-1 C.B. 161.
38. I.R.C. § 613(b)(6) (West Supp. 1983).

as fuel, fertilizer, or packaging."[39] The term "peat moss" is equivalent to peat for percentage depletion purposes, identifying the source of peat. Depletion is allowed peat or peat moss after it becomes peat but is not allowable for any moss while still in the form of moss, and before it becomes peat.[40]

Extraction or Severance

In *A. Duda & Sons, Inc. v. United States*,[41] the Fifth Circuit held that extraction is a necessary prerequisite to depletion. The taxpayer in *Duda* was engaged in farming operations on tracts of land consisting of peat that had been cultivated by draining the water that had covered the peat and compacting the soil. The result of cultivation of such peat soil is oxidation of the soil, so that the soil subsides. It was conceded by the government that, had the taxpayer dug up and sold the peat, depletion would have been allowable. However, the government argued that no depletion should be allowed for a natural deposit that is wasting in place because extraction or severance is a necessary prerequisite to the deduction.

In its holding, the Fifth Circuit Court of Appeals discussed the *Shurbet*[42] case, in which the court had allowed depletion deductions for exhaustion of ground water that was not sold. The court stated that the *Shurbet* court had "carefully limited its holding to 'the allowance of cost depletion for ground water *extracted* from the Ogallala water reservoir'. . . ."[43]

Economic Interest

"Annual depletion deductions are available only to the owner of an economic interest in mineral deposits or standing timber."[44] By definition, first enunciated in *Palmer v. Bender*[45] and stated in the Regulations, "[a]n 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."[46]

Ownership of an economic interest is significant in that (i) the owner of an economic interest is generally taxed on income derived from production

39. Warren v. Commissioner, 40 T.C. 991, 998 (1963).
40. Rev. Rul. 57-336, 1957-2 C.B. 325.
41. A. Duda & Sons, Inc. v. United States, 560 F.2d 669 (5th Cir. 1977).
42. United States v. Shurbet, 347 F.2d 103 (5th Cir. 1965).
43. A. Duda & Sons, Inc. v. United States, 560 F.2d at 678 n.11. Footnote 11 of *Duda* places an interesting twist on the policy underlying depletion:

> For example, should an industrial concern that owns a lake, uses its water in production, but gradually pollutes the lake be entitled to claim depletion deductions as it exhausts the supply of fresh water? . . . The only significant difference between *Shurbet* and the polluter hypothetical is that in *Shurbet* the court carefully limited its holding to 'the allowance for cost depletion for ground water *extracted* from the Ogallala water reservoir. . . .'

44. Treas. Reg. § 1.611-1(b)(1) (1960).
45. Palmer v. Bender, 287 U.S. 551 (1933).
46. Treas. Reg. § 1.611-1(b)(1) (1960).

from the property, (ii) the owner is generally entitled to a depletion deduction against such income accrued against his interest and (iii) in certain situations, the owner is entitled to capital gain treatment with respect to gain realized on the sale or exchange of his property interest.[47]

The term economic interest does not mean title to the natural resource, but the possibility of profit dependent solely on extraction and sale of the resource.[48] In general, by a lease of subsurface (mineral or oil and gas) rights to land, the landowner creates both working and nonworking interests.[49] A working interest is an interest in minerals in place that is burdened with the cost of development and operation of the property.[50] The nonworking, or royalty, interest is an interest in minerals in place that entitles the owner thereof "to a specified fraction, in kind or in value, of the total production from the property, free of expense of development and operation."[51] Although both working and nonworking interests constitute economic interests, in order to constitute income with respect to an economic interest, payments must be from the production of the mineral.[52] If payments to the holder of the interest are made regardless of any extraction, then such payments shall not be deemed to be income with respect to an economic interest.[53] An example of such payments are delay rentals. Delay rentals are not payments in advance for mineral to be extracted, but are in the nature of rent.[54] The landowner must treat such payments as ordinary income not subject to depletion.[55]

47. *See* Jefferson Lake Sulphur Co. v. United States, 207 F. Supp. 124 (E.D. La. 1962); Lesher v. Commissioner, 73 T.C. 340 (1979), *aff'd per curiam on other issue*, 638 F.2d 64 (8th Cir. 1981).

48. Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, 604 (1946).

49. For a detailed discussion of oil and gas leases, see E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 15.9 (1962 and Supp. 1983).

50. Brooks v. Commissioner, 424 F.2d 116 (5th Cir. 1970); Standard Oil Co. v. Commissioner, 68 T.C. 325 (1977).

51. Getty Oil Co. v. United States, 399 F.2d 222, 225 (Ct. Cl. 1968). *See* Commissioner v. P.G. Lake, Inc. 356 U.S. 260 (1957).

52. *See* Burton-Sutton Oil Co., Inc. v. Commissioner, 328 U.S. 25 (1946); Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); Twin Bell Oil v. Helvering Syndicate, 293 U.S. 312 (1934).

53. *See* Anderson v. Helvering, 310 U.S. 404 (1940); Lehigh Portland Cement Co. v. United States, 433 F. Supp. 639 (E.D. Pa. 1977). In *Engle v. Commissioner*, the Seventh Circuit reversed a decision of the Tax Court in an oil and gas situation, and held that the "average daily production" language of Code § 613A(c) does not make actual physical extraction a prerequisite to the allowance for percentage depletion, but is a limitation on the allowance. Engle v. Commissioner, 677 F.2d 594 (7th Cir. 1982).

54. Treas. Reg. § 1.612-3(c)(1) (1960). According to the Fifth Circuit in *White Castle Lumber & Shingle Co. v. United States*, delay rentals "accrue by the mere lapse of time like any other rent. They do not depend on the finding or production of oil or gas and do not exhaust the substance of the land. . . . [T]he delay rental is not paid directly or indirectly for oil to be produced, but is for additional time in which to utilize the land." White Castle Lumber & Shingle Co. v. United States, 481 F.2d 1274, 1276 (5th Cir. 1973), *quoting* Commissioner v. Wilson, 76 F.2d 766, 769 (5th Cir. 1935).

Delay rentals should be contrasted with bonus payments which are depletable income to the lessor. Treas. Reg. § 1.612-3(a)(1) (1960). A true bonus cannot be avoided by termination or abandonment of the lease and is a return of the taxpayer's capital investment in anticipation of production. White Castle Lumber & Shingle Co. v. United States, 481 F.2d at 1276.

55. Bennett v. Scofield, 170 F.2d 887, 889 (5th Cir. 1948), *quoting with approval* Houston Farms Dev. Co. v. United States, 131 F.2d 577 (5th Cir. 1943).

There are two parts to the economic interest test: (1) that the taxpayer has acquired by investment any interest in mineral in place or standing timber and (2) secured by 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.[56] If a taxpayer sells his interest in depletable resources other than timber, coal or domestic iron ore, the treatment of the gain will be ordinary income subject to depletion (and not capital gain) if he retains an economic interest in the resource. The transaction will not constitute an absolute sale qualifying for capital gain treatment if the second part of the economic interest test is satisfied, that of securing "by any form of legal relationship, income derived from the extraction of the [mineral] to which he must look for a return of his capital."[57] Even in the case of a technical sale, the seller is deemed to have retained an economic interest in the property transferred if all or part of the price is payable out of the minerals produced or the net proceeds of production.[58]

The second element of the economic interest test has been uniformly held to mean that proceeds from the sale of minerals are taxable as ordinary income unless the seller proves that (i) he retained no economic interest in the minerals sold and (ii) he never solely depended upon the removal of the minerals for a return of his capital.[59] The construction of the second part of the test as meaning "solely" was set out in *Commissioner v. Southwest Exploration Company*.[60] Taxpayers, in attempts to transmute leases into sales qualifying for capital gain treatment, inserted provisions into agreements that could be read as income not dependent upon the extraction of the mineral.[61] Alternatively, taxpayers argued an absolute sale on an installment basis. Such provisions have included guaranteed minimum royalties,[62] backlog provisions,[63] recoupment clauses,[64] payments whether or not mineral is extracted[65] and requirements clauses.[66] Such provisions will not de-

56. Commissioner v. Southwest Exploration Co., 350 U.S. 308, 314 (1956).

57. *Id. See* Helvering v. Elbe Oil Land Dev. Co., 303 U.S. 372 (1938).

58. Ray v. Commissioner, 32 T.C. 1244, 1254 (1959), *aff'd*, 283 F.2d 337 (5th Cir. 1960). The doctrine of substance over form will control where the conveying document is styled as a sale, although the presence of language of sale will be relevant. Vest v. Commissioner, 481 F.2d 238, 243 (5th Cir. 1973); Lesher v. Commissioner, 73 T.C. 340, 353 (1979).

59. Lesher v. Commissioner, 73 T.C. 340 (1979), *citing* Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956), and Helvering v. Elbe Oil Land Dev. Co., 303 U.S. 372 (1938).

60. Commissioner v. Southwest Exploration Co., 350 U.S. 308, 314 (1956).

61. *See* Hartman Tobacco Co. v. United States, 471 F.2d 1327, 1329 (2d Cir. 1973).

62. The presence of a minimum royalty provision is merely an advancement for future payments in the form of a guarantee and does not render payment dependent on a factor other than extraction or production. Wood v. United States, 377 F.2d 300 (5th Cir. 1967), *cert. denied* 389 U.S. 977 (1967).

63. Backlog provisions that specify any payments made which exceed the amounts due for mineral actually removed would be credited against amounts owed in excess of a minimum annual royalty in subsequent years will not defeat retention of an economic interest. Gitzinger v. United States, 404 F.2d 191 (6th Cir. 1968).

64. Payments of advance royalties paid up front but recoupable out of production will not defeat retention of an economic interest. O'Connor v. Commissioner, 78 T.C. 1 (1982).

65. A contract to make an annual payment whether or not extracted will not defeat retention of an economic interest. Rutledge v. United States, 428 F.2d 347, 349 (5th Cir. 1970).

66. A contract that specified payment based upon cents per cubic yard of fill dirt, and required

feat retention of an economic interest, and capital gain will be denied the taxpayer.

Transactions have been held to be sales rather than leases where there has been conveyed (i) all,[67] or (ii) a specific predetermined quantity of minerals in place,[68] (iii) for a fixed consideration.[69] Where a fixed quantity (sixty-five percent) of the mineral was transferred for a fixed consideration and the transferee received one-year options to purchase the remaining thirty-five percent in increments of 50,000 or more cubic yards, the Fifth Circuit held that the original transfer had sufficient significance, independent of the options, to be treated as a sale.[70] The IRS agreed with the Fifth Circuit in Revenue Ruling 82-221[71] and held that such a transaction constituted a sale. However, the holding stated that "the nature and tax consequences of the option would have to be considered based on all the facts and circumstances, when and if it is exercised."[72]

Timber

Timber is a depletable natural resource for federal income tax purposes, but the depletion allowance for timber is only cost, not percentage depletion, and computed solely upon the adjusted basis of the property.[73] Timber is not categorized as a "natural deposit," but a separate natural resource granted a depletion allowance.[74]

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that a minimum of 400,000 cubic yards would be removed, but that quantities could be adjusted based on requirements did not defeat retention of an economic interest. Laudenslager v. Commissioner, 305 F.2d 686 (3d Cir. 1962).

67. *See* Rhodes v. United States, 464 F.2d 1307 (5th Cir. 1972).

68. *See* Gowans v. Commissioner, 246 F.2d 448 (9th Cir. 1957). A fixed price per ton is not a fixed quantity. Gitzinger v. United States, 404 F.2d 191 (6th Cir. 1968); Wood v. United States, 377 F.2d 300 (5th Cir. 1967), *cert. denied* 389 U.S. 977 (1967).

69. Vest v. Commissioner, 481 F.2d 238 (5th Cir. 1973).

70. Whitehead v. United States, 555 F.2d 1290 (5th Cir. 1977).

71. Rev. Rul. 82-221, 1982-2 C.B. 113.

72. *Id.* at 115.

73. Treas. Reg. § 1.611-1(a)(1) (1960). A complete discussion of the depletion allowance for timber is outside the scope of this article. Briefly stated, the depletion unit for timber is the quotient obtained by dividing (i) the adjusted basis of merchantable timber by (ii) the timber block merchantable timber quantity. Treas. Reg. § 1.611-3(b)(2) (1960). The amount of depletion allowable for the taxable year is obtained by multiplying the number of units of timber of a given timber account cut during any taxable year by the depletion unit of that timber account applicable to such year. Treas. Reg. § 1.611-3(b)(2) (1960).

The total units (board feet measure, log scale, cords or other units) of merchantable timber standing in a timber account must be carefully estimated as nearly as possible on the date of acquisition. The original estimate must be revised when increases or decreases occur in the number of units of timber available for utilization. Such increases or decreases occur from growth of the timber, changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work. Treas. Reg. § 1.611-3(e) (1960).

The adjusted basis of merchantable timber is the cost or other basis increased by all subsequent allowable capital additions in each timber account and decreased by adjustments to basis provided in § 1016 and the regulations thereunder, including depletion allowances previously allowed. Treas. Reg. § 1.611-3(c)(1) (1960).

74. Although timber was not specifically mentioned in depletion legislation until the Revenue Act of 1918, ch. 18, §§ 214(a)(10) and 234(a)(9) (the corresponding provision for corporations), 40 Stat. 1057, 1067, 1078 (1918), timber was by regulation afforded depreciation based upon cost, or actually cost depletion. Income Tax Regulations, No. 33, Art. 139 (1914). Section 214(a)(10) of the Revenue Act of 1918 placed timber in a separate category from other natural deposits: "[i]n the

Timber is defined in the Regulations for purposes of sections 631(a) and (b) as including evergreen trees more than six years old at the time severed from their roots and sold for ornamental purposes.[75] Timber has been parenthetically defined as "merchantable timber of cutting size and smaller young growth of appraisable value."[76] Timber is further defined by secondary authority as the total of all rights to standing trees suitable for the production of lumber, pulpwood, veneer, poles, pilings, crossties and other wood products.[77]

With the exception of evergreen trees defined in Treasury Regulation section 1.631-1(b)(2), the term "timber" is restricted to standing trees.[78] Components of trees and tops and limbs of severed trees are not considered timber.[79]

Taxpayers who sell timber may have some or all of the gain realized treated as capital gain if the timber is sold (i) in a lump sum transaction,[80] (ii) in a transaction by which the taxpayer elects to treat cutting as a sale or exchange,[81] (iii) as a disposal with a retained economic interest[82] or (iv) under a long-term lease.[83] Conversely, losses incurred by taxpayers on sales of timber may be capital losses if incurred in a lump-sum transaction or long-term lease where the timber is a capital asset in the hands of the taxpayer or ordinary losses if incurred in transactions under Code sections 631(a) or 631(b).[84]

Lump-Sum Sales

The gain or loss on sale of standing timber will be capital in nature if the timber is a capital asset in the hands of the taxpayer under Code section 1221. The pertinent holding period (twelve months) requirement will determine whether the gain or loss is long or short term. In timber transactions, the primary issue has been whether or not the timber is a capital asset in the hands of the taxpayer. A capital asset includes property held by the taxpayer whether or not connected with his trade or business, but does not include property held for sale to customers in the ordinary course of the taxpayer's trade or business.[85] Farmers who sell timber in a series of trans-

case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion. . . ." The segregation of timber from other natural deposits was made by amendment during House consideration of the Revenue Act of 1918. 56 CONG. REC. H10538-10539 (daily ed. Sept. 20, 1918) (statements of Reps. Hawkins and Kitchin).

75. Treas. Reg. § 1.631-1(b)(2) (1960).

76. Rev. Rul. 62-81, 1962-1 C.B. 153, 154.

77. U.S. DEP'T OF AGRICULTURE, THE TIMBER OWNER AND HIS FEDERAL INCOME TAX 13 (1975).

78. United States v. Brown Wood Preserving Co., 275 F.2d 525, 528 (6th Cir. 1960).

79. *Id.*; Rev. Rul. 56-434, 1956-2 C.B. 334-36.

80. *See* I.R.C. § 1221 (West Supp. 1983).

81. I.R.C. § 631(a) (West Supp. 1983).

82. I.R.C. § 631(b) (West Supp. 1983).

83. Rev. Rul. 62-81, 1962-1 C.B. 153.

84. I.R.C. § 1231(b)(2) includes timber to which section 631 applies in the definition of property used in a trade or business.

85. I.R.C. § 1221(1) (West Supp. 1983).

actions may be subject to the query of sales to customers in the ordinary course of business. Such a determination is a question of fact[86] and under the principles of *Malat v. Riddell*,[87] primarily means "principally" or "of first importance." Courts have included in the determination such factors as (i) "the nature of the acquisition of the property," (ii) "the frequency and continuity of transactions over a period of time as distinguished from isolated transactions," (iii) "substantiality of transactions," and (iv) "the activity of the seller with respect to that property."[88] Although timber may have been acquired for investment, that factor alone is not controlling and, as stated by the Tax Court, "such purpose 'has no built-in perpetuity nor a guarantee of capital gains forevermore.' "[89]

Election to Treat Cutting as a Sale or Exchange

Section 631(a) of the Code provides that "[i]f the taxpayer so elects on his tax return for a taxable year, the cutting of timber (for sale or for use in [his] 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 1 year) shall be considered as a sale or exchange of such timber cut during such year."[90] For the farmer, section 631(a) is important only if he cuts his own timber for sale or for use in his business,[91] and if he does, it is important to remember that while the provision eliminates consideration of the status of the timber as a capital asset, section 631(a) (i) is elective and binding after election, (ii) it makes the *cutting* of timber a taxable event, not the subsequent sale and (iii) any gain will be capital gain to the extent of the fair market value of the timber, not the amount realized.

The benefits of section 631(a) are available either to the timber owner or to one who has a contract right to cut timber. "In order to have a 'contract right to cut timber' . . . [the contract holder] must have the right to sell the timber cut under the contract on his own account or to use such cut timber in his trade or business."[92] Such a right constitutes a proprietary interest in such timber and the holder must have an unrestricted right to sell

86. Kirby Lumber Corp. v. Phinney, 412 F.2d 598 (5th Cir. 1969).

87. Malat v. Riddell, 383 U.S. 569, 572 (1966).

88. Wineberg v. Commissioner, 20 T.C.M. 1715, 1747 (1961 C.C.H.), *aff'd*, 326 F.2d 157 (9th Cir. 1964). According to the Fifth Circuit in Kirby Lumber Corp. v. Phinney, 412 F.2d at 600, "[w]e may consider the nature and character of the taxpayer's title, reason, purpose, and intent of acquisition and ownership, its duration, taxpayer's vocation, extent of its activities, extent and nature of efforts to sell, and such like."

89. Powe, Trust v. Comm'r., T.C.M. 1982-488, 2214 (P-H), *citing* Biedenharn Realty Co. v. United States, 526 F.2d 409, 421 (5th Cir. 1976).

90. I.R.C. § 631(a) (West Supp. 1983). The gain or loss is subject to the rules of § 1231. I.R.C. § 1231(b)(2).

91. The timber must be cut by or for the taxpayer and the cut timber must be for sale or for use in the taxpayer's trade or business. Timber cut for personal consumption, such as firewood, will not qualify. Treas. Reg. § 1.631-1(a)(4) (1960).

92. Treas. Reg. § 1.631-1(b)(1) (1960).

the cut timber or use it in his trade or business.[93]

The election is made on the taxpayer's tax return, not on an amended return, and is made in the form of computations under sections 631(a) and 1231.[94] The election applies to all timber owned by the taxpayer or to which the taxpayer has a contract right to cut.[95] The election is binding for the taxable year and for all subsequent taxable years, unless the IRS, on showing of undue hardship, permits revocation.[96] The tax consequences of the election are that the cutting of timber is considered a sale or exchange of the timber and gain or loss is 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."[97] The timber cut shall be considered as property used in the trade or business of the taxpayer for purpose of section 1231 irrespective of the actual purpose for which the timber is held.[98] Therefore, it is immaterial whether the timber is property held by the taxpayer for sale to customers in the ordinary course of his trade or business.

Since the cutting rather than an actual sale or exchange of timber is the taxable event, gains or losses are computed whether or not the taxpayer subsequently sells the timber he has already cut. Whether such gain or loss will be considered as a gain or loss resulting from a sale or exchange of capital assets "depends upon the application of section 1231 to the taxpayer for the taxable year."[99] Moreover, because gains or losses are determined by reference fo fair market value, rather than amount realized, the determination of fair market value of the timber must be made, according to the Regulations, in light of the most reliable and accurate information available with reference to the condition of the property as it existed on the first day of the taxable year in which it was cut, regardless of all subsequent changes.[100] Although the value sought will be the selling price between a willing seller and a willing buyer as of that particular day, the Regulations provide that certain facts will be taken into consideration.[101] Those factors, described in the Regulations under section 611, include (i) the character and quality of the timber as determined by species, age, size and condition, (ii) the quantity of the timber, (iii) accessibility of the timber from the standpoint of probable

93. Rev. Rul. 58-295, 1958-1 C.B. 249. According to the Ninth Circuit, similar restrictions do not apply to the owner of timber who does not have to possess an unrestricted right to sell or use the timber. Weyerhaeuser Co. v. United States, 402 F.2d 620 (9th Cir. 1968).

94. Treas. Reg. § 1.631-1(c) (1960).

95. Treas. Reg. § 1.631-1(a)(4) (1960).

96. Treas. Reg. § 1.631-1(a)(3) (1960). Such revocation shall preclude any further elections except with consent of the Commissioner. *Id.*

97. I.R.C. § 631(a) (West Supp. 1983).

98. Treas. Reg. § 1.631-1(d)(4) (1960).

99. *Id.* In general, section 1231 provides that the taxpayer must aggregate his recognized gains and losses from (i) section 1231(b) assets and (ii) involuntary conversion of capital assets held for more than 12 months. If § 1231 gains exceed § 1231 losses, the gains and losses are treated as long-term capital gains and losses. If § 1231 gains do not exceed § 1231 losses, the gains and losses are treated as ordinary gains and losses. Treas. Reg. § 1.1231-1(b) (1960).

100. Treas. Reg. § 1.631-1(d)(2) (1960).

101. *Id.*

cost of cutting and transportation, (vi) climate and state of industrial development of the locality and (v) freight charges to market.[102]

Disposal of Timber with a Retained Economic Interest

Legislation was enacted in 1943 to grant capital gain/ordinary loss treatment to timber owners who disposed of their timber under cutting contracts.[103] According to the legislative history, owners who sold their timber under cutting contracts under which the owner retained an economic interest in the property were held to have leased their property, by analogy to the oil and gas leases, and not afforded capital gain treatment.[104] The classic definition of a "cutting contract" is a contract that provides for timber to be sold on the stump, cut by the vendee, measured after cut and payment is made on a per-unit cut basis.[105] The essential elements of section 631(b)[106] are that one must be in the first instance an owner of the timber. An owner by statutory definition includes a sublessor and a holder of a contract right to cut timber. Second, there must be a disposal of the timber. Third, the disposal must be under "any form or type of contract." Fourth, under such contract the owner must have retained an economic interest in the timber and fifth, there is the capital gain holding period requirement.

For purposes of section 631(b) an owner "means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber."[107] However, the owner of such 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)."[108] The right of an owner to cut and sell the timber for his own account is important in order to prevent transactions that would superfluously transfer ownership.[109] It is not necessary for legal title to pass in order to qualify as an owner. Equitable ownership in a timber sales contract is sufficient, as in a conditional sales contract with the legal title retained by the timber owner for security.[110] However, equitable or beneficial ownership will not extend

102. Treas. Reg. §§ 1.631-1(d)(2) and 1.611-3(f)(1) (1960).

103. Revenue Act of 1943, ch. 63, § 127(a), 58 Stat. 21, 46-47 (1944).

104. S. REP. NO. 627, 78th Cong., 1st Sess. 25, 26 (1943), 1944-2 C.B. 973, 992. As stated by the Fifth Circuit, "[W]here the owner granted the right to cut and remove the timber to another, reserving a royalty interest to himself, the Internal Revenue Service, by analogy to the oil and gas situation, might have accorded ordinary income treatment to the royalties received." Dyal v. United States, 342 F.2d 248, 251 (5th Cir. 1965).

105. *See, e.g.*, Estate of Lawton v. Commissioner, 33 T.C. 47 (1959); Wilson v. Commissioner, 26 T.C. 474 (1956); Boeing v. United States, 98 F. Supp. 581 (Ct. Cl. 1951).

106. I.R.C. § 631(b) (West Supp. 1983) states:
> In the case of the disposal of timber held for more than 1 year 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.

107. *Id.*

108. Treas. Reg. § 1.631-2(e)(2) (1960).

109. *See* Schnitzer v. United States, 69-1 U.S.T.C. ¶ 9160 (C.C.H.) (D. Ore. 1968).

110. *See* Wilson v. Commissioner, 26 T.C. 474 (1956); Barclay v. United States, 333 F.2d 847 (Ct. Cl. 1964).

so far as to include as an owner one who has contracted to perform logging operations and who has apparently assumed the economic risk of the logging operation.[111]

A disposal is something less than a completed sale of the timber since the disposal must be made with an economic interest retained.[112] In *Boeing v. United States*,[113] a clause in a contract granting the right "to cut, remove and appropriate all merchantable timber" was insufficient to overcome the entire contract that showed a completed sale. The disposal must be of standing timber, not cut logs.[114] One of the reasons for this requirement is to avoid conflict between sections 631(b) and 631(a). If a taxpayer who was in fact selling cut timber were allowed to characterize such sale as a disposal with a retained economic interest, as stated by the Fifth Circuit, "the binding election of section 631(a) would effectively be read out of the statute."[115] A disposal also contemplates transfer of the cutting rights to the timber.[116] The most emphasized factor in the determination of whether or not there is a disposal is the party who actually cuts the timber.[117] If the seller cuts the timber himself, the disposition time shifts from the time of contracting to the time of the actual delivery of the logs and he has, at that time, sold cut timber. Where the buyer cuts and removes, there is generally little question that there has been a prior contractual disposal. Where the seller hires an independent contractor to perform the cutting, there is a division of authority. The Tax Court in *Ray v. Commissioner*[118] held that there had been no disposal because the seller chose the independent contractor, directed the operations and had the primary obligation to cut, remove and ship the timber. The Fifth Circuit in *Dyalwood v. United States*[119] held that there was no disposal based upon the fact that the seller owned the cutting rights and hired a contractor to do the cutting for it. The Ninth Circuit, in *United States v. Giustina*,[120] passed over the agency issue even though the cutting buyer was a wholly-owned subsidiary of the seller partnership because there were express contractual terms that the buyer, not the seller, was to perform the cutting.[121] The Court of Claims has been the most liberal in its treatment of the disposal issue. In *Barclay v. United States*,[122] plaintiff partnership bought timber cutting rights from the Secretary of the Interior. Plaintiff individuals then formed a corporation for the sole purpose of securing capi-

111. Ellison v. Frank, 245 F.2d 837, 840 (9th Cir. 1957).
112. See Boeing v. United States, 98 F. Supp. 581, 585 (Ct. Cl. 1951) where the court stated: "A stranger in going through this entire contract looking for some clause reserving an economic interest would have difficulty in finding a peg on which to hang his hat."
113. 98 F. Supp. 581 (Ct. Cl. 1951).
114. Barclay v. United States, 333 F.2d 847, 854 (Ct. Cl. 1964).
115. Dyalwood, Inc. v. United States, 588 F.2d 467, 469 (5th Cir. 1979).
116. Ray v. Commissioner, 32 T.C. 1244, 1251 (1959), *aff'd*, 283 F.2d 337 (5th Cir. 1960).
117. Dyalwood, Inc. v. United States, 588 F.2d at 470.
118. 32 T.C. 1244.
119. 588 F.2d 467.
120. 313 F.2d 710 (9th Cir. 1962).
121. *Id.*
122. 333 F.2d 847.

tal gain treatment of the income derived from the timber and, said the court, "this could be done only by a transfer to the corporation of plaintiff's rights of ownership in the timber. . . ."[123] There were no written and no oral contracts as such. The parties were dealing with themselves, as individuals on the one hand, as partners on another, and as officers of the corporation on another. The partnership did the logging, making an agency issue of the situation. Because the partnership was paid by the corporation, the court held that it must have cut down trees as the agent of the corporation and held a qualified disposal. In the case of *Varn, Inc. v. United States*,[124] the Court of Claims held a qualified disposal where the taxpayer obtained a loan from a paper company, in exchange for which the taxpayer agreed to supply pulpwood to the paper company from land that he owned. Plaintiff then contracted with a related corporation by an oral agreement that the corporation would arrange for the cutting and pay the plaintiff the going stumpage rate. The court held a qualified disposal. The facts in *Dyalwood* and *Varn* were nearly identical, yet the Court of Claims in *Varn* found a qualified disposal and the Fifth Circuit in *Dyalwood* did not. The Fifth Circuit in *Dyalwood* distinguished *Varn* by stating that the *Varn* court found a valid disposal not between the seller and ultimate buyer, but between the seller and the independent contractor that did the cutting.[125]

The contract requirements are statutorily liberal. An oral contract would be sufficient.[126] However, "a loose, oral arrangement terminable at the will of either party," of no express duration, and putting no obligation on buyer to cut and remove the timber is insufficient as a contract.[127] Although the contract requirements are broad, there must be in fact a contract. In *Ah Pah Redwood v. Commissioner*,[128] the Ninth Circuit held that there was no contract, not because it had not been written but because the oral arrangement was that the petitioner had "allowed" the buyer to "start cutting timber."[129]

The most important and most litigated issue of section 631(b) is the essential element of retained economic interest. At the time the provision was enacted, it was felt that the reservation of a royalty interest in timber would mean taxation at ordinary income rates subject to depletion. Section 631(b) reverses the tax consequences and grants capital gain/ordinary loss treatment to one who retains an economic interest. It has been held, however, that the same economic interest test applies to timber as to the other

123. *Id.* at 854.

124. 425 F.2d 1231 (Ct. Cl. 1970).

125. 588 F.2d at 471, n.2.

126. Ah Pah Redwood Co., v. Commissioner, 26 T.C. 1197 (1956), *rev'd on other grounds*, 251 F.2d 163 (9th Cir. 1957).

127. Jantzer v. Commissioner, 284 F.2d 348, 350 (9th Cir. 1960). The Ninth Circuit held that there was no contract but a continuing offer to sell. *Id.* at 357.

128. 251 F.2d 163 (9th Cir. 1957).

129. *Id.* at 167.

depletable resources.[130] When timber cutting contracts deviate from the classic model[131] payments under such contracts could be construed as payments from other than the proceeds of the timber, thus not satisfying the second part of the economic interest test, i.e., "income derived from . . . severance of the timber, to which he must look for a return of his capital."[132] The matter of advance payment (advance minimum royalties) is the deviation most frequently litigated. The regulations provide that amounts received prior to cutting shall be treated "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."[133] Courts have held however, that if such payments are *guaranteed*, the taxpayer has not satisfied that portion of the economic interest test that requires him to look solely to the proceeds of the resource for return of his capital.[134]

Taxpayers have argued that a guaranteed income does not defeat a retained economic interest in other natural resource cases and therefore, a similar result should obtain with respect to timber.[135] In *Crosby v. United States*,[136] the Fifth Circuit held that the taxpayers had not retained an economic interest in timber under a contract whereby they were entitled to receive guaranteed quarter-annual payments based upon a minimum fee schedule or upon the actual average growth of the timber, if greater. There existed a timber backlog provision, entitling the buyer to later cut timber previously paid for. Payments were to be made whether or not timber was actually cut. The court held the taxpayers had not retained an economic interest because there existed the possibility that payments could be received "without a single tree ever being cut"[137] and further held the advance royalty regulations inapplicable since there was no such guarantee. The Elev-

130. In Ray v. Commissioner, 32 T.C. 1244, 1254 (1959), the Tax Court, quoting from *Godshall v. Commissioner*, 13 T.C. 681 (1949), stated:

> '[T]he essential test is whether or not a taxpayer held an economic interest in minerals in place. If he did, the amounts paid him out of the proceeds of their production constitute ordinary taxable income, and he is entitled to a deduction for depletion.' We think it clear that the same rules are applicable to timber properties.

See also Lawton v. Commissioner, 33 T.C. 47, 53-4 (1959) where the Tax Court stated:

> Economic interest is the right to share in the proceeds of the natural resource (here timber). Recovery of the capital investment must be conditioned upon severance of the timber.
>
> * * *
>
> *See* Lincoln D. Godshall, 13 T.C. 681 (1948) [sic], where we held that the taxpayer had reserved an economic interest in a mining property since the rental payment received under an instrument, styled as a lease, was wholly contingent on what the lessee could or would produce from the mineral property. The same principal has been applied in the case of timber properties.

131. *See* cases collected *supra*, note 105.

132. Treas. Reg. § 1.611-1(b)(1) (1960).

133. Treas. Reg. § 1.631-2(d)(1) (1960).

134. *See* Plant v. United States, 682 F.2d 914 (11th Cir. 1982), *cert. denied*, 103 S. Ct. 1771 (April 18, 1983); Crosby v. United States, 414 F.2d 822 (5th Cir. 1969); Dyal v. United States, 342 F.2d 248 (5th Cir. 1965); Huxford v. United States, 299 F. Supp. 218 (N.D. Fla. 1969); Gammill v. Commissioner, 62 T.C. 607 (1974).

135. *See* Plant v. United States, 682 F.2d at 917.

136. 414 F.2d 822 (5th Cir. 1969).

137. *Id.* at 825.

enth Circuit in *Plant, Jr. v. United States*[138] held that *Crosby* controlled its decision.[139] The taxpayers in *Plant* argued that after *Crosby*, Regulation section 1.631-2(d)(2) which provides a recomputation feature,[140] would have no meaning because the regulations come into play only where an economic interest is retained and *Crosby* precludes any such interest in a factual situation covered by the regulation. The Eleventh Circuit stated:

> The *Crosby* court obviously did not consider the effect of 2(d)(2) because its applicability is premised on 2(d)(1). The court held that 2(d)(1) governs only advance payments received from timber which the contract *guarantees* will be cut at a subsequent date. Here, as in *Crosby*, there is no such contractual requirement. For that reason, subsection 2(d)(1) and hence 2(d)(2) have no significance.[141]

The holding period is one year prior to the date of disposal.[142] The date of disposal is deemed to be the date such timber is cut, unless prior payment is made under the contract. If so, the owner may elect to treat the date of payment as the date of disposal.[143] The amount of the gain is the difference between the amount realized and the adjusted basis for depletion. The gain or loss will be considered as though it were a section 1231 gain or loss, as the case may be, on the sale of such timber.[144]

Long-Term Leases

Many cutting contracts have involved considerations other than payment from the proceeds of the timber, thus violating the provisions of section 631(b) and related case law. Such contracts are frequently for terms of years, and so are termed long-term leases. In the long-term lease, in addition to the right of the lessee to cut and remove a certain number of cords of timber per year, other terms have included various combinations of the following: (i) terms in excess of forty years, (ii) fixed annual rental on a per-acre basis, (iii) payments made on the growth of the timber subject to periodic adjustments, (iv) acquisition by lessee of exclusive use and control of the land for timber farming or tree farming, (v) requirement that the lessee manage and operate land and timber in accordance with good forestry practices so that the average annual growth is not less than the amount cut and removed annually, (vi) acquisition by the lessee of other rights, such as mineral, water, hunting, grazing, rights of way, and easements and surface rights

138. 682 F.2d 914 (11th Cir. 1982).

139. The case was decided by a three-judge panel of the reconstituted Eleventh Circuit and under Bonner v. City of Prichard, 661 F.2d 1206 (11th Cir. 1981), the case law of the former Fifth Circuit was adopted by the Eleventh Circuit as binding unless and until overruled or modified by the Court sitting *en banc*. *Plant*, 682 F.2d at 915, n.1.

140. Treas. Reg. § 1.631-2(d)(2) (1960). It is provided that if the right to cut timber terminates before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and recompute his tax liability for the year in which such payments were received or accrued, by an amended return where necessary.

141. *Plant*, 682 F.2d at 917, n.11.

142. I.R.C. § 631(b) (West Supp. 1983).

143. Treas. Reg. § 1.631-2(b)(1) (1960).

144. Treas. Reg. § 1.631-2(a)(2) (1960).

including rights needed for the purpose of removing timber, (vii) payments by lessee of ad valorem and severance taxes, (viii) minimum annual or other guaranteed minimum payments.

Revenue Ruling 62-81 (followed by Revenue Ruling 62-82)[145] provided that such contracts are not qualfied disposals under section 631(b). However, such a contract will accomplish a sale of timber existing at the date of the contract since only timber in existence can be the subject of a present sale. Payments equal to the fair market value of such timber are the proceeds of such a sale and the gain is capital gain if the conditions in Code section 1221 or 1231 are met.

A taxpayer who disposes of his timber under section 631(b) is relieved from the requirement that the timber be a capital asset in his hands. Moreover, the gain is the difference between the amount realized and the adjusted basis for depletion. In the long-term lease, in order to qualify for capital gain treatment, the timber must pass the capital asset test and the gain is the difference between the fair market value of the timber and the adjusted basis for depletion. Finally, gains or losses are considered section 1231 gains or losses for purposes of section 631(b). In a long-term lease, in order to qualify for section 1231 treatment, the timber must pass the section 1231 trade or business test.

Coal and domestic iron ore are granted capital gain treatment for a disposal with a retained economic interest by virtue of section 631(c).[146] Section 631(c) provides similar requirements and restrictions as section 631(b).[147] However, in the case of coal, Revenue Procedure 77-11[148] sets out conditions for the issuance of rulings as to whether advance royalties will be treated as capital gain from a disposal.

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145. Rev. Rul. 62-81, 1962-1 C.B. 153; Rev. Rul. 62-82, 1962-1 C.B. 155, *amplified by* Rev. Rul. 78-267, 1978-2 C.B. 171.

146. I.R.C. § 631(c). Section 631(c), granting the same treatment to coal that section 631(b) gave to timber, was enacted in 1951. Revenue Act of 1951, ch. 521, § 325, 65 Stat. 452, 501 (1951). At that time there was also a perceived inequity in the tax treatment of owners of retained economic interests in coal. This perception was not based upon the question of whether or not a transfer of an interest in coal constituted a sale or lease, as in the case of timber, but upon royalties that were fixed at cents per ton, many of which were at extremely low rates. *See* Sentate discussion, 97 CONG. REC. S11737-11740 (daily ed. Sept. 20, 1951).

147. The requirements for capital gain treatment under section 631(c) are similar to those of section 631(b). In the case of *Omer v. United States*, an owner of surface lands was denied capital gain treatment of proceeds under a strip mining lease. The taxpayer owned only the surface rights to the land, the underlying coal having been previously conveyed away by the taxpayer's predecessor in title. The taxpayers argued that they had retained an economic interest in the underlying coal because the coal could only be strip-mined, thus destroying their land. They relied on *Commissioner v. Southwest Exploration Company*, where the Supreme Court had held that a party essential to the drilling for and extraction of oil has made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share of the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received. The Sixth Circuit held that *Southwest* was not controlling, because that case involved depletion and did not present the question of capital gain treatment. The Court held that section 631(c) should be narrowly construed. Omer v. United States, 329 F.2d 393 (6th Cir. 1964).

148. Rev. Proc. 77-11, 1977-2 C.B. 568.