

Part I

Section 162.--Trade or Business Expenses

26 CFR 1.162-1: Business expenses.
(Also §§ 263, 263A; 1.263(a)-1)

Rev. Rul. 2004-62

ISSUE

Whether costs incurred by a timber grower for the post-establishment fertilization of an established timber stand are ordinary and necessary business expenses deductible under § 162 of the Internal Revenue Code or capital expenditures under § 263.

FACTS

X owns and manages timberlands in the United States on which it grows trees for use in its lumber and wood products business. After the target species of timber establishes dominance in an area and becomes an established timber stand, X incurs costs to perform various silvicultural practices for the purposes of managing, maintaining, and protecting the stand. These post-establishment silvicultural costs include labor and materials for fire, disease, insect, and brush control. X performs these silvicultural practices to maintain optimal growing conditions that will promote healthy development and maximize timber volume.

In 2004, X incurs costs to apply fertilizer to a portion of its timberlands underlying an established stand of trees. This application, commonly referred to as “post-establishment fertilization,” is performed after the target species of timber has established dominance in the stand. X generally performs post-establishment fertilization once during the long-term growth cycle of a timber stand. X performs the fertilization to supplement nutrients in the soil to maintain optimal growing conditions that will promote healthy development and maximize timber volume.

LAW AND ANALYSIS

Section 162 and § 1.162-1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a)(1) provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. See *also* § 1.263(a)-1(a).

Section 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt property to a new or different use. However, amounts paid or incurred for incidental repairs and maintenance of property for purposes of § 162 and § 1.162-4 are not capital expenditures under § 1.263(a)-1.

Section 263A generally provides that the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer must be capitalized. Section 263A(c)(5)(A) provides that § 263A shall not apply to trees raised, harvested, or grown by the taxpayer other than trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees more than 6 years old at the time severed from their roots).

Certain costs incurred by timber growers for silvicultural practices performed in established timber stands are ordinary and necessary business expenses deductible under § 162. These costs include amounts incurred for labor and materials for fire, disease, insect, and brush control. See *Barham v. United States*, 301 F. Supp. 43 (M.D. Ga. 1969), *aff'd on other grounds*, 429 F.2d 40 (5th Cir. 1970); H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-117 (1986); H.R. Rep. No. 426, 99th Cong., 1st Sess. 624 (1985). These costs are incurred for the management, maintenance, and protection of the timber stand. These costs are not incurred to materially add value to the timber stand, substantially prolong its useful life, or adapt the timber stand to a new or different use. Accordingly, these costs are not required to be capitalized under § 263.

Like fire, disease, insect, and brush control, post-establishment fertilization promotes healthy development and maximizes timber volume and is performed for the management, maintenance, and protection of the timber stand. There are no significant differences between post-establishment fertilization and the types of post-establishment silvicultural practices, such as brush control, that have previously been held to be ordinary and necessary business expenses deductible under § 162. Therefore, X's costs for post-establishment fertilization are deductible as ordinary and necessary business expenses under § 162. Furthermore, because X is growing trees for timber production, X is not required to capitalize the direct and indirect costs allocable to producing such trees under § 263A. See § 263A(c)(5).

HOLDING

Costs incurred by a timber grower for the post-establishment fertilization of an established timber stand are ordinary and necessary business expenses deductible under § 162.

CHANGE IN METHOD OF ACCOUNTING

Any change in a taxpayer's treatment of post-establishment fertilization costs to conform to this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer changing its method of accounting to comply with this revenue ruling must file a Form 3115 in accordance with the automatic change in method of accounting provisions of Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, except that the scope limitations in section 4.02 of Rev. Proc. 2002-9 are not applicable. For purposes of line 1a of Form 3115, the designated number for the automatic accounting method change authorized by this revenue ruling is "86."

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include in the APPENDIX the automatic change provided in this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Amy Pfalzgraf of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Pfalzgraf at (202) 622-4950 (not a toll-free call).