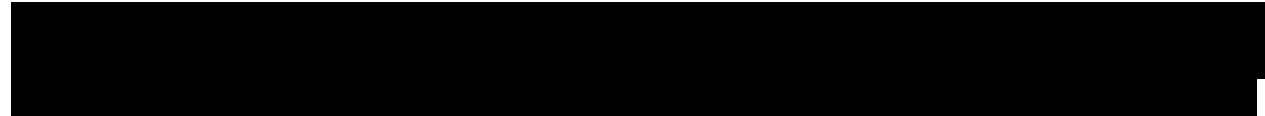


INTERNAL REVENUE SERVICE

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Senator Wellstone asked us to respond to your letter, dated April 30, 2000, concerning the tax treatment of reforestation expenditures.

Your questions are based on a part of the Internal Code (Code) dealing with capital expenditures. The Code sections overlap and one answer depends on another, so we have not answered each question separately.

Direct and indirect costs allotted to property produced by the taxpayer must be considered as capital expenditures. Capital expenditures are amounts paid or incurred to restore, add to the value of, or substantially prolong the useful life of property owned by the taxpayer (§ 263A). Capital expenditures generally cannot be deducted from gross income for the year you made them (“currently”). Rather, they must be charged to capital account and recovered through depreciation, depletion, or amortization. If the property is not subject to depreciation, depletion, or amortization, you recover the expenditures when the property is disposed of (§ 263).

Direct costs incurred in the reforestation of timberlands are capital expenditures. As capital expenditures, unless you have a special provision to the contrary, reforestation expenses are not deductible currently, but are charged to capital account and recovered through depletion when the timber is cut.

To promote reforestation on both private and public timberlands, in 1980, Congress enacted an exception to the capitalization requirement of §§ 263 and 263A. It allows a taxpayer to claim, over an 84-month period, an amortization deduction on up to \$10,000 of reforestation expenses each year (§ 194).

The Conference Report underlying § 194 explains that the limitation on the reforestation expenditures that could be amortized was intended to ensure that taxpayers get an equal tax benefit, without regard to the size of their timber enterprise. The Conference Report states that “the annual limitation on the dollar amount of expenditures which can be amortized by a taxpayer is intended to insure that these provisions allow only a

limited dollar benefit to any enterprise regardless of size.” Thus, for example, if an individual owns qualified timber property directly and is a partner in a partnership that owns qualified timber property, the maximum amount of reforestation expenditures on which the individual could obtain amortization is \$10,000, the same as that for an individual who only owns qualified timber property directly.

In addition to the tax benefit provided under § 194, a taxpayer may also claim the reforestation credit provided under § 48 for the taxable year the qualified timber property is acquired.

Thus, the Code, through the amortization deduction provided in § 194 and the credit provided in § 48 provides taxpayers a current tax benefit for expenditures that otherwise would be recovered years in the future when the timber is cut and sold.

To reconsider the Tax Code on reforestation, legislative action by the Congress is necessary.

If you have further questions, please call Brenda Stewart, ID# 50-06991, at (202) 622-3120.

Sincerely,

Joseph H. Makurath

Christine E. Ellison
Chief, Branch 7
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cc: The Honorable Paul D. Wellstone
United States Senate
Washington, D.C. 20510