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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR AREA COUNSEL,
SMALL BUSINESS/SELF-EMPLOYED

FROM: Associate Chief Counsel
(Income Tax and Accounting)

SUBJECT: Definition of Farming Business in § 448(d)(1)(B)

LEGEND

Taxpayer =

Taxable Years =

This Chief Counsel Advice provides a response to your memorandum dated March 27, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES:

1. Whether Taxpayer is a “farming business” as defined in § 448(d)(1)(B) and therefore excepted from the § 448 limitation on using the cash receipts and disbursements method of accounting (“cash method”) during the Taxable Years.

2. If Taxpayer is excepted from the § 448 limitation on using the cash method, whether its method of accounting clearly reflects income.

CONCLUSIONS:

1. Taxpayer is a "farming business" as defined in § 448(d)(1) only to the extent that Taxpayer raises timber or harvests timber that it raises; harvesting of timber grown by another does not constitute a "farming business" under § 448(d)(1).

2. Even if Taxpayer were entirely exempted from the § 448 limitation on use of the cash method, Taxpayer's use of an overall cash method would not clearly reflect its income because Taxpayer is required by § 471 to maintain inventories and to use an accrual method with respect to its purchases and sales of timber.

FACTS

Taxpayer is a privately held C corporation. The majority of the outstanding stock is held by an individual. His wife and their adult children hold the rest. Taxpayer maintains its books and records and computes its taxable income on the cash method. Taxpayer had gross receipts in excess of $ in the years prior to each of the Taxable Years.

The facts, as currently developed, present contradictory statements concerning Taxpayer's business activities.

On its Forms 1120 (U.S. Corporation Income Tax Returns) for the Taxable Years, Taxpayer listed its business activity as "wood operator" and its product or service as "pulpwood and logs."

Taxpayer's financial statements for the relevant years provide the following description. Taxpayer is a timber harvesting corporation. The company buys wood and stumpage from others, along with cutting its own land. This timber is sold to mills and other entities. Once the company's lands are fully cut, the lands are put up for sale. The company grants credit to customers.

An early letter from one of Taxpayer's representatives provides the following description. Taxpayer is a timber logging business. Taxpayer owns timberland on which trees are raised and grown, and eventually harvested for market. It also contracts with other timberland owners to harvest the timber on their land and to market it, if necessary.

Most recently, Taxpayer has provided the following description. Taxpayer's sole business is the harvesting of standing timber, both on land it owns and land owned by others. Taxpayer's harvesting activities involve different kinds of arrangements, as described below.

(1) “Controlled Property”: For standing timber on land owned by Taxpayer, its shareholders, or their affiliates, Taxpayer’s foresters would generally survey tracts of land to be cut, mark trees for cutting, and otherwise supervise the cutting. In general, the crews that did the actual cutting were employed by others operating under contract with Taxpayer.

(2) “Independent Property”: Taxpayer had timber purchase agreements with unrelated independent landowners. Taxpayer’s activities were virtually the same as when Taxpayer dealt with affiliated parties.

(3) “Financed Property”: Taxpayer had contractual harvesting agreements with third parties who identify and acquire tracts of land with financial assistance from Taxpayer. Taxpayer’s foresters or log buyers would survey the property in question, identify and price the marketable timber, provide purchase financing to the land buyer, and contract to acquire timber at the designated price.

(4) “Major Landowner Property”: Taxpayer had arrangements with major timber landowners. In some cases, Taxpayer contracted with the landowner to purchase timber, similar to the Independent Property arrangement. In other cases, the landowner hired Taxpayer as the harvesting company with the landowner designating the trees to be cut. Frequently, the landowner also designated where the wood was to be delivered.

(5) “Harvest Delivery Arrangements”: Taxpayer participated in the harvesting activities of others. Taxpayer authorized specific companies to deliver timber cut by such persons under Taxpayer’s contract with specific mills.

Taxpayer has submitted an unexecuted document entitled “Timber Sale Agreement.” The company identified as the seller is listed as a related party in the notes to the financial statements. That document provides that “All timber included in this agreement shall remain the property of the seller until paid for in full.” (Article 1, flush language.)

LAW

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 447(a)(1) provides the general rule that, except as otherwise provided by law, the taxable income from farming of a corporation engaged in the

trade or business of farming shall be computed on an accrual method of accounting. However, that general rule does not apply to the trade or business of operating a nursery or sod farm or to the raising or harvesting of trees (other than fruit and nut trees).

Section 448(a)(1) provides the general rule that, except as otherwise provided in § 448, taxable income shall not be computed under the cash receipts and disbursements method of accounting in the case of a C corporation.

Section 448(b)(1) provides that § 448(a)(1) does not apply to any farming business. Section 448(d)(1) defines a farming business for purposes of § 448. Pursuant to § 448(d)(1)(A), the term "farming business" means the trade or business of farming (within the meaning of § 263A(e)(4)). Pursuant to § 448(d)(1)(B), the term "farming business" includes the raising, harvesting, or growing of trees to which § 263A(c)(5) applies.

Section 1.448-1T(a)(2) provides that, except as provided in § 1.448-1T, the computation of taxable income using the cash method is prohibited in the case of a C corporation, a partnership with a C corporation as a partner, or a tax shelter.

Section 1.448-1T(a)(4) provides that, for purposes of § 1.448-1T, the use of a method of accounting that records some, but not all, items on the cash method shall be considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

Section 1.448-1T(c) provides that nothing in § 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from § 448 with respect to the application of any such provision. For example, nothing in § 448 affects the authority of the Commissioner under § 446(b) to require the use of an accounting method that clearly reflects income, or the requirement of § 1.446-1(c)(2) that an accrual method be used with regard to purchases and sales of inventory.

Section 1.448-1T(d)(2) provides that the term "farming business" means (i) the trade or business of farming as defined in § 263A(e)(4) (including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees), or (ii) the raising, harvesting, or growing of trees described in § 263A(c)(5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in § 1.448-1T(d)(2)(i)). The flush language of the regulation expressly provides that the term "farming business" includes the raising of timber. It also provides that the term "farming business" does not include the processing of commodities or products beyond those activities normally incident to the growing, raising, or harvesting of such products.

Section 263A(c)(5) provides that § 263A shall not apply to trees raised, harvested or grown by the taxpayer other than trees described in § 263A(e)(4)(B)(ii) (after application of the last sentence thereof), and any real property underlying such trees.

Section 263A(e)(4)(A) provides that the term "farming business" means the trade or business of farming. Section 263A(e)(4)(B) provides that the term "farming business" shall include the trade or business of (i) operating a nursery or sod farm, or (ii) the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. For purposes of clause (ii) of § 263A(e)(4)(B), an evergreen tree which is more than 6 years old at the time severed from the roots shall not be treated as an ornamental tree.

Section 471 provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. Inventories should include all finished or partly finished goods, and raw materials and supplies that have been acquired for sale or will be physically incorporated into merchandise intended for sale.

Section 1.471-1 provides that in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

Section 1.446-1(c)(2)(i) provides that in any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under § 1.446-1(c)(2)(ii).

Section 1.446-1(c)(2)(ii) provides that the Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method.

ANALYSIS:

We recommend that you consider the following arguments in your development of the case.

1. The exemption for “farming businesses” in § 448(b)(1).

Taxpayer is a C corporation. Section 448(a)(1) provides that, except as otherwise provided in § 448, a C corporation shall not compute its taxable income under the cash method. Section 448(b) sets forth certain exceptions to this requirement. Of these, the only potentially applicable exception is set forth in § 448(b)(1), which provides that § 448(a)(1) shall not apply to any “farming business.”

The definition of “farming business” for purposes of § 448(b)(1) is set forth in § 448(d)(1). The general definition is set forth in subparagraph (A), which provides:

> (A) In general.--The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).

Thus, § 448 incorporates the definition of “farming business” from the Uniform Capitalization (“UNICAP”) provisions of § 263A. Specifically, § 263A(e)(4) defines “farming business” as follows:

> (4) Farming business.--For purposes of this section--
> (A) In general.--The term "farming business" means the trade or business of farming.
> (B) Certain trades and businesses included.--The term "farming business" shall include the trade or business of--
> (i) operating a nursery or sod farm, or
> (ii) the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.
> For purposes of clause (ii), an evergreen tree which is more than 6 years old at the time severed from the roots shall not be treated as an ornamental tree.

Section 1.263A-4(a)(4)(i) elaborates that “farming business” means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. For purposes of this definition, harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another.

The definition of “farming business” under § 448 is extended to timber in subparagraph (B) of § 448(d)(1), which provides:

> (B) Timber and ornamental trees.--The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

Section 263A(c)(5) provides that § 263A shall not apply to trees raised, harvested, or grown by the taxpayer other than trees described in § 263A(e)(4)(B)(ii) (after application of the last sentence thereof), and any real property underlying such trees. Trees thus described in § 263A(e)(4)(B)(ii) are trees bearing fruit, nuts or other crops, and ornamental trees (but not including evergreen trees more than 6 years old when severed from the roots).

The effect of subparagraph (B) is to include timber within the UNICAP-based definition of "farming business" in § 448(d)(1)(A). In effect, timber is treated as if it were an agricultural or horticultural commodity for purposes of § 448(d)(1)(A) (and the provisions of § 263A(e)(4) incorporated therein). Under such definition, "farming business" includes the raising or harvesting of any agricultural or horticultural commodity, but harvesting does not include the contract harvesting of commodities grown or raised by another. § 1.263A-4(a)(4). Accordingly, for purposes of § 448, "farming business" includes the raising of timber and the harvesting of timber that has not been raised or grown by another.

As a result, Taxpayer qualifies for the "farming business" exception in § 448(d)(1) only to the extent that it grows trees or harvests trees that it grows. Taxpayer is not engaged in the farming business to the extent that it harvests trees that were grown or raised by another.

Taxpayer, however, argues that the "farming business" exception in § 448(d)(1) applies to the harvesting of all timber, without regard to whether the timber was grown by the harvester. This result follows, Taxpayer urges, from a strict and literal reading of § 448(d)(1)(B), which provides that the term farming business "includes the raising, harvesting, or growing" of timber. According to Taxpayer, the disjunctive "or" indicates each of the three activities are sufficient in themselves to constitute a farming business. Thus, Taxpayer concludes, § 448(d)(1)(B) allows a farming business to consist solely of harvesting timber, with no raising or growing being required. Although initially plausible, Taxpayer's interpretation of the farming business exception in § 448(d)(1) is a fundamental misconstruction of the statute that relies upon two erroneous assumptions.

First, Taxpayer artificially severs the definition of farming business in § 448(d)(1) into two separate components: subparagraph (A), defining "farming business" generally, and subparagraph (B), which includes the raising, harvesting, or growing of timber in the definition of "farming businesses." Taxpayer treats subparagraph (B) as a self-contained definition that is not subject to the general definition of farming business in subparagraph (A). Under this approach, the farming business exemption for taxpayers not in the timber business is governed by

subparagraph (A) and the UNICAP definition of "farming business" incorporated therein, while the farming business exemption for taxpayers in the timber business is governed solely by the terms of subparagraph (B) without reference to the UNICAP definition.

Taxpayer's approach is contrary to the language and design of the statute. Congress created a single exemption in § 448(b)(1) for a class of taxpayers known as "farming businesses." If Congress had intended to treat "farming businesses" involving timber differently from "farming businesses" involving other commodities, then Congress presumably would have created a separate exemption for the timber industry to reflect this intended difference in treatment. Instead, Congress included timber operations within the exemption for "farming businesses," which indicates that timber operators are subject to the same provisions as other taxpayers with regard to the exemption. Accordingly, subparagraph (B) should not be read in isolation from the general definition of subparagraph (A); rather, subparagraph (B) incorporates the general definition and extends it to timber operations.

The intent to integrate, rather than isolate, subparagraphs (A) and (B) is further reflected in the operative language of § 448(d)(1) (emphasis supplied):

> (A) In general.--The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).
> (B) Timber and ornamental trees.--The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies."

Subparagraph (A) frames the general definition using "means," a term ordinarily used to express exclusive or exhaustive meaning, while subparagraph (B) introduces the timber provision with "includes," a term typically employed to exemplify or expand a definition. See, e.g., Brown v. Scott Paper Worldwide Co., 20 P.3d 921, 926 (Wash. 2001); U.S. v. Massachusetts Bay Transportation Authority, 614 F.2d 27 (1st Cir. 1980); Highway and City Freight Drivers, Dockmen and Helpers, Local Union No. 600 v. Gordon Transports, Inc., 576 F.2d 1285, 1289 (8th Cir. 1978), cert. denied sub nom. Gordon Transports, Inc. v. Highway and City Freight Drivers, 439 U.S. 1002 (1978). This indicates that subparagraph (A) – with its incorporation of the UNICAP concept of "farming business" – furnishes the primary definition of "farming business," and subparagraph (B) expands this primary definition by including timber. Thus, a timber operation cannot be a farming business under § 448(d)(1) unless it engages in actual "farming" within the meaning of § 263A(e)(4), i.e., the cultivation of land or the raising or harvesting of an agricultural or horticultural commodity (including timber).

Taxpayer's second error is to impose a disjunctive reading on § 448(d)(1)(B), despite clear indications that such reading is contrary to Congressional intent. Under § 448(d)(1)(B), the term farming business includes the "raising, harvesting,

or growing" of timber. Taxpayer argues that the use of the disjunctive "or" indicates that the three activities are alternative, rather than cumulative, conditions. Thus, Taxpayer concludes, § 448(d)(1)(B) allows a farming business to consist solely of harvesting timber, with no raising or growing being required.

Again, Taxpayer's reading is initially plausible. The term "or" in a statute typically indicates disjunctive requirements or alternatives which operate independently of each other. But the proper construction of "or" in any particular instance is ultimately dependent upon the context in which it is used. Reiter v. Sonotone Corp., 442 U.S. 330, 338-39 (1979); U.S. v. One 1973 Rolls Royce, V.I.N. SRH-16266 By and Through Goodman, 43 F.3d 794 (3rd Cir. 1994) reh'g denied 1994 U.S. App. LEXIS 33185. Thus, the customary disjunctive reading of "or" does not apply where such reading leads to absurd or repellent results [George Hyman Construction Co. v. Occupational Safety and Health Review Commission, 582 F.2d 834 (4th Cir. 1978); Garratt v. City of Philadelphia, 127 A.2d 738 (Pa. 1956)], is contrary to legislative intent [U.S. v. Smeathers, 884 F.2d 363 (8th Cir. 1989); U.S. v. O'Driscoll, 761 F.2d 589 (10th Cir. 1985) Bruce v. First Federal Savings And Loan Association of Conroe, Inc., 837 F.2d 712 (5th Cir. 1988)], or is contrary to other provisions of the statute [In re Rice, 165 F.2d 617 (D.C.Cir. 1947); Gray Union Corp. v. Wallace, 112 F.2d 192, 196 (D.C.Cir. 1940)].

Where context indicates that the disjunctive reading is inappropriate, courts do not hesitate to interpret "or" as a conjunctive. For example, in Reliable Credit Association v. Commissioner, T.C. Memo. 1997-68, the Tax Court examined the requirement of § 1.6001-1(a) that taxpayers maintain books and records "as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax." Although the term "or" was used, the Court determined that a conjunctive reading (requiring taxpayers to comply with all of the listed items) was clearly more appropriate than a disjunctive reading (requiring taxpayers to comply with respect to any one of the listed items). The United States Supreme Court has even observed that "the word 'or' is often used as a careless substitute for the word 'and'; that is, it is often used in phrases where 'and' would express the thought with greater clarity. That trouble with the word has been with us for a long time: see, e.g., United States v. Fisk, 3 Wall. 445, 18 L.Ed. 243." De Sylva v. Ballentine, 351 U.S. 570, 573 (1956), rehearing denied 352 U.S. 859 (1956), rehearing denied, 362 U.S. 907 (1960).

In other situations, courts have interpreted "or" as a coordinating conjunction that joins related terms in a manner that may be neither purely disjunctive nor purely conjunctive. See People v. Swain, 959 P.2d 426 (Colo. 1998); State v. Ramsey, 430 S.E.2d 511, 514 (1993); Bowles v. Weiner, 6 F.R.D. 540 (E.D. Mich. 1947). For example, an insurance policy requiring the insurer to pay benefits for "loss of life, limbs, sight or time" could not sensibly be read in a purely disjunctive manner (to restrict recovery to instances where only one of the losses occurs) or a purely conjunctive manner (to restrict recovery to instances where all of the listed

losses occurr simultaneously). The context demands that "or" be read as a connector in a compound phrase, such that the insurer would be obliged to pay benefits when one or more of the listed losses occurs. See, e.g., Van Zanten v. National Casualty Co., 52 N.W.2d 581 (Mi. 1952).

As a further example, in Pittsburgh-Erie Saw Corp. v. Southern Saw Service, 136 F. Supp. 96 (N.D.Ga. 1955), modified by 239 F.2d 339 (5th Cir. 1956), cert. denied 353 U.S. 964 (1957), the Court examined a patent statute [35 U.S.C. § 252] that employed the phrase "made, purchased or used" in defining the creation of intervening rights with respect to an invention. Despite the use of "or," the Court declined to give the phrase a strict disjunctive or conjunctive reading. Instead, the Court concluded that Congress intended the phrase to have "substantially the meaning of 'made or purchased and used'." Thus, the requirements of the phrase would be satisfied in either of two instances: (i) 'made and used,' or (ii) 'purchased and used' – a reading that is neither purely conjunctive nor purely disjunctive.

The context surrounding "raising, harvesting or growing" in § 448(d)(1)(B) indicates that Taxpayer's mechanically disjunctive reading – raising *or* harvesting *or* growing – is incorrect. Properly construed, the phrase expresses the core concept of farming embodied in § 263A and other areas of tax law: farming is raising or growing; harvesting is part of farming only as an ancillary activity to the raising or growing.[1] This construction is confirmed by the following items of context.

First, under the UNICAP definition of "farming business" incorporated into § 448, harvesting does not include contract harvesting of plants grown by another. § 1.263A-4(a)(4)(i). Stated another way, harvesting on its own, without growing or raising, does not constitute a farming activity under §§ 263A and 448(d)(1).

Second, the notion that contract harvesting is not, in itself, a farming activity is not an innovation of § 263A; it is reflected in Maple Leaf Farms, Inc. v. Commissioner, 64 T.C. 438 (1975), the leading case on whether a taxpayer qualifies as a farmer. In analyzing this case, the Tax Court posits a continuum reflecting varying degrees of involvement in the raising of ducks. At one extreme, the taxpayer would clearly be a farmer if it carried on the growing process itself, even if that process did not occur on its own land. On the other end of the continuum, the Court observes, "is the situation which would exist if petitioner had in no way been involved in the growing of the ducks but had simply purchased matured ducks from growers and processed them; in such circumstances, it would not be considered a 'farmer.' Cf. N.L.R.B. v. Strain Poultry Farms, Inc., 405 F.2d 1025, 1028 (5th Cir. 1969)." 64 T.C. at 448.

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[1] We note that this meaning would not have been perfectly captured by substituting "and" for "or" in § 448(d)(1)(B), because that would have suggested (at least under a strict conjunctive reading) that only farmers that also harvest their own crops would be included.

Under the Tax Court's continuum, then, a taxpayer that bought, slaughtered and processed mature ducks would not be a farmer because it did not participate in the growing process of those ducks. It follows that a taxpayer that simply slaughtered mature ducks would also not qualify as a farmer. The analogous result must hold for plants: a taxpayer that buys, harvests and processes mature plants, or simply harvests such plants, is also not a farmer. In short, harvesting without growing does not constitute farming under the Maple Leaf Farms continuum.

After discussing the continuum, the Tax Court articulates a test reflecting the "two essential elements" in the decided cases: (i) does the taxpayer participate to a significant degree in the growing process, and (ii) does taxpayer bear a substantial risk of loss from the growing process. This widely cited text further underscores that the growing process is the indispensable core of a farming business. This idea is reiterated in the definitions of farming in §§ 1.61-4 and 1.175-3.

Third, Congress has previously taken the view that farming does not include contract harvesting. The Tax Reform Act of 1976 ("TRA 1976") (P.L. 94-455, Oct. 4, 1976) enacted § 464, which related to farming syndicates and set forth a definition of "farming," and § 447, which related to farming corporations. The legislative history of TRA 1976 expressly states that income from contract harvesting -- i.e., harvesting without raising -- is not income from a farming business for purposes of §§ 464 and 447. H.R. Rep. No. 94-658, 94th Cong., 1st Sess. (Nov. 12, 1975), at 46, 51 & 95; General Explanation of the Tax Reform Act of 1976 (H.R. 10612, 94th Cong., Public Law 94-455), Joint Committee on Taxation (Dec. 29, 1976) at 48, 53.

Fourth, Congress expressed its conclusion that farming does not include contract harvesting in the very sort of nominally disjunctive language that Taxpayer relies upon to establish the contrary conclusion. TRA 1976 set forth a definition of "farming" in § 464(e), which remains unchanged as § 464(e)(1) to this day:

> "The term "farming" means the cultivation of land or the *raising or harvesting of any agricultural or horticultural commodity* including the raising, shearing, feeding, caring for, training, and management of animals. For purposes of the preceding sentence, trees (other than trees bearing fruit or nuts) shall not be treated as an agricultural or horticultural commodity." [emphasis supplied][2]

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[2] Although the enacted definition of farming in § 464(e) excluded timber operations, we note that the House version (H.R. 10612) included timber operations within the definition of farming by providing that all trees would be treated as agricultural or horticultural commodities (H.R. Rep. No. 94-658 at 46), while also providing that income from contract harvesting of such commodities was not income from a farming business.

The definition uses the disjunctive "or" between raising and harvesting, which under the strict disjunctive reading urged by Taxpayer would indicate that harvesting is sufficient without raising. Yet the legislative history expressly states that income from contract harvesting -- i.e., harvesting without raising -- is not income from a farming business. This indicates Congress chose to express its view that farming excludes contract harvesting in disjunctive language ("raising or harvesting") that is very similar to the language of § 448(d)(1)(B) ("raising, harvesting, or growing"), which suggests in turn that Congress intended to express the same view in § 448(d)(1)(B).

Finally, Taxpayer's construction of "raising, harvesting, or growing" of timber in § 448(d)(1)(B) is inconsistent with the meanings attached to similar phraseology in § 263A, which was enacted at the same time as § 448(d)(1). Section 263A(e)(4)(B)(ii) provides that farming business includes "the raising or harvesting" of certain trees. The regulations, however, clearly state that contract harvesting – that is, harvesting without raising – is not a farming activity, which establishes that the "or" in this phrase is not used in a disjunctive sense. Rather, the phrase means either raising by itself or raising with harvesting, which is consistent with the rationale in Maple Leaf Farms.

In addition to the two erroneous assumptions discussed above, Taxpayer's construction of the farming business exception in § 448(d)(1) leads to the disparate treatment of taxpayers. Specifically, taxpayers in the timber industry would be entitled to the § 448(d)(1) exemption for any contract harvesting they performed under Taxpayer's strict disjunctive construction of § 448(d)(1)(B). The taxpayers in the almond or peach industries, by contrast, would not be entitled to the § 448(d)(1) exemption because contract harvesting is not farming under §§ 448(d)(1)(A) and 263A(e)(4). It is highly unlikely that Congress intended the farming business exception in § 448(d)(1) to apply in such an unequal and arbitrary fashion.

In sum, although initially plausible, Taxpayer's reading of § 448(d)(1) pursues the letter of the statute but ignores its purpose and substance. The result is a fundamental misconstruction of the statute which is contrary to legislative intent and would lead to anomalous results.

Accordingly, Taxpayer qualifies for the "farming business" exception in § 448(d)(1) only to the extent that it grows trees or harvests trees that it grows. Taxpayer is not engaged in the farming business, and does not qualify for the exception in §448(d)(1), to the extent that it harvests trees that were grown or raised by another.

Taxpayer is prohibited by § 448 from using the cash method with respect to activities not qualifying for the farming business exception in § 448(b)(1). Taxpayer is not prohibited by § 448 from using the cash method with respect to activities qualifying for the farming business exception in § 448(b)(1). § 1.448-1T(d)(1).

However, nothing in § 448 has any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference should be drawn from § 448 with respect to the application of any such provision. Specifically, nothing in § 448 affects the requirement of § 1.446-1(c)(2) that an accrual method be used with regard to purchases and sale of inventory (see discussion below). § 1.448-1T(c).

2. The use of inventories and the accrual method for timber purchases and sales.

As described above, Taxpayer engages in timber harvesting under a number of different arrangements. In some cases, Taxpayer apparently harvests timber on a fee for service basis, without ever obtaining any interest in the timber. In other cases, Taxpayer either holds or acquires an interest in standing timber, performs the harvesting, and then sells the resulting timber. The available facts indicate that the exact nature of the interest held or acquired differs somewhat under the various contractual arrangements used by Taxpayer.

Taxpayer is required to maintain inventories for those activities where timber is purchased and sold. Section 1.471-1 requires the use of inventories in every case in which the production, purchase, or sale of merchandise is an income-producing factor. This requirement applies even if Taxpayer has minimal, or even no, ending inventories. Record Wide Distributors, Inc. v. Commissioner, 682 F.2d 204 (8th Cir. 1982); Falk v. Commissioner, 332 F.2d 922 (5th Cir. 1964), acq. 1965-2 C.B. 4; Diamond A. Cattle Co. v. Commissioner, 233 F.2d 739 (10th Cir. 1956); Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953); Herberger v. Commissioner, 195 F.2d 293 (9th Cir. 1952); Stoller v. United States, 320 F.2d 340 (Ct. Cl. 1963); J.P. Sheahan Assocs., Inc. v. Commissioner, T.C. Memo. 1992-239; Epic Metals Corp. v. Commissioner, T.C. Memo. 1984-322, affd. without published opinion, 770 F.2d 1069 (3rd Cir. 1985); Thomas Nelson, Inc. v. United States, 694 F.Supp. 428, amended 734 F.Supp. 810 (M.D.Tenn. 1988); Boynton v. Pedrick, 136 F. Supp. 888 (S.D.N.Y. 1954), affd. per curiam, 228 F.2d 745 (2d Cir. 1956), cert. denied 351 U.S. 938 (1956), reh'g denied 351 U.S. 990 (1956).

The inventory requirement only applies to merchandise to which Taxpayer has title; however, even momentary title is sufficient. Epic Metals Corporation and Subds. v. Commissioner, T.C. Memo. 1984-322 (1984), affd. without published opinion 770 F.2d 1069 (3rd Cir. 1985); Thomas Nelson, Inc. and Subd. v. United States, 694 F.Supp. 428, amended 734 F.Supp. 810 (M.D.Tenn. 1988); Middlebrooks v. Commissioner, T.C.Memo. 1975-275.

Inventories should include all finished or partly finished goods, and raw materials and supplies that have been acquired for sale or will be physically incorporated into merchandise intended for sale. § 1.471-1.

In those activities where Taxpayer is required to maintain inventories, the taxpayer is required to use an accrual method to account for its inventoriable costs and sales revenues. § 1.446-1(c)(2)(i).

The foregoing requirements to maintain inventories and to use the accrual method of accounting for such inventories apply even if Taxpayer would not otherwise be required to use the accrual method of accounting under § 448. § 1.448-1T(c).

SUMMARY

Taxpayer is subject to two independent requirements to use the accrual method of accounting for some of its business activities. First, Taxpayer is required to use an accrual method of accounting for those activities which do not constitute a "farming business" under § 448(d)(1). Second, Taxpayer is required to use an accrual method of accounting with respect to inventories that it is required to maintain for its purchases and sales of timber, and this requirement applies even if Taxpayer would not otherwise be prohibited from using the cash method under § 448.

If Taxpayer cannot adequately segregate those activities requiring an accrual method of accounting from those activities for which the cash method is allowed, the taxpayer will be required to use the accrual method for all its business activities. See, e.g., Thompson Electric Inc. v. Commissioner, T.C. Memo. 1995-292.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]

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Please call (202) 622-4930 if you have any further questions.

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