APPEALS

INDUSTRY SPECIALIZATION PROGRAM

COORDINATED ISSUE PAPER

INDUSTRY: Forest Products

ISSUE: Logging Roads - Depreciation and Investment Tax Credit

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SETTLEMENT POSITION

Logging Roads - Depreciation and Investment Tax Credit

STATEMENT OF ISSUES

What portion, if any, of the cost incurred by the taxpayer in constructing logging roads on its own land, should be considered as a non-depreciable cost and therefore not subject to either a deduction for depreciation under IRC 167(a) or the investment credit under IRC 48(a)? Note that the ITC generally is not applicable to roads placed in service after 1985.

EXAMINATION DIVISION POSITION

Whether a logging road has a determinable useful life versus an indefinite useful life is the key to the issue and a question of fact. Terminology used to describe the road such as the terminology used in Rev. Rul. 68-281, 1968-1 C.B. 22, is not the determining factor.

The logging road is integral to the production of timber and serves the forest which has a perpetual, indeterminate life. It is incorrect to link the life of the logging road to the life of the mill which the forest supplies.

A good discussion of the issue is contained in a Tax Court case, Wolfsen Land and Cattle Company v. Commissioner, 72 TC 1 (1979). Although the case deals with canals and ditches, the issue is identical to logging roads.

The current position of the Service can be illustrated by the following:

> The taxpayer is engaged in the business of growing and harvesting commercial timber on land it owns in fee. Some of the timber land is in the Southeast and is cut as early as 30 years after planting with commercial thinnings as early as 15 years. Other lands in the West have growing cycles as long as 60 years. The taxpayer's permanent mainline road system has been in place for many years. Various public roads also serve this purpose.
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> Situation 1. The taxpayer builds a road on its own land to harvest a small block of timber. After harvest and replanting the block, the road is abandoned. No maintenance is performed and, in some cases, culverts are removed and access to the road is blocked by construction of a large ditch across the entrance of the road. Due to a combination of environmental factors, including soil conditions, drainage, terrain characteristics, vegetation, and the length of time between harvests, it is expected that a new road will be required for the next harvest. While some portion of the old road right-of-way may be utilized for the new road, any cost savings due to the existence of the old road would be negligible. No portion of the cost of this road should be capitalized to non-depreciable land improvement account.
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> Situation 2. Same facts as Situation 1, except that the environmental factors, original road quality, and harvest cycle are such that it is expected that the old road will be repaired and utilized for the next harvest.
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> The cost of engineering, clearing, grubbing, and grading has an indefinite useful life and should be placed in a non-depreciable account. The cost of surfacing and culverts should be placed in a depreciable account as should the cost of reclamation when the road is prepared for the next harvest.
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> Situation 3. Same facts as Situation 1, except that a portion of the road is constructed across the face of a steep slope. This portion of the road requires extensive drilling and blasting of rock to create a notch or cut across the face of the slope. Upon the next harvest, a new road will be constructed but the cost for this portion will be substantially less since it can utilize the existing cut.

Settlement Position

The cost of the drilling and blasting is a permanent land improvement and should be placed in a non-depreciable account.

DISCUSSION

As stated in the Examination Division position, the issue to be resolved as to whether a particular road has an indefinite useful life to the taxpayer is a question of fact to be determined on a case by case basis. If a road is determined to have an indefinite life, costs such as for clearing, grubbing, and grading of the roadbed that provide a benefit over the life of the road would not be recoverable through depreciation and not be subject to ITC; costs such as for surfacing (rock pavement, etc.) and culverts provide benefits with a determinable life and would be recoverable through depreciation and would be subject to ITC as factually determined.

All parts of a road which are determined to have a useful life are, of course, subject to depreciation as factually determined and subject to ITC.

The preceding may be graphically illustrated as follows:

	Road Has No Discernable Life	Road Has Discernable Life
Clearing, Grubbing Grading	Non-Depreciable No ITC	Depreciable Sub to ITC
Surfacing & Culverts	Depreciable Sub to ITC	Depreciable Sub to ITC

Given the above, it will be necessary to factually determine:

1. Whether each road has or does not have a discernable life, and
2. Whether the expenditures are for the roadbed that has a life coterminous with that of the road or for another part of the road that has its own discernable life.

Factors Indicating a Discernable Life:

1. Intention: Will the road be used after logging for planting, fire control, forest management, thinning and harvesting the next cycle, or is it used only for harvesting and then abandoned. (Rev. Rul. 88-99, 1988-2 C.B. 33)

    ♦ In a case dealing with the expected life of cattle ranch drainage ditches, Wolfsen Land and Cattle, 72 TC 1 (1979), the Court found that maintenance on drainage ditches, although done only when the ditches were almost dysfunctional indicated an indeterminate life for the ditches; they would last indefinitely if maintained. The theory of the case seemed to be that since the ranch would have no value without the ditches it could be assumed that the maintenance would be performed, absent evidence to the contrary.

2. Use: The forest logging road is associated with the continuing asset of the forest. The life should not be tied to the sawmill which it serves unless the road will be retired, replaced, or abandoned contemporaneously with the facility. (Rev. Rul. 68-193, 1968-1 C.B. 79).

    ♦ Taxpayers often cite the following rulings in support of their position that logging roads have a discernable life:

        1) Rev. Rul. 71-448, 1971-2 C.B. 130 (cost of clearing and grading pipeline

easements are depreciable over the life of the pipeline);

2) Rev. Rul. 72-96, 1972-1 C.B. 67 (clearing stripping and grading of reservoir site and roadway along top of dam site is depreciable property and is "other tangible property" for investment tax credit purposes);

3) Rev. Rul. 71-555, 1971-2 C.B. 65 (roadways devoted solely to truck traffic in manufacturing complex are section 38 property); and

4) Rev. Rul. 73-488, 1973-2 C.B. 207 (expenditures for construction of a road solely for transport of equipment and supplies from shipping point to inaccessible mining area are recoverable through depreciation or amortization).

All of these rulings are distinguishable from the issue at hand in that we are dealing with a roadway which serves (absent other evidence) a forest which has an indefinite life due to continual reforestation. The question to be answered is whether or not the road will be used through future harvesting cycles.

Factors Regarding Permanent Costs vs. Non-Permanent Costs:

1. Books of Account: The Revenue Rulings requiring a distinction between clearing, grubbing, and grading costs and those costs for surfacing and culverts have been in place for many years (Rev. Rul. 68-281, 1968-1 C.B. 22) and should not present a problem at the Appeals level. This factual problem is generally resolved at the Examination level.