CAMP MANUFACTURING CO. v. COMMISSIONER
3 TC, 467 (1944); Ace. 1944 C.B. 4.

Editor's Summary

Key Topics

OUTRIGHT SALE--CAPITAL GAIN v. ORDINARY INCOME
• Sales of standing timber by lumber company

Facts

The taxpayer was engaged in the business of manufacturing and marketing lumber and lumber products. It owned over 100,000 acres of timberlands from which it ordinarily cut timber for its own requirements. However, on occasion it sold small amounts of standing timber pursuant to unsolicited requests, two of which accounted for over 90% of the amount sold. The trees were marked, cut, logged and removed by the purchasers at their own expense. The Commissioner contended that the timber was held for sale to customers in the ordinary course of the taxpayer's business and that gains realized from its sale were taxable as ordinary income.

Tax Court

Held: For the taxpayer. The ordinary course of the taxpayer's business was the processing of timber and the sale of finished products. It did not engage in the business of selling standing timber. The taxpayer's gains from the sale of standing timber were capital gains.

Case Text

This proceeding involves the redetermination of deficiencies in taxes as follows: For the year 1939, income tax $326,06; for the year 1940~ income tax $1,417.79, declared value excess profits tax $946.05, and excess profits tax $10,016.39. Only a part of such deficiencies determined by respondent are in controversy.

Adjustments made by the respondent to petitioner's income for 1939 included "recoveries of bad debts" in the amount of $358.96. At the hearing the parties filed a stipulation that income for 1939, as shown by the deficiency notice, should be reduced by the above amount, thus eliminating the only contested issue relating to that year. Certain disputed matters pertaining to the taxable year 1940 also were settled by the Parties, their agreements being contained in the same stipulation. This stipulation will be given effect in the final settlement under Rule 50.

Two issues involving income for 1940 were submitted for decision, namely, (1) whether the amount of $12,463 paid by the petitioner in 1940 for the release of its contingent liability as guarantor on certain preferred stock of the Chesapeake-Camp Corporation constituted an allowable deduction from income for the year 1940, and (2) whether profit from the sale of standing timber in 1940 constituted capital gain.

The case was submitted upon a stipulation of the parties and oral and documentary evidence. The stipulated facts are found accordingly, but we set forth only so much thereof, together with additional material facts, as is necessary to an understanding of the issues.

FINDINGS OF FACT

Petitioner is a Virginia corporation organized in 1887, with its principal office at Franklin, Virginia. It has been engaged in the business of manufacturing and marketing lumber and lumber products since the date of its organization. Among its other purposes, as stated by its charter, is the buying and selling of timber. In 1936 petitioner owned in fee approximately 106,000 acres of timber lands and held timber rights in 15,000 additional acres.

Petitioner had been accustomed to manufacture its logs of every size and grade into lumber. It was manufacturing smaller and low grade logs at a loss and desired the establishment of a nearby paper mill to which such logs as well as tree tops and waste could be marketed for conversion into pulp. Petitioner could interest no paper company in building a mill in its vicinity and, therefore, it determined to take the lead in creating one.

To that end the Chesapeake-Camp Corporation was organized in December 1936 under the laws of Virginia, with authorized capital stock of 10,000 shares of common and 12,500 shares of 5 percent cumulative preferred, all of the par value of $100 per share. Petitioner subscribed for 5,000 shares of the common stock and 6,250 shares of the preferred stock, or 50 percent of each class of capital stock. The balance was subscribed and paid in by the Chesapeake Corporation of West Point, Virginia, and the Albemarle Paper Co. of Richmond, Virginia, neither of which was affiliated with the petitioner. Petitioner thereafter furnished the Chesapeake-Camp Corporation with about 50 percent of its pulpwood requirements.

On or about January 13, 1937, petitioner determined that it was advisable for it to sell a substantial portion of the preferred stock of Chesapeake-Camp Corporation to which it had subscribed in order to secure working capital for its own operations. Through negotiations with Investment Corporation of Norfolk an agreement was entered into whereby the Investment Corporation of Norfolk would sell preferred stock of a par value of $500,000 in Chesapeake-Camp Corporation at a price of $97.50 per share, provided the petitioner would guarantee the payment of dividends of 5 percent per annum, payable quarterly, and would also guarantee the liquidation of the stock at par. It was determined in 1937 that the preferred stock of the Chesapeake-Camp Corporation could not be resold for any substantial sum of money without the guaranty of petitioner.

Pursuant to the aforesaid agreement, 5,166 shares of preferred stock were sold to the public, to which the guaranty of the petitioner, as above mentioned was attached.

In 1940 the officers and directors of petitioner became desirous of extricating the company from the contingent liability on the preferred stock under the guaranty, and through negotiation a plan was adopted whereby the holders of such preferred stock were offered an opportunity to

exchange such stock for new shares with the guaranty of the petitioner eliminated therefrom and a payment by petitioner of $5 per share. Excerpts from a special meeting of petitioner's directors at which this plan was discussed and acted upon are as follows:

> The President stated to the meeting that there is outstanding 5,156 shares of Chesapeake-Camp Corporation 5% preferred stock which is guaranteed as to payment of dividends and liquidation at par value and accrued dividends to date of such liquidation by Camp Manufacturing Company. He stated further that it seems desirable for Camp Manufacturing Company to be relieved of this guarantee and he stated to the meeting that, as guarantor of this principal and interest, the Camp Company has the right to purchase this outstanding stock at $105.00 per share.
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> He stated further that, in his opinion, a large majority, if not all of the present holders of the Chesapeake-Camp Corporation 5% preferred stock, so guaranteed by the Camp Company, would be willing to exchange the said guaranteed stock for the same number of shares of Chesapeake-Camp Corporation 5% preferred stock not guaranteed by Camp Manufacturing

Company, upon payment of the sum of $5.00 per share. After some discussion of this matter the following resolution was, upon motion, unanimously carried:

RESOLVED that Camp Manufacturing Company agrees, and it does hereby agree, to offer to cause to be issued and delivered to the present holders of the Chesapeake-Camp Corporation 5% preferred stock guaranteed by Camp Manufacturing Company, a certificate or certificates for a number of shares of Chesapeake. Camp Corporation 5% preferred stock, not guaranteed in any way by Camp Manufacturing Company, equal to the number of shares of so called guaranteed stock which they now hold, in exchange for the certificate or certificates for preferred stock guaranteed by Camp Manufacturing Company now held by them and to pay in addition to each such stockholder a premium of Five Dollars ($5.00) per share for each and every share of Chesapeake Camp Corporation 5% preferred stock, guaranteed by Camp Manufacturing Company, held by them; and

RESOLVED FURTHER, that the proper officers of the Company be, and they are hereby authorized to so exchange the said unguaranteed stock for the presently held guaranteed stock and pay to each stockholder a premium of $5.00 per share for each and every share of such guaranteed stock now held by them.

The plan to eliminate the guaranty as described above was agreed to by the Chesapeake-Camp Corporation. During the year 1940 the offer was accepted by the holders of 2,507 shares of stock, with the result that a total of $12,463 was paid by the petitioner to secure the release of the liability contained in the guaranty, and the amount was claimed as a deduction from income in the 1940 return.

During the year 1940 petitioner sold to various unsolicited purchasers 1,672,524 feet of standing timber in Virginia, South Carolina and North Carolina at a gain of $16,464.42 over stumpage costs. In each instance the timber was owned and held by petitioner for more than two years prior to the sale thereof. About *95* percent of such timber was sold to two parties. In each instance the trees were individually selected and marked and the purchaser was obliged to take them from the moment they were marked. They were then cut, logged and removed by the purchaser at his sole expense and for his own account. The purchasers did not act as agents for petitioner, but bought the trees to make pilings for sale to their own customers. Sales were made at the solicitation of the buyers, not petitioner.

The principal business of the petitioner was the manufacture of lumber. It never engaged in the regular business of buying and selling standing timber, though from 1931 through 1939 it did sell about $500 worth of standing timber per year. During the same period it bought about one million dollars worth of timber. All timber purchased by petitioner was bought for the sole purpose of manufacturing it into lumber at its own mills and none of the standing timber owned by petitioner, including that sold in 1940, was included in petitioner's inventory or regarded as an inventory item until manufactured into lumber.

In 1941 and 1942 petitioner sold about as much timber as it sold in 1949. The increased demand

was due to the Government's enlarged requirements for pilings for wharves and defense work.

OPINION

HILL, Judge: The first question presented is whether petitioner is entitled to deduct from its 1940 income the sum of $12,463 paid to procure the release of its contingent liability as guarantor on certain preferred stock of another corporation. Respondent disallowed the deduction. Petitioner contends that he did so erroneously.

Petitioner has been in the business of manufacturing lumber and lumber products since 1887. It found it unprofitable to thus process small and low grade trees and impossible to dispose of its waste. Such trees and waste could be used advantageously for pulpwood in the milling of paper, but there were no local paper mills to which petitioner might sell and it had been unable to induce anyone to build a mill in the vicinity. Therefore, to provide a market for these materials, petitioner joined with two others in the financing of a new company, Chesapeake-Camp Corporation, which would erect a paper mill and buy from petitioner the trees and waste which it could not profitably manufacture into lumber. Petitioner subscribed to one-half of the new company's capital stock, at a cost of $1,125,000. However, three weeks later, petitioner deemed it advisable to sell 5,000 shares of the preferred stock so subscribed for in order to replenish its own working capital. To sell this stock it was necessary for petitioner to guarantee, and it did guarantee, the payment of 5 percent cumulative dividends and the redemption of the stock at par in tile event of liquidation. The guaranty was printed on the back of tile stock certificates, which were thereupon sold to the public through the Investment Corporation of Norfolk. About four years later, petitioner, desirous of relieving itself of the guaranty and having secured the cooperation of Chesapeake Camp Corporation, offered to exchange a new share of Chesapeake Camp Corporation's preferred stock without the guaranty plus $5 for each share of guaranteed stock. In 1940 the offer was accepted by the holders of 2,507 shares. Petitioner paid out $12,463 in connection with the exchanges thus made. This is the payment which petitioner believes it is entitled to deduct from gross income either as a business expense or as a loss.

It is well established that business expenses must be both ordinary and necessary to be deductible under section 23(a) of the Internal Revenue Code. *Welch v. Helvering,* 290 U. S. 111. This is the double test to be applied in determining whether the outlay in question is deductible as a business expense.

Petitioner had the unquestioned right to determine the means of replenishing its working capital and in adopting therefor the plan to sell a portion of the preferred stock purchased from the new company it exercised a judgment to subserve a legitimate business purpose. To effectuate the sale of the stock the obligation of guaranty was necessary. It was therefore a necessary obligation incurred in carrying on petitioner's business. It was also a t)10e of obligation which business concerns under similar circumstances might normally and ordinarily be expected to incur. The guaranty was a continuing obligation so long as the stock to which it was applied was unliquidated. It imposed a continuing potential necessity of performance entailing a potentially heavy financial burden which could not be anticipated or measured in advance.

Whether or not petitioner may have been subrogated to the rights of the holders of the guaranteed stock against the new company in respect of payments which petitioner might be called upon to make under the guaranty, recoupment of such payments would depend upon the problematic financial status of the new company for an indeterminable period of time and the extent, if any, to which recoupment might be realized was at best speculative. Hence it is apparent that a release from the obligation of guaranty, secured at a reasonable price, would be in keeping with good business practice. Petitioner secured such · release in the taxable year by the payment of $12,463 in cancellation of its contract of guaranty in respect of 2,507 shares of stock covered thereby.

Since the obligation of guaranty was a necessary and ordinary obligation incurred by petitioner in carrying on its business, the expense in the amount reasonably necessary to secure a cancellation or release of such guaranty is a necessary and ordinary business expense. Cf. *Robert Gaylord, Inc.,* 41 B. T. A. 1119.

The question of reasonableness of $5 a share as a consideration for release of the guaranty has not been presented, but it appears to us under the facts here that it is not an unreasonable amount therefor. We, therefore, hold that the amount of $12,463 paid out by petitioner in the taxable year for release from the guaranty was a necessary and ordinary business expense and deductible as such.

The above holding renders it unnecessary to consider the alternative contention of petitioner that the outlay in question was a loss deductible under section 23(f) of the Internal Revenue Code.

We next must determine whether profit from the sale of standing timber in 1940 constituted capital gain, as contended by petitioner, or ordinary gain, as claimed by respondent. The question arises in connection with the ascertainment of petitioner's excess profits net income for the year 1940. Section 711 (a) of the Internal Revenue Code provides that excess profits net income shall be the normal tax income, with certain named adjustments. One such adjustment, applicable to 1940 and to be made where the excess profits credit is computed under the income method, is that "There shall be excluded long-term capital gains and losses. * * *" Sec. 711(a)(1)(B), Excess Profits Tax Act of 1940. See also Regulations 109, sec. 30.711(a)-2, giving the Treasury's interpretation of such statute, wherein it is said "In recomputing normal-tax net income for the purpose of determining the excess-profits net income for the taxable year * * * there shall be excluded long-term capital gains and losses. * * *"

In respect of the taxable year 1940 a "long-term capital gain" was defined as, meaning "gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income." Sec. t 17{a) (4), Internal Revenue Code. It is stipulated that the standing timber, the sale of which is here involved, was owned and held by petitioner for over two years. Hence, the profit arising from its sale became a long-term capital gain if the standing timber was a capital asset. The question is thus narrowed to a determination as to whether it was a capital asset.

The term "capital assets" is defined in section l17(a)(1) of the Internal Revenue Code. [1] By virtue of such definition the term means property held by the taxpayer, whether or not connected with

his trade or business, except that it does not include the taxpayer's stock in trade or other property properly includable in his inventory, property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property used in the trade or business which is subject to depreciation allowance under section 23(1). Since the standing timber was property held by petitioner, it follows that the trees sold constituted capital assets unless they were property of a character excluded from the concept by one of the exceptions in the definition.

Identical questions arising from the sale of timber have been previously resolved when tested against the slightly different definitions of "capital assets" contained in prior revenue acts. A case in which the facts closely approach those present here is *Carroll v. Commissioner,* 70 Fed. (2d)806, which affirmed 27 B. T. A. 65 on this point, but reversed it on another. There a partnership, which had always been engaged in the manufacture and sale of lumber at wholesale, made an agreement with a company whereby the latter cut timber on the lands of the partnership, for which it paid $10 per thousand feet. The court held that the timber so sold was a capital asset and, in so doing, said:

> * * * The business in which the partnership was engaged was that of manufacturing lumber and selling it at wholesale. Its timber land or standing timber came within each of the above quoted definitions [contained in the Revenue Acts of 1921, 1924 and 1926], and did not come within any exception stated in either of those definitions. It was not part of the business of the partnership to buy and sell or trade in timber land or standing timber. The timber land or standing timber was not included in its stock in trade, would not properly be included in its inventory if on hand at the close of a taxable year, and was not held by it primarily for sale in the course of its trade or business. The timber was part of the partnership's capital assets, as much so as one of its sawmills which might advantageously be disposed of because it had ceased to be profitable or conveniently located. *Doyle v. Mitchell Brothers Co.,* 247 U. S, 179, 187, 38 S. Ct. 467, 62 L. Ed. I054.

By substituting the word "petitioner" for "partnership," the statement becomes peculiarly apropos to the case at bar and, with the additional observation that standing timber is obviously not property of the type subject to depreciation allowance under section 23(1), should serve to dispose of respondent's contention upon this issue. See also *Estate o] M. M. Stark,* 45 B. T. A. 882; *John W. Blodgett,* 13 B. T. A. 1388.
However, some further discussion is, perhaps, warranted in view of respondent's insistence that petitioner's sale of standing timber in years other than the taxable year and its purpose of buying and selling timber as evinced by its charter require a conclusion that the timber was held primarily for sale *to customers* in the *ordinary* course of its trade or business and, hence, must be excluded from the definition of capital asset under section 117(a)(1). The words emphasized above were added to section 117(a)(1) by the Revenue Act of 1943. It is apparent that their inclusion narrows the scope of the exception as it previously existed. Disregarding for the moment the *Carroll* case, whatever merit there might have been in respondent's contention under the old definition, we think it untenable now.

Petitioner sold an average of $500 worth of standing timber per year from 1930 to 1939. In 1940, due largely to the unsolicited orders of two purchasers, the amount sold increased to about

$16,000 worth, where it remained in 1941 and 1942. The increase probably resulted from the Government's war demands for piling. In view of other evidence, such as the fact that over $1,000,000 worth of timber was bought in the same period, the evidence of relatively insignificant sales thereof falls far short of proving that the standing timber was held primarily for sale to customers in the ordinary course of its trade and business. Petitioner had been in the lumber manufacturing business since 1887. Its customers were buyers of lumber and lumber products with whom it dealt over the years, not the unexpected and unsolicited purchasers of a few standing trees. The ordinary course of its trade and business was to process its raw material, the timber, and to sell the finished product, not to buy and sell standing timber. See *United States v. Robinson,* 129 Fed. (2d) 297. The fact that petitioner might have engaged in the business of buying and selling timber under its charter is of no moment, since the facts establish that it did not enter this business. *Thompson Lumber Co.,* 43 B. T. A. 726.

The case of *Commissioner v. Boeing,* 106 Fed (2d) 1305, upon which respondent largely relies, is not in conflict with our conclusion that petitioner's standing timber was a capital asset. *Carroll v. Commissioner, supra; and John W. Blodgett, supra,* are cited and distinguished therein on the ground that, unlike the *Boeing* facts, the contracts between the parties and the logging companies resulted in a sale of the timber to the logging companies. By the same token, the *Boeing* case is distinguishable from the present proceeding, for here too the sales were made to purchasers who cut, removed, and sold the purchased trees for their own account and not as agents of petitioner.

Respondent erred in failing to treat the profit realized by petitioner in 1940 from the sale of standing timber as a capital gain.

Decision will be entered under Rule 50.