CARLEN v. COMMISSIONER
20 T.C. 573 (1953).
***Aff'd* 220 F.2d 338; *55-I* USTC ¶9296;**
47 AFTR 322 (9th Cir. 1955).

[The opinion which follows is that of the Tax Court. The complete text of the Court of Appeals opinion and the Editor's Summary of the case are at p. 770.]

Case Text

The Commissioner determined the following deficiencies in income tax:

Year	*Taxpayer*	*Amount*
1947	Arthur R. McKay	$561.52
1947	Cathryn McKay	561.52
1947	John T, Carlen	548.01
1947	Helga Carlen	548.00
1948	Arthur R. and Cathryn McKay	3,928.78
1948	John T, and Helga Carlen	3,904.26
1949	Arthur R. and Cathryn McKay	73,052.04
1949	John T, and Helga Carlen	3,093.50
1950	Arthur R. and Cathryn McKay	1,405.86
1950	John T. and Helga Carlen	1,401.90

The stipulation of facts shows $3,071.61 with no explanation for the difference.

The only issue is whether the Commissioner erred in finding that the taxpayers are not ,entitled to capital-gains treatment of lumber cut under certain contracts as provided for in section 117(k)(1) of the Internal Revenue Code.

FINDINGS OF FACT

The stipulate facts are so found and the stipulation is included herein by reference.

Arthur R. McKay and Cathryn McKay are residents of Aberdeen, Washington. John T. Carlen and Helga Carlen are residents of Raymond, Washington.

For the calendar year 1947 the McKays and the Carlens, as members of marital communities, each filed a separate income tax return. For the calendar years 1948, 1949, and 1950, joint returns were filed. All returns were filed with the collector of internal revenue, Tacoma, Washington.

As of May 1, 1945, Arthur R. McKay and John T. Carlen formed an oral general partnership to engage in the logging and cutting of timber in southwest Washington. During all the years in question the partnership was engaged in the trade or business of logging timber and was not engaged in the business of cutting timber for sale on its own account or for use in its business.

On March 15, 1945, Rayonier Incorporated and Neuskah Timber Company entered into a contract by the terms of which Neuskah purchased from Rayonier all of the merchantable cedar and spruce timber and certain hemlock located on tracts described in the contract and owned by Rayonier. Title to the timber and risk of loss by fire or other casualty was to pass to Neuskah on cutting. Rayonier was to designate the hemlock to be cut and all logs were to be branded with a distinctive design approved by Rayonier. Neuskah agreed to sell back to Rayonier and Rayonier agreed to buy all hemlock logs cut under the contract.

On April 23, 1945, Neuskah entered into the following contract' with the McKay and Carlen partnership for cutting part of the spruce and cedar included in the Rayonier-Neuskah contract.

> *THIS CONTRACT,* Made and entered into by and between the Neuskah Tbr. Co. Inc., a corporation, of Aberdeen, Washington, hereinafter called First Party and Arthur R. McKay and John Carlen, of Aberdeen, Washington, a co-partnership, hereinafter known as McKay and Carlen, and hereinafter called Second Party, WITNESSETH:
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> That First Party owns or controls certain timber in Section Thirty (30) and North Half (N ½) of Section Twenty Nine (20) *[sic],* Township Thirteen (13) North, Range Nine (9) West, W.M., Pacific County, Washington.
>
> Second Party agrees to selective log all the merchantable Sitka Spruce and Western Red Cedar on the above described land in accordance with the usual custom. In the conduct of said operation the second Party agrees to comply with and conform to all the requirements of law now or hereafter during the term of the contract in effect relating to the operation of cutting, logging and removal of timber, or to fire or the prevention of fire and shall hold First Party harmless from any and all damages resulting from the negligence *[sic]* acts of the Second Party or its agents and employees. Upon completion of logging any definite tract Second Party agrees to leave such land, tract or tracts in such condition that certificate of clearance can be obtained from the State departments pertaining to logging and fire.
>
> All logs when cut shall be branded or stamped with a brand or stamp suitable to the First Party, and absolute title and control of all logs, until sold and paid for, shall rest in the First Party.
>
> All Select, Number One (1) and Number Two (2) Sitka Spruce logs are to be delivered to the mill of E. K. Bishop Lumber Company, Aberdeen, Washington. All other Sitka Spruce and all Western Red Cedar logs are to be delivered to any mill or mills on Willapa Harbor, such mill or mills to be designated by First Party.
>
> Second Party agrees to operate at least Forty Eight (48) hours per week and to do each and everything necessary to log and deliver said logs to the various mills and agrees to construct and maintain all necessary roads, furnish alt necessary equipment and supplies, do all falling, bucking, yarding, loading, trucking, booming, rafting, scaling and towing and to pay when due all labor, state and federal taxes of every kind and nature whatsoever,

> including but not limited to industrial insurance, unemployment compensation, medical aid, and agrees to keep said logs free from any and all claims, liens or liability.
>
> The Parties hereto agree that from the total net Cash returns from the sale of all logs shall be deducted stumpage of Seven Dollars Fifty Cents ($7.50) on all Sitka Spruce logs and Four Dollars ($4.00) on all Western Red Cedar logs plus One Dollars *[sic]* ($1,00) on all logs, per thousand feet board measure, and that after such deductions the balance shall be paid by First Party to Second Party for this service, such payments to be made within ten (10)days after said logs are rafted and scaled, such scaling to be done by any recognized scaling bureau, to be selected by First Party.
>
> Time is of the essence of this contract and Second Party agrees to start operations promptly and continue said logging without interruption, barring such factors as bad weather or strikes which are beyond Second Party's control.
>
> It is expressly understood and agreed that in all its logging operations hereunder the Second Party acts as and is an independent contractor and nothing herein contained shall operate to make the Second Party an agent of the First Party or to be construed as authorizing or empowering the Second Party to obligate or bind the First Party in any manner whatsoever. It is expressly understood and agreed the First Party and Second Party are not partners or principal or agent.

Neuskah was a subsidiary of E. K. Bishop Lumber Company. On January 31, 1946, Neuskah assigned its contract with Rayonier to E. K. Bishop Lumber Company and thereafter McKay and Carlen dealt with the assignee with regard to the contract. The assignment was approved by Rayonier.

On November 1, 1946, August 15, 1948, and October 25, 1948, Rayonier and E. K. Bishop Lumber Company entered into additional contracts similar in material respects to the contract between Neuskah and Rayonier. At the time these additional contracts were entered into E. K. Bishop Lumber Company immediately entered into an agreement with McKay and Carlen for the logging of the areas described in the contracts between Rayonier and Bishop. The agreements with McKay and Carlen were oral and contemplated terms and conditions similar to those stated in the contract of April 23, 1945, between Neuskah and McKay and Carlen Under the basic contracts between Rayonier and Neuskah and E. K. Bishop, Neuskah and Bishop retained the spruce for themselves, but resold all the hemlock and cedar to Rayonier at the market price.

McKay and Carlen faithfully performed its contracts and payments have been made in accordance therewith, including the service charge of $1 per thousand board feet of Neuskah (later E. K. Bishop Lumber Company). McKay and Carlen logged the timber at their own expense and charged all of the costs, including road building, to current operating expenses. They received the net cash returns from the sale of the logs, less the stumpage charge agreed upon and a service fee deducted by E. K. Bishop Lumber Company, which conducted all the selling, collected the proceeds; and remitted to McKay and Carlen the net amount.

McKay and Carlen elected to report their gains on the sale of timber under the various contracts under section l17(k).

OPINION

TIETJENS, Judge: The issue for decision is whether the taxpayer may properly treat the cutting of timber under the contracts between the partnership and Neuskah and E. K. Bishop Lumber Company "as a sale or exchange of such timber" as provided in section 117(k) (1). [1] See also section l17(j)(1). [2] If so, they were entitled to treat their gains as capital gains.

In summary, the taxpayers' argument is that they are entitled to the benefits of l17(k)(1) "either on the basis that [they] purchased the timber and were the owners thereof at all times (subject to the reservation of title for security purposes)or had a contract right to cut such timber and to sell the timber or logs in the normal course of taxpayers' business."

The Commissioner's position is that the contracts involved were essentially to perform services for compensation and that the partnership did not acquire any interest in the standing timber or the logs as cut which would entitle it to capital gains treatment under the subsection in question.

The question is one of first impression and we have no decided cases to serve as guide posts. Cases such as *Springfield Plywood Corporation,* 15 T. C. 697, which was concerned with section 117(k)(2), where the decisive question was whether there had been a "disposal" of timber by the owner under a contract by which the owner retained an "economic interest" in the timber, are not controlling here.

Both parties agree that section 117(k)(2) has no application to the situation before us.
We look to Regulations 111, section 29.177-8(a), but find little help. The regulations hardly do more than follow the language of the statute.

Some assistance can be found in that part of the report of the Finance Committee of the Senate, Revenue Bill of 1943, 78th Cong., 1st Sess., Rept. No. 627, dealing with section 117(k)(1). There the following statement appears, at page 25:

> Your committee is of the opinion that various timber owners are seriously handicapped under the Federal income and excess profits tax laws. The law discriminates against taxpayers who dispose of timber by cutting it as compared with those who sell timber outright. The income realized from the cutting of timber is now taxed as ordinary income at full income and excess profits tax rates and not at capital gain rates. In short, if the taxpayer cuts his own timber he loses the benefit of the capital gain rate which applies when he sells the same timber outfight to another. Similarly, owners who sell their timber on a so-called cutting contract under which the owner retains an economic interest in the property are held to have leased their property and are therefore not accorded under present law capital-gain treatment of any increase in value realized over the depletion basis.

Our attention also has been called to *Boeing v. United States* (Ct. Cl. 1951), 98 F. Supp. 581, where the Court of Claims in dealing with section l17(k)(2) and not with our specific problem said:

> The legislative history of l17(k) indicates that Congress' principal purpose was to afford relief to timber owners.

These quotations do not decide the question. Nevertheless, they seem to fortify the Commissioner's position that unless the taxpayers can be considered as owners of the timber or as persons having a contract right to cut the timber for sale or for use in their own trade or business they are not entitled to claim the benefits of the section.

We do not think the taxpayers were the owners of the timber. Original ownership was in Rayonier Incorporated. Rayonier, in its contracts with Neuskah and E. K. Bishop Lumber Company, specifically sold the limber to those parties, agreeing at the same time to buy back certain species, and appropriate language indicating a sale was employed in those contracts. We do not find language importing a sale in the arrangements between the McKay and Carlen partnership and Neuskah and E. K. Bishop. The taxpayers attempt to explain this discrepancy by pointing out that the original written agreement between the partnership and Neuskah, on which the subsequent oral agreements were based, was drafted by a person unskilled in legal terminology. However that may be, it is stipulated that the partnership's business was "logging timber." That term as explained in oral testimony may or may not encompass cutting timber for sale, but on this record we do not think the partnership had any timber for sale. To be sure, McKay and Carlen had a contract to cut the timber In question, but we Cannot find that they owned the timber or had any proprietary interest which would permit them to sell it, All sales were made by Neuskah or E. K. Bishop Lumber Company. McKay and Carlen never had any contact with the purchasers, except insofar as E. K, Bishop invoiced itself for logs it retained. This seems simply to have been for bookkeeping purposes and did not purport to evidence a sale by the partnership to Bishop. Absolute title and control of all logs until sold and paid for remained under the contracts with Neuskah or Bishop. The taxpayers say this was for security only, but we cannot agree.

The agreement between Neuskah and the partnership is" essentially a logging arrangement and the amounts payable to the partnership thereunder are said in the contract to be paid "for this service." We conclude that the essence of the arrangement was that the .partnership was employed to cut timber on lands of another for compensation determined on the basis of market price of the logs and that the partnership did not own or have any proprietary interest in the timber, either before or after cutting. The statute speaks of the cutting of timber for sale by a taxpayer who has a right to cut such timber. To us this means that the taxpayer who would claim the benefit of the statute must be the one who has not only the right to cut but also the right to sell on his own account. The taxpayers here were not such persons. We agree with the Commissioner that the statutory language does not cover a taxpayer who cuts timber in which he himself has no proprietary interest which he can dispose of by sale.

Neither, in our opinion, can the petitioners qualify as taxpayers cutting the timber "for use in the taxpayer's trade or business" as required by the statute. They were loggers and were cuffing

timber which belonged to others and was to be used by others. The taxpayers themselves did not use the timber and they had no control over it except to cut and deliver it according to the terms of their cutting contracts with Neuskah and E. K. Bishop.

We conclude and hold that the petitioners are not entitled to the benefits of section 117(k)(1) and approve the action of the Commissioner in this respect.

Reviewed by the Court.

Decision will be entered under Rule 50.

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1 SEC. 117(k) Gain or Loss in the Case of Timber or Coal -
(1) If the taxpayer so elects upon his return for a taxable year, the cutting of timber (for sale or for use in the taxpayers trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than six months prior to the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. In case such election has been made, gain or loss, to the taxpayer shall be recognized in an amount equal to the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer and the fair market value of such timber. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which cost is a necessary factor. If a taxpayer makes an election under this paragraph such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding upon the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Commissioner, on showing if undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this paragraph except with the consent of the Commissioner.

2 Sec. 117 (j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.-
(1) Definition of Property Used in the Trade or Business - For the purposes of this subsection, the term "property used in the trade or business" * * * includes timber wit respect to which subsection (k)(1) or (2) is applicable.