

DYAL v. UNITED STATES
64-1 USTC ¶ 9196; 13 AFTR 2d 446 (S.D. Ga. 1963).
Rev'd 342 F.2d 248; 65-1 USTC ¶ 9285;
15 AFTR 2d 490 (5th Cir. 1965).

[The opinion which follows is that of the U.S. District Court. The complete text of the Court of Appeals' opinion and the Editor's Summary of the case are at p. 866.]

Case Text

OPINION

SCARLETT, District Judge: These actions were timely filed on May 26, 1961 for the recovery of income taxes and assessed interest in the total amount of \$4,860.18 plus statutory interest for the years 1956 through 1958. The issue presented in each case is the treatment of receipts from lands leased by the plaintiffs in 1941 and 1946 for terms of 99 years to Union Bag & Paper Corporation. The Government contended that such annual payments were ordinary income from rents while the taxpayers urged that the payments be treated as capital gains from the sale or disposal of timber in which they had retained an economic interest.

At the conclusion of the plaintiffs' evidence in these cases, which were consolidated for trial, the Court granted defendant's Motion for Directed Verdicts in view of the following findings of fact and conclusions of law which demonstrate that no issue triable by jury was presented:

FINDINGS OF FACT

1. As of the 30th day of December, 1941 the Citizens and Southern National Bank of Savannah, Georgia, as trustee on behalf of the plaintiffs herein and as lessor entered into a written 99 year lease of 10,400 acres of land in Appling and Wayne Counties, Georgia with what was then known as the Union Bag & Paper Corporation * as lessee. This lease will hereinafter be referred to as Lease #2.

2. As of the 30th day of December, 1941 James E. Dyal, father of the surviving plaintiffs herein, as lessor entered into a similar written lease for 99 years of an additional 28,883 acres in Appling and Wayne Counties of Georgia with Union Bag as lessee. This lease will hereinafter be referred to as Lease #2.

3. As of the 1st day of February, 1946 the same James E. Dyal, as lessor, entered into a similar 99 year written lease of 23,255 acres of land located in Clinch and Ware Counties, Georgia, with Union Bag as lessee. This lease will hereinafter be referred to as Lease #3.

4. Lease #3 was executed by Mr. James E. Dyal on behalf of his relatives, the plaintiffs herein. Prior or simultaneously with the execution of Lease #3 Mr. Dyal had conveyed by gift deeds the said 23,255 acres comprising the property leased under Lease #3 to his children and former wife, reserving to himself the right to lease the lands to Union Bag on behalf of the donees.

5. Each of the 3 leases provides that Union Bag will pay the lessors "as rental" annually, an amount equal to 5% interest on a value agreed upon for the purposes of these contracts. These values were also the amounts for which Union Bag was given the option to purchase the fee

simple ownership in the lands after the death of James E. Dyal.

6. Under Leases #1 and #2 the lessors "granted, leased and demised" all of the lands therein described "TOGETHER WITH ALL AND SINGULAR the complete and exclusive use and control of said lands and the rights, members, hereditaments and appurtenances thereof; including (without in any way limiting the generality of the foregoing), all timber, logging, wood, turpentine and naval stores, oil, mining, mineral, water, water power, grazing, farming and hunting rights, and all rights of ways, privileges and easements in and over said lands which may be useful, convenient or necessary in the conduct of Lessee's business thereon."

7. Lease #3 conveys the identical rights to the lessee with the exception that the lessor specifically retained a interest in any oil, gas or mineral rights, royalties or rentals.

8. By an agreement entered into on April 9, 1946, James E. Dyal and/or his sons was granted by Union Bag the right of refusal "to supervise, superintend or engage in timber or naval stores operations on the aforesaid lands [and] shall be entitled to the refusal on the same terms, at the same price, of any and all timber contracts or operations including saw-log, pulpwood or other timber operations as well as naval stores or turpentine operations on the lands * * * which operations may be carried out, contracted for or subleased by UNION BAG as permitted by the terms of said 99 year lease."

9. In addition other covenants of the 3 leases imposed upon the Lessee the obligations to:

(a) pay to the proper governmental agency all taxes assessed against the lands and premises during the continuance of the leases, except inheritance or succession taxes.

(b) pay annually into a Forestry Management Fund to be carried in the name of the lessee, an -amount equal to five cents per acre. This fund was to be expended by the Lessee in forest management of the lands, namely: fire lanes were to be cut, Fire Warden service was to be maintained, and sound forestry methods were to be applied.

10. With respect to the cutting of timber, the 3 leases provided that:

(a) Union Bag will not cut or remove any timber during the first seven years of the lease (except such as may be necessary for construction, fire protection, to enhance the growth .of the main timber crop, or as fuel wood for turpentine operations.)

(b) after the first seven years Union Bag will not cut or remove any timber excess of the computed and estimated growth of the entire tract since the end of said first seven year period" (except such as is necessary for construction, fire protection, or "to enhance the growth of the main timber crop.")

11. The lessors sought these provisions prohibiting cutting during the first seven years (with immaterial exceptions)and limiting the cutting thereafter, as aforesaid, as security; thereby having the assurance that, since only the annual growth could be cut after the seven year waiting period, the lands would probably be returned to them with as much or more standing timber thereon than existed at the inception of the leases.

12. By an agreement entered into as of the 28th day of December, 1953 (Plaintiffs' Exhibit #5), the lessors and Union Bag agreed that "In case fire or other damage to the timber or said lands should occur under circumstances giving a right of recovery to Union Bag and Lessor any amount obtained through claim or action for such loss shall be paid to the Lessor and Union Bag

in equal shares. The legal and other expenses in connection with any such recovery shall be equally borne between Union Bag and Lessors."

13. By an agreement made and entered into as of the 1st day of January, 1957 (Plaintiffs' Exhibit #7), Union Bag, as *lessor*, entered into a turpentine lease covering all of the lands leased under the Dyal #1 and #2 leases. James E. Dyal, the lessor under Lease #2, was the *lessee under* the turpentine lease. By the aforesaid turpentine lease Union Bag granted to Mr. Dyal "the right and privilege to enter upon the lands * * * for turpentine purposes." As consideration, Mr. Dyal was to pay \$460 per crop, was to assume "throughout the term of the naval stores lease all of the obligations of Union Bag contained in said 99 year leases pertaining to the proper forest management, fire lane and fire protection services," and became responsible for spraying infested trees, control burning and maintaining in good repair all roads, rights of way and bridges. Union Bag agreed to furnish Mr. Dyal such lumber as may be necessary for the proper maintenance and repair of the bridges.

14. Union Bag entered into these leases in order to obtain the land upon which to tree farm or to produce successive and continuing crops of pulpwood and timber.

CONCLUSIONS OF LAW

1. This Court has jurisdiction of the parties and subject matter of these actions.

2. The question before the Court in all four of these actions is a determination of the true character of the annual payments made to the plaintiffs by Union Bag under the above described long-term leases. The proper tax treatment of such payments constitutes the controversy created by the Commissioner of Internal Revenue's denial of capital gains treatment to the instant plaintiffs as recipients of the annual rentals. This question, as to the legal effect of the agreements, to be ascertained by a construction of their terms, is a question of law.

3. The 3 leases in question are true leases of land rather than so-called "timber leases" or "cutting contracts." Each lease is referred to as "this lease." The Dyals are denominated lessors and Union Bag lessee. The annual payments are called "rentals." The terminology used is completely that of a lease. Each recites the names of the lessors and lessee. Each describes the boundaries of the property leased. Each lease fixes the annual rental payable in all events, and a periodic time of payment. Each lease is executed by both the lessor and the lessee. Each provides for a specified limited term only and they do not pretend to convey any title or equity. It would be difficult to draft an instrument more completely embodying the language of a typical lease. "While the descriptive terminology of the contracts is not controlling, we cannot ignore or go beyond the language adopted by the parties as the memorial of their agreements." *Albritton v. Commissioner*, 248 F. 2d 49, 50 (C. A. 5th).

4. Union Bag acquired the right to cut only the estimated annual growth during its tenancy, not a purchase of standing timber or a timber cutting contract.

5. The leases grant Union Bag "the complete and exclusive use and control of said lands," not a mere license to enter on the land and cut timber. Union Bag received many other valuable rights, i.e., turpentine, naval stores, mining, water, water power, grazing, farming and hunting rights plus mineral rights. In short, Union Bag is virtually free to use the lands in any way it sees fit, so long as they contain at the end of the terms the same amount of timber. For all practical purposes, Union Bag secured the exclusive use, control, and enjoyment of all of the possessory rights in the real estate. The annual consideration paid to acquire these rights in the real estate is "rent."

6, The annual rentals, the only payments in dispute in these cases, are fixed and in no wise based upon the amount of timber cut or removed, or indeed, even upon the presence of any timber.

7. These leases for all practical purposes are but refinements upon the established right of any lessee of timberlands to cut and remove timber in order to enjoy the full use of the land. As the Fifth Circuit Court of Appeals stated in *Dyal v. Union Bag-Camp Paper Corp.*, 263 F. 2d 387 (wherein the same leases were construed and uniformly referred to as "leases" and annual payments as rentals), Union Bag obtained the right to remove the "computed and estimated growth" during the terms of the leases. This right is the same right that any farmer receives When he leases land to grow crops. It was the use of the land which was conveyed by the lessors for Union Bag's tree farming operations.

8. The Plaintiffs contend that they are entitled to capital gains treatment upon the receipt of these annual payments from Union Bag by virtue of Section 631(b) of the Internal Revenue Code of 1954. Section 631 (b) applies to an owner of timber:

- (a) who owns it for more than six months before disposal; and
- (b) who disposes of it under a contract by virtue of which he retains an economic interest.

The disposer of timber must derive his pay out of the severance or sale of the timber, Payments by way of rentals for land, or other .payments for land use not attributable to the cutting of timber existing or to be grown upon the land, are not entitled to capital gains treatment. *Lawton v. Commissioner*, 33 T. C. 47. Treasury Regulations on Income Tax (1954 Code), Section 1.611-1 (b) (1).

9. In the instant cases, there was neither a sale of timber nor a disposal of timber with a retained economic interest therein. Therefore, the payments in question do not qualify for capital gains treatment under either Section 631(b) or 1231 of the Internal Revenue Code of 1954.

10. Capital gains treatment is not therefore applicable to the lessors' receipts. As the Tax Court stated in construing a lease quite similar to the instant leases, the "Rent was to be paid each year regardless whether or not any of the timber involved was cut or removed from petitioner's acreage. As the agreement is explicit in this respect, we think it clear that petitioners have not, in any sense of the term, retained the necessary economic interest in the timber which would entitle them to capital gains treatment * * *." *Lawton v. commissioner*, 33 T. C. 47, 54. The *Lawton* case similarly rejected that lessor's contention that his contract of lease was essentially a sale of timber-cutting rights and stated (p. 56):

Viewing the contract in its entirety, in our opinion the payment of \$1.75 · per acre by Union Bag was in the nature of rent for the right to use and occupy petitioner's acreage for "pine tree farming" and other independent forestry activities * * *

The very essence of the term, "retained economic interest" is that the owner must derive his pay out of the severance of the timber. As aforesaid, the leases in question provide for annual rental payments not conditioned upon the amount of timber cut and sold. The amounts received by the taxpayers which they seek to have treated as capital gains are made up entirely of these annual fixed payments.

11. The right to conduct the extractive operations alone is not a sufficient economic interest.

Scofield v. La Gloria Oil and Gas Co., 268 F. 2d 699 (C. A. 5th). Thus, the fact that the Dyals had the right of first refusal to cut the trees for Union Bag or lease the turpentine operations is irrelevant.

12. Similarly irrelevant is the fact that the Dyals were charged with the responsibility for fire control and forest managements as part of the obligations they assumed as *lessees* from Union Bag under turpentine leases.

13. Also irrelevant is the fact that Lease #3 provided for a interest in the mineral rights in the property. While that would indicate a retained interest in the mineral rights, in fact the explicit retention of mineral rights would indicate that the leases did not contain an implicit retention of interest in the timber.

14. The leases in question do not fall within *Revenue Ruling 62-81*, 1962-1 *Cum. Bull.* 153, which provides for capital gains treatment of that part of the consideration received attributable to a transfer of property in a transaction amounting to a present sale of timber. That revenue ruling presupposes a sale of existing timber. Under the terms of the leases in these cases, the annual payments made by Union Bag during 1956, 1957 and 1958 cannot be attributed to timber existing at the execution of the leases as Union Bag is cuffing only the annual growth after a seven year waiting period. These payments are clearly consideration for the use of the land by the paper company, including as a part of its possessory rights the right to cultivate and cut the annual timber growth. Here, the lessee has undertaken to return the leased lands to the lessors with as much, or more, timber standing thereon as existed at the beginning of the leases, no timber depletion will occur on these lands. In *Superior Pine Products v. Williams*, 214 Ga. 485, 106 S. E. 2d 6, the Supreme Court of Georgia held that an agreement between Superior and St. Regis Paper Co. (which had far fewer of the characteristics of a lease of land than the Dyal leases) was in fact, under Georgia law, a lease rather than a sale, and that the payments made thereunder were "rentals," taxable as ordinary income to the lessor.

15. The annual payments required to be made by Union Bag constitute rentals and as such are taxable as ordinary income. This Court notes that the identical contracts have been construed by Commissioner Fletcher of the Court of Claims who determined that they were in fact leases for the use of lands and that the payments made by Union Bag were true rentals and deductible as such by the lessee. *Union Bag Camp Paper Corp. v. United States* (Court of Claims No. 386-58) Opinion and Findings of Fact of Commissioner Fletcher pending review by the Court, filed February 25, 1963. See also Ray *v. Commissioner*, 283 F. 2d 337 (C. A. 5th), affirming 32 T. C. 1244.

16. In view of the foregoing, the Commissioner of Internal Revenue correctly determined that the plaintiff-taxpayers are not entitled to treat the annual payments in question as long-term capital gains and the defendant, United States of America, is entitled to Judgment and its costs in each of the four cases.

JUDGMENT

These cases, having been consolidated for trial, were heard on November 4 and 5, 1963, during the regular November Term of Court in Brunswick, Georgia before the Court and a jury of regularly empanelled jurors. Messrs. Albert Fending and Chris Conyers appeared for the plaintiffs and Leon W. Vaseliades, Attorney, Department of Justice, appeared as counsel for the defendant.

At the conclusion of the presentation of the plaintiffs' evidence and case, and upon timely motion

by the defendant for Directed Verdicts and after extensive legal argument, the Court granted the defendant's Motion for those reasons set out in the Court's Opinion, Findings and Conclusions filed this date, and directed the jury to return a verdict for the defendant in each of these cases. Whereupon, the jury returned into Open Court its verdicts in favor of the defendant in each case.

Pursuant to the foregoing it is hereby ORDERED, ADJUDGED and DECREED that judgment be and is hereby entered in favor of the defendant in each case, together with costs and that the plaintiffs take and recover nothing.

* Hereinafter referred to as Union Bag.