FORBES v. UNITED STATES
75-1 U.S. Tax Cas. ¶9126, 35 Am. Fed. Tax R.2d 75-448 (1974).

Editor's Summary

Key Topics

CAPITAL ASSET
• Defined

ECONOMIC INTEREST
• As precluding outright sale

DISPOSAL WITH A RETAINED ECONOMIC INTEREST
• Contract, necessity of
• Ordinary course of business, disposals in

OUTRIGHT SALE--CAPITAL GAIN v. ORDINARY INCOME
• "Primarily for sale" discussed

Facts

Taxpayers, who were principally engaged in raising livestock, growing peanuts and pecans, and providing quail for hunting, sold timber from their ranch in 1961, 1964, 1965, and 1966, the latter two years being the taxable years involved in litigation. The taxpayers reported the proceeds from the sales as long-term capital gains, but the Commissioner concluded that they should be treated as ordinary income. The 1965 sale was conducted by a consulting firm which had advised the sale due to beaver damage to the timber, but title did not pass to the buyer until the logs cut by the taxpayers were picked up by the buyer at a distribution point. The 1966 sale was precipitated by the discovery of diseased timber on one tract. An oral agreement was made whereby the buyer, in his discretion, had the right to cut as much standing timber as he desired, paying only for what he cut. The taxpayers claimed the timber sold in both years as a capital asset under section 1221.

District Court

Held: For the Government. The court found that neither the logs sold in 1965 nor the standing timber sold in 1966 were capital assets under section 1221 because they were held primarily for sale to customers in the ordinary course of the ranch's business. The court noted that although the sales were somewhat isolated and unrelated to the ranch's other businesses, three factors were present which indicated that the sales were made in the ordinary course of business: (1) The professional manner in which the sales were planned and conducted; (2) The sales in prior years;

and (3) The irregular availability of a timber "crop" due to its stow growth and natural growing hazards. The court also found that taxpayers had retained an economic interest in the timber sold in both years, preventing the sales from being treated as outright sales. With respect to the 1966 sale, the court found that section 631(b) was inapplicable because the oral agreement granting wide discretion to the buyer did not constitute a cutting contract within the meaning of the section. Accordingly, the court held, the taxpayers were not entitled to treat the proceeds in either year as long-term capital gains.

Case Text

Findings of Fact and Conclusions of Law

WILSON, District Judge: This is an action for recovery of income tax and interest that the plaintiffs contend were erroneously assessed. The case involves proceeds from the sale of timber in the years 1965 and 1966. The plaintiffs contend that the proceeds were entitled to capital gains treatment, while the Government contends that the proceeds were ordinary income. A settlement of certain issues originally involved in the lawsuits has been effected and the parties have stipulated that the only issue for adjudication by the Court is whether the timber sales in 1965 and 1966 generated capital gains or ordinary income. In the event that the Court concludes that capital gains treatment is proper for either or both years in issue, the parties are to determine the amount of any refund due under the Court's decision. The case was tried by the Court sitting without a jury and the Court now enters the following findings of fact and conclusions of law upon the full record made upon the trial of the case.

Findings of Fact

(1) Walter T. Forbes and Lucy F. Forbes, the plaintiffs in Civil Action No. 6469, are husband and wife. During the years 1965 and 1966 they operated a farm partnership known as the "Malatchie Ranch," located upon 6,000 acres of land owned by them and located in Houseton and Macon Counties, Georgia. Walter T. Forbes, Jr. and Katherine B. Forbes, the plaintiffs in Civil Action No, 6471, are likewise husband and wife. Walter T. Forbes, Jr. is the son of the plaintiffs in Civil Action No. 6469 and he and his wife have a partial interest in a 114 acre tract included within the Malatchie Ranch, the particular tract being generally known as the "Charlie Roger" tract:

(2) Prior to 1966, the plaintiffs raised cattle and engaged in general farming operations on the ranch, but in that year the cattle operations were discontinued, and the plaintiffs began growing pecans in addition to their farming operations'. The partnership also has operated for several years a hunting lodge for use by the plaintiffs and their affiliated corporations as a business entertainment facility.

(3) During the years 1961, 1964, 1965 and 1966 the plaintiffs sold timber from the ranch in varying amounts. At issue in this lawsuit are the timber sales in 1965 and 1966 only.

(4) The 1965 sales involved timber that was owned entirely by Walter T. Forbes, Sr. and Lucy F. Forbes. The gain upon this sale was reported by the taxpayers as capital gains. The Internal Revenue Service subsequently decided that the gain from this sale was ordinary income rather than capital gains and made a deficiency assessment against Mr. and Mrs. Forbes, Sr. The deficiency with interest was paid. The plaintiffs made a timely claim to the Internal Revenue Service for a refund, but the claim was denied, resulting in this lawsuit being filed.

(5) The 1966 sales involved timber that was owned in certain shares by all four plaintiffs. The gain realized upon this sale was likewise reported by the taxpayers as capital gain. Once again the Internal Revenue Service concluded that the gain was ordinary income rather than a capital gain and made a deficiency assessment which was paid. Following a denial of the plaintiffs' claims for refund, these lawsuits were filed.

1965 Timber Sale

(6) In 1965, Eley Frazer, the consulting firm of F & W Forestry Services (F & W), advised the Malatchie Ranch partnership that due to damage being caused by beavers it would be desirable to dispose of timber on one area on the ranch.

(7) Plaintiffs subsequently authorized Frazer to cut a representative sample of logs for purposes of receiving bids. Frazer hired a logger to felt, trim, cut into merchantable lengths and haul to a clear pasture a sufficient quantity of logs to accomplish this purpose.

(8) The logger, E. E. Landford, cut approximately 100,000 board feet of timber on which prospective buyers were invited to make bids. Southern Crate & Veneer Company (Southern Crate) of Macon, Georgia, made the high bid of $65 per thousand board/feet.

(9) The logging operation was thereafter commenced. The logger and a team of five to ten men felled, trimmed, and skidded the trees to a suitable flat area. At that point the trunks were cut into merchantable lengths and loaded onto trucks for transportation to an open pasture area. In the pasture, the logging team graded and scaled the logs under the supervision of F & W.

(10) Once every week or two, Southern Crate Sent logging trucks to the pickup point in the pasture and loaded and hauled away the logs that had accumulated.

(11) F & W. Submitted periodic Statements' to the logger setting forth the grades and quantities of logs cut and paid the logger his fee at the same time. F & W also submitted statements" to Southern Crate, which in turn sent checks to Lucy F. Forbes in payment of the quantity of logs shown on each statement, F & W also submitted periodic statements to plaintiffs setting forth gross receipts, logger's fees, consultant's fees and net return. The final of such statement submitted to plaintiffs contained the following information:

Summary	
Board Footage in logs cut May-November	818,792 Bd. Ft.
Gross income from logs cut May-November	$ 53,221.49
Cost of logger (E. E. Landford)	25,829.83
Gross net to Malatchie	27,391.66
Less cost of professional services	2,344.46
Net to Malatchie	25,057.20
Average net per thousand Bd. Ft.	32.68

(12) Title to the logs consisting of the 818,792 board feet of timber sold to Southern Crate passed to the buyer at the time the buyer took possession of the logs in the open pasture at the pickup point. Title to the 818,792 board feet of timber did not pass to Southern Crate at the time its bid of $65 per thousand as accepted or at the time the trees were felled or any time prior to delivery to Southern Crate at the pickup point in the pasture.

(13) There is no question upon the record in this case but that when the trimmed and scaled logs were offered for sale in 1965 they were property held by the taxpayers primarily for sale to customers. However, a rather close question is presented as to whether the timber sale in 1965, was an isolated timber sale, unrelated to the ordinary business, activities of the Malatchie Ranch, or whether the sale was made in the ordinary course of the ranch's business. Cattle raising, peanuts, pecans, row crops, and quail hunting appear to have been the principal sources of income upon the ranch during the period in question. However, it appears that significant sales of timber did occur on the ranch in 1961, 1964, 1965 and 1966. In two of these years, 1964 and 1965, the sales were motivated by natural timber casualties caused by ice damage in 1964 and beaver damage in 1965. When all factors are considered, including (1) the professional manner in which the timber sale was planned and conducted in that year, (2) the sales in prior and subsequent years, and (3) the irregular availability of a timber "crop" due to its slow growth and its natural growing hazards, the evidence would appear to preponderate in favor or a finding that the sale of the cut and scaled timber in 1965 was a sale made in the ordinary course of the Malatchie Ranch business.

(14) Furthermore, in view of the fact that the monetary return realized upon the timber sale conducted in 1965 was solely dependent upon the number of board feet which the plaintiff elected to cut and offer for sale, the plaintiffs admit in their answer to Defendant's Interrogatory No. 2 that they retained an economic interest in the timber within the meaning of Section 1.611-1(b)(1) of Treasury Income Tax Regulations.

(15) On the tax return of plaintiffs in Civil No. 6469 they reported as a long-term capital gain the net proceeds of the sale in the amount of $25,057.20.

1966 Timber Sale

(16) In 1966, plaintiffs in both actions entered into an oral contract with Fred Moore, Jr., under the terms of which Moore was given the right to cut and remove so much or all of the timber located on or around the Charlie Roger's tract of Malatchie Ranch consisting of approximately

114 acres as he in his discretion might determine. Although the plaintiffs now contend that the Moore agreement was to cut undesirable "marked" trees, in their answer to Defendant's Interrogatory No. 4(c) they conceded that the cutting was left to Moore's discretion. Moore agreed to pay to the plaintiffs in both actions for the timber cut by him a price varying from $20 per thousand board feet of pine to $32 per thousand board feet of number 2 hardwood to $35 per thousand board feet of number 1 hardwood.

(17) Moore actually cut approximately one-half of the timber located on the tract of land. He remitted $2,366.06 to plaintiffs in Civil No. 6469 and $1,195.97 to plaintiffs in Civil No. 6471 for their respective interests in the timber sold.

(18) With reference to the 1966 timber sale, a close question is again presented as to whether the sale was in the ordinary course of the Malatchie Ranch business. This sale was motivated by the recommendation of the forester to remove diseased and overcrowded trees in the designated area. However, when all factors are considered, as referred to in paragraph (13)above, the evidence would appear to preponderate in favor of a finding that the sale of timber in 1966 was also a sale made in the ordinary course of the Malatchie Ranch business.

(19) Furthermore, since timber in place is a depletable natural resource and since the plaintiff realized income in 1966 from the severance of that resource and since the timber sale in that year was not a sale of a total tract of timber, but rather was a sale of selective trees, the selection being within the buyer's discretion, the plaintiff retained an economic interest in the timber within the meaning of section 1.611-1 (b)(1) of Treasury Income Tax Regulations.

(20) On the 1966 return of plaintiffs in Civil No. 6469, plaintiffs reported a long-term capital gain of $2,366.06 from the disposition of timber; and on the return of plaintiffs in Civil No. 6471, plaintiffs reported a long-term capital gain of $1,195.97 from the disposition of timber.

Conclusions of Law

(1) This Court has jurisdiction over these actions under 28 U.S.C. § 1346(a)(1).

(2) The logs sold by the plaintiffs in 1965, as well as the timber in place sold in 1966 were not capital assets under Section 1221 because they were held primarily for sale to customers in the ordinary course of the plaintiffs' trade or business.

(3) The logs sold by the plaintiffs in *1965* and the timber sold in 1966 were likewise not capital assets under Section 1221 for the further reason that the plaintiffs retained an economic interest in the timber prior to severance. As stated in *Ray v. Commissioner of Internal Revenue* [CCH Dec. 23,762], 32 T. C. 1244 (1959), *affd,* [60-2 USTC ¶ 9739], 283 F. 2d 337 (5th Cir. 1960):

> "It is well settled that (except where section 631 is applicable) proceeds derived from the severance of natural resources by the holder of an economic interest in the property constitute ordinary income subject to depletion." 32 T. C. at 1254.

This conclusion is based upon the relationship between the capital gains provisions of the Internal Revenue Code and the provisions authorizing depletion allowances. As stated in the case of *Commissioner of Internal Revenue v. Brown* [65-1 USTC ¶ 9375], 380 U.S. 563,575-76, 14 L. Ed. 2d 75, 85 (1965):

> "Congress has recognized the peculiar character of the business of extracting natural resources.., which is viewed as an income producing operation and not as a conversion of capital investment.., but one which has its own built-in method of allowing through depletion a tax free return of the capital consumed in the production of gross income through severance."

Timber is, of course, a depletable natural resource. 26 U.S.C. § 611. The "economic interest" test originated in the field of oil and gas, but it has since been utilized in other fields. For example, the Sixth Circuit Court of Appeals has used the test to determine whether gains from the sale of hard minerals is ordinary income or capital gain. *See Belknap v. United States* [69-1 USTC ¶ 9203], 406 F. 2d 737 (6th Cir. 1969); *Gitzinger v. United States* [69-1 USTC ¶ 9120], 404 F. 2d 191 (6th Cir. 1968). Timber owners are only entitled to cost depletion rather than the more advantageous provisions for percentage depletion that are available to drillers and miners, but this distinction should make no difference. See *Vest v. Commissioner of Internal Revenue* [73-2 USTC ¶ 9513], 481 F. 2d 238 (5th Cir. 1973), *reh. denied en banc,* 481 F. 2d 1404 (1973). The fact that different types of natural resources receive different depletion allowances makes no difference. For example, the mineral involved in *Gitzinger v. United States* [69-1 USTC ¶ 9120], 404 F. 2d 191 (6th Cir. 1968) was limestone which was entitled to a depletion percentage of only 15%, whereas oil and gas owners received a 27% depletion percentage. See 26 U.S.C. § 613. See also *Wood v. United States* [67-1 USTC ¶ 9441], 377 F. 2d 300, 306-07 (5th Cir. 1967) (involving sand and gravel that was entitled to only a 5% depletion Percentage).

Applying the "economic interest" test to the present case, it is clear that the plaintiffs acquired an interest in timber in place, and it is equally clear that in both years the plaintiffs secured income from the cutting of the timber to which they looked for a return of their capital. Thus, to the extent that 26 U.S.C. § 1221 is relied upon, their gains from the sale of timber in 1965 and 1966 would be ordinary income rather than capital gains. The fact that the 1965 transactions would ordinarily be considered an outright sale makes no difference since the form of the instrument of transfer is not determinative. *Gitzinger v. United States* [69-1 USTC ¶ 9120], 404 F. 2d 191 (6th Cir. 1968). See *also Palmer v. Bender* [3 USTC ¶ 1026], 287 U. S. *551,* 77 L. Ed. 489 (1933).

(4) Since the plaintiffs relied entirely upon 26 U.S.C. § 1221 to qualify the 1965 sales for capital gains treatment, the Court con-dudes that the gains from those sales were ordinary income. The Court must, however, consider their alternative argument based upon 26 U.S.C. § 631(b) before making a final determination regarding the 1966 sales. See *Ray v. Commissioner of Internal Revenue* [CCH Dec. 23,762], 32 T. C. 1244 (1959), *aff'd,* [60-2 USTC ¶ 9739], 283 F. 2d 337 (5th Cir. 1960).

(5) In order to qualify for capital gains treatment under 26 U.S.C. § 631(b), the disposal of timber must be "under any form or type of contract," 26 U.S.C. § 631(b), and "This language covers just about every means by which people come to an understanding with one another." *Barclay v. United States* [64-2 USTC ¶ 9547], 333 F. 2d 847,855 (Ct. Cl. 1964). Nevertheless, there must be some sort of contract that is mutually binding upon the parties. Thus it was held in *Ah Pah Redwood Co. v. Commissioner of Internal Revenue* [58-1 USTC ¶ 9153], 251 F. 2d 163 (9th Cir. 1957) that there was no such disposal by contract where the buyer "was under no obligation to remove any timber and accepted no risk with respect to timber not removed." 251 F. 2d at 167. See also *United States v. Giustina* [63-1 USTC ¶ 9145], 313 F. 2d 710 (9th Cir. 1962), *aff'ing* [61-1 USTC ¶ 9169], 190 F. Supp. 303 (D. Ore. 1960); *Barclay v. United States* [64-2 USTC ¶ 9547], 333 F, 2d 847 (Ct. Cl. 1964).

(6) Although there is some inconsistency in the evidence as to the exact terms of the 1966 oral contract with Mr. Moore, the Court is of the opinion that the terms of the contract were in accordance with the plaintiffs' answer to one of the defendant's interrogatories. Those terms were that Mr. Moore "was given the right to cut and remove so much or all of the timber in the identified area as he may in his discretion determine..." Since this broad grant of discretion placed no obligation on the buyer to remove any timber, it appears that the present case falls within the holding of the *Ah Pah* decision, *supra.*

(7) The Court therefore finds that the 1966 sales do not qualify for capital gains treatment under the provisions of 26 U.S.C. § 631(b) and that the gains from those sales were ordinary income.

Conclusion

The Court having concluded that the sales of timber in 1965 and 1966 each resulted in ordinary income to the plaintiffs, the plaintiffs would be entitled to no refunds of income taxes assessed against and collected from them for those respective years.

An order will accordingly enter dismissing the plaintiffs' lawsuits.

Judgment of Dismissal

These are actions for the recovery of income tax and interest which the plaintiffs contend were erroneously assessed for the calendar years 1965 and 1966 in Civil Action No. 6469 and for the calendar year 1966 in Civil Action No. 6471. The cases were tried in a consolidated trial before the Court sitting without a jury. For the reasons set forth in Findings of Fact and Conclusions of Law filed herein by the Court, the Court is of the opinion that the plaintiffs' claims in each lawsuit are without merit and should be dismissed.

It is accordingly ORDERED that each of these lawsuits be and the same is hereby dismissed.

APPROVED FOR ENTRY.