GEORGIA-PACIFIC CORP. v. UNITED STATES
78-2 U.S.T.C. ¶9811 (1978)
43 AFTR 2d 79-337 (1978)

Editor's Summary

Key Topics

DEPLETION
· Who may take

DISPOSAL
· Related business entity, disposal to

AFFILIATED CORPORATIONS
· Effect of filing consolidated returns

Facts

Georgia-Pacific Corporation ("G-P") entered into timber cutting contracts with two of its wholly-owned subsidiaries. In one contract, G-P was the seller, and in the other it was the buyer. In the consolidated tax return filed by the G-P affiliated group of corporations, the income from the cutting contracts was treated as capital gain under Section 631(b). In addition, the members of the affiliated group who were the purchasers under the cutting contracts took depletion deductions reflecting payments made for the timber. The Internal Revenue Service agreed that the cutting contracts qualified under Section 631(b), However, it claimed that Treasury Regulations applicable to consolidated returns of affiliated corporations require that the income for the cutting contracts be treated as ordinary income.

District Court

HELD: For the Government. Treasury Regulation 1.1502-13 governs the effect of "intercompany transactions" on the tax liability of affiliated groups of corporations. That regulation provides that capital gains transactions under Section 631 and Section 1231 are to be treated as ordinary income transactions if they are deferred intercompany transactions and if the property involved is subject to a depletion deduction by a member of the affiliated group. G-P conceded that the timber cutting contracts were intercompany transactions. Hence, the only issues were whether the transactions were deferred and whether the timber involved in the transactions was subject to a depletion deduction. Treasury Regulation 1.1502-13 provides that an intercompany transaction is deferred if the amount of the expenditure is capitalized. Under Treasury Regulation 1.631-2(e)(l), amounts paid for timber cutting rights are part of a lessee's depletable basis of the timber. Thus, the amounts expended by the purchasers under the G-P cutting contracts are capitalized (i.e., form the basis of the timber in the hands of the purchaser). Further, the timber is subject to depletion by the lessee-purchaser. Although G-P stated that the taking of a depletion deduction in

the return was a mistake, the regulations, as read by the Court, would have permitted the purchasers to take a depletion deduction, and that is, according to the Court, sufficient to call for the application of Regulation 1.1502-13. Specifically, the Court held that a timber cutter who, under a contract with an affiliate for a definite term, purchases timber at a flat rate and who uses or disposes of the timber for its own account has an economic interest in the timber, and hence is entitled to a depletion deduction under Section 611.

Case Text

SOLOMON, District Judge: Plaintiff, the Georgia-Pacific Corporation (G-P) is the parent corporation of the "affiliated group" which includes Rex Timber Corporation (Rex) and Timber, Inc. (Timber), two wholly owned subsidiaries, which G-P organized.

G-P filed this action to recover part of its 1973 incomes taxes. G-P claims it was entitled to capital gains treatment for income from transactions between G-P and its two subsidiaries, Rex and Timber.

The parties submitted the case for decision on exhibits and stipulated facts.

G-P owned timber lands and timber cutting fights in many areas of the United States. In March 1973, G-P and Timber entered into a timber cutting contract (Timber Contract) by which Timber agreed to buy and cut timber on G-P's land located in Mendocino County, California.

On September 1, 1973, G-P transferred timber and timber cutting fights, located in Alabama, Arkansas and Mississippi to Rex as a contribution to Rex's capital. On the same day, G-P and Rex entered into a timber cutting contract (Rex Contract) by which G-P agreed to buy and cut the timber which it had transferred to Rex.

The Rex Contract and the Timber Contract were substantially the same. In one G-P was the buyer (Rex Contract) and in the other G-P was the seller (Timber Contract).

In 1973, timber under both contracts was cut and paid for monthly according to the terms of the cutting contracts. The buyers, G-P and Timber, contracted with independent loggers to do the logging. The buyers used the timber in their businesses or sold it for their own accounts.

The affiliated group filed a joint income tax return for 1973 under the consolidated returns chapter of the Internal Revenue Code (Code) 26 U.S.C. §§ 1501-63). Rex reported as a net long-term capital gain its profit of $1,478, 348 on some timber sold to G-P. G-P reported as a net long-term capital gain its profit of $376,872 from the sale of timber under the Timber Contract. The buyers, G-P and Timber, took depletion deductions reflecting these payments to the sellers.

The Internal Revenue Service (IRS) audited the consolidated return and proposed an assessment taxing the income of the timber sellers, Rex and G-P, as ordinary income, citing Treasury Regulation 1.1502-13 (26 C.F.R. § 1.1502-13). Plaintiff protested the assessment. Nevertheless, the IRS assessed G-P for the deficiency. G-P paid it and filed a timely claim for a refund of $372,471.52.

When the IRS disallowed it, G-P filed this action. [1]

G-P contends that it is entitled to long-term capital gains treatment for this income of the affiliated group under sections 1231 and 631(b) of the Code [26 U.S.C. §§ 1231 and 631(b)]. Section 631(b) provides that a timber transfer meeting certain requirements maybe regarded as a "sale or exchange" for tax purposes. Under section 1231, timber governed by section 631 is eligible for capital gains treatment. The government admits that Rex and G-P, as the sellers, qualify for section 1231 capital gains treatment under section 631(b). But the government points to Treasury Regulation 1.1502-13, governing consolidated returns, which establishes an exception to the capital gains provisions. The government argues that the income comes within the exception and is therefore taxable as ordinary income.

The Code requires the Secretary to issue regulations which fix the tax liability of an affiliated group filing a consolidated return. The return must "clearly... reflect the [affiliated group's] income-tax liability.., and.., prevent avoidance of such tax liability." (26 U.S.C. § 1502). A corporation agrees to these regulations by joining in a consolidated return (26 U.S.C. § 1501).

Treasury Regulation 1.1502-13 governs the effect of "intercompany transactions" on the tax liability of affiliated groups. G-P admits that the transaction under the Rex and Timber Contracts were intercompany transactions.

This regulation (1.1502-13) establishes an exception to those sections which permit capital gains treatment (§§ 631 and 1231) for income from some intercompany transactions, Subsection (c)(4)(ii) of this regulation provides that gains governed by subsection (d)(l) are to be "treated as ordinary income." This latter subsection applies to income from deferred intercompany transactions involving property eligible for depletion deductions. If income is governed by subsection (d)(1), then that income may not be treated as a capital gain.

The issue in this case is whether subsection (d)(l) applies to this income.

G-P is entitled to prevail unless (1) these transactions were deferred intercompany transactions and (2) members of the affiliated group were entitled to depletion deductions for this timber.

In my opinion these transactions were deferred intercompany transactions and the timber buyers were entitled to depletion deductions. I therefore hold that the income in question was properly treated as ordinary income and G-P is not entitled to a tax refund.

I. *Deferred Intercompany Transactions*

An intercompany transaction is "deferred" if "the amount of the expenditure is capitalized." [26 C. F. R. § 1.1502-13(a)(2)(iii).]

The government contends the payments made by the buyers under the contracts are capital expenditures. It asserts that amounts paid for timber cutting rights under Treasury Regulation 1.631-2(e)(1) [26 C.F.R. § 1,631-2(e)(1)] are regarded as "part of the lessee's depletable basis of

the timber." [1.631-2(e)(1)], [2] The government contends that timber costs are specifically included in the taxpayer's basis and are not otherwise deductible; they are capital expenditures recoverable through depletion over the lifetime of the contracts.

G-P contends that regulation 1.631-2(e)(1) only applies to income of lessees who make a section 631(b) disposition of their timber; therefore 1.631-2(e)(1) does not govern these expenditures. It bases this interpretation on the legislative history of section 631(b), [3] its language and the order in which the provisions of the section were enacted.

G-P argues that the second sentence of section 631(b) [4] means that section 63 l(b) does not affect the tax treatment of a timber buyer.

This sentence was added in 1951 when the provision for timber, then section 117(k)(2) of the Internal Revenue Code of 1939, was extended to coal. [65 Stat. 452, at 501 (1951)]. The *1951* amendments provided that coal owners who were authorized to receive capital gains treatment were not entitled to percentage depletion deductions. The sentence was suggested by Henry Fernaid of the American Mining Congress to preserve the percentage depletion deductions then authorized for coal lessees. [5]

When Congress separated the timber [§ 631(b)] and coal [§ 631(c)] provisions in the Internal Revenue Code of 1954, it kept this sentence in both subsections.

G-P contends that this provision was enacted to insure that section 631(b) would not give depletion deductions to timber cutters.

I disagree. In my view the sentence was intended to preserve the percentage depletion deductions available to coal lessees. It does not prohibit depletion deductions permitted under the depletion provision, section 611 (26 U.S.C. § 611), which are consistent with section 631.

G-P next contends that regulation 1.631-2(e)(1), adopted in 1957, was prompted by the last sentence of section 631(b) which was added by the 1954 amendment and which extended section 631(b) benefits to all timber cutters by broadening the definition of "owners." [6] G-P contends that the regulation only applies to contractors who are eligible for capital gains treatment as a result of a section 631(b) disposition.

This regulation, 1.631-2(e)(1), provides:

> "Amounts paid by the lessee for timber or the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor."

I reject this limited interpretation. In my view, 1.631-2(e)(1) governs the tax treatment of timber costs of these buyers.

Here, G-P did treat its costs as capital costs. It originally regarded the timber rights transferred to Rex as a "contribution to capital" and then bought back all these "capital" rights. Now G-P contends that Rex as a seller is entitled to capital gains benefits authorized for capital transactions. But here G-P as a buyer capitalized these costs and originally claimed depletion deductions for the costs of this timber.

The costs incurred by Timber were also treated as capital costs. G-P asserts that, as the seller under the Timber Contract, it is entitled to the capital gains benefits authorized for capital transactions. Yet originally Timber, the buyer, capitalized its costs by claiming depletion deductions for the costs of its timber.

In other words, G-P treated these buyers' costs as capital expenditures. This was proper. In my view, regulation 1.631-2(e)(1) required such treatment. I therefore find these transactions are deferred intercompany transactions for the purposes of calculating plaintiffs taxes.

II. *Depletion Deductions*

Code section 611 authorizes "a reasonable allowance for depletion [of timber].., according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate."

Treasury Regulation 1.611-1(b) [26 C.F.R. § 1.611-1(b)] governs this deduction. 1.611-1(b)(2) provides that one who sells timber while retaining an economic interest is not entitled to depletion deductions. The government agrees that the *sellers are* not entitled to depletion deductions. Nevertheless, the government asserts the *buyers* are eligible for depletion deductions and the sellers' income is therefore not entitled to capital gains treatment.

G-P took depletion deductions for this timber. G-P now says that it was a mistake which it desires to correct.

I do not believe it was a mistake. In my view the buyers are entitled to depletion deductions. Regulation 1.611-1(b)(1) provides that:

> *"Economic Interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in... standing timber. An economic interest is possessed... [when] the taxpayer has acquired by investment any interest in... standing timber and secures, by any form of legal relationship, income derived from the.., severance of the timber, to which he must look for a return of his capital .... A person who has no capital investment in the.., standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production."

For the reasons hereafter stated I hold that the buyers have interests in standing timber, which are economic interests and which result from capital investments.

A. *Interests in Standing Timber*

Timber must be standing timber to be eligible for depletion under regulation 1.611-1(b)(1). G-P argues that the timber here is cut timber.

The government first contends that the court may not consider this issue on jurisdictional grounds. It asserts that G-P did not adequately present this issue in its claim. I disagree. G-P discussed the depletion issue and the relevant regulations in its initial filings. It fully informed the IRS that it contested the timber's eligibility for depletion deductions. This is sufficient. *Mayer v. United States* [61-1 USTC ¶ 9147], 285 F. 2d 683 (9th Cir. 1960).

The government asserts that these timber cutting contracts conveyed an interest in standing timber. It cites *United States v. Giustina* [63-1 USTC ¶ 9145], 313 F. 2d 710 (9th Cir. 1962); *Barclay v. United States* [64-2 USTC ¶ 9547], 333 F. 2d 847 (Ct. Cl. 1964), and *Willamette Valley Lumber Co. v. United States* [66-1 USTC ¶ 9258], 252F. Supp. 199 (D. Or. 1966).

Guistina and *Barclay* involved timber cutting contracts which conveyed interests in standing timber. In each case, the court held that a cutter was entitled to section 117(k)(2) [7] capital gains treatment. In *Willamette*, which also involved a timber cutting contract, the court held that the cutter had a sufficient interest to deduct real property taxes. Although none of these cases considered whether a timber cutting contract conveys an interest in standing timber for depletion purposes, the government contends that the reasoning of these cases is applicable here.

G-P, on the other hand, cites *Norton v. United States* [77-I USTC ¶ 9296], 551 F. 2d 821 (Ct. Cl. 1977), and *J. R. Simplot Co. v. Commissioner* [CCH Dec. 28,458(M)], 26 T.C.M. (CCH) 488, ¶67-104 T.C.M. (P-H) (1967), to show that timber cutting contracts do not convey an interest in standing timber. These cases denied timber cutters, who were not eligible for section 631 benefits, other section 1231 capital gains benefits because they did not have an interest in standing timber. But neither case considered depletion deductions.

G-P also points to some of the provisions of its contracts which appear to negative a transfer of an interest in standing timber. Both contracts contain risk of loss clauses which reserve title in the sellers until cutting and payment, clauses barring assignment and clauses requiring the sellers to pay property taxes on the timber.

Under the Rex Contract, G-P agreed to cut "all" timber within ten years, and in its contract Timber agreed to cut "up to fifty million (50,000,000) board feet" of timber in 22 months. Each buyer had an absolute right to the standing timber.

I therefore find that these contracts conveyed an interest in standing timber.

B. Economic Interests

The buyers must have economic interests in the timber to be eligible for depletion deductions.

The government asserts and G-P denies that the buyers have such interests.

Here, the buyers agreed to cut and pay a set rate for timber, and they were free to use or sell the timber for their own accounts. These contracts ran for definite periods. They were not terminable at will.

A taxpayer may have an economic interest in a resource even though the taxpayer neither owns nor leases the land where the resource is found, *Commissioner v. Southwest Exploration Co.* [56-1 USTC ¶ 9304], 350, U.S. 308 (1956).

A contract miner, working under a contract terminable at will, who mines coal for a flat rate without investing in the coal, does not have an economic interest in the coal. *Paragon Jewel Coal Co. v. Commissioner* [65-1 USTC ¶ 9379], 380 U.S. 624 (1965). But a contract miner who pays a flat fee for coal which he then sells for his own account has an economic interest in the coal, *Thornberry Constr. Co. v. United States* [78-1 USTC ¶ 9452], 576 F, 2d 346 (Ct. Cl. 1978).

In my view the same reasoning applies here. A timber cutter who, under a contract with an affiliate for a definite term, purchases timber at flat rate and who uses or disposes of the timber for its own account has an economic interest in the timber.

I therefore hold that the buyers, G-P and Timber, had economic interests which entitle them to depletion deductions.

C. Capital Investments

The economic interests must have been "acquired by investment". I have already held, in Part I of this opinion, that the buyers made capital expenditures. These capital expenditures were capital investments which entitle the buyers to depletion deductions.

III. Conclusion

I hold these transactions are deferred intercompany transactions and that the timber buyers are entitled to depletion deductions. Under regulation 1.1502-13 this income is taxable as ordinary income. This action should be dismissed.

This opinion shall constitute findings of fact and conclusions of law under Fed. R. Civ. P. 52(a).

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1 Georgia-Pacific agrees that, due to an unspecified adjustment, it is not entitled to the full amount of its claim.

2 Timber cutters are treated as lessees under section 631(b).

3 Section 631(b) states:

"In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. *In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection* .... For purposes of this subsection, the term 'owner' means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber." [Emphasis added.]

4 Underlined in footnote 3.

5 Hearings on H.R. 4473 before the Senate Committee on Finance, 82d Cong., 1st Sess., pt. 2, 1174, 1177-78, 1184.

6 See footnote 3.

7 Section 117(k)(2) of the 1939 Code is now section 631(b) of the 1954 Code.