**INDIAN CREEK LUMBER COMPANY V. COMMISSIONER**
**43 T.C.M. 841**
**Tax Ct. Mem. Dec. (CCH) 38,877(M), (P-H) ¶82,146**
(Timber issue only)

***Editor's Summary***

***Key Topics***

*CUTTING CONTRACT*
• Assignment or sale of
• Outright sale---capital gains v. ordinary income
*DISPOSAL WITH A RETAINED ECONOMIC INTEREST RETAINED*
• Economic interest
•• defined
•• requirement that owner retain
•• risk of loss
• Owner defined

***Facts***

The taxpayer produced lumber from timber purchased from the United States Forest Service (USFS) and numerous other outside sources. In 1973 the business, which included a USFS and a private timber cutting contract (Cheney), was sold. On its 1974 tax return taxpayer reported a long-term capital gain of $1,458,735 from the sale of the cutting contracts, pursuant to Section 631(b). The government contended that the sale of the contracts did not qualify for capital gains treatment under Section 631 (b) because an economic interest was not retained. Furthermore, the government maintained that the contracts did not otherwise qualify as Section 1231 property and were not capital assets since they fell within the exception to Section 1221 defined by *Corn Products Refining* Co. v. *Commissioner,* 350 U.S. 46 (1955).

***Tax Court***

**HELD: For the Government.** Section 631(b) requires that the taxpayer be the "owner" of the timber and dispose of it with an economic interest retained, Although the taxpayer qualifies as the owner of the USFS timber, it did not qualify as the owner of the Cheny timber since it only had the right to receive timber cut, not the right to cut, Furthermore, as regards both contracts the taxpayer did not retain an economic interest since the buyer was required to cut all of the contracted timber and pay for the "warranted" volume of timber. The Court rejected taxpayer's argument that the contractual provision requiring payment of a "bonus" or "damages," to reflect the actual volume of timber received by buyer constituted a retention of an economic interest. The Court focused on contractual provisions which transferred all risks of production to buyer as indicative of complete transfer of economic interest. Capital gains treatment under Section 1231

did not otherwise apply because the contracts were neither real nor depreciable property used in the trade or business of the taxpayer. They were not real property since the taxpayer did not receive an interest in standing timber; and were not depreciable property since the contracts had neither a basis nor a useful life, and their value did not diminish with use or the passage of time. Finally, capital gains treatment under Section 1221 did not apply. Although the contracts did not fall within one of the specific exemptions set forth in Section 1221, under *Corn Products* an asset is excluded if it constitutes an integral part of the business. The taxpayer acquired virtually all of the timber needed to supply its sawmill by means of such contracts, making them an integral part of the business, not an investment.

## *Case Text*

WILES, Judge: Respondent determined the following deficiencies in petitioners' Federal income taxes:

| Taxable Year Ended | Deficiency |
|---|---|
| May 31, 1972 | $ 136,539 |
| May 31, 1973 | 380,618 |
| May 31, 1974 | 186,130 |
| May 31, 1975 | 133,781 |

By amended answer, respondent determined an additional deficiency of $262,572 for the taxable year ended May 31, 1974. After concessions, the issues for decision are: [1]

1. Whether the original use of certain property commenced with a member of the Indian Creek Lumber Company group of consolidated subsidiaries for purposes of determining the amount of the investment credit and the method of depreciation allowable for such property.

2. Whether the payment received by a member of the Indian Creek Lumber Company group of consolidated subsidiaries upon the sale of its interest in certain timber contracts must be included in income in the taxable year of receipt, and if so, whether such income is taxable as capital gain or ordinary income.

## *Findings of Fact*

Some of the facts have been stipulated and are found accordingly.

Indian Creek Lumber Company (hereinafter IC) is a California corporation with its principal office in Central Point, Oregon. For the taxable year ended May 31, 1972, IC filed a consolidated income tax return with its subsidiaries, Plumas Lumber Company (hereinafter Plumas) and Erickson Air-Crane Co. (hereinafter Air-Crane). For the taxable years ended May 31, 1973, 1974, and 1975, IC filed consolidated income tax returns with its subsidiaries, Plumas, Air-Crane, and Erickson Air-Crane Co. of Washington, Inc. [2] IC and its subsidiaries (hereinafter petitioners) maintain their books on the basis of a fiscal year ending May 31 and compute their income under the accrual method of accounting.

* * * * *

*Issue 2: Income from Sale of Timber Contracts.* Plumas was formed in June 1956. From that time until June 1973, Plumas engaged in the business of operating a lumber sawmill near Crescent Mills, California. The annual capacity of Plumas's sawmill was approximately 30,000,000 board feet of timber. While the principal source of the timber processed by Plumas's sawmill was timber purchased from the United States Forest Service [7] (hereinafter USFS), Plumas also purchased a significant quantity of timber from other parties. Virtually all of the timber processed by the sawmill was acquired from these two sources.

Pursuant to separate timber cutting contracts awarded to Plumas by the USFS, it purchased the timber on the following tracts of land for use in its business:

| Tract | Date of Award |
|---|---|
| Babcock | February 26, 1973 |
| Cold Stream | March 16, 1970 |
| Lights Creek Skyline | June 2, 1970 |
| Nye Creek | December 28, 1970 |
| Flournoy | November 30, 1970 |
| Bagley | June 17, 1968 |
| Bogard | November 8, 1972 |

Under each timber cutting contract, the USFS agreed to sell and Plumas agreed to purchase, cut, and remove all of the "included timber" [8] within the identified tract. Each contract required plumas to cut and remove all of the timber designated for cutting by the termination date of the contract. Plumas paid for each specie of timber cut at a specified rate per thousand board feet (Mbf), with some rates subject to adjustment under escalation procedures. The timber cutting contracts required Plumas to pay for any designated timber remaining uncut upon the expiration of the contract. Plumas could only obtain an extension of the contract period under certain enumerated circumstances.

All right, title, and interest in and to any included timber remained with the USFS until it had been cut, scaled, removed from the sale area, and paid for; at which time title would vest in Plumas. All losses, other than those due to negligence, attributable to timber damaged or destroyed by causes such as fire or disease were to be borne by the person holding title to such timber, except that Plumas would bear such losses when incurred after the removal of timber from the sale area.

With respect to the assignment by Plumas of its rights under the timber cutting contracts, the contract pertaining to the Babcock tract, the provisions of which are representative of other contracts, provided:

> B8.4 Performance by Other Than Purchaser. The acquisition or assumption by another party under an agreement with Purchaser of any right or obligation of Purchaser under this contract shall be ineffective as to Forest Service, until Forest Service has been notified of such agreement and has given written approval by the forest officer who approved this

contract, his successor or superior officer; and in no case shall such recognition or approval:

(a) Operate to relieve Purchaser of the responsibilities or liabilities he has assumed hereunder; or

(b) Be given unless such other party:

(i) Is acceptable to Forest Service as a purchaser of timber and assumes in writing alt of the obligations to Forest Service under the terms of this contract as to the uncompleted portion thereof, or

(ii) Acquires the rights in trust as security and subject to such conditions as may be necessary for the protection of the public interest.

Pursuant to an agreement dated June 15, 1973[9] (hereinafter "the sale agreement"), Plumas sold its plant, equipment, the above-mentioned USFS timber cutting contracts, [10] and other real and personal property to Louisiana-Pacific Corporation (hereinafter LP) for $3,110,648. In addition, Plumas assigned to LP a contract under which it was entitled to receive the logs removed by Cheney Forest Products Co. (hereinafter Cheney) from a certain USFS timber sale known as "Jenny Springs" (hereinafter referred to as the "Cheney contract").[11] Plumas did not own the USFS timber cutting contract pertaining to the Jenny Springs sale, but merely had the right to receive the logs removed therefrom by Cheney. During the taxable year ended May 31, 1974, Plumas received full payment of the purchase price set forth in the sale agreement. After the sale, the principal business activity of Plumas was "investments."

In pertinent part, the sale agreement provided as follows:

(3) The risk of loss as to all items sold hereunder, including any rights under the U.S. Forest Service contracts, shall shift on closing from the Seller to Buyer, However, Buyer shall not permit or suffer any breach of any timber sale contract, and will harvest all logs harvestable under the terms of said timber sale contract within the time provided by each contract, or prior to June 15, 1976, whichever shall be the earlier. Buyer shall not apply for reduction in permissible log harvest, or extension of said contract without the prior written consent of Seller.

(4) From and after the date of closing, all logs cut from timber sale contracts shall be branded with a brand different from the brand heretofore used by Seller. Seller warrants to the Buyer that the total net volume of logs receivable, Forest Service Scale Scribner Decimal C, short log, of the within Agreement is 84 million feet. To the extent that Buyer receives less than the aforesaid volume, Buyer will be damaged. On the other hand, to the extent that Buyer receives more than 84 million feet, Buyer will receive an unbargained for benefit.

In the event that the total volume received is more than 84 million feet, Buyer will pay a bonus to Seller upon ascertainment of final volume. In the event that the footage is less than 84 million feet, Seller will pay unto Buyer, Buyer's damages. If the parties cannot agree upon the bonus or damages, as the case may be, they agree to arbitrate the same under the rules of the American Arbitration Association.

Buyer will provide Seller with scale tickets, and other reasonable documentation, from time to time so that Seller may be informed as to the volumes that Buyer receives near

[sic] the within Agreement.
(5) In order to transfer the United States Forest Service contracts above referred to, it will be necessary that the consent of the Forest Service be obtained, Both parties hereto Will cooperate in obtaining such consent, and will execute all documents as may be reasonably required in furtherance thereto. In the interim, and pending transfer, following the date of closing, it will be necessary that Buyer continue to operate on such sales in the name of Seller, and Seller consents thereof.

By an ancillary agreement dated November 7, 1973, Plumas and LP agreed as follows with respect to the bonus or damages payable if LP received more or less than the warranted volume of timber. [12]

> This will express and confirm the agreement of Louisiana-Pacific Corporation and Plumas Lumber Company, related to their contract dated June 15, 1973, that the bonus/damages for overrun/underrun of the nominal 84,000 Mbf (Scribner's Decimal "C" scale) * * * shall be at the rate of $17.52 Mbf (Scribner's Decimal "C" scale). The foregoing adjustment shall be made Within 60 days after ascertainment of the overrun/underrun.

Although the sale agreement is not clear on this point, the parties intended that the logs received under the Cheney contract would be taken into account together with the timber cut by LP under the nine USFS timber cutting contracts in computing whether LP had received the warranted volume of timber and any overrun or underrun with respect thereto. [13]

Pursuant to a document entitled "Third Part Agreement," the USFS approved the transfer from Plumas to LP of all of the timber cutting contracts, except those pertaining to the Bogard and Fleming tracts. Under the third party agreement, LP assumed all of Plumas's obligations under the timber cutting contracts, agreeing to perform those contracts in accordance with the terms thereof.

Due to their failure to obtain USFS approval of the transfer of the timber cutting contracts pertaining to the Bogard and Fleming tracts, Plumas and LP entered into a supplemental agreement dated May 18, 1974. This agreement provided as follows:

> It is agreed:
> 1. Plumas will exclude the Bogard and Fleming sales from the group of sales submitted to the Forest Service for its acceptance of the transfers contemplated by the contract of 15 June 1973. It is understood that the Forest Service will confirm and approve such transfers if the Bogard and Fleming sales are so excluded.
> 2. In so excluding the Bogard and Fleming sales from the group submitted to the Forest Service, Plumas will not be deemed to have rescinded the sale of those two contracts (Bogard and Fleming) to L-P, but will instead be regarded, and conduct itself as holding said Bogard and Fleming sales contracts as the property of L-P (as between these parties); and Plumas will promptly comply with L-P's written instructions to transfer the Bogard and Fleming contracts to any person, firm or corporation in a lawful manner, or to dispose of the same in any lawful manner directed by L-P.

3. The parties hereto agree that the stumpage on the Bogard and Fleming sales shall be established forthwith by appropriate means (cruise or agreement between parties). If the parties are unable to agree upon the amount of the stumpage, then L-P shall have a cruise made by a cruiser acceptable to Plumas, at L-P's expense, to determine the stumpage. As used herein, "stumpage" means the volume of timber that a qualified owner of the sales could legally remove therefrom; and it shall also include the scaled amount of timber already cut by L-P on either or both of said sales to the extent that credit therefor has not already been applied to the 84,000 Mbf guarantee. In the event that L-P fails to harvest the timber on the Bogard and Fleming sales, then the volume established under the terms of this paragraph shall be credited toward the 84,000 Mbf guaranteed minimum cut mentioned in the contract of June 15, 1973 and the ancillary agreement of November 7, 1973.

* * *

5. L-P shall wholly defend and indemnify Plumas against any liability incurred by Plumas in performing this agreement, and in holding or transferring said sales contracts hereto; exclusive of liabilities caused by Plumas' breach of this agreement.

6. The risk of loss, legal or material, of any property or value related to the Bogard and Fleming sales shall be assumed by L-P. This includes the risk of fire or other natural occurrence, and the risk of termination or other action by government that may wholly or partially affect the value of said sales.

* * *

On the date of the sale to L-P, Plumas assigned $1,471,680 of the purchase price to the timber contracts it had sold to L-P. This allocation was computed on the basis of a sale of 84,000,000 board feet of timber at a price of $17.52 per thousand board feet. Although subsequent adjustments to certain accounts caused Plumas to allocate only $1,458,735 of the purchase price to the timber contracts for tax and financial reporting purposes, Plumas and LP had contemplated a sale of the timber contracts in exchange for a purchase price of $17.52 per thousand board feet of timber subject to those contracts. On the consolidated return filed by petitioner for the year ended May 31, 1974, Plumas reported long-term capital gain of $1,458,735, under section 1231 from the sale of the timber contracts. [14] By Amended answer, respondent alleged that the $1,458,735 gain reported on petitioners' consolidated return constituted ordinary income, and accordingly, asserted an additional deficiency of $262,572 for the taxable year ended May 31, 1974.

## ***Opinion***

*Issue 2: Income from Sale of Timber Contracts.* By way of amended answer, respondent alleges that the income reported by Plumas from the sale of the timber contracts constitutes ordinary income rather than long-term capital gain. Petitioners, on the other hand, maintain that Plumas erred in reporting any income from the sale of the timber contracts on the return filed for the year ended May 31, 1974, because the income from such sale was not ascertainable during that year. While Petitioners bear the burden of proving that Plumas did not realize any taxable income from the sale of the timber contracts during the year ended May 31, 1974, the additional deficiency attributable to the issue raised by respondent's amended answer requires him to carry the burden of proof with respect thereto. Rule 142(a), Tax Court Rules of Practice and Procedure.

Initially, we must reject the contention that Plumas did not receive any taxable income from the sale of the timber contracts during the year ended May 31, 1974. Petitioners insist that under the accrual method of accounting Plumas did not realize any taxable income from the sale during that year because the price payable for timber contracts was subject to adjustment upon the subsequent determination of the volume of timber actually received by LP. It is well settled, however, that under the accrual method of accounting payments received without restriction as to disposition are generally includable in income in the year of receipt. *Schude v. Commissioner,* 372 U.S. 128 (1963); *American Automobile Association v. United States,* 367 U.S. 687 (I961); *Farrarra v. Commissioner,* 44 T.C. 189 (1965). The fact that the taxpayer is subject to a *contingent liability* to refund a portion of the payment does not require a different conclusion. *Brown v. Helvering,* 291 U.S. 193 (1934); *North American Oil Consolidated v. Burnet,* 286 U.S. 417 (I 932); *S. Garber, Inc. v. Commissioner, 51* T.C. 733 (1969). In the instant case, the record clearly shows that Plumas received full payment of the purchase price set forth in the sale agreement during the year ended May 31, 1974, and allocated $1,458,735 thereof to the sale of the timber con-tracts--an allocation which respondent has not challenged. No evidence has been introduced which even suggests that any restrictions were placed upon Plumas's use or disposition of the funds it received from LP. Pursuant to the sale agreement, Plumas sold the timber contracts in exchange for a payment based upon an estimate of the volume of timber subject to those contracts. The record does not show that this estimate was unreasonable, and Plumas's obligation to refund a portion of the payment if the actual volume of timber fell short of this estimate was a mere contingent liability. Accordingly, we hold that the amount of the purchase price allocated to the timber contracts was includable in income in the year of receipt.

We now consider whether the income from the sale of the timber contracts constitutes ordinary income or long-term capital gain. Petitioners contend that the sale of the timber contracts is within the terms of section 631 (b), thereby entitling Plumas to the claimed long-term capital gain treatment under section 1231. Respondent, on the other hand, argues that section 631(b) is inapplicable to the sale of the timber contracts because Plumas did not retain an economic interest in the timber disposed of pursuant thereto and, therefore, the income from such sale cannot qualify for capital gain treatment under section 1231. Furthermore, respondent maintains that the timber contracts are not capital assets because they fall within the exception to section 1221 carved out by the Supreme Court in *Corn Products Refining Co, v. Commissioner,* 350 U.S. 46(1955). Consequently, respondent insists that the income from the sale constitutes ordinary income. For the reasons set forth below, we agree with and hold for respondent.

Section 631 (b) provided as follows:

(b) Disposal of Timber With a Retained Economic Interest.--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, 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. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. *For purposes o f 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.]

Thus, section 631(b) permits an owner of timber to treat any gain or loss realized upon the disposal of such timber subject to a retained economic interest as gain or loss realized upon the sale thereof. Such gain or loss is considered gain or loss from the sale of "property used in the trade or business" for purposes of section 1231. Sec. 1231(b)(2). Prior to the enactment of the predecessor of section 631(b),[19] receipts from a disposal of standing timber subject to a retained economic interest were taxable as ordinary income, the transaction being considered a lease of property. [20] See S. Rept. No. 627, 78th Cong., 1st Sess. (1943), 1944 C.B. 973,993. Section 631(b) overrides this result with respect to disposals that meet the requirements set forth thereunder,

For purposes of section 63 l(b), an "owner" of timber means any person who owns an interest in standing timber, including the owner of a contract to cut timber. To own an interest in timber within the meaning of section 631(b), the taxpayer must have a right to cut timber for sale on his own account or for use in his trade or business. Sec. 1.631-2(e)(2), Income Tax Regs. For purposes of section 631 (b), Plumas was the owner of the timber it was entitled to cut under the USFS timber cutting contracts it held, and respondent has so conceded. We have found as a fact, however, that under the Cheney contract Plumas only possessed the right to receive logs removed by Cheney from the Jenny Springs sale. Since Plumas did not have the right to cut the standing timber subject to the Jenny Springs sale, it was not the "owner" of such timber. Accordingly, section 63 l(b) is inapplicable to the assignment of the Cheney contract to LP,

It is clear that under section 63 l(b) Plumas was the owner of the timber subject to the USFS timber cutting contracts it held and that it made a disposal of such timber when it sold those contracts to LP. Consequently, the applicability of section 631 (b) to this sale depends upon whether Plumas retained an economic interest in the timber. Section 1.61 l-l(b)(1), Income Tax Regs., provides, in pertinent part:

> * * * An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived: from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. * * * A person who has. no capital investment in the mineral deposit or 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. * * .[21]

In disposing of an interest in timber, the taxpayer retains an economic interest in such timber when the consideration to be derived from the transaction is dependent solely upon the severance of the timber. *Dyal v. United States,* 342 F.2d 248, 252 (5th Cir. 1965); *Wilson v. Commissioner,* 26

T.C. 474, 481 (1956). See also *Kirby Petroleum Co. v. Commissioner,* 326 U.S. 599,604 (1946). Whether or not the taxpayer has made an absolute sale or has retained an economic interest, turns upon the particular facts and circumstances of each transaction. *Kirby Petroleum Co. v. Commissioner,* supra at 606.

On the basis of the facts and circumstances herein, we are convinced that Plumas made an outright sale of the timber cutting contracts to LP and, therefore, hold that Plumas did not retain an economic interest in the timber subject to those contracts.

Pursuant to the sale agreement, Plumas sold the timber contracts to LP and "warranted" that there was 84,000,000 board feet of timber subject to those contracts. At the time of the sale, LP paid Plumas a purchase price for the timber contracts which had been computed on the basis of a sale of the warranted volume of timber. [22] If LP received more or less than the warranted volume of timber, the agreements between Plumas and LP provided for the payment of a "bonus" or "damages," as the case may be, to reflect the actual volume of timber received by LP. Petitioners maintain that this provision made Plumas's receipt of the purchase price dependent upon the severance of the timber subject to timber cutting contracts. We disagree.

We cannot conclude that Plumas was simply seeking to profit from the severance of the timber when it transferred its rights under the timber cutting contracts to LP. Pursuant to this transfer, LP was required to cut all of the harvestable timber subject to the contracts and had to pay for such timber whether or not cut. Under the sale agreement, the risk of loss as to all items sold thereunder, including "any rights" under the USFS timber cutting contracts, shifted to LP on the date of closing, June 15, 1973. In addition, the supplemental agreement pertaining to the Bogard and Fleming timber cutting contracts stated the following with respect to the risk of loss:

> The risk of loss, legal or material, of any property or value related to the Bogard and Fleming sales shall be assumed by L-P. This includes the risk of fire or other natural occurrence, and the risk of termination or other action by government that may wholly or partially affect the value of said sales.

Thus, Plumas and LP agreed to value the rights under the timber cutting contracts on the basis of the volume of harvestable timber subject thereto, and LP assumed the risk of any diminution in the value of those contract rights that might occur after the date of closing, including the risk of loss from the destruction of the timber by fire or other natural causes. [23] Even if all of the timber had been destroyed by fire on the day after closing, Plumas would have been entitled to retain the payment it had received from LP By shifting all of the risks of production under the timber cutting contracts to LP, Plumas completely divested itself of any economic interest in the timber subject thereto. See *O'Connor v. Commissioner,* 78 T.C. [1] Jan. 4, 1982.

In our view, Plumas made an absolute sale of its contractual rights to a fixed volume of timber, retaining no interest therein. See *Boeing v. United States,* 121 Ct. Cl. 9, 27-29, 98 F. Supp. 581,585 (1951). Although petitioners think that the contractual terms requiring the payment of a bonus or damages in the event that LP received more or less than the warranted volume of timber constitutes the reservation of the requisite economic interest by Plumas, we do not. Plumas did

not retain an economic interest in the timber merely because the purchase price was determined pursuant to a formula based upon the volume of timber actually received by LP. In determining the purchase price for the timber contracts, Plumas and LP estimated that there was 84,000,000 board feet of timber subject to those contracts, and LP paid Plumas an amount based upon this estimate. If this estimate proved to be incorrect, the purchase price would be adjusted to reflect the correct volume of timber by the payment of a "bonus" or "damages." Consequently, this feature of their agreement merely represented the means by which the purchase price for the timber contracts could be adjusted upon an exact determination of the volume of timber subject thereto. It was not designed to make tile price to be paid to Plumas for the timber cutting contracts dependent upon the severance of the timber. In addition, we believe that it is important to note that any overrun or underrun in the estimated volume of logs receivable under the Cheney contract could offset any error with respect to the estimated volume of timber subject to the timber cutting contracts. Accordingly, there was not an inevitable correlation between the amount of timber LP would harvest under the USFS timber cutting contracts and the total purchase price Plumas would receive for the timber contracts.

Notwithstanding the inapplicability of section 631 (b), we must now determine whether the timber contracts constituted property used in the trade or business under section 1231 or capital assets as defined under section 1221 so as to qualify the income from the sale thereof for capital gain treatment. Since section 631 (b) is inapplicable to the sale, section 1231 will not apply to the gain realized therefrom unless the timber contracts qualify as "property used in the trade or business" under section 1231(b)(1), Section 1231(b)(1) defines that term to include both "real property used in the trade or business" and "property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167." We hold that the timber contracts did not constitute either real or depreciable property. See *Norton v. United States,* 213 Ct. Cl. 215, 551 F. 2d 821 ( 1977).[24] To constitute realty, the timber contracts must have given Plumas an interest in standing timber upon execution of the contracts. Nevertheless, the timber cutting contracts provided that alt right, title, and interest in and to the timber subject thereto remained with the USFS until it had been cut, scaled, and removed from the sale area. In addition, the Cheney contract only gave Plumas the right to receive cut logs. Consequently, it is clear that the timber contracts did not pass any present interest in standing timber to Plumas and cannot be regarded as real property used in Plumas's trade or business. [25] See *Norton v. United States, supra.* It is equally clear that the timber contracts were not property of a character subject to the allowance for depreciation. Pursuant to the timber contracts, Plumas simply agreed to purchase certain specified timber. The timber contracts were merely sales contracts which had neither a basis nor a useful life and whose value did not diminish with use or the passage of time. See *Norton v. United States, supra.*

Finally, we hold that the timber contracts were not capital assets as defined under section 1221.[26] Although the timber contracts did not fall within any of the specific exceptions to the term "capital asset" set forth in section 1221, we believe that those contracts must be excluded from the definition of a capital asset under the doctrine established by the Supreme Court in *Corn Products Refining Co. v. Commissioner,* 350 U.S. 46 (1955). In *Corn Products,* the Supreme Court determined that sales of property which are an integral part of the taxpayer's business may generate ordinary income or losses even though the property is not literally excluded from the

definition of a capital asset by section 1221.

In the instant case, Plumas acquired virtually all of the timber for the sawmill from either the USFS or other parties, such as Cheney. By means of the timber contracts, Plumas acquired a supply of the raw material that was essential to the everyday operation of its sawmill. Consequently, we are convinced that the timber contracts constituted an integral part of Plumas's business within the meaning of *Corn Products.* Clearly, the timber contracts were acquired and held by Plumas to serve an integral function in the operation of its sawmill business and not for investment purposes. The mere fact the Plumas decided to liquidate that business cannot change the character of these assets. See *Grace Bros., Inc. v. Commissioner,* 10 T.C. 158, 164 (1948), affd, 173 F.2d 170 (9th Cir. 1949); *Shumaker v. Commissioner,* 648 F.2d 1198 (9th Cir. 1981), affg. on this issue, T.C. Memo. 1979-71. Under these circumstances, the decision of the Supreme Court in *Corn Products* requires us to hold that the sale of the timber contracts generated ordinary income. See *Norton v. United States, supra; Mansfield Journal Co. v. Commissioner,* 31 T.C. 902
(1959), affd. 274 F.2d 284 (6th Cir. 1960).[27]

To reflect the foregoing.

*Decision will be entered under Rule 155.*

---

1 In the petition filed herein, petitioner alleged that assessment and collection of the deficiencies determined by respondent for the taxable years ended May 31, 1972 and May 31, 1973, were barred by section 6501(a), I.R.C. 1954. Nevertheless, petitioner has failed to raise this issue at any other point in this proceeding. Accordingly, we find that petitioner has abandoned this issue, and therefore, we need not consider it.

2 Erickson Air-Crane Co. of Washington, Inc., became an IC subsidiary during the taxable year ended May 31, 1973.

7 The United States Forest Service is part of the Department of Agriculture and sells timber located on National Forest lands.

8 Not all of the timber within a tract was included in the contract with respect thereto. Each contract set forth a detailed definition of the term "included timber" that encompassed both timber "designated for cutting" and certain timber which was not so designated.

9 This agreement referred to June 15, 1973, as the "date of closing."

10 Prior to June 15, 1973, Plumas had already logged some of the timber from the following tracts: Cold Stream; Bagley; Flournoy; and Lights Creek Skyline.

11 Throughout the opinion, we shall collectively refer to the nine above-mentioned USFS timber cutting contracts and the Cheney contract as "the timber contracts."

12 Plumas and LP have agreed that the volume of timber LP received pursuant to the sale agreement exceeded the warranted volume of 84.000,000 board feet. As of December 12, 1978. however, they had not resolved the calculation of the overrun.

13 Approximately 4,000,000 board feet of the warranted volume of timber was attributable to the estimated volume of logs receivable under the Cheney contract.

14 Plumas had no basis in these contracts.

19 Sec. 117(k)(2), I.R.C. 1939, as amended.

20 For a discussion of the background of the concept of economic interest see O'Con*nor v. Commissioner,* 78 T.C. [1] (Jan. 4, 1982). When sec. 631(b) is inapplicable to a disposition subject to a retained economic interest because, for example, the timber had not been held for the requisite period, the receipts are taxable as ordinary income subject to cost depletion. Sec; 611. If sec. 631(b) applies, however, the taxpayer is not entitled to a depletion deduction for the timber. Sec. 1.61 !-l(b)(2), Income Tax · Regs.

21 The term "capital investment" as used in this regulation "does not require an investment of cash or property by the taxpayer but can consist of an economic interest acquired by gift, inheritance, personal effort, governmental permits, or other circumstances." Bittker, Federal Taxation of Income, Estates and Gifts, par. 24.1.2 (Vol. 1, 1981). See, *e.g., Commissioner v. Southwest Exploration Co.,* 350 U.S. 308 (1956).

22 The warranted volume of timber included an estimated 4,000,000 board feet of timber which would be received under the Cheney contract. Consequently, the parties must have estimated that there was approximately 80,000,000 board feet of timber subject to the USFS timber cutting contracts. At the time of the sale, Plumes and LP had contemplated a sale of the timber contracts for a purchase price of $17.52 per thousand board feet of timber subject to those contracts.

23 Under the USFS timber cutting contracts, the purchaser was not responsible for losses, other than those due to its own negligence, attributable to the destruction of timber by causes such as fire or disease prior to the removal of the timber from the sale area.
24 See also *J.R. Simplot Company v. Commissioner,* T.C. Memo. 1967-104.

25 Although Plumas is considered the "owner" of the timber subject to the USFS timber cutting contracts for the purposes of sec. 631(b), that fact has no bearing on the question of whether those contracts passed any present interest in standing timber. See *Norton v. United States,* 213 Ct. Cl. 215, 551 F.2d 821 (1977); *J.R. Simplot Company v. Commissioner,* T.C. Mem. 1967-104.

26 Section 1221 provides, in part:
For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include-

(I) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sate to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167 or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property * * *

(4) accounts or notes receivable * * *

(5) an obligation of the United States or any of its possessions * * *

27 See also *J.R. Simplot Company v. Commissioner,* T.C. Memo 1967-104.