

**KIRBY LUMBER CORPORATION v. PHINNEY**  
**68-2 USTC ¶ 9446;**  
**22 AFTR 2d 5069 (W.D, Tex. 1968).**

*Editor's Summary*

*Key Topics*

OUTRIGHT SALES-CAPITAL GAIN v. ORDINARY INCOME

- Liquidation of tie grade hardwood holdings by manufacturer of pine products
- Over 200 sales contracts with 14 purchasers not, in this case, destructive of capital gain treatment

*Facts*

The taxpayer was engaged in the business of manufacturing lumber and other forest products. It grew its own source of supply on timberlands owned by it. From 1901 until the period 1922-23 the taxpayer's predecessor used only pine timber in its business, However, from that latter period until 1950, the taxpayer or its predecessor used both pine and hardwood timber. In 1950, the taxpayer's management decided to cease the production of hardwood lumber, to close down its scattered sawmills, to construct one large sawmill designed for the production of pine products alone, and to begin a program of forest management called "perpetual cut forestry." It was decided that the 87,000 acres currently growing hardwood timber would be returned to pine, The method chosen for disposing of the hardwood timber differed according to the grade of hardwood in question. Lumber grade hardwood was cut by contractors employed by the taxpayer, and the logs were sold to a single purchaser. This accounted for 82,000 acres of hardwood, and was accorded capital gain treatment under Section 1231. Pulpwood grade hardwood was sold under cutting contracts on a per unit cut basis, and these sales were accorded capital gain treatment under Section 631(b), The problem arose with respect to tie grade hardwood. This was sold outright in small amounts to several different purchasers under contracts calling for advance payment rather than payment on a per unit cut basis. Purchasers of such timber were of extremely limited financial resources, and knowing this, the taxpayer's management decided against selling to them on a per unit cut basis, which is, in effect, a credit arrangement. Had there been a single purchaser desiring all the tie grade hardwood, taxpayer would have sold it all at once rather than in small parcels. During the tax year in question, 1959, the taxpayer sold 10,650,282 board feet of standing tie grade hardwood timber by virtue of 206 separate contracts with fourteen separate individuals. The amount received by the taxpayer in 1959 from the sale of tie grade hardwood equaled 1.3% of its total sales of timber and lumber products. The taxpayer had no separate department for the handling of hardwood timber sales; no portion of the time of its sales department was devoted to sales of hardwood timber; there was no advertising promulgated or displayed or sales promotional activity engaged in by any employee of the taxpayer; there were no improvements made to the property; and the hardwood timber was not listed with an agent or broker for sale. The taxpayer treated its gain on sales of tie grade hardwood timber as capital gain

under Section 1231. This was contested by the Revenue Service which contended that the *amount of sales* made of such timber by the taxpayer was not consistent with capital gain treatment under Section 1231, but instead indicated that such timber was either (1) property properly includable in the taxpayer's inventory, or (2) property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

### *District Court*

**Held: For the taxpayer.** The disposals of tie grade hardwood made in 1959 by the taxpayer were but an incident to the development of the pine forest under the taxpayer's perpetual cut forestry management program, in addition, they were pursuant to and consistent with the liquidation program begun in 1951, and were made upon the only available market and consistent with its demand. The sales were incidental to the taxpayer's trade or business and were required for its economical and successful management. It was not a part of the business of the taxpayer to buy and sell or trade in timberland or standing timber. Tie grade hardwood timber was, in 1959, real property used in the trade or business of the taxpayer, and was not (1) property properly includable in inventory, or (2) property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Hence, taxpayer properly treated gains from its sales of tie grade hardwood timber as capital gain under Section 1231.

### *Case Text*

#### **FINDINGS OF FACT AND CONCLUSIONS OF LAW**

ROBERTS, District Judge: 1. This is an action by Kirby Lumber Corporation, plaintiff, against R. L. Phinney, District Director, defendant, for \$36,539.40 collected by him from plaintiff for taxes and interest claimed to be due the United States of America, with interest, for the year 1959.

2. Plaintiff is a corporation duly incorporated under the laws of the State of Delaware, with a permit to do business in the State of Texas, with its principal place of business and executive office at Houston, Harris County, Texas.

3. Defendant at all times material was and now is the duly appointed, qualified and acting District Director of the Internal Revenue Service of the Treasury Department of the United States of America for the First District of the State of Texas, at Austin, Texas.

4. Plaintiff operates on the basis of the calendar year and timely filed its corporate return for the year 1959. In such return income from sales by plaintiff of hardwood stumpage under the contracts in question was reported and treated as capital gain and not as ordinary income. Thereafter the Commissioner of Internal Revenue issued a deficiency notice proposing an assessment in the sum of \$29,139.55. Plaintiff thereafter duly filed a protest against such deficiency. The Commissioner thereafter issued a 90 day deficiency notice determining that \$107,924.27 received by plaintiff during 1959 from such sales of hardwood stumpage should be taxed as ordinary income. Plaintiff thereafter paid to defendant, under protest, the sum of \$29,139.55 and interest due thereon in the sum of \$7,399.85, for a total of \$36,539.40, and filed, on November 18, 1964, its claim for refund which was, on March 5, 1965, rejected by defendant.

5. Plaintiff is the successor, after bankruptcy proceedings concluded in 1936, to the property and business of Kirby Lumber Company, a Texas corporation chartered in 1901. Kirby Lumber Company was formed in such year for the purpose of cutting and manufacturing into lumber and other products pine timber from 800,000 to 1,000,000 acres of land owned by Houston Oil Company. Thereafter it began to acquire fee title to lands and timber of its own. Prior to the period 1922-1923 Kirby Lumber Company cut and manufactured only pine timber. During such time it built and acquired several hardwood mills and began to cut and manufacture lumber grade hardwood timber. Kirby Lumber Company through 1936 and plaintiff thereafter were engaged in the trade or business of manufacturing and selling at wholesale both pine and hardwood lumber and other timber products.

6. By the year 1950, plaintiff owned over 550,000 acres of timberlands in East Texas and western Louisiana, on which grew both pine and hardwood timber. The land, with the timber growing thereon, was acquired for the purpose of owning, as a part of the lands, the timber to be utilized as a natural resource for production into lumber and other timber products. It was purchased for use in the plaintiff's trade or business. No timberland had ever been purchased by plaintiff for the purpose of resale. The hardwood timber on plaintiff's land was and is divided generally into three grades, being lumber grade, tie and local log grade and pulpwood. While all grades of hardwood are usually found throughout the forest, there were and are 82,000 acres owned by plaintiff scattered along rivers, and known as "bottom lands," where pine would not and does not grow, and which prior to 1950 were almost exclusively lumber grade hardwood timberlands. There are an additional 87,000 acres scattered throughout the forest which are called "predominantly hardwood" (where, generally, former pine lands have grown up in hardwood), where the tie grade hardwood is principally found, intermingled with pine, standing on land capable of being restored to pine growth. The remainder of the acreage is termed "predominantly pine." To and through 1950 plaintiff owned and operated five sawmills, cutting and manufacturing both pine and lumber grade hardwood. It had not theretofore utilized in its sawmills any tie or pulpwood hardwood, nor had it sold such grades of hardwood as stumpage.

7. In or about 1950, plaintiff's management determined to cease the production of hardwood lumber, to close down its scattered sawmills, to construct one giant sawmill designed for the production of pine products alone, and to begin a program of forest management called "perpetual cut forestry," where under all pine productive acreage would be devoted to pine, the pine nurtured and maintained to achieve an optimum growth, and thereafter only an amount equal to annual growth would be cut, leaving the forest as a perpetual natural resource. As a constituent part of this decision to devote the production and manufacturing effort to pine, it was determined that the 87,000 acres which were predominantly hardwood must be returned to pine. It was determined, therefore, to eradicate, consistent with market demands, all of the tie grade hardwood timber located thereon. This process was begun in 1951. It was determined, at the same time, to dispose of lumber grade hardwood, such determination being based, as well, upon the necessity of devoting all productive acreage to pine. The last sale of manufactured hardwood lumber occurred in 1953 and none has been produced by plaintiff since that time, including 1959. Lumber grade hardwood was disposed of by a contract with Hillyer-Deutsch-Edwards, a substantial hardwood lumber manufacturer, pursuant to which Kirby employed contractors to cut the hardwood and

sold the trees as logs. The 82,000 scattered "bottom land" acres, where pine does not grow, were logged under the Hillyer-Deutsch-Edwards contract and were thereafter removed from use in plaintiff's trade or business. In addition, the disposal of pulpwood hardwood was begun by sales of stumpage to paper mills, also being substantial purchasers, by virtue of contracts calling for payment on a per unit cut basis. The gains on sales of lumber grade and pulpwood grade hardwood were reported at capital gains rates and such sales and tax treatment are not here in question. As the result of a cruise (survey) taken in 1959, which results were made known in 1960, it was estimated that there were 934,600,000 feet of hardwood of all grades in the Kirby forest, of which tie grade hardwood comprised 245,700,000 feet. From 1951 through 1959, a total of 162,893,750 board feet of tie grade hardwood timber was sold from plaintiff's lands. The number of feet sold in 1959 (10,650,282) equaled approximately 1/25th (or 4%) of the total estimated tie grade hardwood stand then remaining.

8. The market for tie grade hardwood was from 1951 through 1959 extremely limited. The number of persons then engaged in producing railroad ties, board road planks, etc., is unknown, but plaintiff had contracts only with fourteen in 1959. Those with whom plaintiff dealt through the period 1951-1959 were of extremely limited financial resources, and were, thus, unable to purchase large quantities of timber at any one time. This fact was known by plaintiff's management and resulted in the decision to sell the tie grade stumpage by a cutting contract calling for advance payment rather than payment on a per unit cut basis, which would, in effect, be a credit sale. At no time did there exist, to plaintiff's knowledge, any buyer or buyers interested in and capable of buying all of the tie grade timber at one time, although if such a buyer or buyers had been forthcoming plaintiff would have disposed of such timber all at once.

9. During the tax year in question, 1959, plaintiff sold 10,650,282 feet of standing tie grade hardwood timber by virtue of 206 separate contracts with fourteen separate individuals, receiving a total of \$122,454.45, less basis of \$14,530.18, for a gain of \$107,924.27. Of such sales, more than half, 117, were to only two persons. On an average, the 206 sales involved 51,700 feet of timber on 144.73 acres, for a sales price of \$595.55, or just over 1 cent per board foot. The 117 sales involved an average of about 48,700 feet, on an average 121.94 acres for an average \$445.59 per sale, or just under 1 cent per board foot. In 1959 plaintiff received from the sale of lumber and other timber products a total of \$9,217,484.32, of which 90.5% is attributable to pine products. The amount received in 1959 from the sale of tie grade hardwood stumpage under the contracts in question, \$122,454.45, equals 1.3% of such total sales figure. Total sales in this calculation did not include receipts on sales of capital assets, income entitled to capital gain treatment, income from rents and royalties, and other miscellaneous income not attributable to sales of manufactured products. The income from the sales here in question is separate from the mainstream of the enterprise of plaintiff, is not the normal source of plaintiff's business income, and is comprised of sums received in liquidation of standing tie grade hardwood. Plaintiff was in 1959 primarily engaged in the trade or business of manufacturing pine timber into lumber and other products for sale at wholesale.

10. All of the hardwood timber in question had been held by plaintiff at the time of sale for a period of time in excess of six (6) months.

11. Plaintiff maintained in 1959 two offices for the conduct of its business, the executive office in Houston, and the plant office at the mill in Silsbee. At the executive office are located the Sales, Tax, and Land & Forestry departments and a portion of the Accounting department together with the executive officers, including the Treasurer and the Secretary, in total numbering about forty-five persons. At Silsbee about 850 persons are employed as production employees, plant managers, logging superintendents, purchasing agents, accounting personnel, foresters and supervisors. There was no separate department for the handling of hardwood timber sales. No portion of the time of the Sales department was devoted to sales of hardwood timber. Less than half of the time of one employee in the Land & Forestry department in the Houston office was involved with the administration of hardwood sales. Only about 30% of the time of up to ten woods employees is involved with hardwood activity-locating and marking hardwood for cutting as an incident to the management of the pine and giving notice to known prospective purchasers that hardwood was marked and available for removal. There was no advertising promulgated or displayed or sales promotional activity engaged in by any employee of plaintiff. There were no improvements made to the property in question designed to entice a prospective purchaser to buy or to increase the sales price or value of the property, nor was tie grade hardwood listed with an agent or broker for sale. The disposals of tie grade hardwood made in 1959 were but an incident of the development of the pine forest under the perpetual cut forestry management program, were pursuant to and consistent with the liquidation program begun in 1951 and continued through 1959, and were disposals as possible upon the only available market and consistent with its demand. The sales were incidental to the plaintiff's trade or business and were required for its economical and successful management.

12. The lands on which stood the tie grade hardwood timber sold in 1959 and of which land said timber was a part, and was, thus, real property, were held by plaintiff for use in its trade or business. The gain realized on such sales was not profit arising from the everyday operation of a business, but, rather represented the realization of appreciation in value of an asset held over a substantial period of time. It was not a part of the business of the taxpayer to buy and sell or trade in timberland or standing timber, be it pine or hardwood. Tie grade hardwood timber was properly carried on the books of plaintiff as a fixed asset and therefore was not stock in trade of the taxpayer or property properly includable in inventory and, further, was not property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

### CONCLUSIONS OF LAW

1. This Court has jurisdiction of this case under Title 28, United States Code, § 1340. The plaintiff has accomplished the prerequisite procedural steps hereto timely, and in the manner and form required by law.

2. The property here in question, sold by plaintiff in the year 1959, was property which was not (a) 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 (b) property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. *Malat v. Riddell*, 383 U.S. 569 (1966); *Alabama Mineral Land Co. v. Commissioner*, 250 F. 2d 870 (CA 5th, 1957); *Consolidated Naval Stores Co. v. Fahs*, 227 F. 2d 923 (CA 5th, 1955); *Chandler v. United States*, 226 F. 2d 403 (CA

8th, 1955); *Goldberg v. Commissioner*, 223 F. 2d 709 (CA 5th, 1955); *United States v. Bennett*, 186 F. 2d 407 (CA 5th, 1951); *Three States Lumber Co. v. Commissioner*, 158 F. 2d 61 (CA 7th, 1946); and see *Kirby Lumber Corporation v. Scoffeld*, 89 Fed. Supp. 102 (U. S. D. C. W. D. Tex. 1950).

3. Tie grade hardwood timber was, in 1959, real property used in the trade or business of plaintiff, entitling plaintiff to recover from defendant under Section 1231 of the Internal Revenue Code (1954) the sum of Thirty-six Thousand Five Hundred Thirty-Nine and 4/100 Dollars (\$36,539.40), with interest thereon at 6% per annum from and after June 8, 1964, until paid, and the judgment to be entered herein shall so provide.