MCMULLAN v. UNITED STATES
78-2 U.S.T.C. ¶ 9656 (1978)
42 AFTR 2d 78-5723 (1978)

Editor's summary

Key Topics

CAPITAL v. EXPENSE
• Generally
• Ad valorem taxes
• Attorney's fees
• Direct expenses of disposal
• Land management expenses
• Operating expenses
• Rent
• Selling expenses

Facts

The taxpayers jointly owned land which produced income from oil, gas, coal and timber. The income from the timber, about 80 percent of the total, was received from cutting contracts and was treated by the taxpayers as capital gain under Section 631(b) of the Internal Revenue Code. All of the taxpayers' costs of managing the land, including expenses directly related to the sale of the timber under the cutting contracts (i.e., a disposal of timber with a retained economic interest) were treated as ordinary and necessary business expenses and deducted by the taxpayers from ordinary income. The Internal Revenue Service disagreed with the taxpayers' deduction of the expenses directly related to the acquisition, negotiation and management of the timber cutting contracts, contending that these expenses (salaries of foresters for marking timber, legal fees for drafting contracts, etc.) were capital expenditures rather than deductible expenses and as such should be treated for tax purposes as an offset against the taxpayers' capital gains on the timber disposals. In arguments before the Court of Claims the Government relied on a previous Court of Claims case *(Casey v. united States)* in which the Court had required a taxpayer purchasing timber from public lands to treat the cost of a logging road it had to construct under the government contract as a capital expenditure rather than a deductible expense. The Commissioner also relied on a basic principle of tax law that the direct costs of a sale of a capital asset must be offset from the gain on the sale rather than deducted from ordinary income. The taxpayers argued that the *Casey* case involving the logging road was not controlling since the expenses in the two cases are of a different nature. They further argued that the controlling case was the decision of the Court of Claims in *Union Bag-Camp Paper Corp. v. United States,* decided in 1963, which held that certain direct costs of disposing of timber under a cutting contract could be deducted rather than capitalized because (a) in the particular case the costs were "nominal", or (b) even if the direct costs of the disposal under Section 631(b) were not nominal, the legislative history of that section

indicates that Congress did not intend to require that the direct costs of a Section 631(b) disposal be capitalized and offset against the capital gains resulting from the disposal.

COURT OF CLAIMS

HELD*:* For the taxpayers. The decision in the *Union Bag-Camp Paper Corp,* case is the controlling case in the Court of Claims and thus is precedent in that court for the rule that the direct expenses of disposals of timber under cutting contracts under Section 631(b)may be deducted as ordinary and necessary business expenses and thus do not have to be offset against the capital gains from the disposals.

Case Text
Opinion *

BROWNE, Trial Judge: Plaintiffs are suing for the recovery of income tax deficiencies (together with interest and penalties) assessed by the Internal Revenue Service for the calendar years 1969, 1970, and 1971. In those years plaintiff, Neva S. McMullan (Mrs. McMullan), filed a joint return with her husband, Harry McMullan, Jr., (McMullan) who died in March 1973. Neva S. McMullan (Executrix) is also suing in her capacity as Executrix of her husband's estate (the Estate). No claim is made on behalf of Neva S. McMullan (the surviving spouse) with respect to the tax consequences of this litigation as it may affect her own tax liability for the post-March 1973 period.

* * * * *

This court has jurisdiction under 28 U.S.C. § 1491.

The basic dispute is whether certain forest management expenses incurred by the joint taxpayers during the years in issue should be treated as ordinary and necessary expenses or should be treated as capital expenditures; in other words, whether such expenses should be deducted from ordinary income or offset against the capital gain resulting from the sale of the timber. [1]

* * * * *

For reasons which follow, it is concluded that the forest management expenses are properly deductible from ordinary income, as plaintiffs maintain. Also, it is concluded that the Government is entitled to equitable recoupment of the related Estate tax reduction, and plaintiffs' recovery is offset accordingly. Determination of the net amount to be recovered by plaintiffs, if any, is reserved for determination under Rule 131(c) (2).

I. Summary of The Facts. During the tax years in question, 1969, 1970, and 1971, the joint taxpayers, Harry McMullan, Jr. and Neva S. McMullan, owned an undivided half interest in certain lands located in West Virginia and North Carolina, known as the Ellamore-Kent lands, The other half interest was owned by Connecticut General Life Insurance Company (CGLI), which interest was leased by the joint taxpayers from CGLI. Full title to that half interest was

acquired from CGLI by the joint taxpayers at a later date. The land was held for investment purposes, yielding income from several sources, including oil, gas, and coal; but the primary source of income was timber. All income from the lands was treated as long-term capital gain for federal income tax purposes.

The joint taxpayers incurred various expenses in connection with management of the lands during the tax years in question. The expenses fell within the following categories: rental payments, real estate and other taxes, insurance, forestry, legal and audit, telephone, travel, lodge, office, survey vehicle, and miscellaneous. The joint taxpayers deducted all these expenses from ordinary income during the years in question. Whether this treatment was proper lies at the heart of this dispute, defendant contending that such expenditures should have been offset against capital gains.

On July 9, 1973, the Internal Revenue Service assessed income tax deficiencies for the years 1969, 1970, and 1971 against the joint taxpayers, asserting that a specified percentage of the management costs listed above must be offset against the capital gain resulting from the sale of the timber, rather than being deducted from ordinary income. [2] The percentage of management expenses to be so treated was calculated on the basis of the ratio of timber sales to total sales of all products (including oil, gas, coal, etc.) in each year. These percentages were calculated by defendant to be 81.66 percent in 1969, 82.07 percent in 1970, and 74.67 percent in 1971. Thus, the amounts of forest management expenses at issue in this litigation are as follows:

1969	$25,740.97
1970	35,297.89
1971	26,925.71

The joint taxpayers' deficiencies, plus interest and penalties, were paid in August and September 1973, after McMullan's death. In December 1973, the Estate tax return, filed with respect to McMullan's Estate, took as a claim against the Estate under Section 2053(a) (3) the amount of the deficiencies (plus accrued interest). The deductions were allowed by the Internal Revenue Service on a subsequent audit of the Estate tax return. The statute of limitations precludes the assessment of an estate tax deficiency against the Estate at this time.

In July 1974 a claim for refund of the deficiencies was filed with the Internal Revenue Service on behalf of the joint taxpayers. The Commissioner disallowed the claim in May 1975. Plaintiffs filed a timely petition for refund in this court on March 22, 1976.

II. *Management Expense Issue.* The Government's argument for capitalization of forest management expenses is based on a contention that part of those expenses were directly related to the sale of timber under timber-cutting contracts. For example, in the category of "forestry" expenses, the joint taxpayers included the salaries paid to foresters, whose duties included, among others, the marking of timber to be cut and supervision of performance under the timber-cutting agreements; legal fees paid for the preparation of the timber-cutting agreements were included as "legal and audit" expenses; expenses incurred in connection with trips made by McMullan during which he negotiated the timber-cutting agreements were deducted as "travel" expenses.

The Government contends that, as a general matter, expenses directly related to the sale or disposition of a capital asset should be treated as capital expenditures to be offset against capital gains, rather than being deductible from ordinary income. See *Woodward v. Commissioner* [70-1 USTC ¶9348], 397 U.S. 572, *575* (1970). Since timber is treated as a capital asset when disposed of in accordance with Section 631(b), the Government urges that the general rule should be applied to expenses directly related to timber sales.

In support of this argument, the Government relies on the recent decision by this court in *Casey v. United States,* 198 Ct. Cl. 232 [72-1 USTC ¶9419], 459 F. 2d 495 (1972). In that case, the plaintiff had acquired timber-cutting rights on property owned by the Forest Service. The contract required the plaintiff to construct logging access roads to the timber stands covered by the contracts. The court held that the cost of building those access roads was directly related to the acquisition of a capital asset (the timber), and should, therefore, be treated as a capital expenditure,

Plaintiffs deny that the holding in *Casey* has any bearing on the tax treatment to be accorded the type of expenses involved in this case. Their legal position is pitched entirely upon this court's earlier decision in *Union Bag-Camp Paper Corp. v. United States* [64-1 USTC ¶9122], 163 Ct. Cl. 525, 325 F. 2d 730 (1963). In that case, the court allowed the deduction of forest management expenses, even though a small part of those expenses were attributable to the negotiation and supervision of timber-cutting contracts. The holding was made on two grounds: (1) selling expenses comprised only a nominal portion of total management expenses; (2) neither the language nor the legislative history of this area of the Code suggests that forest management expenses should be capitalized, "even if * * * some portion thereof could be singled out as selling expense." 163 Ct. Cl. at *548-49,* 325 F. 2d at 743-44.

The holding in the *Union Bag* case was carefully considered and distinguished by this court in *Casey.* After reviewing the facts and holding of *Union Bag,* the court concluded in *Casey:*

> The cost of the road, in the case before us, is quite another matter than management expenses. For one thing, the Forest Service contract *required* its construction by the joint venture [of which the plaintiffs were members.] Therefore, we think that the cost of the cutting fights acquired by the joint venturers necessarily must have been affected by the cost of the road. Presumably, if the Forest Service had paid for the road, it would have increased the stumpage price payable by the joint venture, and if the road cost had been passed on to a third party transferee of the cutting rights, the stumpage rate would have been lesser [sic] than it actually was. In either case, the result would have been reduced capital gain, which conforms to the result we reach by adding the cost to the adjusted depletion basis, §§ 612, 1012, 1016. Thus, we believe that the cost of the road was incurred in order to acquire a capital gain, and it should be treated just as any other capital expenditure. [198 Ct. Cl. at 237, 459 F. 2d at 497].

Thus, *Union Bag* is still the law of this court on the matter of deductibility of forest management expenses, and must control as *stare decisis* unless a rational basis for distinction can be found. The Government asserts that in this case, unlike *Union Bag,* the portion of management expenses directly related to the sale of timber has not been shown to be "only incidental," nor has it been

shown that complete elimination of the contract activities would have affected the total management expenses merely in nominal amounts.

The record does not provide a basis for a definitive finding that only a minimal portion of management expenses were attributable to timber *sales.* The largest portion of these expenses were devoted to foresters' salaries. While some part of the foresters' duties did involve marking the timber for sale and inspecting areas from which timber had been cut, there is no estimate of the time spent by the foresters on *contract-related* duties.

Even if it is assumed that a substantial portion of management expenses were directly related to timber *sales,* only the first ground of the *Union Bag* holding would be overcome. Putting the question of allocation aside, the court went on to address the broader legal issue of "whether, *in any event, the* proceeds from plaintiff's cutting contracts must be offset by its selling expenses attributable to the negotiation and supervision of those contracts." 163 Ct. Cl. at 546, 325 F. 2d at 742 (emphasis in original). The answer was "No." An extensive review of the legislative history was made, and led the court to conclude:

> The history of the tax law in this area shows with reasonable clarity that selling expenses, such as those involved here, are properly deductible from gross income and are not required to be restricted to an offset against contract proceeds.

The Government has advanced no reason why this second ground of the *Union Bag* decision is not controlling in the present case.

Though *Union Bag* was decided under the 1939 Code predecessor of Section 631 (b) of the I954 Code, the provisions of the two sections are alike in all relevant respects. Thus, the court's analysis of the legislative intent regarding the present section is still applicable. If anything, the legislative history of the 1954 Code lends even stronger support than that of its predecessor to the *Union Bag* holding. The original (House) version of the 1954 Code contained a provision which precluded the deductibility of precisely the kind of expenses that are in issue here:

> §272 (b) Where the disposal of coal or timber by the taxpayer is covered by §631 (b), *no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract.* This subsection shall not apply to any taxable year during which there is not production, or income, under the contract. [Emphasis added. H. R. 8300, 83d Cong., 2d Sess. § 272 (1954).]

See also, H, R. Rep No. 1337, 83 Cong., 2d Sess. A67-A68 (1954). The Senate Finance Committee, however, excluded timber disposals from the operation of this section S. Rep. No. 1622, 83d Cong., 2d Sess. 229 (1954). The Conference Committee accepted the amendment, and the final version of Section 272, therefore, applied only to disposal of coal. H.R. Rep. No. 2543, 83d Cong., 2d Sess. 33 (1954). [3] The section has since been amended again to apply to disposal of iron ore, as well as coal. Revenue Act of 1964, Pub. L. No. 88-272, § 227 (a) (3), 78 Stat. 97-8 (1964).

Inasmuch as the congressional action on the 1964 Code was contemporaneous with the enactment of the Code provision currently applicable to timber disposals (Section 631 (b)), there is simply no doubt as to the legislative intent. Congress did *not* intend to *disallow* the deduction of expenses attributable to the making and administering of contracts effecting a Section 631 (b) disposal of timber. If this court were to accept the Government's argument, it would, in effect, be putting into effect legislation which Congress deliberately chose not to enact. It is recognized that the treatment which Congress has accorded selling expenses related to the disposal of timber is somewhat inconsistent with that accorded selling expenses related to most other kinds of capital assets. See, Section 272 of the Code; *Woodward v. Commissioner, supra,* 397 U.S. 572 (1970). Such an inconsistency is not properly the concern of the courts, but rather is the prerogative of Congress. As one tax authority puts it:

> [A] basic fundamental of the Internal Revenue Code is not to allow the deduction of capital expenses from ordinary income but to offset such against capital gains; nevertheless, Congress can and does digress from the fundamental when granting tax relief. [3B MERTENS, LAW OF FEDERAL INCOME TAXATION, § 22.128 (rev. ed. 1973)].

It is concluded that plaintiffs are entitled to a refund of the income tax deficiencies, penalties, and interest erroneously assessed by the
Government. [4]

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* The opinion and conclusion of law are submitted in accordance with Rule 134(b).

1 See Section 631(b) of the Internal revenue Code of 1954. Except when otherwise indicted the term "section" refers to a section of the Internal Revenue Code of 1954, Title 26, United States Code (as amended).

2 The Internal Revenue Service originally took the position that portions of the lease payments and real estate taxes were required to be capitalized along with the rest of the management expenses, and the assessments were made and the deficiencies were paid on that basis. The Government now concedes that the lease payments and real estate taxes were properly deductible from ordinary income. Therefore, plaintiffs are entitled to recover at least the amount of the deficiencies attributable to the admittedly incorrect treatment of these items as capital expenditures, subject to defendant's claim for equitable recoupment.

3 *The opinion in Union Bag-Camp Paper Corp. v. United States* [66-2 USTC ¶ 9694], 163 Ct. Cl. *525,325* F. 2d 730 (1963), also noted the congressional action in support of its interpretation of Section 631's predecessor in the 1939 Code, even though the tax year there in question preceded 1954.

4 In view of our holding on this issue, we are not unmindful of the contrary position heretofore taken by the Internal Revenue Service in Rev. Rul. 71-334, 197I-2 Cum. Bull. 248.