

PLANT v. UNITED STATES
81-2 U.S.T.C. ¶9661
48 AFTR2d 81-5936

Editor's Summary

Key Topics

DISPOSAL WITH A RETAINED ECONOMIC INTEREST

- Generally
- Advanced payments, treatment of
- Economic interest
 - defined
- requirement that owner retain
- Effect of timber backlog provisions

Facts

The taxpayer entered into a contract to sell all the timber standing and growing during a twenty-year period on certain land he owned. This contract obligated the buyer to pay a fixed annual amount equal to the value of estimated average annual growth determined on a unit price basis and subject to adjustment by the Wholesale Commodity Price Index. Payment for trees cut in excess of the average annual growth was to be made after an annual accounting. If the buyer cut fewer trees than the estimated annual growth during any year, it could subsequently cut the amount of this shortfall without paying additional consideration. The taxpayer received the fixed annual payments for three years, even though no timber was cut, and reported these receipts as long-term capital gains. He asserted that Section 631(b) provided capital gain treatment because the contract represented a disposal of timber with a retained economic interest. The government denied treatment under Section 631(b). It contended that the taxpayer retained no economic interest in the timber within the meaning of that Section because the annual payments were fixed and not dependent on the cutting of timber.

District Court

HELD: For the Government. Citing *Crosby* (6 T.T.J. 148), the Court rejected taxpayer's contention that the annual payments constituted "advance payments" under Regulation §1.631-2d(1). As such, the payments would have represented a retained economic interest. The Court ruled that the regulation was inapplicable because there was no assurance under the contract that the timber would ever be cut.

Case Text

HALTON, District Judge: This is a tax refund suit in which the plaintiffs claim they are entitled to

capital gain treatment of proceeds received from a Timber Sale Contract.

This cause came on for consideration by the court on the cross motions for summary judgment filed by the plaintiffs and the defendant seeking summary judgment in their respective favors with regard to all issues involved in the above entitled action. By filing their motions for summary judgment, the parties herein have represented to the court that there is no genuine issue as to any material fact with regard to the issues here presented.

The court has before it plaintiffs' complaint and the exhibits made a part thereof, answer of defendant essentially admitting all allegations of fact made in the complaint but expressly denying that any taxes were erroneously or illegally assessed or collected from plaintiffs, affidavit of Harold J. Hill [Manager, Forest Resources and Operations, Southern Timberlands Division, Hammermill Paper Company] offered in support of plaintiffs' motion for summary judgment, and briefs of counsel. The court hereby finds the following facts established by the foregoing and proceeds to make the following conclusions of law based thereon.

[Timber to be cut by 1987]

On February 21, 1967, W. H. Plant, Jr. and Doris D. Plant entered into a timber sale contract with Hammermill Paper Company covering approximately 2,394 acres situated in Lowndes County, Alabama. Pursuant to the contract, the Plants agreed to sell and Hammermill agreed to purchase all the timber standing and growing during the term of the twenty year contract. Under the contract, the price of pulpwood, subject to adjustment according to the Wholesale Commodity Price Index, was \$6.00 per cord for pine and \$2.50 per cord for hardwood. Based on an estimated annual growth of 2,000 cords of pine pulpwood, Hammermill was obligated to pay the plaintiffs \$12,000.00 annually. Payments for amounts cut in excess of the average annual growth were to be made after an annual accounting. In the event Hammermill undercut it was to pay the Plants the minimum amount but had the right to cut the timber paid for in advance at any time prior to December 31, 1987.

Although no timber was cut for the years 1973, 1974 and 1975, the Plants received as consideration under the agreement the respective payments of \$14,330.75, \$15,427.16 and \$17,633.47. The Plants reported these payments as long term capital gains on their joint Federal income tax returns for such years. In 1977, the Internal Revenue Service disallowed capital gain treatment and the additional federal income taxes were subsequently paid by the Plants. Thereafter the Plants filed a claim for refund which was disallowed by the Commissioner and this action was subsequently filed.

The taxpayers claim that the Hammermill contract constitutes a disposal of timber by the Plants with a retained economic interest within the meaning of §63 l(b) of the Internal Revenue Code of 1954, as amended (hereinafter referred to as the "Code"). That Section provides that for income to be treated as capital gain from a sale of timber, the following requirements must be satisfied:

- (1) the timber must have been held by the taxpayers more than twelve months;
- (2) there must have been a "disposal" of the timber; and

(3) the owner must have retained an economic interest in the timber.

[Disposal]

In the present case, the Plants have „satisfied the holding period requirement. Next, it must be determined whether there has been a "disposal" of timber. The court in *Dyalwood v. United States* [79-1 USTC ¶9112], 588 F.2d 467 (5th Cir. 1979) stated that to constitute a "disposal" of timber, it is necessary that there be some indication that the taxpayer has surrendered control of the timber. According to the Fifth Circuit in *Dyalwood*:

"Of the factors that have been considered in determining in such cases whether a disposal has been effected, the one most emphasized is who does the cutting... [where] the buyer enters the land and removes timber without the involvement of the seller, a stronger argument can be made that there was a prior disposal of cutting rights."

Here, under the contract with Hammermill, the Plants released all rights to cut or control cutting of the timber unless Hammermill ceased its pulpwood activity in Dallas County, Alabama.

Section 63 l(b) of the Code also requires that the disposal must be "under any form or type of contract by virtue of which such owner retains an economic interest in such timber." Treasury Regulation §1.611-1(b)(1) provides that:

"An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals 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."

The Fifth Circuit in *Dyal v. United States* [65-1 USTC ¶9285], 342 F.2d 248, 252 (5th Cir., 1965) stated the controlling principle in determining whether the owner retains an economic interest:

"It is essential that the consideration for the transaction, whether payable in cash or kind, be contingent upon severance of the timber and payable to the owner solely out of the proceeds from the natural resource itself."

See also *Estate of James M. Lawton v. Commissioner* [CCH Dec. 23,795], (T.C. 1959), 33 T.C. 47; Int. Rev. Rul. 62-81. Therefore, if the income generated by this agreement is not contingent upon the severance of the timber, Section 631(b) does not apply because the taxpayers will have failed to maintain an economic interest in the timber.

[No contemporaneous obligation to cut]

Here, the Plants' agreement with Hammermill provides for a \$12,000 minimum annual payment

regardless of the amount of timber cut in that year. Thus, the facts of the present case are very similar to the situation in *Crosby v. United States* 414 F.2d 822 (5th Cir. 1964). In *Crosby*, the Fifth Circuit characterized the taxpayers' payments in a similar situation as guaranteed payments which were the equivalent of rental payments and thus did not qualify for Section 631 (b) treatment. The court in that case held that the taxpayers were not entitled to treat the income generated by the Timber Purchase Agreements as capital gains since it was possible for the taxpayers to receive payments without a single tree being cut. In *Crosby* under the Timber Purchase Agreements, the Paper company was required to make payments equal to the average growth of the timber. After making those payments, the paper company was entitled to cut and remove a prescribed number of cords. Any timber so purchased and paid for, if not cut during the year of the payment became a "timber backlog" which the paper company could cut without making further payment. Although the paper company retained a "backlog" right, the Fifth Circuit held that the agreement did not obligate the paper company to exercise its backlog privilege. Thus, the possibility that the taxpayers would receive their payments without a single tree being cut clearly demonstrated to the court that the payments were not contingent upon the severance of the timber as required. Therefore, the court held that the taxpayers were not entitled to treat the income received by the taxpayers as capital gains.

The Fifth Circuit in *Crosby* also rejected the taxpayers' contention that the annual payments involved should be treated as advance payments within Treasury Regulation § 1.631-2d(1). Section 1.631-2d(1) extends capital gains treatment to advance payments received in consideration for timber subsequently cut. The court in *Crosby* in refusing to treat the annual payments in that case as advance payments within Section 1.631-2d(1) stated: "there [was] simply no guarantee that the timber would ever be cut." Thus the regulation is inapplicable here as in *Crosby* for under the Plants' agreement with Hammermill there also are no assurances that the timber would be cut.

[Plaintiffs argument re obligation to cut]

The plaintiffs assert that there are distinctions between their contract with Hammermill and the contract in *Crosby*. In particular, the Plants assert that in *Crosby*, St. Regis could only cut the annual growth of timber, whereas Hammermill is not limited to cutting the annual timber. The Plants also argue that unlike the situation in *Crosby*, paragraph 10, as well as paragraphs 2 and 5 of the Hammermill contract obligate Hammermill to cut timber. Paragraph 10 provides that title to and risk of loss to timber remains in the Plants until the timber is cut and that:

"In the event the damage occurs while title to the timber is in Owner, Purchaser shall be relieved of its obligation to cut the trees so damaged except as to the extent that it is economically and otherwise feasible for purchaser to cut and use or sell trees so damaged."

Despite the differences in the *Crosby* contract and the contract in the present case, the fact still remains that the Plants may receive their annual payment without a single tree being cut. In such a situation *Crosby* clearly states unless the income received is conditioned on the severance of the timber and payable solely out of the proceeds from the timber there is no retained economic interest within the meaning of Section 631(b).

For the foregoing reasons the court is of the opinion that there is no genuine issue as to any material fact and that the defendant is entitled to judgment as a matter of law.

Order

This cause came on for consideration by the court on the cross motions for summary judgment filed by the plaintiffs and the defendant seeking summary judgment in their respective favors with regard to all issues involved in the above entitled action.

Having considered the respective motions for summary judgment, the evidentiary matter offered in support of and in opposition thereto, the pleadings and briefs of counsel, and having heard counsel in oral argument, the court is of the opinion that plaintiff's motion for summary judgment is due to be denied and that defendant's motion for summary judgment is due to be granted. The court expressly determines that there is no genuine issue as to any material fact with respect to plaintiffs' claims made against defendant in the above entitled civil action, that the defendant is entitled to judgment as a matter of law with respect to plaintiffs' claims made in this action against defendant, and that there is no just cause or reason for delay in entry of final judgment in favor of defendant.

Accordingly, in conformity with the Memorandum of Decision filed contemporaneously in this cause, it is

Ordered, Adjudged and Decreed that plaintiffs' motion for summary judgment in their favor in the above entitled civil action be and the same hereby is DENIED.

Further Ordered, Adjudged and Decreed that defendant's motion for summary judgment in its favor with respect to plaintiffs' claims made against defendant in the above entitled civil action be and the same hereby is GRANTED and that summary judgment be and the same hereby is ENTERED herein in favor of defendant with respect to plaintiffs' claims made against defendant in the above entitled civil action.

Further Ordered, Adjudged and Decreed that plaintiffs W. H. Plant, Jr. and Doris D. Plant have and recover NOTHING of the defendant United States of America in the above entitled civil action and that the costs in this cause be and the same hereby are taxed against plaintiffs, for which let execution issue.