

Capital Gains on Proceeds of Timber Sales

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tant fault will be imputed to the manufacturer. Thus, the majority in *Weber*, without relying on the *Restatement* or mentioning strict liability, as suggested by plaintiff's attorney³⁷ successfully meshes established Louisiana legal principles to protect an injured consumer by placing the burden of proof and weight of presumption against the party best able to bear the burden and produce information. The ultimate value of *Weber* will be determined by hindsight alone, but, this writer submits, if the cause of action is deemed to sound in tort and the case is applied widely beyond its facts, the potential protection available to persons injured by defective products is significantly increased.

Jacque B. Pucheu, Jr.

CAPITAL GAINS ON PROCEEDS OF TIMBER SALES

Plaintiff's ancestor operated a naval stores business¹ on his land. Subsequent to his death, the land was conveyed to a corporation whose sole shareholders were beneficiaries of the estate and plaintiffs herein. The corporation terminated the naval stores business and, after determining that the land's future lay in the production of trees for sale, implemented a program of site improvement.² A county directory listing the corporation as a buyer and seller of timber was the only advertising undertaken. In a single transaction the corporation sold all the timber growing on its land. The corporation later became a Subchapter S corporation,³ and plaintiffs filed individual income tax returns, treating their distributive shares of the taxable year's payment on the sale price as capital gains.⁴ The Commissioner of the Internal Revenue Service determined that the proceeds were taxable as ordinary income. The Fifth Circuit Court of Appeals *affirmed* a jury finding upholding that determination. *Huxford v. United States*, 441 F.2d 1371 (5th Cir. 1971).

The Internal Revenue Code creates a distinction between

37. 259 La. at 628, 250 So.2d at 765.

1. Generally, the term "naval stores" refers to turpentine, tar, pitch, pine oil, rosin, and other products obtained from the resin of pine and other cone-bearing trees.

2. The trees used in the naval stores business and other inferior trees were gradually cleared out, young trees planted, new fire-breaks made and new roads built.

3. INT. REV. CODE of 1954, § 1371.

4. *Id.* § 1378.

ordinary income and long-term capital gains, the significance of which lies in the tax preference which returns on investment enjoy.⁵ Because a long-term capital gain is said to result from the sale or exchange of a capital asset held for at least six months,⁶ favorable tax treatment depends upon what is meant by the term capital asset. The Internal Revenue Code defines it in exclusionary terms; certain property, such as that held primarily for sale to customers in the ordinary course of a trade or business, is not considered a capital asset for tax purposes.⁷ That the property is connected with the taxpayer's business, however, does not by itself affect its status as a capital asset,⁸ since the Internal Revenue Code expressly permits favored tax treatment for dispositions of certain property so connected.⁹

Whether a particular asset is a capital asset is primarily a question of fact,¹⁰ although it has been treated by some courts as a mixed question of law and fact.¹¹ The courts have developed several criteria to aid in determining the status of the property, including: the taxpayer's purpose in acquiring, holding,¹² and disposing of the property;¹³ the method of acquiring and the nature of the property;¹⁴ the length of time the property was held by the taxpayer;¹⁵ the number, frequency, and continuity

5. *Id.* §§ 631(a)-(b), 1201, 1202, 1221, 1231. The tax preference is in the nature of a lesser rate being applicable to the gain.

6. *Id.* § 1221(3).

7. *Id.* § 1221.

8. *Id.*

9. *Id.* § 1231 provides for capital gains treatment of gains on sales of property used in a trade or business to the extent such gains exceed losses on sales of such property. Property held for sale to customers in the ordinary course of business normally does not fall within this classification.

10. *Dobson v. Commissioner*, 320 U.S. 489 (1943); *United States v. Burket*, 402 F.2d 426 (5th Cir. 1968); *Stockton Harbor Indus. Co. v. Commissioner*, 216 F.2d 638 (9th Cir. 1954), *cert. denied*, 349 U.S. 904 (1955); *Reynolds v. Commissioner*, 155 F.2d 620 (1st Cir. 1946); *Real Estate Mort. & Guar. Corp. v. District of Columbia*, 141 F.2d 361 (D.C. Cir. 1944).

11. *Reynolds v. Commissioner*, 155 F.2d 620 (1st Cir. 1946); *Commissioner v. Boeing*, 106 F.2d 305 (9th Cir.), *cert. denied*, 308 U.S. 619 (1939); *Hollis v. United States*, 121 F. Supp. 191 (N.D. Ohio 1954).

12. *Shearer v. Smyth*, 116 F. Supp. 230 (N.D. Cal. 1953), *aff'd mem.*, 221 F.2d 478 (9th Cir. 1955); *Malouf v. Riddell*, 52-1 U.S. Tax Cas. 45,684 (S.D. Cal. 1952).

13. *Austin v. United States*, 116 F. Supp. 283 (S.D. Tex. 1953); *Shearer v. Smyth*, 116 F. Supp. 230 (N.D. Cal. 1953), *aff'd mem.*, 221 F.2d 478 (9th Cir. 1955); *Boomer v. United States*, 74 F. Supp. 997 (N.D. Iowa 1947).

14. *Smith v. Dunn*, 224 F.2d 353 (5th Cir. 1955); *Stockton Harbor Indus. Co. v. Commissioner*, 216 F.2d 638, 650 (9th Cir. 1954), *cert. denied*, 349 U.S. 904 (1955).

15. *Merchants Nat. Bank v. Commissioner*, 199 F.2d 657 (5th Cir. 1952); *Van Suetendael v. Commissioner*, 152 F.2d 654 (2d Cir. 1945).

of the transactions;¹⁶ the substantiality of the transactions;¹⁷ and the extent of advertising and sales promotion activity.¹⁸ The burden rests on the taxpayer to prove that the asset is a capital asset and not one held primarily for sale to customers in the ordinary course of business.¹⁹

In the instant case the jury finding that the corporation was holding the timber primarily for sale to customers in the ordinary course of business was found to be fully supported by the evidence.²⁰ Regarding the status of the timber as a capital asset under Section 1221 (1) of the Internal Revenue Code,²¹ the court, relying upon *Malat v. Riddell*,²² noted that the purpose of the section "is to differentiate between the profits and losses arising from the everyday operation of a business on the one hand, and the realization of appreciation in value accrued over a substantial period of time."²³ The court further recognized that the appropriate classification is a question of fact, properly resolved by the jury. Section 1231 of the Internal Revenue Code,²⁴ also relied upon by plaintiffs, was inapplicable to the instant case, since the corporation was no longer in the naval stores business, and few, if any, of the trees in the disputed transaction had ever been used in that business.

16. *Williamson v. Commissioner*, 201 F.2d 564 (4th Cir.), *cert. denied*, 345 U.S. 970 (1953); *Friend v. Commissioner*, 198 F.2d 285 (10th Cir. 1952); *Mauldin v. Commissioner*, 195 F.2d 714 (10th Cir. 1952).

17. *Dunlap v. Oldham Lumber Co.*, 178 F.2d 781 (5th Cir. 1950).

18. *Friend v. Commissioner*, 198 F.2d 285 (10th Cir. 1952); *Dunlap v. Oldham Lumber Co.*, 178 F.2d 781 (5th Cir. 1950); *Shearer v. Smyth*, 116 F. Supp. 230 (N.D. Cal. 1953), *aff'd mem.*, 221 F.2d 478 (9th Cir. 1955).

19. *Greene v. Commissioner*, 141 F.2d 645 (5th Cir. 1944); *D. H. Willey*, 9 CCH Tax Ct. Mem. 1109 (1950); *see Malat v. Riddell*, 383 U.S. 569 (1966), holding that the asset in question must be held primarily, not merely substantially, for sale to customers and that "primarily" means "of first importance" or "principally."

20. The evidence included findings that from 1955 to 1960 the corporation had conducted site improvement efforts which resulted in the production of a mature crop of trees; that the corporation had listed itself as a buyer and seller of timber; that the buyer of the timber had committed itself to continuing the reforestation program; and that all rights were to revert to the corporation at the end of twenty years.

21. INT. REV. CODE of 1954, § 1221 provides that a capital asset includes property held by the taxpayers whether or not connected with his trade or business, but does not include stock in trade of the taxpayer, property that would normally be includable in his inventory at the end of the year, or property held primarily for sale to customers in the ordinary course of his trade or business.

22. 383 U.S. 569 (1966).

23. *Huxford v. United States*, 441 F.2d 1371, 1375 (5th Cir. 1971).

24. INT. REV. CODE of 1954, § 1231.

Taxpayers contended that the jury should have received more detailed instructions²⁵ on the subject of liquidations and capital gains.²⁶ However, the court found the instant sale not to be a liquidation in the sense of the cases cited by plaintiffs.²⁷ The trees were not originally acquired for a purpose no longer in existence or no longer profitable, and the corporation did not reduce its timber holdings with the intention of eliminating altogether such holdings.²⁸

Because of inadequate tax planning, plaintiffs in the instant case failed to convince the trier of fact that the disposition of timber should have been regarded as the sale of a capital asset. The importance of the decision rests in the implications raised for the timber owner in Louisiana.²⁹ Striving both for increased timber sales and for preferential tax treatment on the proceeds, he finds himself on the horns of a dilemma: to what extent may he engage in planting, developing, and sales promotion and yet be deemed not in the timber business for tax purposes?

25. The jury received instructions on the language of § 1221(1), which defines capital assets, and on the distinction drawn in *Malat v. Riddell*. The trial judge also instructed the jury that they might consider the following factors: extent of development and improvement of the property; extent to which customers were solicited; portion of the corporate income represented by the sale; frequency and continuity of transactions; and the period of time for which the property had been held. Finally, the judge included an instruction which was garbled in transcription, but which the court of appeals felt was obviously taken from the opinion in *White v. Commissioner*, 172 F.2d 629 (5th Cir. 1949), holding that where liquidation of an asset is accompanied by development and sales activity, the mere fact of liquidation does not preclude the existence of a trade or business.

26. It was recognized that courts in certain cases have classified gains from liquidations as capital gains where they would ordinarily be taxed as ordinary income, on the theory that it would be unjust and unfair to tax a party who is trying to recover only the salvage value of an asset. The term "liquidations" is a jurisprudential concept and serves to classify what is normally an inventory item as a capital asset when the owner of the asset disposed of the entire inventory in a single transaction rather than in the ordinary, day-to-day course of business.

27. *Commissioner v. Williams*, 256 F.2d 152 (5th Cir. 1958); *Thomas v. Commissioner*, 254 F.2d 233 (5th Cir. 1958); *Alabama Mineral Land Co. v. Commissioner*, 250 F.2d 870 (5th Cir. 1957); *Consolidated Naval Stores Co. v. Fahs*, 227 F.2d 923 (5th Cir. 1955).

28. The contract by which the corporation sold its timber included a clause requiring the buyer of the timber to continue the corporation's program of planting and site improvement. The court observed that the corporation would have another mature stand of trees in twenty years, thus indicating the corporation was not reducing its holdings of trees.

29. For an illustration of the value of the forest industry to the Louisiana economy see BUREAU OF THE CENSUS, UNITED STATES DEP'T OF COMMERCE, COUNTY BUSINESS PATTERNS—LOUISIANA 13 (1970); LOUISIANA FORESTRY COMM'N, 1971 TIMBER AND PULPWOOD PRODUCTION IN LOUISIANA (1972).

To qualify timber as a capital asset under Section 1221 (1), proper records are essential in carrying the taxpayer's burden of proof. Thus, one who holds timber as an investment asset should explicitly record upon its acquisition that the timber is not being procured, nor will it be held, for sale to customers in the ordinary course of business. All records and accounts on the timber tract should be kept separate from those of his primary occupation.³⁰ In addition, he should avoid advertisements, solicitation, or other sales promotion activities which suggest that he is in the timber or tree farming business.³¹

Due to the facts of his particular situation, the taxpayer may unavoidably be in the trade or business of tree farming for tax purposes and therefore outside the scope of Section 1221 (1). In such case, capital gains treatment is available from two additional sources. First, under the provisions of Section 631 (a) of the Internal Revenue Code, the taxpayer who cuts his own timber may elect to treat the cutting as a sale or exchange. Gain is recognized to the extent of the difference between the depletion basis³² of the timber and its fair market value at the time of the cutting. That amount is then accorded capital gains treatment under Section 1231 of the Internal Revenue Code, even though the timber might otherwise be classified as held primarily for sale to customers in the ordinary course of business.³³

30. See 4 RESEARCH INSTITUTE OF AMERICA TAX COORDINATOR, § I-4100 (1972). Of course the taxpayer should realize that the substance of his transactions and activities, rather than their form, will govern for tax purposes. Proper recordation alone is not determinative, as it only reflects one fact of several from which his tax liability will be determined. Thus, one who purchases timber recording that the timber is being procured for investment purposes and then embarks on a program of extensive improvements and sales activity concerning the timber could find that he is in the timber business for tax purposes, in spite of his recordation.

31. The taxpayer wishing to avail himself of capital asset status under § 1221 should avoid participation in the "tree farm" system of the American Forestry Institute (operated in Louisiana by the Louisiana Forestry Association), whose members display characteristic green and white signs. Because the purpose of this program is to encourage forest management for profitable timber production, participation would be strong evidence that the owner is in the timber business.

32. See Treas. Reg. § 1.611-3 (1960) for a discussion of timber depletion and depletion basis.

33. INT. REV. CODE of 1954, §§ 631(a), 1231(a), (b)(1)-(2); Treas. Reg. § 1.631-1 (1957); S. REP. No. 627, 78th Cong., 1st Sess. 25 (1943), which indicates a desire to eliminate discrimination against taxpayers who dispose of timber by cutting as compared to those who sell it outright. Formerly, the taxpayer who cut his timber lost the benefit of the capital gain rate which was available when the timber was sold outright; *but see* Wineberg v. Commissioner, 326 F.2d 157 (9th Cir. 1963), which appears to hold that the elec-

Second, the taxpayer, if he is the timber owner, may qualify for capital gains treatment on dispositions whereby he retains an economic interest in the timber. Section 631(b) treats as a gain the difference between the adjusted depletion basis of the timber and the amount realized upon a disposal under any type of contract by which the owner retains an economic interest in the timber. Such gain would then also fall under the provisions of Section 1231.³⁴ In the usual case involving Section 631(b), the basic issue is whether an economic interest has been retained by the taxpayer.³⁵ If the taxpayer can show retention of such an interest, it makes no difference that the timber was held primarily for sale to customers in the ordinary course of business.³⁶

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tion is unavailable to dealers holding the timber primarily for sale to customers in the ordinary course of business.

34. INT. REV. CODE of 1954, § 1231.

35. Compare *Barclay v. United States*, 333 F.2d 847 (Ct. Cl. 1964); *Boeing v. United States*, 98 F. Supp. 581 (Ct. Cl. 1951); *L.D. Wilson*, 26 T.C. 474 (1956) (holding that an economic interest had been retained) with *Ah Pah Redwood Co. v. Commissioner*, 251 F.2d 163 (9th Cir. 1957); *Estate of Lawton*, 33 T.C. 47 (1959); *George L. Jantzer*, 32 T.C. 161 (1959); Rev. Rul. 82, 1962-1 CUM. BULL. 155 (holding that no disposal had been made wherein an economic interest had been retained).

36. Treas. Reg. § 1.631-2 (1957); *Ah Pah Redwood Co. v. Commissioner*, 251 F.2d 163 (9th Cir. 1957); Rev. Rul. 90, 1957-1 CUM. BULL. 199.