BROWN WOOD PRESERVING CO. v. UNITED STATES
58-2 USTC ¶ 9604, 2 AFTR 2d 5013 (W.D. Ky. 1958).
***Rev'd* 275 F.2d 525; 60-1 USTC ¶ 9316; 5 AFTR 2d 953 (6th Cir. 1960).**

[The opinion which follows is that of the U.S. District Court. The complete text of the Court of Appeals' opinion and the Editor's Summary of the case are at p. 805;]

Case Text

MEMORANDUM

SHELBOURNE, District Judge: The above styled and numbered actions were each filed in this Court on January 29, 1957.

The Brown Wood Preserving Company, a Kentucky corporation, seeks a recovery of $12,249.39, the amount of tax deficiencies and interest assessed by the Commissioner against the Company for the taxable years 1949 through 1952.

The Ray E. Loper Lumber Company, an Alabama corporation with its principal place of business at Louisville, Kentucky, seeks a recovery aggregating $3,025.30, the amount of tax deficiencies and interest assessed by the Commissioner for the same years, 1949 through 1952.

The cases were consolidated by an order of the Court, dated July 22, 1957, and the consolidated cases were tried to the Court without a jury on December 12, 1957. Counsel requested time in which to file briefs; the cases were submitted to the Court on briefs on February 19, 1958.

The question involved in each of the cases is identical, and is whether the sale of rights to remove turpentine from standing pine timber held for more than six months, under a contract in which the lessor receives in consideration of the lease a percentage of the gross receipts from the sale of the turpentine and thereby retains an economic interest in the standing timber, constitutes a disposal of the timber within the meaning of Section 117(k)(2) of the Internal Revenue Code of 1939. And, whether or not such percentage of the gross receipts paid to the lessor, after allowance for depletion, is taxable as a long-term capital gain under the provisions of Section 117 (j) of the Internal Revenue Code of 1939. In other words, the lessors here admittedly owned the standing timber in which the turpentine rights were leased for more than six months; hence, the question is whether the net profit to the lessors, after depletion allowances is taxable as a long-term capital gain or should be taxed as ordinary income.

The Commissioner made the assessments upon the theory that the profit constituted ordinary income.

The parties entered into a stipulation of facts, reserving the right to introduce witnesses, and from the stipulated facts and the testimony adduced at the trial the Court makes the following findings of fact.

FINDINGS OF FACT

(1) The Brown Wood Preserving Company, prior to December 1, 1955, was a Kentucky corporation and on that date was merged into the W. P. Brown and Sons Lumber Company, likewise a Kentucky corporation.

The Ray E. Loper Lumber Company is an Alabama corporation with its principal place of business at Louisville, Kentucky.

(2) Each of said corporations filed, with the proper official of the Internal Revenue Service at Louisville, Kentucky, its federal corporation income tax returns for the years 1949, 1950, 1951, and 1952, and on the dates of filing said returns paid the tax shown by the returns to be due.

(3) Thereafter, timely assessments of deficiencies were made which, insofar as involved in this action, were assessed on the ground that each of the taxpayers had erroneously treated as long-term capital gains the profits from the leasing of turpentine rights on standing pine timber. The dates upon which the deficiency assessments were made and the dates upon which timely claims for refunds were filed are as stipulated by the parties, there being no doubt as to the dates or amounts; nor is there any doubt that each of the claimants received notices that the respective claims for refund had been disallowed by the Commissioner.

(4) The Brown Wood Preserving Company and Ray E. Loper Lumber Company both kept their books of accounts and records and prepared and filed their federal tax returns upon the accrual basis and upon the calendar year basis.

(5) The Brown Wood Preserving Company received the following amounts in the following years as income under the leases, which amounts are the subject of dispute:

1949	$12,273.06
1950	12,910.66
1951	14,582.33
1952	13,100.26

The Ray E. Loper Lumber Company received as income under its leases the following amounts in the following years:

1949	$5,034.45
1950	3,899.17
1951	2,225.44
1952	7,040.08

In each of the years 1949 through 1952, the Commissioner allowed as costs depletion allocable to the turpentine receipts the following amounts:

To Brown Wood Preserving Company:

1949	$3,891.92
1950	4,083.20
1951	4,584.70
1952	3,930.08

To Ray E. Loper Lumber Company:

1949	$1,510.34
1950	1,169,75
1951	667.63
1952	222.02

(6) All of the timber subject to the turpentine leases had been purchased by either Brown Wood Preserving Company or Ray E. Loper Lumber Company more than six months prior to ~e execution of the leases.

CONCLUSIONS OF LAW

Counsel for the Government readily concede the physical fact that the gum from which turpentine is obtained comes from the tree, but contend that the gum is not a part of the tree and that its extraction and sale is not a disposal of timber. The dispute hinges about the proper construction of Section l17(k)(2) of the Internal Revenue Code of 1939; that section is as follows:

> (k) Gain or loss upon the cutting of timber. * * *
> (2) In the case of the disposal of timber or coal (including lignite), held for more than 6 months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber or coal, :the difference 'between the amount received for such timber or coal and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the. case may be, upon the sale of such timber or coal. Such owner shall not be entitled to the allowance for percentage depletion provided for in section 114(b)(4) with respect to such coal. This paragraph shall not apply to income realized by the owner as a co-adventurer, partner, or principal in the mining of such coal. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the net income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this paragraph. This paragraph shall have no application, in the case of coal, for the purposes of applying section 102 or subchapter A of Chapter 2 (including computation under section 117(c)(1) of a tax in lieu of the tax imposed by section 500).

The taxpayers contend that the ownership of timber is divided into components, that is, turpentine and the remaining wood products; that, if a taxpayer elects to forego disposal of the turpentine portion of the timber and thereby permits the timber to reach its full maturity, the profit received

from the disposal of the timber is taxed as capital gain under Section 1 l?(k) (2), *supra*, and that, if the taxpayer elects to first dispose of the turpentine portion of the timber and subsequently disposes of the remaining wood products, the aggregate of the receipts represents the sale price of the timber and any gain realized from the sale of the aggregate of the turpentine and wood products is taxed as capital gain.

We think the evidence in the case clearly supports the plaintiffs' contention. Mr. Fred Lemieux, a timber valuation engineer and estimator; Mr. John Crosby, of tong experience in turpentining pine timber and buying and selling long leaf and slash pine; Mr. Charles Henry Bryars, who sold some 9,000 acres of the timber acreage involved in the leases owned by the plaintiffs, and Mr. John G. Guthrie, a graduate forester, all support the taxpayers in their contention that turpentine is one of the component parts of long leaf and slash pine timber.

Mr. Guthrie said, "... when you turpentine a tree, and you decide to merchandise the turpentine, you have sold part of that tree."

Mr. Lemieux said of turpentine, "It is so much a part of it (long leaf or slash pine) as the bark or leaves or the limbs. It is really going back to the tree, itself, is made up and it grows, and everything from its sap, which goes through the process of--and it is actually a part of the tree itself."

"Disposal of timber does not mean merely selling but connotes a broader meaning." *Springfield Plywood Corp. v. Commissioner,* 15 T. C. 597; *Phelps v. Harris,* 101 U. S. 370.

The Court concludes from the evidence introduced at the trial that the sale of the rights to cut and remove the turpentine from the timber constituted disposal of the timber within the meaning of Section l17(k) (2) of the Internal Revenue Code of 1939; that such rights, having been owned for more than six months, constituted a capital asset, and that the income or gain, after allowance for depletion, is taxable as a long-term capital gain under the provisions of Section 117(j) of the Internal Revenue Code of 1939.

The parties to this proceeding have stipulated that, in the event a decision is rendered in favor of the plaintiffs, a recomputation of the taxes will have to be made. Therefore, the Court does now undertake to fix the amounts which plaintiffs will be entitled to recover under this decision.

Judgment in accordance with these views will be submitted by counsel for plaintiffs.