

**CONVERSE v. EARLE**  
**51-2 USTC ¶9430; 43 AFTR 1308 (D. Ore. 1951).**

*Editor's Summary*

*Key Topics*

**OUTRIGHT SALE--CAPITAL GAIN v. ORDINARY INCOME**

- Sale of equipment by contract logger

**CAPITAL v. EXPENSE**

- Road construction costs

*Facts*

*Issue No. 1*

The taxpayer contracted to log timber owned by another party at an agreed rate per thousand feet plus a percentage of profit from the logging operation. The contract stated that these payments were to compensate the taxpayer for his services and for the use and rental of his equipment. The owner of the timber was given the option to purchase the taxpayer's equipment upon termination of the contract, at its original appraised value less such sums as should be paid to the taxpayer for "depreciation" on that value. No such "depreciation" was paid during the life of the contract. The option was exercised, and the taxpayer was paid the full appraised value of his equipment. The taxpayer reported his gain as long-term capital gain, but the Government contended that a part of the price was ordinary income rather than capital gain apparently on the ground that it represented additional compensation to the taxpayer.

*Issue No. 2*

The taxpayer paid part of the cost of a logging road being constructed adjacent to timberlands owned by him and furnished a tractor for use in the construction. He deducted as expenses his part of the cost of the road, expenses of repairing the tractor, and depreciation incurred on the tractor. The Commissioner disallowed these deductions on the ground that they constituted capital expenditures rather than ordinary and necessary business expenses.

*District Court*

*Issue No. 1*

**Held: For the taxpayer.** The equipment furnished by the taxpayer was depreciable property used in his trade or business. The option was actually an agreement to purchase and sell the equipment, and the so-called "depreciation" was actually a part of the purchase price. Consequently, the taxpayer was entitled to report his entire profit on the sale of the equipment as capital gain under section 117(j).

*Issue No. 2*

**Held: For the taxpayer.** The expenses and depreciation associated with the road construction project represented ordinary and necessary expenses of the taxpayer's business. In charging these items to expense, the taxpayer was following an accounting method consistently applied by him over a period of years.

*Case Text*

**AMENDED FINDINGS OF FACT AND CONCLUSIONS OF LAW**

McCOLLOCH, District Judge: This cause having come on regularly for trial without a jury before the Honorable Claude McColloch, one of the judges of the above-entitled Court, at Portland, Oregon, on the 11th day of May, 1951, plaintiff appearing by Charles P. Dully, one of his attorneys, and defendant appearing by Andrew F. Oehmann, Special Assistant to the Attorney General of the United States, and Donald W. McEwen, Assistant United States Attorney for the District of Oregon; and

The parties having produced testimony and evidence in behalf of their respective contentions, as reflected by the pretrial order previously made and entered herein; and

The Court having thereafter considered fully all matters of fact and law presented by the parties and having entered Findings of Fact and Conclusions of Law herein on the 6th day of June, 1951; the defendant having duly filed a motion to amend such Findings of Fact and Conclusions of Law on the 15th day of June, 1951; and the Court being at this time fully advised, does make the following

**AMENDED FINDINGS OF FACT - FIRST CAUSE OF ACTION**

I. Plaintiff instituted this action to recover individual income taxes assessed by the Commissioner of Internal Revenue of the United States and collected from 'plaintiff by defendant. Jurisdiction of this action is based upon Section 1.340 of the Judicial Code of the United States, Title 28.

II. Plaintiff is, and at all times material herein was, a resident of the City of Portland, State of Oregon. Defendant is, and since September 1, 1947 has been, the Collector of Internal Revenue for the District of Oregon.

III. On or about January 1, 1942, plaintiff and one Earl R. Hitchman, as co-partners, entered into a written contract with Hawley Pulp and Paper Company, a Delaware corporation, whereby plaintiff and said Earl R. Hitchman agreed to log certain timber in Tillamook County, Oregon, owned by said Hawley Pulp and Paper Company, and to furnish equipment for such logging. Thereafter, plaintiff acquired all of the interest of said Earl R. Hitchman in said contract and said equipment. Plaintiff furnished the said equipment in accordance with the terms of said logging agreement.

IV. Under the terms of said logging agreement, plaintiff was entitled to positive compensation of 75¢ per M feet of the logs sold, plus a percentage of the profit from said logging operations. The said contract specifically provided that the positive compensation of 75¢ per M feet of logs sold was to compensate plaintiff for his services and for the use and rental of his equipment. Under the terms of the contract, Hawley Pulp and Paper Company was given the right and option to purchase plaintiff's logging equipment at the termination of the agreement at its original appraised value, less such sums as should be paid to plaintiff for "depreciation" upon the original appraised value. No such "depreciation" was paid during the life of the contract. The said option was, in truth and in fact, an agreement to purchase and sell the said equipment, and the so called "depreciation," was a part of the purchase price.

V. At the termination of said logging agreement in the year 1944, Hawley Pulp and Paper Company exercised its said option and in the year 1945 paid to plaintiff for his logging equipment the sum of \$40,139,741 Which was the appraised value of the logging equipment originally supplied by plaintiff, plus the agreed price on other equipment sold.

VI. In filing his individual income tax return for the year 1945, plaintiff duly reported as a long term capital gain the difference between his adjusted tax basis for said logging equipment and the sales price of such equipment. Plaintiff paid the income tax due on his said return to the then Collector of Internal Revenue. for the District of Oregon.

VII. On or about November 13, 1947, the Internal Revenue Agent in Charge of the Seattle Division of the Bureau of Internal Revenue, notified plaintiff of a proposed income tax deficiency against him for the year 1945 in the amount of \$19,896.59, based in part upon the assertion that the proceeds of the sale of plaintiff's said logging equipment to Hawley Pulp and Paper Company, except \$15,533.22 thereof, constituted ordinary income to plaintiff rather than amounts received from the sale of capital assets.

VIII. On December 17, 1947, plaintiff paid to defendant the sum of \$21,796.58, constituting all of the aforesaid deficiency of tax of \$19,896.59, together with interest thereon in the amount of \$1,899.99, and thereafter and on December 12, 1949, plaintiff duly filed with the defendant, for transmission to the Commissioner of Internal Revenue of the United States, his claim for refund of \$14,964.67. The said claim for refund was disallowed by the Commissioner of Internal Revenue of the United States by a notice dated July 25, 1950, in accordance with the provisions of Section 3772(a) (2) of the Internal Revenue Code of the United States, Title 26.

IX. During all times material herein, plaintiff's books of account were kept on the cash basis and his individual income tax returns were filed on the same basis.

From the foregoing Findings of Fact the Court draws the following

## **AMENDED CONCLUSIONS OF LAW - FIRST CAUSE OF ACTION**

I. The logging equipment furnished by plaintiff in accordance with the terms of the said logging agreement was property used by plaintiff in his business and was property of a character subject to depreciation allowance within the purview of Section 117(j) of the Internal Revenue Code of the United States, Title 26.

II. The difference between plaintiff's adjusted tax basis for said logging equipment and the amounts received by him from Hawley Pulp and Paper Company for the year 1945 constituted a long-term capital gain to plaintiff and did not constitute ordinary income to him.

III. By reason of the foregoing, plaintiff is entitled to recover judgment of and from defendant for the sum of \$8,642.59, on his first cause of action, with interest thereon as provided by law and for his allowable costs and disbursements incurred herein.

## **AMENDED FINDINGS OF FACT - SECOND CAUSE OF ACTION**

I. Plaintiff instituted this action to recover individual income taxes assessed by the Commissioner of Internal Revenue of the United States and collected from him by defendant. Jurisdiction of this action is based upon Section 1340 of the Judicial Code of the United States, Title 28.

II. Plaintiff is, and at all times material herein was, a resident of the City of Portland, State of Oregon. Defendant is, and since September 1, 1947 has been, the Collector of Internal Revenue for the District of Oregon.

III. During the year 1944, plaintiff received three certain payments in the aggregate sum of \$4,142.41 from one J. K. Elder who was then logging timber under an agreement with the State of Oregon and who was building a road on land owned by the State of Oregon. Said property was adjacent to timber owned by plaintiff in the vicinity of Niagara, Oregon. During the year 1944 plaintiff paid to J. K. Elder, sums aggregating \$9,031.45 for the construction of said road and expended the further sum of \$3,196.95 for repairs to a Caterpillar tractor owned by plaintiff which was being used by said J. K. Elder in constructing said road. The allowable depreciation on said tractor for the year 1944 was \$608.76.

IV. In filing his individual income tax return for the year 1944, plaintiff reported long income from the said Niagara operation in the total amount of \$4,142.41 and deducted as business expenses the aforesaid sums of \$9,031.45 for road construction work; \$3,196.95 for repairs to said tractor; and \$608.76 as depreciation on said tractor during the year 1944. Plaintiff paid to the then Collector of Internal Revenue for the District of Oregon the sum of \$10,134.69, being the amount of income tax due as shown on his said return Which was filed with the then Collector of Internal Revenue for the District of Oregon.

V. On or about November 13, 1947, the Internal Revenue Agent in Charge of the Seattle Division of the Bureau of Internal Revenue notified plaintiff of a proposed income tax deficiency against him for the year 1944 in the amount of \$6,781.46, based in part upon the assertion that the net sums so expended by plaintiff during the year 1944 constituted capital expenditures for the construction of the logging road, rather than ordinary and necessary expenses paid by him during the taxable year in carrying on his business.

VI. On December 17, 1947, plaintiff paid to defendant the sum of \$6,781.46, together with interest thereon in the amount of \$1,054.47, and thereafter and on December 12, 1949, plaintiff duly filed with the defendant, for transmission to the Commissioner of Internal Revenue of the United States, his claim for refund. The said claim for refund set forth in detail each ground upon which a refund was claimed, contained facts sufficient to apprise the Commissioner of Internal Revenue of the United States of the exact basis thereof and otherwise complied with the pertinent laws and regulations relating to claims for refunds. Based upon the grounds set forth in said refund claim and the facts stated therein plaintiff is entitled to a refund of \$6,537.68, together with the interest thereon from December 17, 1947. Due to an error in the computation of the tax on said refund claim, the amount of the refund was erroneously stated to be \$5,056.88.

The said claim for refund was disallowed by the Commissioner of Internal Revenue of the United States by a notice dated July 25, 1950, in accordance with the provisions of Section 3772(a)(2) of the Internal Revenue Code of the United States, Title 26.

VII. During all times material herein, plaintiff's books of account were kept on the cash basis and his individual income tax returns were filed on the same basis.

From the foregoing Findings of Fact the Court draws the following

#### **AMENDED CONCLUSIONS OF LAW - SECOND CAUSE OF ACTION**

I. The aforesaid sums expended by plaintiff during the year 1944 and the allowable depreciation on said tractor constituted ordinary and necessary expenses paid by plaintiff during the taxable year in carrying on his business and did not constitute capital expenditures.

II. In charging the aforesaid sums to expense, plaintiff followed the accounting method consistently employed by him over a period of years.

III. By reason of the foregoing, plaintiff is entitled to recover judgment of and from defendant for the sum of \$6,537.68 on his second cause of action, with interest thereon as provided by law and for his allowable costs and disbursements incurred herein.