DREY v. UNITED STATES
61-1 USTC ¶ 9116; 7 AFTR 2d 333 (E.D. Mo. 1960).

Editor's Summary

Key Topics

ALLOCATION OF COST BETWEEN LAND AND TIMBER
- Valuation of land
- Immature timber account

CAPITAL v. EXPENSE
- Operating expenses
- Selling expenses

Facts

Issue No. I
The taxpayer owned about 125,000 acres of timberland at an average *cost* of $4.12 per acre. In determining his basis for depletion, he allocated 50 cents :per acre to the cost of land and the balance of cost to merchantable timber. The Government contended that $.1.00 should be allocated to land and the balance to timber. At the trial, expert testimony was presented by both parties. Neither of the Government's witnesses was familiar with land values in the area. One testified that his only experience in the area was buying land for the Government in the 1930's, and the other saw the property on only two occasions. By contrast, the taxpayer's witnesses were familiar with land and timber prices in the area. One of the Government witnesses testified that immature timber was not a factor and that he had considered it so negligible that he lumped it in with merchantable timber.

Issue No. 2
The taxpayer sold his timber by the "stumpage" method; that is, he sold the timber as it stood in the forest and the purchaser bore all expenses of cutting it and hauling the logs to the mill. The taxpayer employed a full-time forester and other employees. In connection with sales of standing timber, his employees would cruise the areas to be cut, mark out the sections ready for cutting, and inspect the cutting to prevent purchasers from cutting unmarked timber or from damaging young growth. Actual selling of the timber was done by the taxpayer. The taxpayer deducted as expenses the salaries paid to his employees, as well as other operating expenses. The Government contended that 20% of these costs were sales expenses which should have been offset against capital gains from the sale of the timber.

District Court

Issue No. I
Held: For the taxpayer. As to the valuation of the land, the Court adopts the taxpayer's valuation, primarily because of the knowledge and experience of the taxpayer's witnesses as

compared with that of the Government's witnesses. Regulations § 1.611-3(d)(3) requires that the total cost of land and timber be allocated to timber and land accounts, respectively. Where immature growth is a factor, a reasonable portion of the total cost is required to be allocated to it and carried in a special account. The Government considers immature timber as negligible and does not Set it up as an account, but yet asks the Court to consider it as a factor in allocating cost between land and timber. This is an arbitrary position.

Issue No. 2
Held: For the taxpayer. The taxpayer's expenses arose in the ordinary course of his business. The fact that they are attributable to the production of income taxable at the capital gain rate does not remove them from the category of ordinary and necessary business expenses. They were not related to the disposal but were ordinary and necessary business expenses and the allocation of the Government was arbitrary.

Case Text

MEMORANDUM

WEBER, District Judge: This is a suit to recover taxes paid for the years 1954, *1955,* and 1956, alleged to have been erroneously assessed and collected. The prayer is for less than $10,000.00 and the Court has jurisdiction. § 1346, T. 28, U. S. C. The matter was tried to the Court and the parties stipulated: that adjustments were made with respect to the year 1954 and that year is not now in issue; that plaintiff's allocation to mineral values is not contested; and that in the event the Court finds for plaintiff, in whole or in part, a re-computation shall be made by the Internal Revenue Service of the amount of refund due, submit same to plaintiff to approval and in the event the parties are unable to agree to the recomputation, the final determination shall be made by the Court.

The facts disclose that plaintiff is actively engaged in the timber business. He owns about 125,000 acres of hardwood forest lands in southeastern Missouri. This acreage is suitable only and primarily for timber, being rough, rocky, rugged Ozark Mountain land, crisscrossed by spring-fed streams and having very little tillable soil. Plaintiff encourages the growth of timber through good forestry practices and has a forester and crew constantly on the job putting those practices into effect. The theory of plaintiff's operation is to prevent fire, encourage growth and harvest a merchantable crop at stated periods. This differs from the practice of previous generations where timber lands were "gutted" of all merchantable timber, the soil almost completely denuded and then the land owners .and their descendants: sat back for another century to await a new growth.

Plaintiff preserves his land and timber, selling only the more profitable merchantable timber each year, thus having a smaller but more constant supply as well as income. His practice is to sell by the “stumpage” method, that is, he sells the merchantable timber as it stands in the forest and the purchaser bears all the expense of cutting and hauling to the mill. His selling price averages about $8.00 per thousand board feet. His employees cruise the areas, mark out the sections ready for cutting; inspect the cutting to prevent: purchasers from getting over the lines or damaging young growth. The actual selling to purchasers is done by the plaintiff himself.

The tax issue between plaintiff and defend thus its inception in § 611, T. 26, U. S. C., which provides for a “reasonable allowance for depletion * * * according to the peculiar conditions in each case; * * * to be made under regulations prescribed by the Secretary or his delegate. * * * In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.” The depletion allowance is determined on a cost basis. § 612, T. 26, U. S. C. In the case of timber held for more than 6 months before disposal, “the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be treated as though it were a gain or loss, as the case may be, on the sale of such timber.” §§ 631(b) and 1231, T. 26, U. S.C.

The Secretary’s regulation in accordance with the statute, provides that the depletion unit of timber shall be "the quotient obtained" by dividing the cost basis of the taxpayer's timber at the beginning of the year plus the cost of units acquired during the year, by the total number of units on hand at the beginning of the year, plus the additions and plus (or minus) the units required to be added (or deducted) by way of correcting the prior estimate of units available to the account. T.R. § 1.611-3(b)(2). The regulation further provides that "The total value or total cost, as the case may be, of land and timber shall be equitably allocated to timber and land accounts, respectively. *In cases in which immature timber growth is a factor,* a reasonable portion of the total value or cost shall be allocated to such immature timber, and when timber becomes merchantable such value or cost shall be recoverable through depletion allowance." T. R. § 1.611-3(d)(3). (Italics supplied.)

Also involved, as will be later disclosed, is Revenue Rule 58-266, 1958-1 Cumulative Bulletin, p. 520. This ruling relates to reduction of the amount of capital gain by expenses incurred in connection with disposal of timber and whether any expense is a direct disposal expense shall be determined "largely on the strength or persuasiveness of the facts of each particular case and how closely related are the activities in connection with which the expense is incurred to the disposal * * *"

Plaintiff began purchasing the land in question in 1951 and his largest purchase was about 80,000 acres in 1954. Beginning in 1951 plaintiff allocated 50¢ an acre out of his total cost of land, as the cost of land without timber, and he placed the balance to the value of the timber for capital gain treatment in accordance with the regulations and the statutory allowance for depletion. He took off all expenses of salaries for the forester and other employees and other operating expenses, from his direct income and made no allocation of "sales expense" on the capita] gain side [line 25(f) of Form T] of the income tax return for timber growers. He thus computed his taxes for the years 1951-1956.

Upon examination of his returns for the years in question, the Revenue Agent increased the amount of the purchase price on purchases in the years 1954, 1955 and 1956, to $1.00 an acre for land and the balance to timber, and allocated 20% of plaintiff's expenses to "sales expense." This resulted in a decrease in cost for depletion and increased the capital gain. It likewise deprived

plaintiff of 20% of his expense deductions on the "regular income" side of his return and placed that percentage of expenses on the "capital gain" side, The result was to create a tax deficiency.

During the trial considerable effort was expended in questioning the witnesses to establish a land-less-timber, as opposed to a land-less-merchantable-timber, value for the basis of capital gain treatment. (Both parties agree that the average price paid by plaintiff was $4.12 per acre.) Thus, plaintiff would place 504 to the land and $3.62 to the timber, while the government contends it should be $1.00 to the land and $3.12 to the timber. The regulation relied on by defendant provides for a reasonable portion of the total value, or cost, to be allocated to immature timber "in cases where it is a factor" and where such timber becomes merchantable such value of costs shall be recoverable. T. R, § 1.611-3(d)(3).

Witnesses for the plaintiff were primarily natives of the area who placed a 504 per acre value on all land, less all timber. The government's expert (Schlatter, Tr. 280-281) testified to the effect that immature growth was not a factor and he treated the amount as so negligible that he lumped it in with the "sawtimber account."

In other words, the government is contending the regulation actually provides for three accounts: (1) land, (2) immature timber, and (3) merchantable timber. It based the questions on value as to the difference between land value and merchantable timber :value including immature growth. It argues the regulation allows this immature growth to be added to the cost in the year it becomes merchantable. Yet it, and its own expert, lumps the sums off into round categories of land and timber. It seems to the Court that the government wants to apply the regulation, but does not want to follow it.

In fact, the defendant has not followed either the statutes or the regulation. The statutes provide for a depletion allowance. The purpose of such allowance is to permit a taxpayer to recover capital cost through the process of taxable gain. *Skinner Bros. Realty Co. v. Commissioner,* 17 B. T. A. 364. The statute further provides that the allowance for depletion should be according to the ,peculiar conditions in each case." § 611, T. 26, U. S. C. And it further provides that where the recoverable units are greater or less than the prior: estimate, then the prior estimate (but not the basis for depletion) shall be revised for subsequent taxable years. Under the government's theory they are actually revising the basis for the depletion rather than the recoverable units. The regulations provide for setting up an immature timber account "in cases where immature timber growth is a factor". The government does not set it up as an account, yet, wants this Court to consider it as a factor in arriving at the difference between cost of land and timber. This appears to the Court as an arbitrary position.

I find from this record that immature growth is not a factor to be considered. The facts from the testimony before the Court show that the land in question only has a value for its timber potential; young growth adds no value to: the land except for its potential; the actual over-all value of the land is in its merchantable timber. Therefore, the proper rule under the facts in this case is the value of the land on the one hand and the value of the timber on the other.

Plaintiff asks the Court to declare the regulation as contrary to the statutes and therefore invalid. I

see no reason for this. The regulation is not invalid per se. It provides a bookkeeping arrangement for immature growth where it is a factor, and where it is a factor it should not be an arbitrary or invalid arrangement. But I do say that the manner in which the government seeks to use it in this case is an arbitrary manner, for here it is not a factor and the government is attempting to use it as such and by its use to revise the basis for depletion.

This brings the Court to a determination of the proper cost values to be applied. Value is the price at which property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell. *Fitts' Estate v. Commissioner,* 237 F. 2d 729, (8. C. A.). The defendant's experts considered factors in arriving at valuation which should not have been considered, Neither did they display to the Court any familiarity with the area in question. One (Svenson) had no knowledge whatsoever of timber values and his only experience in the area was buying land for the government in the "30¥' when the government was the only purchaser and was buying land for national forests. The other (Schlatter) saw the property on only two occasions, for very limited periods and with a very limited inspection. Neither expressed any acquaintance with the area markets or values.

On the other hand, plaintiff's witnesses were persons who bought lands and dealt in timber. They knew what timber, timber lands, farm lands, timber lands without merchantable timber and with merchantable timber were selling for. They may not have fallen in the category of experts, yet the Court is not bound by the opinions of experts as long as it does not disregard or ignore such testimony and has substantial evidence in the record on which to base a decision. *Fitts' Estate v. Commissioner, supra,* at 1. c. 732.

The testimony here further showed by a government witness that one acre of the land in question, on an average, would produce about 72¢ per year gross due to the net growth increase each year. (Tr. p. 299) Plaintiff's testimony (Tr. p. 322) places such amount at 604 per acre because 20% of alt timber on his lands is non-market-able. It is the Court's conclusion from this testimony that the return potential of the land is relatively small and such small return may be considered both in connection with the negligibility of immature growth and the determination of the value of the land less timber.

The Court has considered the evidence of all the witnesses and upon this record finds that the value of the land in question, less timber, is 504 per acre; that this is the value per acre for valuation purposes under the applicable tax statutes and the regulations; that the balance between that figure and the cost shall be computed as the amount and value of timber for determination of plaintiff's capital gain.

This leaves the treatment of plaintiff's expense, the second issue in this case, to be decided. As heretofore pointed out, defendant allocated 20% of plaintiff's expenses as sales expense and deducted it upon the capital gain side of the return. Plaintiff deducted his expenses 100% on the income side of the return as a business expense deduction. *Revenue Ruling* 58-266, *supra,* directs that these matters be "determined largely on the strength or persuasiveness of the facts of each particular case and how closely related are the activities in connection with which the expense is incurred to the disposal of the * * * timber." § 162(a), T. 26, U. S. C. is a statutory allowance for

deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," and includes salaries and other compensation for personal services, traveling expenses, etc.

Again, it is the Court's conclusion that we are not dealing directly with the validity or invalidity of the ruling of the Revenue Department but are dealing with a factual situation in the allocation of expenses. The government contends that 20% of plaintiff's expenses should be picked as a figure to be used as "direct sales expense." The plaintiff contends that he is in the timber business, that he himself conducts all sales of timber and therefore the expenses of salaries, gasoline and car expense and other incidental expenses are usual business expenses ordinarily and necessarily incurred in carrying on his timber business.

The Court believes defendant's 20% allocation is arbitrary and unreasonable in view of the regulations and the statutes. We cannot glibly equate the disposition of timber with the sale of a capital asset. § 1221, T. 26, U. S. C., in defining "capital asset" states that that term does not include "(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer * * * or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;". A reading of ail of the statutes involved leads this Court to the conclusion that timber would not be afforded capital gain treatment except that it is authorized to be treated as such under the theory of a depletion allowance. Therefore, we are not actually dealing with the sale of a capital asset but dealing with the sale of a commodity which is afforded capital gain treatment by statute.

Cases cited by defendant deal in the main with situations where individuals or corporations were not engaged in the business of selling. *Giffin v. Commissioner,* 19 B. T. A. 1243; *Johnson v. Commissioner,* 7 T. C. 465; *General Spring Corp. v. Commissioner,* 12 T. C. M. 847; *Towanda Textile, Inc v. United States,* 180 F. Supp. 373; *Hunt v. Commissioner,* 47: B. T. A. 829. In *Hunt v. Commissioner, supra, the* appeals board 'at 1. c. 839 pointed out:

> If petitioner had proved that she was engaged in the real estate business, there might be merit in her contention, but there is no proof whatever that during the taxable year petitioner was engaged in the real estate business.

The board went on to hold that, under the facts, the Commissioner's method of offsetting the sale price of the property by the real estate commissions was a correct method,

In *Towanda Textiles, Inc. v. United States, supra,* relied on by the government here, a reading of that case leads this Court to the conclusion that it did not hold that wherever a capital gain is realized expenses necessarily incurred must reduce the gain. and cannot be deducted from ordinary income. It held that where an extraordinary event occurred (a fire) and recovery of insurance proceeds which resulted in a capital gain involved expenses in obtaining those proceeds, such expenses could not be included as regular business expenses and would have to be deducted from the Capital gain. That case can be distinguished from the situation here involved because of the extraordinary circumstances of expenses which .were not incidental to the ordinary and necessary expenses of the insured's regular business.

In *Alabama Mineral Land Co. v. Commissioner,* 28 B: T. A, 586, Plaintiff was in the timber business selling :land and standing timber. Plaintiff expended certain amounts for cruising timber which work Was done by regular, employees on plaintiff's payroll throughout the year. The board allowed this expense as a deduction from ordinary income stating at 1. c. 590:

> As a trader in timber and timber lands, the petitioner kept a number of woodsmen and timber cruisers on its payroll at all times. The wages of such employees constitute an ordinary and necessary expense of. its
>
> business. The amount * * * paid to woodsmen and cruisers * * * is deductible from income * * *. The fact that a part of the expense was incurred in cruising timber that was afterwards sold in no wise affects the nature of the expenditures.

In the case at bar it is the Court's conclusion that the question here presented is whether or not the expenses of the plaintiff arose and occurred in the ordinary course of his business as contemplated in § 162, T. 26, U. S. C. *Revenue Ruling* 58-266, 1958-1 *Cumulative Bulletin* provides that it is a matter to be determined largely on the facts of each particular case and how closely the expense is related to the actual sale. Here plaintiff's expenses arose in the ordinary course of his business. The fact that these expenses are attributable to the production of income taxable at the capital gain rate does not place them without the ordinary and necessary business expense category. The test is whether they were ordinary and necessary expenses paid or incurred in carrying on the business or related to the disposal. This Court finds and holds from the evidence in this cause that plaintiff's expenses were not related to the disposal and were necessary and ordinary business expenses and the allocation of 20% thereof to "sales expense" was an arbitrary allocation under the statutes and the regulations.

Therefore, the contentions of the plaintiff, as set forth in his complaint, are sustained. In accordance with this Memorandum and under the stipulation of the parties, the defendant is ordered to re-compute plaintiff's taxes for the years 1955 and 1956. Such computation shall be based upon an allowance of 50¢ per acre to land and the balance of plaintiff's cost shall be allocated for capital gains treatment and shall not be subject to any deduction for sales expense. Defendant shall make such computation within 30 days from this date, submit same to the plaintiff for approval, and if accepted the parties shall, within 15 days thereof, submit a judgment to be entered herein. If the computation is unacceptable to the plaintiff, he shall notify this Court within 15 days after receiving the computation and this Court will set a date for the final determination of that issue and for entry of final judgment.

ORDER

The cause was tried before the Court, briefs were filed by the parties, the Court has reviewed the testimony, the briefs and has filed a written Memorandum which it adopts as its findings of fact and conclusions of law. In view of the stipulation of the parties as to re-computation of the tax due in accordance with the memorandum and opinion of the Court, it is

ORDERED that this cause is passed for a period of 30 days during which time defendant shall make a recomputation of the tax in accordance with the Memorandum and deliver same to

plaintiff. Plaintiff shall have 15 days in which to agree or disagree with such computation and in the event of disagreement shall notify the Court within that Period and the cause will be set for hearing and determination of that issue.

IT IS FURTHER ORDERED that in the event plaintiff agrees with the computation, the parties shall within 15 days after plaintiff receives the computation, file a judgment with the Court for approval and entry.