

PANKRATZ v. COMMISSIONER 22 T.C. 1298 (1954).

Editor's Summary

Key Topics

OWNERSHIP OF A CAPITAL ASSET

- Effect of prior disposal

Facts

A partnership assigned its contract right to cut timber before holding it for six months. Further assignment by the assignee without the partnership's consent was prohibited. Royalty payments received under the assignment contract were treated by the partners as ordinary income: Some five years later, the partnership, for additional consideration, joined with its assignee in a new assignment to a third party. The partners treated the royalty payments received under the new assignment as gain from the sale of a capital asset held for more than six months, arguing that the first assignment did not amount to a sale. The Commissioner contended that the payments under the new assignment, like those received under the earlier one, were ordinary income.

Tax Court

Held: For the Commissioner. The partnership disposed of its cutting rights in the first assignment. For this reason, its act of joining in the later transfer could not constitute the sale of a capital asset held for more than six months.

Case Text

Respondent determined a deficiency of \$1,913.44 in petitioners' income tax for the year 1950. Petitioners do not contest some of the adjustments. The sole question to be decided is whether certain sums received by John S. Pankratz from a partnership of which he was a member constituted either ordinary income or short-term capital gain, rather than long-term capital gain.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. John S. Pankratz, hereinafter called petitioner, and Josephine L. Pankratz, hereinafter referred to as petitioner's wife, are husband and wife and constitute a marital community under the laws of the State of Washington. They reside in Seattle, Washington, and filed a joint Federal income tax return for the year in controversy with the collector of internal revenue for the district of Washington.

Petitioner is extensively engaged in the lumber manufacturing and logging business under the firm

names of Pankratz Lumber Company and Standard Lumber & Manufacturing Company, Inc. He also is a partner in Standard Shingle Company. The partnership of Pankratz and Norris, hereinafter referred to, has no interest or connection with the aforesaid businesses.

Immediately prior to November 1, 1945, O. C. Norris and petitioner became associated as copartners under an oral partnership agreement. The partnership was formed for the sole purpose of acquiring from C. G. Wiggins and Laura Weltha Wiggins, his wife, of Korbel, Humboldt County, California, the right to cut and remove merchantable timber from approximately 25,000 acres of timberland owned by Wiggins and his wife and on their Maple Creek Ranch, as well as other rights and privileges. On November 1, 1945, a 30-year contract, hereinafter called the Wiggins contract, was entered into between Wiggins and his wife, as first parties, and petitioner and his wife, and O. C. Norris and Florence V. Norris, his wife, as second parties. The Wiggins contract and the rights acquired thereunder were owned thereafter by the partnership of petitioner and Norris, hereinafter sometimes called the partnership. The contract provides in part as follows:

first parties do hereby sell and convey to the second parties and to their assigns the right to cut and remove all merchantable [*sic*] fir, cedar and pine timber located and being upon the ranch of first parties * * *

* * *

second parties shall pay to first parties for the lumber and products secured and/or manufactured from the timber removed by second parties and/or their assigns from the herein above described premises, the following amounts and at the times and in the manner as follows:

For all lumber manufactured, a sum equal to \$1.00 per thousand feet board measure.
For logs sold, a sum equal to \$1.35 per thousand feet, figured on the net scale to be made of such logs by an official scaler at the expense of second parties and/or their assigns.
For all piling, a sum equal to two cents per linear foot of such piling.

These sums become due and payable on the 15th day of the month for all sales made during the preceding month. Copies of invoices of all sales are to be furnished to Wiggins. The contract further provides as follows:

It is agreed that second parties and/or their assigns shall have a period of thirty years from and after the date of this contract within which to cut and remove the said timber, provided, that only such time shall be used in the completion of the performance of the terms of this agreement as shall be reasonably necessary, * * *

* * *

In the event of loss of logs or finished products by fire or other casualty, and if second parties and/or their assigns shall have such loss covered by insurance when same occurs, then and in such event the amount recovered on such insurance by second parties and/or their assigns shall be applied and paid to first parties, or so much thereof as shall be necessary to pay to first parties a sum equal to \$1.00 per thousand feet, board measure, for all of such logs and finished products so destroyed.

All taxes on the land and on standing timber are payable by the first parties. Taxes on all felled timber, timber products, buildings, and improvements are payable by the second parties.

Petitioner, his wife, and the Norrises are granted unlimited and unrestricted right to cut and remove the timber, including the whole or any part thereof, without the consent of the first parties. Second parties are not obligated to cut and purchase all or any specific quantity of the timber.

Petitioner, his wife, and the Norrises or their assigns are granted easements and rights-of-way over and across the Wiggins ranch which they are permitted to use for all purposes, the contract providing:

second parties and/or their assigns shall have the right to construct upon said premises any and all reasonably necessary and required roads and roadways for use in the logging and milling operations * * * and they shall have the right to use * * * all roads and roadways now constructed and being upon the above described premises in such operations; * * *

Under the Wiggins contract petitioner, his wife, and the Norrises were required to construct, or cause to be constructed by others, a sawmill having a capacity of not less than 50,000 feet of lumber, board measure, per day, and were required to have such a sawmill ready for production at capacity not later than April 1, 1947. The second parties are required to operate the sawmill as near to full capacity as practically possible. Petitioners and the Norrises "and/or" their assigns are given the right to use such other mills upon the Wiggins ranch as they may desire. The contract also provides that:

It is further hereby agreed that, if desired by second parties and/or their assigns, such other mills as second parties or their assigns may desire may be constructed upon the premises herein above described * * *

At the time petitioner and Norris acquired these rights, they intended to build a sawmill upon the property and remove the timber therefrom. This intention was abandoned shortly after entering into the above contract.

Petitioners have a 50 per cent interest in the partnership and its assets and O. C. Norris and his wife have the remaining 50 per cent interest.

The sole asset of the partnership was the Wiggins contract and the rights and privileges arising therefrom. The contract was acquired by the partnership without cost and petitioner and Norris have at no time had any investment in the timber located on the Wiggins ranch and the Wiggins contract, or either, or any other contract in connection therewith, nor have they had any investment in any property of any kind in connection with their ownership.

Petitioner and Norris have never engaged in the business of buying and selling timber contracts, nor have they at any time engaged in the timber brokerage business. The acquisition of the Wiggins contract and the activities in connection therewith constituted the sole transactions of the

partnership, except for receipt of payments in accordance with the terms of the various contracts.

The partnership has at no time had stock in trade which would be included in an inventory if on hand at the end of the year, nor has it any customers to whom it sells in the regular course of business, nor does it have any property subject to allowance for depreciation or obsolescence.

On November 20, 1945, petitioner, his wife, and O. C. Norris and Florence V. Norris, as vendors, entered into a contract with Clifford W. Addison, Leland B. Addison, Hubert S. Addison, and Thaone P. Addison, as vendees, hereinafter referred to as the Addison contract, by the terms of which the partnership granted to the Addisons the right to cut and remove the merchantable timber from the Wiggins ranch. This right was not transferable or assignable without the partnership's consent.

The Addison contract Provided in part as follows:

It is the understanding and agreement between the parties hereto that the Vendors [petitioners and Norrises have acquired from Dr. and Mrs. C. G. Wiggins the right to cut and remove all of said merchantable *[sic]* timber and this contract is made between the Vendors and the Vendees herein to give to Vendees the right to cut and remove said timber under the terms and conditions hereof.

Vendors agree that seasonably and in accordance with their contract with Dr. and Mrs. C. G. Wiggins they will pay for all of the timber as harvested, manufactured and sold, so as to protect the Vendees herein in their rights hereunder.

* * *

No assignment of this contract or any interest herein or any right secured hereunder shall be made by the Vendees to any person or party whomsoever without previous written consent to such assignment having been first given by the Vendors. Nothing herein contained, however, shall prohibit the acquisition of the interest of any of the Vendees herein named by the remaining Vendees herein named in the event 'of the inability of either or any of said Vendees to continue in the carrying out of the terms hereof.

* * *

In the removal of said timber the Vendees shall have the right to construct any necessary logging roads and shall have the right to use all roads constructed by them and alt roads now constructed and in existence on said described premises. Vendees shall, at their own expense, maintain all of such roads at all times in usable condition.

* * *

the Vendees agree that they will proceed with the construction of a sawmill upon such property, which sawmill shall have a minimum capacity of manufacturing not less than 50000 feet of lumber, board measure, per day; * * * and shall be completed with alt reasonable dispatch so that said mill shall be in production at capacity at the earliest possible date and in any event not later than August 1, 1946.

It is also agreed that the Vendees may desire to arrange with other parties for the

establishment and operation of another mill or mills for the purpose of operations hereunder. No such arrangement, however, shall be made without previous written consent of the Vendors thereto having first been obtained.

Under the Addison contract, in the event of its breach, all buildings and other structures and improvements on the property which are made by the Addisons become the property of the petitioner, his wife, and the Norrises, the contract providing:

but they shall, upon such termination, leave all buildings and other construction and improvements on said property.

The Addison contract further provides:

At the termination of this agreement upon full performance hereof by the Vendees, the Vendees shall have the right and a reasonable time within which to remove their logging and milling equipment and all machinery, supplies and personal property of the Vendees, but they shall, upon such termination, leave all buildings and their construction and improvements on said property.

The contract further provides that:

Wiggins now have a small mill located on said property which they operate for the purpose of cutting such lumber as they may desire to use for ranch purposes and it is agreed that they may continue to use and operate said mill as they may desire and shall be entitled to the use of the roads above mentioned for the purpose of operating said mill and hauling timber, lumber and supplies to and from said mill, and they shall have the right to cut and remove such timber as they may desire from the tract, for cutting into lumber at said mill.

For the rights given them under the Addison contract, the Addisons were required to pay to petitioners and the Norrises \$1.50 per thousand feet, board measure, for lumber manufactured by them; \$2 per thousand feet, net scale, for logs sold by them; and 3 cents per linear foot for piling removed by them. The contract states that:

All payments for logs, piling and/or lumber herein provided for shall be made by the 10th of each month and such payments shall cover all lumber, piling and/or logs sold during the preceding calendar month, * * *

Copies of invoices of all sales are to be furnished both to petitioner and the Norrises and to Wiggins.

Under the terms of the contract, the Addisons have a period of 30 years from and after its date within which to cut and remove the timber.

Under the Addison contract petitioner and the Norrises cannot require the Addisons to perform the contract. A recourse in the event of failure to perform is to forfeit the \$2,000 deposit given by

the Addisons at the time of the execution of the contract and to accept that sum in full payment for damages, if any, resulting to them from failure of the Addisons to perform.

There is no provision in the Addison contract permitting the Addisons to mortgage, encumber, or sell the sawmill, machinery, trucks, equipment, or other personal property.

Petitioners and the Norrises are to be compensated by the Addisons at a specified rate for loss by fire of logs or finished products but only in the event and to the extent the loss is covered by insurance.

Petitioners and the Norrises signed the Addison contract as "Vendors" and the Addisons signed as "Vendees." Wiggins and his wife also signed the Addison contract after noting their approval of it insofar as their rights and obligations were involved.

After the execution of the Addison contract the Addisons constructed a sawmill on the Wiggins ranch and commenced to cut and remove timber in accordance with the terms of their contract with the partnership. The Addisons continued to perform under the terms of their contract until July 28, 1950, and made payments in accordance with the terms of their contract.

The partnership reported the income received from the Addisons for the years 1947, 1948, and 1949 as ordinary income.

On July 28, 1950, an agreement was entered into between Clifford W. Addison, Leland B. Addison, Hubert S. Addison, and Thaone P. Addison, referred to in-the- agreements as vendors, and Humboldt Lumber Corporation, hereinafter sometimes called Humboldt, referred to in the agreement as vendee. This agreement is hereinafter sometimes referred to as the Humboldt Contract.

By the terms of this contract the Addisons transferred to Humboldt their sawmill, planing mill and related buildings, machinery, equipment, vehicles, and tools located on the Wiggins ranch, and other rights.

By the terms of the same agreement petitioner, his wife, and the Norrises, for a valuable consideration, agreed:

to execute a quit claim deed conveying to Humboldt Lumber Corporation whatever interest they may have in the Wiggins Ranch and easements and rights of way there over subject to all of the rights reserved in this agreement. The undersigned further agree to sell, assign, transfer and convey, and do hereby sell, assign, transfer and convey to Humboldt Lumber Corporation * * * all of their rights, title and interest in the agreement dated November 1, 1945 between Wiggins and themselves, * * *

By the terms of the Humboldt contract, the partnership was entitled to enforce any of the provisions of the agreement. The contract further provides in part as follows:

If the vendee shall default in the performance of any of the terms and conditions of this agreement, and such default shall continue for a period of 30 days, the vendors or, in the event of their failure to do so, Pankratz and Norris or Wiggins upon 30 days written notice may rescind the sale of the Cutting Contract and the sale of all loading leases, all roads constructed by the vendors on the Wiggins Ranch, and all water rights, rights of way and easements made hereunder, provided the vendee prior to the expiration of said 30 days notice period has failed to remedy the default specified in the written notice; * * *

Upon any such rescission, the parties to the Cutting Contract dated November 20, 1945, and to the Wiggins Contract dated November 1, 1945, shall be reinstated in their respective rights and obligations thereunder, and the vendee shall forthwith reassign said Cutting Contract, loading leases, all roads constructed by the vendors on the Wiggins Ranch, and all water rights, rights of way and easements made hereunder to the vendors, and shall forthwith reassign the Wiggins Contract to Pankratz and Norris, and shall execute whatever documents may be considered necessary and appropriate to evidence such rescission.

* * *

Wiggins, by their ratification of this agreement, agree that during the faithful performance of this agreement all of the obligations of the vendors and/or Pankratz and Norris under the Wiggins Contract dated November 1, 1945, shall be wholly suspended except for the obligations to make the payments specified in paragraph 3 hereof, and further agree that upon any recission of this agreement, the Cutting Contract between vendors and Pankratz and Norris and the contract between Wiggins and Pankratz and Norris shall both be thereupon fully reinstated, and it shall conclusively be deemed that the vendors and/or Pankratz and Norris have performed the same, and in the event vendors and/or Pankratz and Norris elect to build another sawmill as provided in paragraph 14 hereof, then and in that event, they shall have a reasonable time within which to do so.

The contract further provides that Humboldt shall pay direct to Wiggins and his wife and to the petitioners and the Norrises their respective rates for timber cut and sold specified in the contracts of November 1 and November 20, 1945, and pay the balance to the Addisons; that in the event of the loss by fire of logs, lumber, or piling prior to sale, the Addisons shall be compensated therefor at a specified rate but only in the event the loss is covered by insurance; and that the Wigginses shall pay all taxes on the land and standing timber, while Humboldt shall pay the taxes on down timber, improvements, and personal property.

The contract specifies that Humboldt shall not assign the Humboldt contract, the Addison contract, or the Wiggins contract, except to Humboldt Plywood Corporation, without written consent of the Addisons and petitioners and the Norrises, and that:

This agreement shall be binding not only upon the parties hereto but also upon their respective heirs, successors and assigns.

The Humboldt contract further provides in part as follows:

The undersigned, C. G. WIGGINS and LAURA W. WIGGINS, his wife, hereby consent and agree to the foregoing Agreement of Sale and the terms thereof, and ratify and affirm the performance of the Cutting Contract dated November 20, 1945, to the date of sale, and the undersigned acknowledge that they will not assert any claim of default in regard to such performance.

* * *

It is expressly understood that the vendors are conveying all right, title and interest in the Cutting Contract to the vendee, and that the vendors have no right against the vendee and the vendee is under no obligation to the vendors by virtue of the provisions of the Cutting Contract, except for the rights reserved by vendors, Pankratz and Norris under the provisions of this agreement, and the right of rescission afforded to vendors, Pankratz and Norris under the provisions hereof.

Humboldt agreed to pay to the partnership for the sale and transfer of the Wiggins contract and the cancellation of the Addison contract 50 cents per thousand feet, board measure, for all lumber sold or used by Humboldt; 65 cents per thousand feet, board measure, for all logs sold or used by Humboldt; 1 cent per linear foot for all piling sold or used by Humboldt. These sums are due and payable to the partnership on the 15th day of each month following the month during which the lumber or timber is sold. Humboldt unconditionally agreed to cut and remove all merchantable timber located on the Wiggins ranch. The partnership is given the right to enforce the terms and conditions of the Humboldt contract by Specific performance in a court of equity, or to terminate the contract and to hold Humboldt liable for damages sustained by it as a result of any breach. Roddis Plywood Corporation unconditionally guarantees to the partnership full, prompt, and complete performance by Humboldt under the contract and agrees to be liable to it for any damages sustained by it as a result of a breach thereof.

The partnership was relieved of its obligation to pay a portion of the cost of conducting surveys, as required by the Wiggins contract and the Addison contract, under the terms of the Humboldt Contract.

The Humboldt contract was signed by the Addisons as "Vendors" and by Humboldt as "Vendee." The Wigginses, petitioners, and the Norrises noted their approval by signing the contract :under specific ratification clauses.

On August 5, 1950, the partnership carried out its obligation under the Humboldt contract.

After the execution of the Humboldt contract, Humboldt commenced to operate under its terms and from July 28, 1950, to December 31, 1950, Humboldt paid to the partnership the sum of \$4,525.64 in accordance with its terms.

On March 14,-1951, the partnership filed an amended partnership return of income for the taxable year 1950 with the collector of internal revenue for the district of Washington, reporting thereon, as a long-term capital gain, the sum of \$9,579.56, which was apportioned \$4,789.78 to petitioners and \$4,789.78 to O.C. Norris and Florence. V. Norris.

Of the total sum of \$9,579.56 received under the Addison contract and reported by Pankratz and Norris for the tax year 1950, \$5,053.90 "constituted ordinary income received by the partnership during the taxable year in accordance with the terms of the partnership's contract with the Addisons. which contract is dated November 20, 1945.

OPINION

OPPER, Judge: The facts in brief are as follows: On November 1, 1945, petitioners and the Norrises as partners entered into a cutting contract with the owners of timberland whereby they acquired the right for 30 years to cut all timber on certain property owned by C. G. Wiggins and his wife, Laura Weltha Wiggins. The Wiggins family retained title to the timber until cut and the right to fixed royalties from cut timber, as well as certain obligations, such as the payment of taxes on standing timber. Petitioners and the Norrises were obligated to build a sawmill as soon as possible, and to operate that sawmill at maximum efficiency.

On November 20, 1945, petitioners and the Norrises transferred in substance their rights to cut the timber to the Addisons, in .return for royalties from any cut timber. They further specified that there could be no further assignment by the Addisons of the rights acquired under their contract without the consent of petitioners, the Norrises, and the Wiggins family.

Some 5 years later a new arrangement was ready with Humboldt calling for it to assume the obligations of both the partners and the Addisons, who, along with Wiggins, become parties to the new contract. This is claimed by petitioners to constitute a sale by them resulting only in long-term capital gain.

Both parties seem agreed that section 117(k)(2), Internal Revenue Code of 1939, ¹ cannot apply to the Addison contract, and it makes little difference whether this is because it arose in less than 6 months, as respondent contends, or because petitioners are right that they were not the "owners" of the timber. It would not under either contention have been a "sale," which is not necessary for the application of that provision. *Springfield Plywood Corporation*, 15 T. C. 697. And neither party relies on that section as applying to the Humboldt transfer, the event actually in controversy, though respondent, perhaps inconsistently, there adopts petitioners' contention as to ownership.

What petitioners acquired was in the nature of a lease with the authority to remove and sell. So far the parties are in accord. The partnership was authorized to assign the Wiggins contract. But petitioners insist that there was no assignment to the Addisons and respondent is indifferent.

That the Wiggins contract was assignable by its terms does not thus admit of any doubt. It could have been and was the source of ordinary income while petitioners retained it. It could have been the subject of a capital transaction if it was sold.

The difficulty is, the lease was not assigned by petitioners to Humboldt in any realistic sense. Petitioners' right to cut, use, and market the timber had already been assigned to the Addisons. What petitioners had left was, in essence, the right to receive the proceeds in terms of money.

Had petitioners assigned this right to Humboldt, there might have arisen a problem as to whether the profit was ordinary income, *Hort v. Commissioner*, 313 U. S. 28; *Commissioner v. Starr Bros.*, (C. A. 2) 204 F. 2d 673; or capital gain, *Bell v. Commissioner*, (C. A. 8) 137 F. 2d 454; *McAllister v. Commissioner*, (C. A. 2) 157 F. 2d 235. But petitioners did not assign this right.

Receipt of the money proceeds of cutting was precisely what they continued to be entitled to.

Precedents dealing with assignments of patents, copyrights, and the like are thus beside the point. Cf. *Irving Berlin*, 42 B. T. A. 668; *Herman Shumlin*, 16 T. C. 407. It is not necessary to decide whether the arrangement by petitioners' with the Addisons was a sale, assignment, or other disposition. The 20 days of holding period were insufficient to make it more than short-term capital gain, and petitioners do not contend otherwise. And any "sale" to Humboldt and the transfer to the Addisons were too similar for different treatment. On neither approach can petitioners succeed.

Decision will be entered for the respondent.

1 SEC. 117. CAPITAL GAINS AND LOSSES.

(k) GAIN OR LOSSES IN THE CASE OF TIMBER OR COAL. ---

(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 the computation under section 117 (c) (l) of a tax in lieu of the tax imposed by section 500).

2 , * * * Likewise, it created more than a license for the simple reason it was assignable without any prior authorization." (Resp. br. p. 15)