

**UNITED STATES v. REGAN**  
**410 F.2d 744; 69-1 USTC ¶9369;**  
**23 AFTR 2d 1460 (9th Cir. 1969);**  
*Reversing 67-2 USTC ¶ 9728; 20 AFTR 2d 5759 (D. Ore. 1967).*

**Editor's Summary**

***Key Topics***

**CAPITAL v. EXPENSE**

- Cost of constructing access roads is capital expenditure

***Facts***

The taxpayer was a member of a joint venture which contracted with the Forest Service to cut merchantable timber on Government land. The joint venture agreed to pay a royalty based on a specified stumpage rate per thousand board feet cut and removed, and further agreed to build access roads to the timber stand. The joint venture built the access roads and thereafter transferred to its wholly owned operating corporation the joint venture's cutting rights in return for the corporation's payment of specified royalties. The gain realized by the joint venture on the cutting of the timber was reported by the joint venturers as capital gain under the provisions of Section 631(b) of the Code which allows capital gain treatment for gains from disposals of timber where the owner, including the holder of a cutting contract, retains an economic interest in the timber being cut. The joint venturers, including the taxpayer, amortized the cost of the access roads on the basis of the quantity of timber sold. The taxpayer deducted her share of the amortized costs as ordinary and necessary business expenses. The Government contended that the cost of the access roads should have been treated as an offset to the capital gain realized on the disposal of the timber.

***District Court***

[Opinion of District Court is reprinted at  
4 Timber Tax Journal 214 (1968)]

**HELD: FOR THE TAXPAYER.** Prior to enactment of the capital gain treatment presently accorded by Section 631(b) for disposals with a retained economic interest, the taxpayer's gain would have been treated as ordinary income and the cost of the access roads would clearly have been deductible as an ordinary and necessary business expense. No statute or regulation limits the benefit of Section 631(b) in the manner suggested by the Government.

***Court of Appeals***

[Opinion below]

**HELD: FOR THE GOVERNMENT - DISTRICT COURT REVERSED.** Congress provided in

Section 631(b) that capital gain reportable under that section is measured by "the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof...as though it were a gain...on the sale of such timber." Other sections of the Code (i.e., Sections 612, 1011, 1012 and 1016) when read together contain a direction to include capital expenses as an addition to the cost of timber cut Under Section 631(b) to reach "adjusted depletion basis," This leaves only the question whether expenditures for building access roads are capital expenses. The Court believes they are. Commercial exploitation of the timber would not have been possible without the construction of the roads to reach the trees. The roads are directly related to the acquisition and disposal of the timber. Therefore, as the Government Contended' the expanses in road building should have been offset against capital gains realized on the disposition of the timber. [Note: In reaching its opinion the Court indicated that it disagreed with certain language in the opinion of the Court of Claims in the case of Union Bag-Camp Paper Co. v. United States, 325 F.2d 730 (Ct. Cl. 1963), which is reprinted at 4 Timber Tax Journal 719 (1967). Presumably the language referred to is as follows: "Absent specific language in the statute or regulation so requiring, it should not be held that the taxing authority has with one hand granted a special benefit to a natural resource industry, but with the other hand has taken back part of the benefit through the medium of disallowing a deduction to which the taxpayer had previously been entitled." Similar language is also contained in the case of Drey v. United States, 61-1 USTC 9116, 7 AFTR 2(1 333 (E.D. Mo. 1960) which is reprinted at 4 Timber Tax Journal 600 (1967).]

### *Case Text*

Hufstedler, Circuit Judge: The Government appeals from a judgment in favor of the taxpayer in her suit for a refund of federal income taxes paid for the calendar years 1960-1962. The Government contends that the District Court [67-2 USTC ¶9728] erred in holding that the taxpayer, a member of a joint venture earning income from timber cutting contracts, could deduct from ordinary income her share of the venture's costs of building access roads to the timber and that those costs were not capital expenses.

The facts are uncontroverted. The taxpayer and others formed a joint venture called Idapine Tenants in April 1960. Idapine Tenants bought the assets of a partnership engaged in the lumbering business. The assets included logging equipment, plants, and all of the capital stock of Idapine Mills, Inc., an Oregon corporation. The operating equipment was then leased to the corporation. Idapine Tenants had a contract with the Forest service to cut merchantable timber on certain Government land for which rights Idapine Tenants agreed to pay a royalty based on a specified stumpage rate per thousand board feet cut and removed,, and further agreed to build access roads to the timber stand, Idapine Tenants built the access roads. Thereafter the venture transferred to its wholly owned operating corporation the joint venture's cutting rights in return for the corporation's payment of specified royalties. The joint venturers, including the taxpayer, amortized the cost of access roads on the basis of the quantity of timber sold. The taxpayer deducted her share of the amortized costs as ordinary business expenses. The Commissioner disallowed the deductions and assessed deficiencies. The taxpayer paid the assessments and brought this action for her refund.

The Internal Revenue Code of 1954 does not contain a specific provision disallowing deductions for the expenditures in issue. (*Compare* § 272.) The taxpayer contends that the omission was purposeful and that Congress intended to give taxpayers in her position not only the benefit of capital gains treatment of the income derived from cutting timber, but also the extra tax dividend of deductibility of expenses incurred in reaching the timber. Congress did not create the lacuna through which the taxpayer has tried to leap. section 631(b) of the Internal Revenue Code of 1954 which extends capital gains treatment to the income Idapine Tenants received from Idapine Mills, Inc., provides that gain is measured by "the difference between the amount realized from the disposal of such timber and the adjusted depletion thereof as though it were a gain on the sale of such timber." To find the definition of adjusted depletion basis" one must pursue a clutch of related code sections. Section 612 tells us that the basis on which depletion is to be allowed is provided in Section 1011. Section 1011 says that basis is cost (section 1012) subject to adjustments as provided in section 1016. Section 1016 requires that "proper adjust-merit...be made (1) for expenditures...properly chargeable to capital account." When all of the pieces are pasted together, we can see that section 631(b) contains a direction to include capital expenses as an addition to the cost of the timber to reach "adjusted depletion basis."

Are expenditures for building access roads capital expenses? We think they are. Commercial exploitation of the timber would not have been possible without the construction of the roads to reach the trees. The roads are directly related to the acquisition and disposal of the timber. The expenses in road building should be offset against capital gains realized on the disposition of the timber.

In support of her position the taxpayer cites: *Union Bag-Camp Paper Corp. v. United States* (Ct. Cl. 1963) 325 F.2d 730; *Ransburg v. United States* {S.D. Ind. 1967) 281 F. Supp. 324; *Watts v. Erickson* (D. Ore. 1962) 10 A.F.T.R. 2d 5832; *Drey v. United States* (E.D. Mo. 1960) 7 A.F.T.R. 2d 333; and *Converse v. Earle* (D. Ore. 1951)43 A.F.T.R. 1308. None of these cases, other than *Converse* and *Watts*, considers road construction expenses or road use fees.

*Union Bag-Camp Paper* concerns forest management costs. Public policy strongly favors forest conservation with which forestry management is intimately connected. The court's refusal to require capitalization of such expenses was influenced by the effect a less generous interpretation might have had on good forestry practice. The Court of Claims was also influenced by the difficult accounting burdens the taxpayer would have had to undertake if the Government's position had been sustained. Neither of these considerations is involved in our case. We are aware that dicta in *Union Bag-Camp Paper* are not in harmony with our holding, but we are not persuaded, as was the Court of Claims, that Congress intended to give timber cutters a tax bonanza, instead of a capital gains benefit, when it rewrote the timber section of the tax law in 1944. We disapprove of anything in *Converse* and *Watts* which may be contrary to our views herein expressed.

The judgment is reversed.