

SCHNITZER v. UNITED STATES
69-1 USTC ¶9160,
22 AFTR 2d 5972 (D. Ore. 1968).

Editor's Summary

Key Topics

DISPOSAL WITH A RETAINED ECONOMIC INTEREST

- Owner defined.
- Right to sell cut timber on own account or for use in business
- Must have to qualify as "owner" under section 631 (b)

Facts

Georgia Mills acquired all of the assets of Pilot Rock Lumber Co. To finance the acquisition, Georgia Mills gave the taxpayers a "Timber Production Indenture," under which the taxpayers acquired title to 102 million board feet of merchantable timber. In return for the timber, the taxpayers gave Georgia Mills two million dollars. The indenture provided for its own termination when the taxpayers received from the sale of the timber two million dollars plus 61/4% of any unliquidated portion of the principal sum. Title to all remaining trees would then revert to Georgia Mills. As part of the same financing arrangement, but in a separate document, taxpayers and Georgia Mills entered into a timber cutting contract under which Georgia Mills acquired the right to harvest the timber previously conveyed to the taxpayers. The taxpayers claimed capital gain treatment of the profit they made from the cutting arrangement. They claimed that they were the owners of the timber and that they had made a disposal of the timber to Georgia Mills within the meaning of Section 631(b). They admitted that they took title to the timber with the prior understanding that Georgia Mills would have the right to cut it. They contended, however, that despite this understanding they nevertheless qualified as "owners" of the standing timber under Section 631(b), citing *Weyerhaeuser* (page) which held that a taxpayer may be an owner of standing timber under *Section 631(a)* even though he does not have a right to cut the timber for sale on his own account or for use in his trade or business.

District Court

Held: For the Government. The indenture and the contract were part of a single transaction. Georgia Mills would not have agreed to the indenture if the contract were not sure to follow. At no time did taxpayers have the power to determine who would sever the timber from the land. They themselves could not have cut the trees. As a consequence, the taxpayers did not have a right to cut timber for sale on their own account or for use in their trade or business, and thus they were not "owners" of timber *within the meaning of Section 631(b)*. A taxpayer claiming the benefit of *Section 631(a)* by virtue of being an owner of timber need not have the right to cut for his own account or for use in his trade or business. (Citing *Weyerhaeuser*). Taxpayers argue that this same distinction applies to Section 631(b). The Regulations [Section §1.631-2(e)(2)] plainly

reject this view. Under *Section 631(b)*, even an owner of timber must have a right to cut on his own account or for use in his trade or business.

Case Text
OPINION
(Nature of Suit)

BELLONI, Judge: Manuel Schnitzer and his three brothers (Taxpayers)¹ sue to recover income taxes paid for the years 1961 and 1962. They claim they were owners of standing timber within the meaning of 26 U. S. C. §631(b) and are entitled to capital gains treatment of profits earned on the sale of the timber. This Court has jurisdiction under 28 U. S. C. § 1346-(a)(1).

Taxpayers filed timely returns for the years involved; the Internal Revenue Service denied capital gains treatment of profits from certain transactions and Taxpayers paid the resulting deficiencies. Subsequent claims for refunds were also denied and Taxpayers brought this action.

(Facts)

The Georgia-Pacific Corporation organized the Georgia-Pacific Pine Mills Company (Georgia Mills) and acquired all its stock. Georgia-Pacific, through Georgia Mills, intended to acquire the assets of Pilot Rock Lumber Company, including a substantial amount of standing timber in Eastern Oregon.

Georgia Mills financed this acquisition, in part, by giving Taxpayers a "Timber Production Indenture." Under this indenture, Taxpayers acquired title to 102 million board feet of merchantable timber; in return, Taxpayers gave Georgia Mills two million dollars. The indenture provided for its own termination when Taxpayers received from the sale of the timber two million dollars plus 6¼% of any unliquidated portion of the principal sum. Title to all remaining trees would then revert to Georgia Mills.

Immediately after signing the indenture, Taxpayers and Georgia Mills entered a Timber Cutting Contract. Under this contract, Georgia Mills acquired the right to harvest the timber previously conveyed to Taxpayers. At the contract price of \$30.00 per thousand board feet, about 75 million board feet had to be cut in order to give the Taxpayers the two million dollars plus 6¼% necessary to terminate the indenture. Title to the remaining 27 million board feet would then revert to Georgia Mills.

The contract and the indenture were signed on November 30, 1960. On this day, too, Taxpayers borrowed \$1,900,000.00 from the Bank of America at 6%. The Bank of America kept the indenture and contract in its possession; all payments by Georgia Mills were made directly to the Bank. Taxpayers supplied the difference between the \$1,900,000.00 they borrowed from the bank of America and the two million dollars they gave Georgia Mills.

(Single Transaction)

These transactions, occurring the same day, were part of a single financial scheme. Taxpayers bought the timber from Georgia Mills knowing they would immediately give Georgia Mills the right to harvest it. Both parties realized that only 75 million of the 102 million board feet covered by the indenture had to be cut in order to liquidate Taxpayers' investment at the contract price.

During the life of the indenture, Taxpayers had the risk of loss to the trees except if caused by the negligence of Georgia Mills. There was conflicting evidence of the quantity of merchantable trees that would remain if a fire "swept" the areas involved. In the event of fire, probably 75 to 85% of the remaining board feet would still meet the contractual definition of "merchantable."

Contentions

Taxpayers claim they were owners of the trees and entitled to treat any profits earned as a result of the resale to Georgia Mills as capital gains under 26 U. S. C. §631(b).

This section permits an owner who disposes of his timber under any form of contract, by virtue of which he retains an economic interest in the timber, to claim capital gains treatment of his profit, providing he has held the timber longer than six months. ²

The Government contends that the transaction between Georgia Mills and Taxpayers was, in substance, a loan secured by the transfer of an interest in the trees. The Government maintains that the tax consequences of this transaction depend on its substance and not its form. The Government also contends that Taxpayers were, in any event, not owners within the meaning of §631 (b) because they did not have the right to "cut and sell the timber for [their] own account." Treas. Reg. §1.631-2(e)(2). Finally, the Government argues that even if Taxpayers were owners within the meaning of §631 (b), they still may not get capital gains treatment because they disposed of the timber without retaining an economic interest in it, as required by §631 (b).

No Right to Cut and Sell

I find that Taxpayers did not have the right to "cut and sell the timber for [their] own account or for use in [their] trade or business" as required by Treas. Reg. §1.631-2(e)(2). Since I base my decision on this finding, I do not discuss the Government's two other contentions.

Treas. Reg. §1.631-2(e)(2) states, in full:

"The provisions of section 631 (b) apply only to an owner of timber. An owner of timber means any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber. *Such owner of timber must have a right to cut timber for sale on his own account or for use in his trade or business in order to own an interest in timber Within the meaning of section 631(b).*" [Emphasis added.]

Taxpayers admit that they bought the timber with the prior understanding that Georgia Mills would have the right to cut it. The indenture and the contract were part of a single transaction.

Georgia Mills would not have agreed to the indenture if the contract were not sure to follow. At no time did Taxpayers have the power to determine who would sever the timber from the land. They themselves could not have cut the trees.

Taxpayers did not have a right to cut timber for sale on their own account or for use in their trade or business. They were not owners within the meaning of §631 (b).

Taxpayers argue that §631 (b) must be read in conjunction with §631 (a). Section 631 (a) permits an owner of timber, or one with a contract right to cut timber, to consider severance of the timber a sale or exchange of property for the year in which the severance occurs. Treas. Reg. § 1.631-1 (b)(1) says that a taxpayer claiming the benefit of §631 (a) by virtue of having a contract right to cut timber must have a "right to sell the timber cut under the contract on his own account or to use such cut timber in his trade or business." However, a taxpayer claiming the benefit of §631(a) by virtue of being an *owner* of timber need not have the right to cut for his own account or for use in his trade or business. *Weyerhaeuser v. United States*, 68-2 USTC ¶9629,--F. 2d-(No. 21,834, 9th Cir. Oct. 22, 1968). Taxpayers argue that this same distinction applies to §631 (b).

The Regulations plainly reject this view. Under §631 (b), even an owner of timber must have a right to cut on his own account or for use in his trade or business. Treas. Reg. §631-2(e)(2). Taxpayers concede, as I believe they must, that the Regulations correctly interpret the statute.

This opinion shall serve as findings of fact and conclusions of law under Rule 52(a), Fed. R. Civ. P. and judgment shall be entered for the defendant.

1 Morris, Gilbert, and Leonard Schnitzer are also plaintiffs in this action; the four wives are parties only because the relevant tax returns are joint.

2 Taxpayers claim capital gains treatment only for the timber cut after May 30, 1961, six months after the indenture was signed. Section 631(b) provides in full: "(b) *Disposal of timber with a retained economic interest.*-In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term 'owner' means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber."