

SOUTHERN PACIFIC TRANSPORTATION CO. v. COMMISSIONER
75 T.C. No. 44 (1980)
(Timber issue only)

Editor's Summary

Key Topics

CAPITAL v. EXPENSE

· Selling expenses

Facts

This suit is brought by the taxpayer as successor to the Southern Pacific Land Company (SPLC). The taxpayer contests the Commissioner's determination that certain allocated expenses incurred in connection with SPLC's timber management program should reduce the amount realized from its timber sales, and hence its capital gains under Section 631(b); instead, taxpayer maintains that these expenses were ordinary and necessary under Section 162, and should be deductible from ordinary income. During the years at issue SPLC owned and managed over 700,000 acres of timberland in northern California. It was stipulated that the SPLC timber sale contracts are predominantly cutting contracts to which Section 631 (b) applies.

These costs in issue include expenses for selecting stands to cut, determining and marking boundary lines, marking trees to be cut and determining the volume to be cut and the residual volume, appraisal, scaling of the logs cut, locating yarding areas and skid trails, and controlling felling in order to minimize damage to the residual stand and the soil. Petitioner maintained that these costs were necessary for its timber management program and not directly related to its sales of timber.

Alternatively, taxpayer argued that were the expenses deemed sales-related, since the timber sales themselves were a management tool, the sales-related expenditures should be deductible under Section 162. Taxpayer urged that this position was supported by the legislative history to the Internal Revenue Code of 1954. In this connection, taxpayer also argued that the sustained yield management program was undertaken to conserve timber and to increase the productivity of the land. Additional long-term benefits accrued from the annual harvesting activities, including stimulation of growth in the residual stand and improvement of the general health of the stands by elimination of trees that are over mature, dying or subject to insect attacks. Fire hazard was also reduced.

Tax Court

HELD: For the Government. Expenditures directly attributable and closely related to the Sale or other disposition of property are properly treated either as additions to the basis of such property or offsets to the selling price in arriving at the amount realized.

The Court rejected taxpayer's argument that the result was controlled by that *Union Bag-Camp Paper Corp.*, 1963 Court of Claims case which allowed the taxpayer to deduct such selling expenses, and *Wilmington Trust Co.* [see 16 *Timber Tax Journal* 96] which had similar holding. It noted that in *Union Bag-Camp Paper Corp.*, and in *Wilmington Trust Co.*, the taxpayers had acquired timberlands solely for the purpose of assuring themselves of a constant source of raw material; here selling timber at a profit was SPLC's principal objective.

In rejecting the taxpayer's contention, the Court noted that the taxpayer had applied a formula to allocate its total forestry salaries to activities directly related to its section 63 l(b) sales. As this was the allocation used by the Government in reducing taxpayer's capital gains, taxpayer was bound by it unless it could be shown to be clearly unreasonable or erroneous, which it did not.

The Court also rejected taxpayer's alternative argument. It noted that while "language can be found [in the legislative history] which would tend to support" taxpayer's argument, it did not deal with precisely the issue in question. The court found the timber sales were conducted for the sales revenue they produced for SPLC, and indirectly for the increased freight revenues they generated.

Case Text

DRENNEN, *Judge*: In the statutory notice in this case, respondent determined income tax deficiencies as follows:

Taxable year ended Dec. 31,	Deficiency
1959	\$4,411,069.04
1960	5,986,337.91
1961	9,994,970.22

In its petition, petitioner placed all of the asserted deficiencies in controversy. Petitioner also alleged overpayments of income taxes in each of the years at issue. The petition has been amended three times, and in the most recent amendment, dated February 9, 1979, petitioner alleges that, during the indicated years, it made overpayments of income taxes in not less than the following amounts:

Taxable year ended Dec. 31,	Deficiency
1959	\$15,252,000
1960	14,438,000
1961	15,531,000

Most of the issues raised by the pleadings have been conceded or otherwise settled by the parties. Various issues were presented for the Court's consideration in five extended trial sessions which took place over a 3-year period. For the most part, the contested issues were tried and briefed separately, although in some instances related questions were tried and briefed together. As a result, the Court has been called upon to write 16 generally lengthy opinions to resolve the

outstanding disputes. The legal questions involved in each opinion are stated just prior to the specific Findings of Fact relating to each opinion.

* * * * *

III. DEDUCTION OF TIMBER EXPENSES¹

This issue presents the following question for our consideration: Whether timber expenses incurred by petitioner are expenses of management deductible as ordinary and necessary business expenses under section 162 or whether they are expenses directly related to cutting contracts under section 631(b); and, if the latter, whether such expenses are applied as a reduction of capital gain under the contracts (as reported by petitioner) or as a reduction of petitioner's ordinary income.

Findings of Fact

Issue (kk)

Some of the facts relating to this issue have been stipulated by the parties, and those facts, with associated exhibits, are incorporated herein by this reference.

Among the assets of the predecessor Southern-Pacific Company received by the former Southern Pacific Company in the 1947 rein-corporation was all of the outstanding stock of the Southern Pacific Land Company (SPLC).

SPLC has been incorporated under the laws of the State of California on February 1, 1912. In 1912 and in 1930, various predecessors² of petitioner transferred real property to SPLC. This real property consisted principally of what the companies called "outlying" acreage, i.e., alternate sections of land adjacent to railroad rights-of-way. Much of the land was located in the timber country of northern California and bore timber. During the years at issue (1959, 1960, and 1961), all of the real property held by SPLC was located within the State of California.

From the outset (and continuing through the years at issue), the SPLC lands were managed by the Land Department of the predecessor Southern Pacific Company and, subsequently, by the Land Department of the former Southern Pacific Company.

Between the years 1916 and 1949, the Land Department was actively engaged in a program of trying to dispose of the acreage owned by SPLC and other land-grant properties under the jurisdiction of the department, including timberlands. During this period the Land Department did not permit any timber cutting on the lands under its jurisdiction, and between 1916 and 1949, no cutting leases were executed. Even buyers were not permitted to enter upon the land to cut timber until the contracts were paid in full.

During the period 1912 to 1949, SPLC transferred substantial outlying timberland acreage to outsiders. In 1949, SPLC withdrew from the practice of actively selling its timber holdings, and

thereafter, except for isolated accommodation transactions, transfers of outlying timber acreage were made by SPLC only to governmental authorities (Federal, state, or local) or to utilities, under threat of condemnation.

The decision by the Land Department to withdraw the SPLC properties from sale (and also certain lands of the former Southern Pacific Company) was made to permit a study of whether such sales should continue Or whether a land management program should be commenced.

A preliminary study in 1949 determined that the SPLC timber holdings would benefit by a management program, In 1951, SPLC adopted such a program with respect to its timberlands in Northern California which called for limited cutting of timber on a sustained yield basis. Under this method, old and mature trees are permitted to be cut on a given section of land, but only to the extent they will be replaced by new trees.

The 1951 management Program was undertaken to conserve timber, to increase the productivity of the land, to generate income for SPLC from timber sales, and, indirectly to generate freight revenues for the former Southern Pacific Company. In order to implement this program, the Land Department employed photogrammetrists to conduct a timber survey and hired additional graduate foresters and experienced woodsmen.

During 1952, a further study was undertaken to determine the volume of timber on the SPLC lands and to estimate the allowable annual cut on a sustained yield basis. The study determined that it would take 30 years to achieve removal of all of the old and mature trees, and it was estimated that 64 million board feet could be cut each year (and would be replaced each year). SPLC adopted this program of cutting timber on a sustained yield basis, and continued it through 1959, 1960, and 1961.

Annual timber sales were negotiated for the disposition of the allowable cut (i.e., 64 million board feet per year). These sales resulted in an annual harvesting program which was designed to average the calculated sustained production of the forest properties. The only reasons for exceeding allowable cut were fire damage, storm damage, insect damage, and other miscellaneous causes.

During the years at issue, SPLC held approximately 1,900,000 acres of outlying land in California. Of this land, over 700,000 acres were in the timber country of northern California. This timber acreage had been held essentially intact since 1949. Over half of the acreage was considered to contain merchantable timber of excellent to marginal quality.

During the years at issue, SPLC was operating in its first 30-year cutting cycle, in which over mature trees and trees in danger of death from insects and disease were to be cut. This 30-year period was established because the United States Forest Service was operating under a 30-year development program. Because of the checkerboard ownership pattern,³ it was essential for road-planning purposes that SPLC cooperate with the Forest Service.

While the primary purpose of the timber program was the production of income, there were

several long-term benefits that accrued from the annual harvesting activity. The harvesting served to regenerate the forest by stimulating growth in the remaining timber stand and it improved the general health of the stand by eliminating trees that were over mature, dying, and subject to insect attack. Fire hazard was reduced by the removal of dead trees.

During 1959, 1960, and 1961, a timber sale was commenced in the following manner: Discussions would be held between the chief forester and the district foresters regarding the most appropriate places to have a sale of timber. Relying on the district foresters' field knowledge of the property and information available from SPLC files, certain locations for timber sales were designated. Thereafter formal "assignment" letters were sent out to the district directors designating the areas within their districts where cutting contracts should be obtained.

Typically, in a year prior to entering into a contract of sale with a purchaser, SPLC's headquarters offices in San Francisco would have sent one or more "assignment" letters to its pertinent district, asking the district personnel to cruise and appraise timber on acreage described in the letter according to section, township, and range. This involved reconnaissance, line running, marking, cruising, and appraising, and the results of this activity were rendered in written reports referred to as "timber sale offerings." These written reports served as the basis for offering specific timber in specific areas and specific prices to customers.⁴

The field reconnaissance conducted by the district personnel was rather extensive. They would go through an area for the purpose of gaining a general impression of the character of the timber, the topography, the roads, the stand conditions, the status of the section corners and the accessibility of the timber. Aside from its primary purpose of providing information relative to a sale, a reconnaissance also gave the district forester a knowledge of conditions in the area that would affect its future management. Following the field reconnaissance was line running, involving the surveying of boundary lines. No contracts entered into during the years in issue involved a requirement that the purchaser survey the boundaries of the sales area.

SPLC maintained maps for each township showing land ownership and survey information from SPLC sources and from outside sources like the United States Forest Service. Other maps showed what areas had been logged and remained to be logged. As a survey was made in preparation for timber sales, the year of the survey and the points determined by the survey were marked on the township maps.

The timber sale contracts described the land on which timber was to be cut by subdivision, section, township, and range. If property lines were not readily ascertainable from prior surveys, it was necessary at times for SPLC employees to perform extensive surveying to delineate the property boundaries involved in the contracts in order to avoid cutting timber upon adjacent lands. This involved locating the corner points of the original survey on the ground and either running lines between the corners or, where a sale involved an area well within a section, flagging a temporary cutting line. In addition to their use in a sales context, line running surveys were also useful in preventing trespass upon SPLC lands, in the granting of easements, and in the establishment of the number of productive acres available for purposes of management.

After the survey, the district forester and his assistant would go into the area in which the timber was to be offered for sale and mark with a paint stripe each tree that was to be cut. This marking was a time-consuming process, and it was limited only to those areas where there was a sale in the immediate offing. SPLC chose to be specific about the individual trees it would allow to be cut in order to prevent indiscriminate cutting by purchasers and to assure that the trees left after the cutting would be suitable for future sales of timber. Marking also gave the foresters control over the forest stand that would remain after logging for management purposes.

Thereafter, an employee would perform a timber cruise (i.e., an on-site examination of timberland) to determine the quantity and quality of the timber to be sold. From an examination of the number, size, species, and quality of the trees to be cut, he estimated the volume of timber on the tract to be cut. The information obtained from a timber cruise was included in a written report.

The report of the timber cruiser generally included data on the volume of trees by species and on the volume of trees anticipated to remain after the sale. It included a map showing existing and proposed roads, and it contained a description of the condition of the boundary references. Also generally contained in the report was information regarding (1) the quality and character of the timber by species, including defects and breakage, (2) the average number of logs per tree, including average diameters, (3) the fire damage to the timber, (4) the status of reproduction in the area, (5) the status of site and soil improvements, (6) the potential inclusion of other SPLC lands in the logging unit, (7) the nature of occupancy on the land, (8) the status of water and minerals, and (9) the potential of the area for recreational use.

On most occasions, a cruise was conducted primarily to gain data pertinent to a sale of timber, although the acquisition of this data produced information which was useful in managing the land. On some occasions, cruises were conducted solely for the purpose of reporting on everything within a given section of land. Such cruises, unrelated to timber sales, produced data that was used primarily for management purposes and the cost of such cruises is not included in the amounts in issue.

Appraising the timber to be cut was the final step of a district forester in response to the "assignment" letter. He calculated the sales prices by grade, using the Forest Service printed statement of price recovery and overrun percentages. The appraisal was very similar to that which the Forest Service used.⁵

The district forester forwarded the foregoing information (including the report of the timber cruiser) with his letter of transmittal outlining his plan for the sale to the headquarters office. This information was used to prepare a sales offering.

While appraisals were prepared primarily as part of the contract process, they had incidental uses outside of a sales context. They were used to establish the value of timber at the time of a discovered trespass in collecting from the trespasser. They were used in connection with land condemnation cases. They were used in property tax matters.

Following the cruise and appraisal, the headquarters office would make a proposal to a purchaser. If the proposal was accepted, the contract would be prepared and would be submitted to the purchaser for signature. It would then be submitted to the SPLC board of directors and to the executive committee of the former Southern Pacific Company for approval. A copy of the contract was then forwarded to the district forester. He had the responsibility to see that its terms were complied with.

During the years at issue, employees of the Land Department and SPLC tried to negotiate the cutting contracts for a 1-year term but very often made them for a 2-year term (but never more than 2 years). Under extraordinary circumstances, a contract would be extended for another logging season. The usual purchasers of timber were operators who had established mills along the railroad and who, in prior years, had been customers for the purchase of timberland.

After the contract had been executed and the purchaser began cutting timber, employees scaled (i.e., measured the quantity of) the cut timber, determined the volume cut, and transmitted the log scale books and log scale journal sheets to the headquarters office. The hours spent scaling were reported when it was necessary to make a computation to determine if the purchaser was to pay the cost of the scaling.

Scaling records have value apart from their principal use in billing the purchaser. They are used in adjusting property tax records, in updating inventories, in checking on the efficiency and the quality of the cruise, and in checking on the efficiency of personnel.

The foresters exercised a great deal of control over the felling of timber by purchasers in order to prevent damage to the remaining stand in both the felling and yarding operations. Yarding is the process of moving fallen logs to the roadside. To control damage caused by yarding, the foresters would locate the skid trails of the hauling machinery and determine whether there was damage to the reserve stand, to young growth, or to the soil. If such damage existed, discussions would be held with the operator of the logging operation for the purpose of minimizing the damage.

After felling and yarding were completed, the purchaser was required to cut water bars or ditches across the skid trails to prevent erosion. In addition, slash disposal by the purchaser (i.e., the cutting of damaged young trees) was required in order to prevent insect buildup and to reduce the fire hazard.

During the years at issue, the forestry activities of reconnaissance line running, marking, cruising, appraising, scaling, and inspection were engaged in primarily because of timber sales arising under the cutting contracts in question. While to some extent a portion of these activities served long-term management goals in addition to their immediate sales-related purpose, the forestry work, to a very substantial degree, would not have been required were it not for an actual or potential contract for sale of timber. The fulfillment of management goals was frequently fortuitous, an incidental benefit which flowed from activities that were necessary for preparing or carrying out specific sales contracts. Essentially, the above-described forestry activities were occasioned by and necessitated by the timber sales, and most of the forestry work at issue fulfilled only sales-

related goals. Only a small portion of these activities was totally unrelated to the cutting contracts and served solely a management purpose.

It is stipulated that the SPLC timber sale contracts are predominantly cutting contracts to which section 631(b), I.R.C. 1954, applies. (This section is discussed in our opinion, *infra.*) The issue presently under discussion involves only such stumpage sale cutting contracts.⁶

In the consolidated income tax returns filed by the former Southern Pacific Company and its affiliates for 1959, 1960, and 1961, SPLC reported the following amounts as timber "expenses of sale":

Year	Amount
1959	\$133,487.89
1960	261,888.24
1961	68,524.61

The foregoing amounts include both (1) expenses incident to sales under cutting contracts to which section 631(b) applies, and (2) expenses not within the scope of section 631(b) (e.g., amounts paid to contractors to log timber for SPLC's own account, and costs of Christmas tree sales). The latter expenses are stipulated by the parties to be within the purview of section 631(a) and to be deductible as ordinary and necessary business expenses. The present issue involves a controversy only as to the expenses attributable to timber sales qualifying for treatment under section 631(b). The expenses attributed to section 631(a) and section 631(b) during the years at issue are as follows:

Year	Amount attributable to sec. 631(a) sales	Expenditures in controversy attributable to sec. 631(a) sales
1959	\$ 67,969.47	\$ 65,518.42
1960	237,231.96	24,656.28
1961	35,066.84	33,457.77

The gains from the sales under the cutting contracts at issue were reported as section 631 (b) capital gains on the tax returns, and the expenses incident to such sales were offset against these gains.⁷

In the consolidated returns for the years at issue, SPLC reported the following as (1) total quantity of timber sold, expressed in thousands of board feet, (2) gross receipts from total timber sales, and (3) total quantity of timber sold under contracts qualifying for section 631(b) treatment, expressed in thousands of board feet:

Year	(1) Total Quantity	(2) Gross Receipts	(3) Sec. 631(a) Quantity
1959	90,683	\$1,878,720.06	89,000.50
1960	31,181	877,217.16	47,181.18
1961	66,636	1,313,448.61	66,191.00

The amounts set out above under the heading "Expenditures in Controversy Attributable to Sec. 631(b) Sales" are stipulated by the parties to be the amounts at issue herein. To compute these amounts, the total quantity of timber (expressed in thousands of board feet) sold during 1959, 1960, and 1961 under section 631(b) contracts was multiplied by a figure representing average cost (per thousand board feet of timber) during each year. The average cost figures which were used for the years at issue are as follows:

Year	Average cost per thousand board feet
1959	\$0.71
1960	0.50
1961	0.50

The average cost for 1959 (\$0.71 per thousand board feet of timber) was derived by totaling the daily salaries of the employees engaged in activities relating to the section 631(b) timber sales and by multiplying that figure by the estimated total days these employees spent engaged in the activities of cruising, appraising, marking, scaling, and inspection. The figure thus obtained was divided by the total quantity of board feet of timber scaled during 1959. In this manner, a cost of \$0.71 per thousand board feet cut was calculated for that year.⁸

The average cost for 1960 and 1961 (\$0.50 per thousand board feet of timber) was derived from the 1959 computation above, except that work days relating to the inspection function were eliminated from the calculation.⁹

The petition filed in this case claims, *inter alia*, an overpayment of tax due to "Commissioner's failure to allow claims for deduction of costs of cruising, marking, and other expenses in connection with timber." In this regard, the petition states:

- (1) For each of the taxable years ended December 31, 1959, 1960 and 1961, Southern Pacific Land Company incurred expenses in cruising and marking timber and other activity pertaining to its standing timber.
- (2) In the consolidated returns for the taxable years ended December 31, 1959, 1960 and 1961, Southern Pacific Land Company inadvertently treated the foregoing as expenses incident to sale of timber pursuant to cutting contracts and offset them against section 631(b) capital gains.
- (3) On audit certain adjustments were made, but the Commissioner's agents erroneously continued to treat amounts of \$65,518.42, \$24,656.28, and \$33,457.77 as such sales expenses to be offset against section 631(b) capital gains for the taxable years ended December 31, 1959, 1960 and 1961, respectively.
- (4) The Commissioner has failed to allow claims by Southern Pacific Land Company for deduction of the foregoing amounts as ordinary and necessary business expenses for the taxable years ended December 31, 1959, 1960 and 1961.

Opinion

Issue (kk)

During the years 1959, 1960, and 1961, petitioner¹⁰ received proceeds of sales under cutting contracts falling within the purview of section 631(b). That section, in the circumstances therein specified, provides for capital gains treatment of the proceeds from the disposal of timber of certain cutting contracts with a retained economic interest.¹¹ See sec. 1.631-2(a)(2), Income Tax Regs. Also during 1959, 1960, and 1961, petitioner incurred expenses in the form of salaries for forestry work performed by its employees.

As a general rule, "ordinary and necessary expenses" of a taxpayer's business are deductible under section 162. However, even if related to a business, such expenses are treated as capital expenditures when they are incurred in the acquisition or disposition of a capital asset. Capital expenditures "are added to the basis of the capital asset with respect to which they are incurred, and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the asset is sold." *Woodward v. Commissioner* [70-1 ustr ¶ 9348], 397 U.S. 572, 574-575 (1970).

Thus, if the forestry expenses at issue in the present case were incurred in connection with a timber transaction described in section 631(b)¹² the provisions of section 162 will not apply. Instead, the expenses will be viewed either as additions to basis¹³ or as selling expenses applied in reduction of the amount realized on the sale.¹⁴ Clearly, the expenses will not be currently deductible. *Woodward v. Commissioner, supra.*¹⁵

Petitioner's position is that the forestry activities were not directly related to the sales of timber but were primarily directed at carrying out its timber management program, even though some of the activities may have had some incidental connection with the sales of timber. Accordingly, petitioner contends that the full amount of the salaries paid for forestry work is deductible against ordinary income as a section 162 business expense. Respondent's position is that the allocated expenses here involved are directly related to the sales of timber under section: 631(b) and must be offset against the price received for the timber, thus reducing the capital gain realized on the disposal of the timber.

Respondent's position herein follows the one taken by him in Revenue Ruling 71-334, 1971-2 C.B. 248, dealing with expenses directly related to timber disposals under section 631(b), and in Revenue Ruling. 58-266, 1958-1 C.B. 520, dealing with expenses directly related to disposals under the predecessor of section 631(b), section 117(k)(2) of the 1939 Code. Both of these rulings conclude that direct expenditures are to be applied as offsets to the capital gains from such disposals.

Revenue Ruling 71-334 provides in part:

In connection with a disposal of timber, so as to produce the maximum income therefrom, the taxpayer expended certain amounts directly attributable to the disposal for:

- (1) advertising the timber for disposal;
- (2) cruising to determine the quantity and quality of timber to be disposed of;
- (3) marking or otherwise designating the timber for cutting;
- (4) marking seed trees to be retained;
- (5) scaling, measuring, or otherwise determining the quantity of timber cut;
- (6) fees paid to consulting foresters, selling agents, and others for services directly related to the timber disposal;
- (7) supervising or checking performance under the contract; and
- (8) other expenses directly attributable to the disposal.

* * *

It has been the consistent position of the Internal Revenue Service, in connection with transactions qualifying for capital gain or loss treatment, that selling expenses are treated as an offset to the selling price. [Citations omitted.] Since the selling expenses in a sale of a capital asset are considered in arriving at income subject to a capital gain tax, it is reasonable to give like consideration to direct expenses in connection with income from leases. * * *

* * * it is held that expenditures directly attributable to a disposal of timber subject to the provisions of section 631(b) of the Code are reductions of the "amount received" for the purpose of computing gain or loss from such disposal.

On the question of whether or not an expenditure is directly related to a timber cutting contract, Revenue Ruling 71-334 provides:

Whether any expenditure is directly attributable to a disposal of timber is to 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 expenditure is incurred to the disposal of the timber.

Respondent argues the evidence establishes that a substantial portion of forestry activity was directly attributable to the disposal of timber under the cutting contracts. While respondent seems to admit that some portion of the salaries at issue were paid for work that was management oriented, he contends that petitioner expended not less than the stipulated amounts (\$65,518.42 in 1959, \$24,656.28 in 1960, and \$33,457.77 in 1961) on activities that were directly related to the section 631(b) contracts. Accordingly, respondent concludes that no portion of these amounts is deductible as a management expense.

Petitioner views the evidence as showing the forestry activities to be primarily management oriented and only incidentally related to sales. In this regard, petitioner believes the instant case is similar to *Union Bag-Camp Paper Corp. v. United States* [64-1 USTC ¶ 9122], 325 F.2d 730 (Ct. Cl. 1963).~6 There the Government argued that, to the extent of 5 percent of the total cutting contract receipts in that case, the taxpayer's expenses were to be applied to offset capital gains from the disposition of timber, In refusing to accept the Government's allocation, the court stated (325 F.2d at 741):

The record shows that during 1949 plaintiffs [taxpayer's] employees did spend a small part of their time negotiating sales prices for cutting contracts, designating areas to be cut, marking certain trees to be left standing, making casual checks as to quantities of timber cut, and occasionally inspecting the areas involved after cutting had been completed, * * * The record further shows, however, that the foregoing activities were only incidental to overall forest management activities, and that, even the complete elimination of the contract activities would have affected total management expenses in nominal amounts. * * *

In *Union Bag-Camp Paper Corp. v. United States, supra*, the facts were quite different from those we have found here; In that case the taxpayer had acquired timberlands solely for the purpose of assuring itself of a constant source of its raw material, wood pulp. The expenses Of negotiating and supervising cutting contracts were only a nominal portion of its overall forest management expenses which were in issue, and the sale of timber under cutting contracts was only incidental to the primary purpose for acquiring and managing timberlands. In this case SPLC had been in the business of selling its timberlands outright until it realized that it would be more efficient and profitable to sell the timber through cutting contracts. Selling timber at a profit was SPLC's principal objective. As can be seen from our extensive findings relating to the reconnaissance, line running, marking, cruising, appraising, scaling, and inspection activities, the evidence of record demonstrates that basically these forestry activities resulted from and were in furtherance of the disposal of timber under section 631 (b) cutting contracts. While to some extent a portion of these activities served long-term management goals in addition to their immediate sales-related purpose, the forestry work, to a very substantial degree, would not have been required were it not for an actual or potential contract for the sale of timber. In this respect, the instant case is distinguishable, as well, from *Wilmington Trust Co. v. United States* [79-2 USTC ¶ 9707], 610 F.2d 703 (Ct. Cl. 1979), a more recent opinion of the Court of Claims touching upon this question.

In contrast to the *Union Bag* and *Wilmington Trust* cases, the forestry activities at issue in the case at bar were engaged in primarily *because* of the timber sales, and in most instances the fulfillment of management goals was merely an incidental benefit of such activities. Here, as our findings indicate, the major portion of the forestry salaries was paid for work that had an immediate connection with and bore a close, causal, and proximate relationship to the section 631(b) timber disposals. We therefore view such expenditures as directly related to the timber sales and as coming within the purview of Revenue Ruling 71-334.

Further, we agree with respondent that petitioner expended not less than the stipulated amounts for this purpose. The amounts stipulated to be at issue for the years 1959, 1960, and 1961, are, respectively, \$65,518.42, \$24,656.28, and \$33,457.77. These figures were calculated by multiplying the total quantity of timber SPLC sold in each year under section 631(b) contracts by an average cost. As shown by our findings, the average cost figure in each year was based on the total number of days SPLC's forestry employees engaged, during 1959, in the specific activities of cruising, appraising, marking, and scaling. The 1959 average cost figure also took into account the days spent in the inspection function. The evidence does not establish that time spent in other activities relating to the section 631(b) contracts, i.e., reconnaissance and line running (and in 1960 and 1961, inspection), entered into the computation of average cost.

The record does not apprise us with precision of the extent to which, under section 631(b), all forestry functions served a sales purpose and the extent to which they did not.¹⁷ Nevertheless, it is clear that these functions served such a sales purpose to a very substantial degree. For this reason and for the reason that time spent by employees in significant activity related to the cutting contracts was not considered in computing the dollar amounts set out above, we are of the opinion, based on all the evidence before us, that these stipulated figures reflect no less than the minimum amount spent by petitioner on salaries for work occasioned by the section 631(b) timber sales.

Petitioner adopted the formula discussed herein for the purpose of attributing portions of the total forestry salaries to activities directly related to the section 631(b) contracts and, by necessary implication, to attribute the remainder of the salaries to activities not so related. In using this formula (regardless of where it originated), petitioner has adopted a method of allocation which petitioner cannot now repudiate without establishing it to be unreasonable and erroneous. The evidence of record does not do so, and we must hold petitioner to the allocation method it employed.

Under Revenue Ruling 71-334, the stipulated amounts, reflecting those forestry salaries directly attributable to disposals of timber under section 631(b), are properly offset against the gain from such disposals.

Petitioner makes the additional argument that the timber sales themselves were a management tool and, therefore, that even sales-related expenditures should be deductible under section 162. We cannot agree. It seems clear to us that the timber sales were conducted for the sales revenue they produced for SPLC and indirectly for the freight revenues produced for the former Southern Pacific Company. All sales-related activity was directed at consummating sales of timber and not at achieving some obscure management goal. The fact that some portion of petitioner's forestry activities was incidentally related to management does not convert the timber sales into a management activity.

In support of its position, petitioner cites *Alabama Mineral Land Co. v. Commissioner* [Dec. 8146], 28 B.T.A. 586 (193.3). That case involved the deduction of cruising expenses as ordinary and necessary business expenses by a trader in timber and timber lands. We regard that case as having limited precedential value because it predates the statute at issue and does not involve sales which are related to cutting contracts, as does the case at bar. Petitioner also regards the *Union Bag* opinion as supportive of its position, but for the reasons given above (and for the reasons given subsequently in this opinion), we find that case not to be controlling. Other authority and evidence cited by petitioner are not adequate to convince us that the sales at issue herein were primarily a management tool and that expenses attributable to such sales are thereby deductible under section 162.

Petitioner would have us conclude that Revenue Ruling 71-334 and Revenue Ruling 58-266 are not accurate reflections of the law. Petitioner makes reference to congressional committee reports associated with the Revenue Act of 1954 and argues that these reports are in conflict with the position adopted by: the respondent in his rulings. Petitioner asserts that these reports support its

view that, even where expenditures are directly attributable to the disposal of timber under the provisions of section 631(b), they are deductible against ordinary income and are not in any way to be applied as a reduction of the capital gains from such disposal.

We have carefully considered the pertinent legislative history. See H. Rept. No. 1337, 83d Cong., 2d Sess. 59, A67 (1954); S. Rept. No. 1622, 83d Cong., 2d Sess. 229, 337(1954); and H. Rept. No. 2543, 83d Cong., 2d Sess. 33 (1954). While language can be found in those reports which would tend to support petitioner's argument, the legislation which was being considered did not deal directly with the deductibility of the expenses associated with timber contracts as "ordinary and necessary expenses" under section 162. As a result, the reports have little significance in the present circumstances and clearly do not stand as authority for the proposition petitioner advances.

More importantly, the reports seem to be concerned with expenses which differ, for the most part, from the forestry expenses at issue herein. The reports discuss property taxes, insurance costs, costs of administering timber leases, costs of timber measurement, and interest on loans attributable to timber. The reports do not seem to be dealing with expenses, such as we are concerned with here, which are directly related to and occasioned by the specific disposals of timber to which the statute is directed. Many of the expenses discussed in the committee reports are of the type that usually are deductible from ordinary income by any taxpayer regardless of the context in which incurred (such as interest and property taxes). Other expenses dealt with in the reports which might have a sales connotation (such as the costs of timber measurement) are of the type that usually would have been deductible from ordinary income prior to the enactment of section 117(k)(2) because the gains from timber disposals had previously been taxed at ordinary rates. We believe the committee reports are concerned with preserving for the owners of timberlands the right to deduct as ordinary expenses such expenses as are not directly related to the timber disposals covered by the statute. We do not read the reports as suggestive of an intent to preserve as deductions from ordinary income those expenses which are directly related to the specific transactions being accorded capital gains treatment under the Code.

We do not agree with petitioner that the committee reports are supportive of its position, and we do not believe an extended law review article discussion of our reasoning is either necessary or justified in this lengthy opinion.

We conclude that, under the relevant case authority, petitioner is required to treat its forestry expenses as a reduction of its gains under the cutting contracts and not as a reduction of its ordinary income. This conclusion finds support in a decision of the Court of Appeals for the Ninth Circuit (to which an appeal in this case would normally lie). See *United States v. Regan* [69-1 uste ¶ 9369], 410 F.2d 744 (9th Cir. 1969), cert. denied 396 U.S. 834 (1969), a case involving section 631(b). There the court held that expenses "directly related to the acquisition and disposal of timber" pursuant to a contract to which section 631(b) applies are required by the Code to be added to basis.

The pertinent statutory language found in section 631(b) is as follows:

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. [Emphasis added.]

As to the meaning of "adjusted depletion basis," section 612 provides:

the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 1011 * * *'

In section 1011, the following language appears:

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 * * *), adjusted as provided in section 1016.

Section 1016, entitled "Adjustments to Basis," states:

Proper adjustment in respect of the property shall in all cases be made * * * for expenditures * * * properly chargeable to capital account * * *

After reviewing these provisions of the Code, the Court of Appeals in *United States v. Regan, supra*, concluded that "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. 410 F.2d at 746. To a similar effect, regarding the term "adjusted depletion basis" in section 631(c), see our recent opinion in *Davis v. Commissioner* [Dec. 37,112], 74 T.C. 881 (1980)(Court-reviewed).¹⁸

Other cases, decided before *Regan*, ostensibly support petitioner's position. None of these cases, however, gives any consideration to the term "adjusted depletion basis" appearing in section 631(b) (and in its predecessor section under the 1939 Code). See, e.g., *Union Bag-Camp Paper Corp. v. United States* [64-1 USTC ¶ 9122], 325 F.2d 730 (Ct. Cl.; 1963); *Drey v. United States*, an unreported opinion (E.D. Mo. 1960, 7 AFTR2d 333, 61-1 USTC ¶ 9116); and *Rahsburg v. United States* [67,2 USTC ¶ 9672], 281 F.Supp. 324 (S.D. Ind. 1967). In *Regan*, the Court of Appeals expressly took issue with the Court of Claims conclusion in the *Union Bag* case that section 631 (b) did not require the offsetting of related expenses. *Regan* called this conclusion "dicta," and stated that it was "not persuaded, as was the Court of Claims, that Congress intended to give timber cutters a tax bonanza instead of a capital gains benefit." (410 F.2d at 746). In a later case, *Casey v. United States* [72-1 USTC ¶ 9419], 459 F.2d 495 (Ct. Cl. 1972), the Court of Claims agreed with the approach adopted by the Ninth Circuit, in a case which presented the same facts as *Regan*.¹⁹

We agree with the view expressed in the *Regan* opinion that the *Union Bag* case incorrectly concluded that expenses directly related to a section 631(b) transaction are deductible under section 162. Cf. *Davis v. Commissioner, supra*. We note that recently the Court of Claims turned down an opportunity to reaffirm that position. See *Wilmington Trust Co. v. United States, supra*.

Accordingly, we hold that an offset against capital gains is necessary here. It is not critical for our present purposes to determine whether the expenses at issue should be viewed as additions to basis (like the expenses in *Regan* and *Davis*) or as selling expenses to be applied in reduction of the proceeds of the section 631(b) cutting contracts (like the expenses in Revenue Ruling 71-334).²¹ On the facts of this case, the result would be the same. What is significant is that there is clearly no justification for applying these expenses in reduction of petitioner's ordinary income.

Consistent with the foregoing discussion, we conclude and hold that petitioner must apply the respective amounts of \$65,518.42, \$24,656.28, and \$33,457.77 during the years 1959, 1960, and 1961, to offset its capital gains under the section 631(b) cutting contracts. We decide this issue for respondent.

1 In trying and briefing this case, this issue was referred to by the parties as "*Issue* (kk)."

2 These predecessor corporations, including the Central Pacific Railway Company, had been authorized by Congress to construct railroad lines. In various acts of Congress, they were granted rights-of-way and alternate sections of adjacent land: Act of July 1, 1862, as amended by an Act of July 2, 1864. Act of July 25, 1886. Act of July 27, 1866. Act of March 3, 1871.

3 The sections of timberlands owned by SPLC were generally square or rectangular in shape and were often adjoined on all four sides by national forest land owned by the Federal Government. Usually a section of SPLC land would meet other SPLC sections only at its corners. On a map, therefore, the parcels of forest land owned by SPLC tended to form a checkerboard pattern.

4 To the extent that offers to sell were accepted by regular purchasers and contracts entered into, or sale contracts entered into by reason of bids, the formal contractual arrangements followed the reconnaissance, line running, marking, cruising, and appraising of the property.

5 The appraisal was made using a discount procedure. The starting point was the price of the milled lumber. To arrive at the selling price, the milled lumber price was reduced by costs incurred by the purchaser. During 1959-1961, road construction costs and road maintenance costs were subtracted from the milled lumber price in arriving at the selling price of timber.

6 Sec. 631(b), as pointed out ahead, relates to contracts for the disposal of timber where the "owner retains an economic interest" in the timber. The timber sale contracts involved in the instant case (commonly referred to as "cutting contracts") provided for the sale of growing timber ("on the stump") by the thousand board feet, measured after it was cut. SPLC was paid an agreed amount ("stumpage price") for each thousand board feet cut.

7 On the books of SPLC, however, these expenses had been included in an operating expense

account.

8 Petitioner argues that this method of calculation on the returns for the years at issue came about as a result of a Revenue Service audit of prior years and does not reflect petitioner's thinking. Respondent contends that the ongoing audit did not influence the employees of the former Southern Pacific Company who prepared the returns. Our conclusions herein are based on the facts of record, and we give little significance to the question of where the calculation originated. For the years 1954 through 1958, all of the expenses incident to SPLC's stumpage sales under cutting contracts were deducted on the consolidated income tax returns as ordinary and necessary business expenses. Upon audit of these returns, respondent disallowed "direct costs of timber sales" as ordinary deductions and applied them to offset income from timber sales. These direct costs were calculated by multiplying the timber cut in the year by a rounded average cost per thousand board feet of \$0.70. This average cost was calculated with 1959 figures under the method above described, in 1964, the former Southern Pacific Company, as parent of the consolidated group, paid a deficiency based in part upon the foregoing method of adjustment, reserving the fight to file claims for refund (which claims were in fact filed in 1968).

9 Our findings herein relating to the dollar amounts at issue and to the board feet scaled during the years at issue are based on the stipulations of the parties. When these stipulated figures are employed in the calculations above described, the average costs for 1959, 1960, and 1961 are approximately \$0.73, \$0.52, and \$0.51, respectively. In our consideration of this issue, we have relied on the stipulated amounts.

10 The term "petitioner" includes, in context, the Southern Pacific Land Company.

11 SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER, COAL, OR DOMESTIC IRON ORE.

* * *

(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.

12 It is unnecessary here to draw any distinction between transactions which involve the sale of a capital asset and transactions which, under the Code, are treated as *though* they involve such a sale. See *Davis v. Commissioner* [Dec. 37,112], 74 T.C.

881 (1980) (Court-reviewed), a case arising under sec. 63 I(c).

13 See our discussion, *infra*, of *United States w Regan* [69-1 USTC ¶ 9369], 410 F.2d 744 (9th Cir. 1969), cert. denied 396 U.S. 834 (1969).

14 See the cases cited, *infra*, in fn. 21.

15 In an alternative argument, petitioner contends that, even if the instant expenses are considered to be directly related to the sec. 631(b) timber disposals, they are nonetheless currently deductible. For the reasons given subsequently in this opinion, we believe petitioner is in error.

16 *Drey vs. United States*, an unreported District Court opinion (E.D. Mo. 1960, 61-1 USTC ¶ 9116, 7 AFTR 2d 333), also relied on by petitioner to establish the unrelated nature of petitioner's expenditures, is not supportive of petitioner's contentions for reasons discussed below.

17 This deficiency in the record must of necessity work to petitioner's detriment since it has the burden of proof as to this issue. *Welch v. Helvering* [3 ustc ¶ 1164], 290 U.S. 111 (1933); Rule 142, Tax Court Rules of Practice and Procedure.

18 While *Davis v. Commissioner*, *supra*, deals with disposals of coal under sec. 631 (c) and; related royalty expenses and is therefore distinguishable, the case is nonetheless supportive of the position adopted herein.

19 Cf. *Coors v. Commissioner* [Dec. 32,003], 60 T.C. 368,403 (1973), affd. [75-2 USTC ¶ 9605] 519 F.2d 1280 (10th Cir. 1975).

20 In *Wilmington Trust Co. v. United States* [79-2 USTC ¶ 9707], 610 F.2d 703 (Ct. Cl. 1979), the Court of Claims found it unnecessary to reach the question of whether *Union Bag-Camp Paper Corp. v. United States* [64-1 USTC ¶ 9122], 325 F.2d 730 (Ct. Cl, 1963), should be overruled insofar as it holds that, under the Code, the expenses there at issue would be deductible *in any event* (i.e., even if directly attributable to cutting contracts). The Government had argued that the *Union Bag* case was incorrect in this respect. The court said it did not have to address this question because of its conclusion that the expenses in *Wilmington Trust* were incurred primarily to maintain and improve the timber, without regard to timber sales. See 610 F.2d at 708.

21 It has long been established that, in a capital gains context, selling expenses are to be offset against the selling price (i.e., are a reduction of "amount realized") rather than applied as an addition to the basis of the property sold. See, e.g., *Thompson v. Commissioner* [Dec. 3339], 9 B.T.A. 1342, 1345-1346 (1928); *Giffin v. Commissioner* [Dec. 6095], 19 B.T.A. 1243 (1930); *Hunt v. Commissioner* [Dec. 12,849], 47 B.T.A. 829, 839 (1942); *Davis v. Commissioner* [Dec. 14,229], 4 T.C. 329 (1944), affd. [45-2 USTC ¶ 9418] 151 F.2d 441 (8th Cir. 1945), cert. denied 327 U.S. 783 (1946); *South Texas Properties Co. v. Commissioner* [Dec. 18,267], 16 T.C. 1003, 1010 (195i); and *Ward v. Commissioner* [Dec. 19.661], 20 T.C. 332,

340-343 (1953), affd. [55-2 USTC ¶ 95371 224 F.2d 547 (9th Cir. 1955)]. See also, *Lanrao, Inc. v. United States* [70-1 USTC ¶ 9223], 422 F.2d 481 (6th Cir. 1970); *Estate of Machris v. Commissioner* [Dec. 24,302], 34 T.C. 827, 829 (1960); *General Spring Corp. v. Commissioner* [Dec. 19,822(M)], a Memorandum Opinion of this Court, decided July 27, 1953.