

VARN, INC. v. UNITED STATES
425 F.2d 1231(Ct. Cl. 1970); 70-1 USTC ¶9406
25 AFTR 2d 2101

Editor's Summary

Key Topics

DISPOSAL WITH A RETAINED ECONOMIC INTEREST

- Cutting as a sale or exchange
- Requirement that owner retain an economic interest

Facts

The taxpayer, Varn, Inc., owned 37,000 acres of pine timber and used such timber principally for the production and sale of turpentine gum from standing trees. Varn Timber Company was a timber dealer engaged primarily in acquiring rights to cut standing timber and in selling the pulpwood derived from the timber. Varn Timber Company and Varn, Inc., had some common officers and directors, but the management and control of the two corporations were in separate hands. Although Varn Timber acquired rights to cut varying quantities of taxpayer's standing timber during the years 1954-1963, the Company's sales of timber from other sources were always much greater. The taxpayer wanted to acquire a tract of land known as the Refuge Tract but needed \$140,000 to complete the transaction. An arrangement was worked out whereby the taxpayer secured a \$140,000 interest-free loan from the Container Corporation by agreeing that Varn Timber would cut belted out timber from taxpayer's 37,000 acre tract and deliver pulpwood to Container Corporation on Varn Timber's account with Varn Timber paying taxpayer the going stumpage price and Container Corporation withholding sufficient sums to repay the \$140,000 debt within a period of several years. Varn Timber agreed to cut and deliver sufficient pulpwood to Container so that Varn, Inc.'s loan would be repaid. The separate agreement between Varn, Inc. and Container Corporation provided that Container was to receive the timber from the Refuge Tract, or any other lands, until taxpayer had repaid the loan. Varn Timber Company, as the independent contractor, in fact cut all of the timber at issue in this case from the 37,000 acre tract and cut none from the Refuge Tract, which had been conveyed by taxpayer to Container until the loan was fully repaid. Under taxpayer's agreement with Varn Timber Company, taxpayer was to receive the going stumpage price for all timber cut from the 37,000 acre tract except to the extent taxpayer received credits to its account with Container. The government contended that under the above arrangement, the taxpayer was cutting its own timber and that since the taxpayer did not properly elect under Section 631(a)¹ capital gains treatment must be denied. Varn, Inc. argued that it was entitled to long-term capital gains treatment under Section 631(b)² since it disposed of the timber under contractual arrangement with Varn Timber Company while retaining an economic interest in such timber.

HELD: FOR THE TAXPAYER. The Court of Claims in a per curiam opinion adopted the findings of fact and conclusions of law of the Trial Commissioner. The Commissioner held that the taxpayer was entitled to long-term capital gains treatment on the proceeds of the timber the

subject of the transaction since the taxpayer, while disposing of the timber under a cutting contract with Varn Timber Company, at all times owned such timber land and retained an economic interest therein. The taxpayer was found not to be cutting its own timber even though the arrangement with Varn Timber Company was somewhat informal. Under the agreement, Container Corporation's right to receive pulpwood was limited to the Refuge Tract, none of which was involved in this case and the taxpayer was left free to dispose of its timber on the 37,000 acre tract in any manner desired. The taxpayer had no reason to make the election under Section 631(a) since it was not cutting its own timber.

Case Text
[OPINION OF COMMISSIONER]

HOGENSON, Commissioner. This is a suit to recover the sum of \$42,364.67, the total amount of the deficiency assessments of federal income tax and interest paid by plaintiff to defendant for the taxable years 1961 through 1963. The issues presented involve the proper characterization of the agreements and circumstances involved in the cutting and disposal of timber on plaintiff's land, and the tax treatment (capital gain or ordinary income) to be accorded the proceeds derived by plaintiff from the transactions.

It is my opinion that plaintiff is entitled to recover under § 631(b) of the Internal Revenue Code of 1954, and that it is unnecessary to decide whether plaintiff's alternate theory of recovery is sustainable under § § 1221 and 1231.

Throughout the taxable years in issue, and for more than 10 years prior thereto, plaintiff, Varn, Inc., a Georgia corporation, owned 37,000 acres of pine timberland in Brantley, Charlton and Ware Counties, Georgia. The timber cutting in this case occurred exclusively on such land.

The subject timber cutting was accomplished through arrangements made independently by Varn Timber Company, another Georgia corporation.

Also involved in this case are 3,500 acres of pine timberland in Camden County, Georgia, known as the Refuge Tract, which plaintiff acquired on November 1, 1959, and has owned ever since that time. None of the subject timber cutting occurred on the Refuge Tract, but such timberland is the subject matter of a pertinent agreement between plaintiff and Container Corporation of America, a Delaware corporation, operating a pulp mill at Fernandina Beach, Florida, in the vicinity of the subject timber cutting land.

Throughout the taxable years in issue, and prior thereto, plaintiff's purpose in owning and holding all of its timberlands was primarily, i.e., principally, of first importance, *Malat v. Riddell*, 383 U.S. 569, 572, 86 S. Ct. 1030, 16 L. Ed. 2d 102 (1969), for the production of turpentine gum from standing trees on such land, and sale of such gum to a certain processing plant. Except for a relatively few trees removed in thinning practices usual in forest maintenance, or removed in the clear cutting of an area of worked out turpentine trees, containing some other trees, reasonably necessary for reforestation practiced, the trees cut in this case were those which had been belted out in the production of turpentine gum by the trade practice of gradually cutting off the bark

over a period of years to the workable height of the tree trunks successively on two and sometimes three faces of each tree.

The pertinent processing plant was owned and operated by a partnership, the members of which were the shareholders of plaintiff corporation. Until about 1950, the partnership had owned and operated both the timberland and the processing plant. It was then that plaintiff corporation was organized, and thereafter owned and operated the timberland.

The enterprises of the partnership and plaintiff had been commenced by K. S. Varn and his older brother many years prior to 1950. In time, this partnership was owned by K. S. Varn individually and by Varn Turpentine & Cattle Co., another Georgia corporation, controlled by the family of Lester Varn, Sr., son of the older brother of K. S. Varn. Apparently K. S. Varn incorporated his share of the holdings of the partnership, at least to the extent of his interest in the timberland, at or prior to the organization of plaintiff corporation.

The stock of plaintiff corporation is and was owned 50 percent by K.S. Varn, Inc., another Georgia corporation, controlled by the family of K. S. Varn; and 50 percent by Varn Turpentine & Cattle Co., previously mentioned.

Varn Timber Company is and was a corporation organized, owned and operated by two sons and a son-in-law of K. S. Varn, i.e., Jacob E. Varn, K.S. Varn, Jr., and Wayne D. Seaman, each of whom held 16-2/3 percent of the stock; and by two sons of Lester Varn, Sr., i.e., George Varn and Lester Varn, Jr., each of whom held 25 percent of the stock.

As members of the respective Varn families, each stockholder of Varn Timber, had some indirect interest in plaintiff, and also there were some common officers and directors of both companies. However, both Varn families left the management of plaintiff to K. S. Varn, and he had no interest in Varn Timber, and participated in no way in its organization, management or control. The organizers and owners of Varn Timber were mature men, and had started and engaged in the business of that company because of their need to supplement income received from plaintiff. While they were in different generations of the overall Varn family, they were generally within the same age grouping.

Varn Timber Company is and was a timber dealer, engaged primarily in acquiring rights to cut standing timber and in the sale of pulpwood derived therefrom. In some instances, it contracted to cut timber into pulpwood for a fee. Generally it purchased standing timber from timberland owners, usually under oral contracts, agreeing to pay the stumpage value in the current market of the standing trees; engaged private contractors, called producers, for a specified fee per cord to cut the standing trees into cords of pulpwood and deliver the same to a pulp mill; and received the going market price of the cords of pulpwood from the mill. This was the nature of the relationship between Varn Timber and plaintiff in the timber cutting involved in this case, except for the circumstances attendant to the Separate Agreement between plaintiff and Container Corporation, hereinafter related.

During the years 1954 through 1963, Varn Timber Company acquired rights to cut varying

quantities of standing timber from plaintiff, but always much more in the aggregate from other timberland owners. During the years 1954-1958, and in terms of Varn Timber's total annual sales of pulpwood derived from all timber purchased, 2.9 to 5.8 percent of such sales were of pulpwood derived from timber on plaintiff's land, increasing to a range of from 16 to 17.4 percent in the years 1959-1963, those most relevant in this case.

On May 2, 1959, plaintiff acquired from Varn Turpentine & Cattle Co. a tract of land located near Albany, Georgia, for \$210,000, paying \$70,000 in cash, with the balance of \$140,000 payable within 6 months thereafter. Plaintiff was desirous of exchanging such land for the 3,500-acre Refuge Tract, Previously mentioned which was then owned by Varn Turpentine & Cattle Co. The exchange was accomplished on November 1, 1959. In the meantime, plaintiff was in need of \$140,000 to complete the transaction.

Sometime prior to November 1, 1959, Jacob Varn and George Varn of Varn Timber Company, who were also indirectly shareholders of plaintiff through their respective family corporations, conferred with K. S. Varn concerning the raising of \$140,000 to complete the proposed exchange of lands. They admittedly had the dual purpose of aiding plaintiff to raise the needed funds and obtaining business for Varn Timber, Varn Timber had been providing pulpwood to Container Corporation, and was aware of the latter's practice of advancing interest free loans to insure a source of supply pulpwood. George Varn explained to K. S. Varn that plaintiff could obtain such: a loan of \$140,000 from Container Corporation, but that plaintiff would have to permit an acceleration of the cutting of its belted out timber to provide Container Corporation with sufficient pulpwood to repay the loan. Mr. K. S. Varn had previously pursued a practice of restrictive cutting of timber, but agreed to negotiations with Container Corporation,

As above stated, Varn Timber had previously acquired and exercised rights to cut belted out timber on plaintiff's land, and in that connection had paid plaintiff the prevailing stumpage price for such timber. It was understood between K. S. Varn and Jacob and George Varn that Varn Timber would have the same right to cut belted out timber on plaintiff's 37,000 acres, and deliver pulpwood to Container Corporation on Varn Timber's account, with Varn Timber to pay plaintiff the going stumpage price of such timber, with Container Corporation to withhold sums of money sufficient to repay the \$140,000 within a period of several years, and with Varn Timber to cut and deliver sufficient pulpwood to Container to repay Container's loan to plaintiff.

Thereupon Jacob Varn went to Container Corporation which committed itself to advance a \$140,000 interest-free loan to plaintiff, which was accomplished on November 1, 1959, when plaintiff and Container Corporation entered into a Separate Agreement reciting the terms of the loan agreement. At the same time, plaintiff, having acquired the Refuge Tract on the same day, by Deed to Secure Debt conveyed the timber on the Refuge Tract to Container Corporation, and granted to Container the right to remove all of such timber, if plaintiff failed to perform the terms and conditions of the Separate Agreement, with the Deed to Secure Debt to become null and void and a reconveyance made by Container upon full performance by plaintiff of such terms and conditions. Both instruments were executed for plaintiff by K. S. Varn as its president.

The Separate Agreement between plaintiff and Container Corporation provided in pertinent parts

that for the payment of \$140,000 by Container to plaintiff, Container was to receive from plaintiff from timber on the Refuge Tract not less than 18,373 cords of pine pulpwood or to recover in pine pulpwood at the stumpage price not less than the sum of \$140,000 by November 1, 1964, whichever would yield to Container the greater quantity of pine pulpwood.

The stumpage price was defined as 48.4 percent of the prevailing price per cord of pine pulpwood. Container was required to credit plaintiff on its books and provide plaintiff with a weekly statement of the number of cords received and the stumpage price thereon. It was stated that when the aggregate of such credits equaled \$140,000, and when the aggregate number of cords received equaled 18,373, then all rights of Container under the Separate Agreement and Deed to Secure Debt would terminate.

If and when the credits aggregated \$140,000, but less than 18,373 cords had been received by Container, Container was entitled to continue to receive cords up to 18,373, and Container was to pay in cash the agreed stump age price for such additional cords.

Plaintiff had the right under the Separate Agreement to cut and deliver to Container pulpwood from any lands other than the Refuge Tract, and Container was required to credit plaintiff for such pulpwood on the same terms as provided with respect to the Refuge Tract, except for freight adjustment provisions irrelevant herein.

As previously stated, all of the timber cutting in this case was on plaintiff's 37,000 acres of timberland, and none on the Refuge Tract.

As the facts concerning actual performance of the Separate Agreement demonstrate, the following provision of such agreement is of major significance in this case:

5. Varn [plaintiff] Shall have the privilege of selecting an independent contractor or wood producer to cut and ship to Container all pulpwood hereunder for which Container shall pay :the current mill price in cash, weekly, as customary in the trade, less stumpage, if any. Such mill price shall be the price for truck wood delivered from areas having a comparable freight or trucking or transportation rate, but in no event less than the price then currently being paid to Varn Timber Company for equivalent wood, Such stumpage deducted from mill price shall be 48.4% of the mill price and shall be credited in the manner provided in paragraph 4 until the aggregate amount advanced by Container to Varn and secured by said Deed to Secure Debt; but when the aggregate amount of such credits shall equal the amount so advanced and secured, then no further deductions for stumpage shall be made, but Container shall pay the full current mill price in cash. Operating under this paragraph, Varn shall deliver or cause to be delivered to Container on Container's requisitions not less than an average of 3675 cords of pine pulpwood per year, unless such delivery be rendered impossible by bad weather, high water, strikes, unavailability of transportation or other similar causes clearly beyond the control of the producer. In event of continued or repeated failure of Varn's producer to comply to with the above delivery schedule, Container shall have the right in its absolute discretion to dispense with the services of Varn's wood producer under this paragraph.

It is noted that Varn Timber Company was specifically mentioned in the foregoing provisions, and consistent with previous separate dealings between Varn Timber and each of the parties to the Separate Agreement, it is reasonably to be inferred (both from the terms of the provisions and from the consistent practice of the parties thereafter) that both plaintiff and Container Corporation expected that Varn Timber would be the independent contractor which would perform under the terms of the above-quoted provisions, and that Varn Timber would receive the going mill price per cord of pulpwood from Container and pay the stumpage price of timber to plaintiff, except to the extent that the stumpage price portion of the pulpwood price would be retained by Container and credited to plaintiff until Container had recouped its \$140,000 advance to plaintiff.

It was further provided in the Separate Agreement between plaintiff and Container Corporation that plaintiff, or its wood producer, were privileged, but not bound, to ship to Container a maximum of 8,000 cords of pulpwood each year.

It is of substantial importance that the Separate Agreement and Deed to Secure Debt did not provide for conveyance by plaintiff to Container of timber, or even timber cutting rights, on any land other than the Refuge Tract. In the event of default by plaintiff of performance of the agreement, Container could enter upon the Refuge Tract and cut and remove timber, but no such right was acquired by Container with respect to any other land. Thus, insofar as the Separate Agreement and Deed to Secure Debt were concerned, plaintiff retained full title to the timber and timber cutting rights on its 37,000-acre timberland, and Container acquired none of such rights or title.

In fact, defendant has conceded in this case that plaintiff retained an economic interest in the timber located on its 37,000-acre timberland,

Plaintiff entered into an oral agreement with Varn Timber Company, as an independent contractor, in accordance with its previous dealings with that company. By such agreement, Varn Timber acquired the right to cut all belted out timber on plaintiff's 37,000-acre timberland, with the understanding that Varn Timber would arrange for and control the cutting of such timber, cause the delivery of sufficient cords of pulpwood to Container to satisfy the terms and conditions of the Separate Agreement between plaintiff and Container, and pay to plaintiff the going stumpage price for such timber except to the extent plaintiff otherwise received such stumpage price by credits to its account with Container. The informality of such agreement, implied in part from the conduct of the parties, has no adverse effect upon plaintiff's right to recover under § 631(b) of the Internal Revenue Code of 1954, *Barclay v. United States*, 333 F.2d 847, 854-855, 166 Ct. Cl. 421, 432-434 (1964).

The informal agreement between plaintiff and Varn Timber is consistent with above-quoted provisions of paragraph 5 of the Separate Agreement between plaintiff and Container, pursuant to which provisions, performance of plaintiff's obligations to Container was accomplished. Such provisions must have been made in contemplation of acquisition by Varn Timber of the Cutting rights to the belted out timber on plaintiff's 37,000-acre timberland. It cannot reasonably be concluded that plaintiff had agreed to sell or sold pulpwood to Container, which had to be derived

from timber on such land, as Container acquired no interest in such timber and had no right to insist that the pulpwood be derived from that source, It is clear that plaintiff sold timber cutting rights to the belted out timber on such land to Varn Timber, with part of the consideration being that Varn Timber would deliver pulpwood to Container in fulfillment of plaintiff's obligations under its Separate Agreement with Container. Plaintiff neither cut nor reserved the right to cut the timber involved herein. In these and other respects, subject case is clearly distinguishable from *Ray v. Commissioner*, 32 T.C. 1244(1959), aff'd per curiam, 283 F.2d 337 (5th Cir. 1960), heavily relied upon by defendant.

Throughout the 5-year period involved in the Separate Agreement between plaintiff and Container, Varn Timber consistently supplied more pulpwood to Container from its timber cutting on subject land, than the amounts required by the terms of such agreement. At the request of K. S. Varn, Container retained the stumpage price on more than the required volume of 3,675 cords of pulpwood per year, resulting in repayment of the \$140,000 loan in advance of the end of the 5-year period. Obviously Varn Timber had no reason to object. Throughout the entire period, Varn Timber caused even greater quantities of pulpwood, derived from its cutting operations on subject timberland, to be delivered to Container. On such greater quantities, Container retained nothing, but paid to Varn Timber the entire mill price of such pulpwood, and Varn Timber in turn paid to plaintiff the stumpage price of the timber involved. Thus, in the overall transaction, Container accounted to Varn Timber for and paid to the latter the mill price of the pulpwood delivered; deducting the stumpage price of the timber on certain volumes of pulpwood, and applying credits therefor to plaintiff's loan account, but on further deliveries of pulpwood, accounted to Varn Timber for and paid to the latter the full mill price of such pulpwood, leaving to Varn Timber full responsibility for accounting to plaintiff for the stumpage price on the excess deliveries of pulpwood.

Varn Timber in effect accounted to plaintiff for all of the stumpage price of timber cut from subject land, either by way of the credits entered by Container on plaintiff's loan account, or by direct payments to plaintiff of the stumpage price of the timber involved in the excess deliveries of pulpwood by Varn Timber to Container.

Plaintiff's proceeds from the three-party transactions, which proceeds are the subject matter of the capital gain or ordinary income treatment to be applied in this case, consisted entirely of the stumpage price of the timber involved.

It is concluded that all of the elements essential to plaintiff's entitlement to long-term capital gain treatment under § 631(b) on its proceeds from the overall transaction were present in this case: (1) plaintiff was the owner of the pertinent timber; (2) plaintiff disposed of the timber under contractual arrangement with Varn Timber Company, by which plaintiff retained an economic interest in such timber; and (3) plaintiff had held such timber for more than 6 months prior to its disposal, *Barclay v. United States*, *supra*, 333 F.2d at 852, 166 Ct. Cl. at 428.

Defendant's position is that plaintiff's entitlement to capital gain treatment is limited to § 631 (a), and that since it is conceded by plaintiff that it did not make the election required under that subsection, and since the provisions of subsections (a) and (b) of § 631 are mutually exclusive,

Ray v. Commissioner, *supra*, 32 T.C. at 1250, plaintiff cannot recover under § 631(b). Defendant concedes that § 631(a) is applicable only if the cutting of the pertinent timber was done by plaintiff, and strains for ultimate findings that plaintiff was cutting its own timber that plaintiff had simply a fee arrangement with Vain Timber Company to cut the timber, and that plaintiff was simply selling pulpwood to Container from the timber cut by Varn Timber.

The fact remains that Container's right to receive pulpwood was limited to the timber on the Refuge Tract, none of which was involved in this case, and plaintiff was left free to dispose of its timber on its 37,000-acre timberland in any manner it desired. In fact, it disposed of the belted out timber on such land by agreement with Varn Timber Company, not merely for a timber-cutting fee, but with the understanding that Varn Timber would pay plaintiff the going stumpage price of such timber, that Varn Timber would arrange for the cutting of such timber at its own cost, and that Varn Timber would receive the going mill price for the pulpwood derived from such timber, assuming the risk that it would have a profit after payment of the stumpage price and its costs of cutting and delivery of the pulpwood to the mill.

It is only incidental that Varn Timber was required by plaintiff to deliver pulpwood to Container at the going mill price, not all of the pulpwood cut, but sufficient quantities to fulfill the terms and conditions of the Separate Agreement between plaintiff and Container Corporation. It is significant that plaintiff never received more than the stumpage price of the timber, whether in the form of credits to its account with Container, or by way of direct payment from Varn Timber, and that Varn Timber received the mill price of the pulpwood, even though on some of the pulpwood, Container retained the stumpage price, which Varn Timber would otherwise have had to pay to plaintiff.

The circumstances attendant to the Separate Agreement between plaintiff and Container Corporation do not alter the facts that plaintiff was not cutting its own timber, did dispose of its belted out timber on the 37,000-acre timberland, retaining an economic interest therein, and was the owner of such timber for the requisite period of time prior to disposal. Since plaintiff was not cutting its own timber, § 631(a) is not applicable, and plaintiff had no reason to make the election called for in that subsection.

From the timber cutting involved in this case, plaintiff received only those proceeds which it was able to command as the owner of the standing timber, and nothing from the cutting of the timber or delivery of the resulting pulpwood to Container. For the proceeds received by it, plaintiff is entitled to long-term capital gain treatment under § 631(b).

1 Sec. 631(a). Election To Consider Cutting As Sale or Exchange.--If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and

the adjusted basis for depletion of such timber in the hands of the taxpayer, Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer had a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate. For purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than 6 years old at the time saved from the roots and are sold for ornamental purposes.

2 Sec. 631(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 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.