

WATTS v. ERICKSON
62-2 USTC ¶ 9778; 10 AFTR 2d 5832 (D. Ore. 1962).

Editor's Summary

Key Topics

CAPITAL GAIN v. ORDINARY INCOME

- Sale of logging road easement

BUSINESS EXPENSE

- Road use fees

Facts

The partnership of which the taxpayers were members granted the Forest Service an easement over land owned by the partnership in order to facilitate an offering by the Forest Service of timber on adjoining land owned by the Government. In accordance with usual practice; the Forest Service offering provided that the successful bidder would be entitled to use the easement subject to the payment of road use fees to the partnership. The partnership was the successful bidder and the amount of the road use fee attributable to each timber sale was credited against the amounts otherwise payable by the partnership to the Forest Service for the timber. The taxpayers reported the amount of the road use fees as long-term capital gain and they deducted an equivalent amount as ordinary and necessary business expense. The Commissioner reclassified the road use fees as ordinary income and denied the deduction of these amounts.

District Court

Held: For the taxpayer. The grant of the easement to the Forest Service constituted a sale by the partnership of property used in its trade or business as defined in section 1231(b), and the gain realized on such sale is capital gain. The road use fees were deductible as ordinary and necessary business expenses.

Case Text

SOLOMON, District Judge: This cause, having come on regularly for trial without a jury before the Honorable Gus J. Solomon, Chief Judge of the above-entitled Court at Portland, Oregon on the 20th day of December, 1961, plaintiffs appearing by Charles P. Duffy and William T. Schantz of their attorneys and defendants appearing by Sidney I. Lezak, Acting United States Attorney for the District of Oregon, and Dale Anderson, attorney, Department of Justice, Washington, D. C., and the parties having produced testimony and evidence in behalf of their respective contentions as reflected by the pretrial order previously made and entered herein; and

The Court having thereafter considered fully all matters of fact and law presented by the parties and being at this time fully advised, does make the following:

FINDINGS OF FACT

1. Plaintiffs instituted this action for recovery of individual income taxes assessed against and collected from the respective plaintiffs for the years 1954, 1955, 1956 and 1957 by the defendant as District Director of Internal Revenue of the United States for the District of Oregon.

2. Jurisdiction of this action exists by virtue of Section 1340 of Title 28 of the United States Code.

3. At all times material herein, plaintiffs R. T. Watts and Martha B. Watts were and now are husband and wife.

During the years 1954 to 1957, inclusive, and prior thereto, B. S. Cole and plaintiff Teden H. Cole were husband and wife. B. S. Cole died May 2, 1958, and, thereafter, plaintiff Paul Beuford Cole was appointed as executor of his estate by the Circuit Court of the State of Oregon for the County of Lane, and he is still acting in that capacity.

During all times material herein, plaintiffs Paul B. Cole and Norma F. Cole were and now are husband and wife.

During all times material herein, plaintiffs Preston R. Butler and Elizabeth C. Butler were and now are husband and wife.

During the years 1954 to 1956, inclusive, plaintiffs Spencer R. Collins and Lucile P. Collins were husband and wife, Spencer R. Collins and Lucile P. Collins were divorced during the year 1957.

4. During the years 1954 to 1957, inclusive, and prior thereto, plaintiffs R. T. Watts, Martha B. Watts, B. S. Cole, Teden H. Cole, Paul B. Cole, Ruth Cole, Elizabeth C. Butler, Spencer R. Collins, and others, were partners in Rosboro Lumber Company, with its principal place of business at Springfield, Oregon.

5. On September 8, 1952, Rosboro Lumber Company executed a deed of easement, effective as of January 1, 1951, to the United States of America, acting by and through the Forest Service, United States Department of Agriculture, by the terms of which Rosboro Lumber Company, for a valuable consideration, granted to the government a perpetual easement and right of way over certain of its real property (improved with a logging road) in Lane County, Oregon.

6. The Forest Service, United States Department of Agriculture, acquired such easement and perpetual right of way from Rosboro Lumber Company in order to insure competition and to facilitate the contemplated public offering by the Forest Service of adjoining tracts of timber owned by the Forest Service and to enable the ultimate purchaser of such timber to transport the logs produced there from over said logging road. In accordance with its usual practice, the Forest Service included as a requirement of the timber sale offerings that the successful bidder at the national forest sale pay to Rosboro Lumber Company, the land owner, the agreed amount for the easement. Such road use fees were included in the government's timber appraisal, and the appraised stumpage rates reflected such item.

Thereafter, the Forest Service duly advertised for bids on said adjoining timber tracts and

offered to sell the same to the highest bidder, provided that such bid was equal to or in excess of the appraised value as determined by the Forest Service. Rosboro Lumber Company submitted the highest bid for each of the said timber tracts and was the successful purchaser. The amount of the road use fee attributable to each timber sale was allowed by the Forest Service as a credit to Rosboro Lumber Company against the amounts otherwise payable by it to the Forest Service as the timber was removed and constituted deductible expense to Rosboro Lumber Company during the years in which such expense was incurred.

7. The pertinent Land Asset Account of Rosboro Lumber Company was as follows:

Description of Land	Acres	Cost Allocated
Original acquisition	18,074.28	\$ 9,790.12
Associated Plywood Mills Tract	20.00	204.80
Weyerhaeuser Timber Tract	1,360.00	<u>36,943.00</u>
Total land costs		\$46,937.92

8. The Rosboro Lumber Company partnership received the following credits as proceeds from the grant of said easement to the government:

Fiscal Year Ended	Amount
June 30	
1951	\$ 1,749.34
1952	22,481.50
1954	35,577.72
1955	26,510.01
1956	24,530.97
1957	<u>19,150.47</u>
	\$130,000.01

9. The Rosboro Lumber Company partnership books recorded the transactions as follows:

Fiscal Year	Operating	Stumpage	Land Asset	Income Classified
Ending June 30	Expenses	Charges	Account	as Capital Gain
1951	\$ 1,749.34	\$ 1,749.34		
1952	22,481.50	22,481.50		
1953				
1954	35,577.72	22,707.08	\$12,870.64	
1955	26,510.01	26,510.01		
1956	\$ 24,530.97	24,530.97		
1957	<u>19,150.47</u>	<u>19,150.47</u>		
	\$ 86,318.57	\$ 43,681.44	\$46,937.92	\$83,062.09

10. In filing its partnership returns of income for each of the fiscal years ending June 30, 1954 to June 30, 1957, inclusive, the amounts credited during each of said years against the amount to be recovered from the agreement with the Forest Service were reported as amounts received from

the sale of a capital asset held for more than six months and the said road use fees so credited were claimed as business expenses for the fiscal years ended June 30, 1954 and 1955 and charged to stumpage costs for the fiscal years ended June 30, 1956 and 1957.

11. In filing their individual income tax returns for each of the calendar years in question, the partners of Rosboro Lumber Company reported their respective distributive shares of income from Rosboro Lumber Company in like manner.

12. By separate deficiency notices dated August 28, 1959, the respective plaintiffs were advised by the Commissioner of Internal Revenue of the United States of income tax deficiencies determined against them. The deficiencies were based, in part, upon increases in each partner's share of the income of Rosboro Lumber Company for each of said years, which resulted from the disallowance of the deduction for road use fees payable by Rosboro Lumber Company, as purchaser of the Forest Service timber, and the elimination of the capital gain reported by Rosboro Lumber Company of the amounts credited against the total amount payable pursuant to the Deed of Easement.

13. During the year 1957, plaintiff Spencer R. Collins incurred and paid legal fees to his attorney in the amount of \$5160.67 and incurred and paid additional expenses to hire a private detective in the amount of \$2290.93, or a total of \$1751.60 [*sic* \$7451.60]. These legal and other expenses were incurred in connection with divorce proceedings which were pending at the time between himself and his then wife, Lucille P. Collins, and were deducted on his 1957 income tax return.

During, the year 1957, said taxpayer paid attorney's fees in connection with the same divorce proceeding, for the services of his former spouse's attorneys, as required by the divorce decree, in the amount of \$2,500.00. No deduction therefore was claimed by said taxpayer in filing his income tax return for the year 1957.

14. Under date of August 28, 1959, plaintiff Spencer R. Collins received notice of an income tax deficiency determined against him for the year 1957 by the Commissioner of Internal Revenue of the United States based; in part, upon the assertion by the said Commissioner that said expenditures aggregating \$7,451.60 constituted nondeductible personal expense to him.

15. The respective plaintiffs on or about January 8, 1960, paid to the defendant, as District Director of Internal Revenue for the District of Oregon, the following amounts for the years indicated:

	Taxable Year	Tax Paid	Interest Paid	Total
R. T. Watts and Martha B. Watts				
	1954	\$9,032.57	\$2,552.88	\$11,585.54
	1955	4,356.35	969.85	5,326.20
	1956	4,041.97	657.35	4,699.32
	1957	1,974.88	202.68	<u>2,177.56</u>
				\$23,788.53
Estate of B. S. Cole, Deceased, Paul B. Cole, Executor, and Teden H. Cole				
	1954	\$7,986.49	\$2,257.22	\$10,243.71
	1955	1,680.95	374.23	2,055.18
	1956	1,907.29	310.18	2,217.47
	1957	1,014.97	104.17	<u>1,119.14</u>
				\$15,635.50
Paul B. Cole and Norma F. Cole				
	1954	\$ 332.23	\$ 93.90	\$ 426.13
	1955	441.83	93.36	540.19
	1956	482.44	78.46	560.90
	1957	137.09	14.07	<u>151.16</u>
				\$1,678.38
Ruth Cole				
	1954	\$ 437.13	\$ 123.55	\$ 560.68
	1955	442.70	98.56	541.26
	1956	531.51	86.44	<u>617.95</u>
				\$ 1,719.89
Preston R. Butler and Elizabeth C. Butler				
	1954	\$ 301.51	\$ 85.22	\$ 386.73
	1955	468.35	104.27	572.62
	1956	433.38	70.48	<u>503.86</u>
				\$ 1,463.21
Spencer R. Collins and Lucile P. Collins				
	1954	\$4,266.17	\$1,205.75	\$ 5,471.92
	1955	1,906.96	424.55	2,331.51
	1956	1,637.64	266.33	<u>1,903.97</u>
				\$ 9,707.40
Spencer R. Collins				
	1957	\$5,508.79	\$ 565.37	\$ 6,074.16

16. On or about August 24, 1960, the respective plaintiffs duly filed with the defendant their

separate claims for refunds of Such taxes, plus interest, for the years and in the amount indicated in the preceding paragraph upon the grounds that the amounts received respectively by them during said years from the grant of the easement and right of way to the United States of America, acting by and through the Forest Service, United States Department of Agriculture, constituted proceeds from the sale of a capital asset and that such road use fees were allowable as business deductions.

In the refund claim of Spencer R. Collins for the year 1957, said plaintiff also alleged that the legal expenses incurred and paid by him during the year 1957 in the total amount of \$7,451.60 (at the time divorce proceedings were pending between himself and his wife, Lucile P. Collins) were substantially all for the conservation or maintenance of property held by him for the production of income and; therefore deductible as such in computing his taxable income for the year 1957.

17. Under date of October 3, 1960, the respective plaintiffs received separate statutory notices of the disallowance of their respective refund claims as provided in Section 6532(a)(2) of the Internal Revenue Code.

18. On September 8, 1961, plaintiff Spencer R. Collins filed with defendant a timely amended claim for refund for the year 1957 to claim a deduction for the \$2500 paid by him during the year 1957 to the attorneys for his former spouse as required by the divorce decree.

19. The grant of the easement to the Forest Service constituted the sale by Rosboro Lumber Company of property used in its trade or business and held for more than six months prior thereto.

20. Plaintiffs were entitled to first recover their entire costs of the land in the area in question before reporting any taxable gain.

21. The road use fees incurred by Rosboro Lumber Company pursuant to the timber purchase agreements entered into between the Forest Service as seller and Rosboro Lumber Company as purchaser constituted ordinary and necessary business expenses to it in the years that these amounts were credited against the purchase price of the easement.

22. The legal and other fees incurred and paid by Spencer R. Collins in the year 1957 in connection with the divorce proceedings constituted ordinary and necessary expenses paid by him for the conservation of property held by him for the production of income. From the foregoing findings of fact, the Court draws the following:

Conclusions of Law

1. The grant of the easement to the Forest Service constituted a sale by Rosboro Lumber Company of property used in its trade or business, as defined in Section 1231(b) of the Internal Revenue Code, and the gain realized on such sale is to be considered as gain from the sale of a capital asset held for more than six months.

2. The road use fees, which were included in the stumpage rate for the Forest Service timber purchased by Rosboro Lumber Company, were deductible by Rosboro Lumber Company, in the

years that these amounts were credited against the purchase price of the easement, as roads use expense.

3. The legal fees paid by Spencer R. Collins to his attorney and to his wife's attorney and the amounts paid to the private investigator in the year 1957 for the conservation of the property involved in the divorce proceedings were allowable as a deduction under the provisions of Section 212(2) of the Internal Revenue Code. Due to the late filing of the mended claim for refund, the, total amount of deductions now allowable for these three expenditures shall be \$7451.60.

4. The respective plaintiffs, therefore, are entitled to refunds in such amounts as may be computed by the Internal Revenue Service, subject to the approval of this Court and the respective plaintiffs.