WILMINGTON TRUST CO. v. UNITED STATES
79-1 U.S.T.C. ¶ 9223 (1979)
43 AFTR2d 79-801
(Timber issue only)

Editor's Summary

Key Topics
CAPITAL v. EXPENSE
· Selling expenses

Facts

This is a consolidation of suits for refund of income taxes for the years 1964-1970 brought by members of a partnership known as Wilmon Timberlands, During the course of the litigation one of the partners died and his executor, Wilmington Trust Co., was substituted as a plaintiff. Wilmon owned and managed in various years between 35,700 and 45,000 acres of timberland in Alabama. The timber was actively managed as an investment.

Wilmon retained between 9 and 11 full-time employees. A forester and office manager were salaried. Hourly employees included a timber management crew working under the direction of the forester, two individuals who maintained the roads and bridges, and a timber scaler. The timber management crew conducted timber growth studies, made insect-damage surveys, repainted boundary lines, and various other activities related to the maintenance, growth, and development of the timber and the timberlands. In addition, some portion of their time was spent in activities directly related to the sales of timber, such as marking the timber to be sold, soliciting bids, supervising performance of the cutting contracts, and scaling the logs removed.

Wilmon treated all of its land and timber management expenses as ordinary and necessary business expenses and deducted them from ordinary income. The Commissioner of Internal Revenue disagreed with the deduction of the expenses which were directly related to the sale of the timber, contending that they could only be offset against the capital gain on the sale of timber.

Trial Division
Court of Claims

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 Trial Judge rejected the taxpayer's argument that *Union Bag-Camp Paper Corp.,* a 1963 Court of Claims decision which allowed the taxpayer to deduct such selling expenses, is controlling. He concluded that the direct selling expenses in the instant case, unlike those in *Union Bag-Camp Paper Corp.,* are recognizable and not at all nominal. The Trial Judge also rejected a line of reasoning underlying the *Union Bag-Camp Paper Corp,* decision, namely, that the

legislative history of Section 631 (b) indicates a Congressional intent to continue to permit taxpayers to deduct timber management expenses even if they were otherwise capital in nature. :[This opinion represents the Trial Judge's recommended decision and conclusion of law. Later in 1979, the Court of Claims rejected the Trial Judge's recommendation .and held that *Union Bag-Camp Paper Corp.* continues to be the controlling decision in this area (see following decision)].

Case Text

Opinion*

Miller, Trial Judge: These are suits for refund of income taxes for the years 1964-70. They were originally brought by W. Sam Carpenter, III, and his wife, Murton, and by C. Porter Schutt, and his wife, Phyllis, During the course of the litigation, W. Sam Carpenter, III, died and the executor of his estate, Wilmington Trust Co., was substituted as a plaintiff. [1] The cases were consolidated.

Some of the issues have been disposed of by settlements between the adverse parties and a concession by defendant. [2] The only ones which remain are:

1. Whether certain portions of the expenditures of taxpayers' partnership, engaged in the management of timberlands and sale of timber, were deductible from the plaintiffs' ordinary income as business expenses (as plaintiffs contend), or were part of the cost of sales of the timber, in transactions for which I.R.C. § 63 l(b) [3] allows capital gain treatment and hence should be treated as capital expenditures or offsets to the sales proceeds (as defendant maintains).

2. Whether overpayments of income tax due the estate of Carpenter in this suit are subject to offset for the amount by which the estate previously reduced the estate tax by deducting such income tax as a liability of the decedent (as defendant contends), or whether such offset is barred by the expiration of the statutory period for assessment of an estate tax deficiency (as plaintiff maintains).

I. The Timber Expenditures Issue

During the years in issue, the taxpayers, W. Sam Carpenter, III, and C. Porter Schutt, were two of the three equal partners in Wilmon Timberlands, which owned and managed in the various years from 35,700 to 45,000 acres of Alabama timberlands.

Wilmon held its timber property for investment purposes but periodically sold standing trees to purchasers for removal under cutting contracts, the income from which qualified for capital gain treatment under I.R.C. § 631(b). In one year, however, 1970, it also conducted its own logging operations.

The partnership's manager is in charge of the entire operation. His objective is to obtain a sustained yield from the timberlands over the years by maintaining a continuous growth, and to do this through natural stand regeneration. This requires that no greater quantity of timber be cut in any year than the equivalent of the annual growth. The manager and his crew make regular growth and volume studies per acre and on the basis of these he periodically selects the area of from 500 to 2,000 acres most suitable for harvesting. On the average such harvesting is done at a

rate which enables going over the entire tract in a 10-year cycle.

Once the area is chosen, an effort is made to maintain the best stock for future growth, harvesting and natural reseeding. Trees are selected by a forester and a technician for harvesting on the basis of whether their growth has been and is likely to be slowed down in the future at the particular location and whether their removal will enhance the growth of other and younger trees of good stock. Those to be cut include trees which have reached their maturity, trees which have been damaged by disease, insect infestation, lightning and other causes, those which grow crookedly, are forked or are otherwise defective, and those which overshadow and dominate less mature trees and retard their growth by depriving them of sun, air and nutrients.

During the years at issue, the Wilmon partnership employed between 9 and 11 full-time employees. These employees included the partnership manager and a forester, who were compensated by salaries, and an office manager, who worked for an hourly wage. The remaining full-time employees worked as a crew for hourly wages directly under the forester, and their activities substantially corresponded to his activities, excepting his supervisory duties. In addition, two employees were charged with maintenance of roads and bridges. Furthermore, the partnership employed a timber scaler, whose functions are discussed *infra,* and at least one other office employee, although it is not clear whether or not she was full time. [4]

The regular activities of Wilmon's timber crews working under the supervision of its forester included cruising the land and conducting timber-growth studies. They made insect-damage surveys by both ground and aerial reconnaissance and took measures to control insect infestation by cutting and eliminating the infected trees. They repainted all boundary lines every 5 years to prevent encroachment both by Wilmon employees and their neighbors. They trapped and attempted to control beavers, which back up water and kill trees. They practiced continuous fire control and fire fighting. And they maintained existing roads and bridges.

Although the major share of the time of the Wilmon partnership employees was devoted to maintenance, growth and development of the timber and timberlands, some portion of their time was spent in activities which were directly related to the sales of limber and would not have taken place absent the sales. After the manager designated an area to be harvested, a team consisting of a forester and a technician went out together to determine and to mark the particular trees to be cut according to the standards referred to above. They marked each tree with a paint-spray gun or can at stump level. The partnership's employees would mark from 50,000 to 100,000 board feet of timber per day. They would spend from 2 days to a week in a designated area depending on the volume of timber in the area, and the aggregate marking time would encompass 3 to 4 months per year.

After marking, the manager solicited three or four potential buyers, showed them the available timber, and negotiated a contract with one of them. During the cutting, which could take from 1 to 6 months for an area, one or two Wilmon employees would spend from a half day to a full day biweekly and weekly, supervising performance of the cutting contract. This would consist primarily of checking the stumps to insure that all of the marked trees, and only those trees, had been cut down, that the purchaser had hauled all of the logs away so that they could be accounted

for in the billing, and that the purchaser was held responsible for damaging other standing timber in the felling and hauling.

In addition to the regular crew which it used for multiple purchases, the Wilmon partnership employed a timber scaler exclusively in connection with sales. It was his function to measure the board :footage of all logs delivered at the sawmill, which was the basis for the partnership billings for all timber sales other than that cut for pulpwood. The partnership could not use him full time and it lent him out to other companies and billed them for his services. Finally, when the scaling reports were received, they were tallied and billed to the purchaser by the office manager and another clerical employee.

The parties have agreed that if any of the expenditures for the foregoing are direct-selling expenses, the proper amounts to be treated as such are as follows:

Year	Total Expenses	Direct selling expenses	Calculated percent of total
1964	$27,693	$ 3,573	12.9
1965	29,078	7,556	26.0
1966	30,599	7,873	25.7
1967	31,898	9,127	28.7
1968	36,063	8,895	24.7
1969	38,252	6,334	16.7
1970	43,216	11,374	26.3

It was stipulated that the direct selling expenses for 1969 and 1970 were arrived at by allocation of the expenditures for the following purposes in the proportions set out; [5]

Expenditures	Allocation to direct selling expenses
Marking timber	75%
Scaling timber	100%
Contract supervision	100%
Personnel transportation	10%
Telephone	5%
Gas, oil, and grease	5%
Manager's salary	5%
Office supplies	2%
Clerk's salary	2%

The statute which prescribes capital gain treatment for the receipts is § 63 l(b) of the Internal Revenue Code, which for the years at issue provided in pertinent part as follows:

> (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 construed as though it were a gain or loss, as the case may be, on the sale of such timber. [Emphasis supplied.]

The legislative purpose for enacting this section was to extend to a taxpayer who has owned his timber for more than 6 months and who sells it by cutting contract where under he retains an economic interest in the timber the same capital gains treatment as is afforded to an investor who after 6 months sells his timber outright? Consistent with the purpose of treating such timber as a capital asset, as Congress has extended the holding period for capital assets generally for long-term capital gains from 6 to 9 months and then to a year, it has done the same for the timber under § 63 l(b). [7] It is no coincidence, therefore, that in the underlined [italicized] portion of § 63 l(b) Congress adopted language similar to that in § 1001(a), which deals with the computation of gain or loss from the sale or other disposition of property generally, to wit:

SEC. 1001 * * *
(a) *Computation of Gain or Loss.--The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section I011* for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized, [Emphasis supplied.]

Internal Revenue Code § 612 provides that the adjusted depletion basis (the basis for computing gain or loss on the sale of timber under § 631(b)) is the adjusted basis provided in § 1011, the same section which § 1001(a) provides is to be used in computing gain or loss on sale of capital assets generally. Section 101 l(a) states that such adjusted basis is cost (§ 1012), adjusted as provided in §1016. Section 1016 in turn requires that "Proper adjustment in respect of the property shall in all cases be made--(l) for expenditures * * * properly chargeable to capital account."

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; either because they are "properly chargeable to capital account" within the meaning of 8 1016 or as an implied term of 8 1001 in arriving at the amount realized. *Spreckels v. Commissioner* [42-1 USTC ¶ 9345], 315 U.S. 626 (1942) and *Helvering v. Union Pacific [Railroad] Co.* [35-1 USTC ¶ 9011], U.S. 282, 286 (1934) (commissions on sales of securities); *Casey v. United States* [72-1 USTC ¶ 9419], 198 Ct. Cl. 232,237, 459 F. 2d 495,497 (1972) and *United States v. Regan* [69-1 USTC ¶ 9369], 410 F. 2d 744 (9th Cir.), cert. denied, 396 U.S. 834 (1969) (cost of building access roads to enable logging of timber sold); *Towanda Textiles, Inc. v. United states* [60-1 USTC ¶ 9258], 149 Ct. Cl. 123, 180 F. Supp. 373 (1960) (attorney and adjuster fees incurred in the collection of fire insurance proceeds on the destruction of a building); *Ward v. Commissioner [55-2* USTC ¶ 9537], 224 F. 2d 547 (9th Cir. 1955) (attorney's and appraiser's fees for obtaining bidders for partner's property and thereby inducing other partners to buy him out); *Spangter v. Commissioner* [63-2 USTC ¶ 9777], 323 F. 2d 913, 921 (9th Cir. 1963) (cost of litigation to obtain increased sales proceeds); *General Spring Corp. v. Commissioner* [CCH Dec. 19,822(M)], 12 TCM 847, 854 (1953) (corporate officer's free engineering services, technical advice and sales promotions to customers of corporation's patent assignee in order to increase corporation's capital gain royalties).

In Woodward v. Commissioner[70-1 USTC ¶ 9348], 397 U.S. 572, 575-76 (1970), the Supreme Court summarized the general rule--

> It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures. * * *
> * * * [T]he courts have held that legal, brokerage, accounting and similar costs incurred in the acquisition or disposition of such property are capital expenditures. * * * The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much a part of the cost of that asset as is the price paid for it.

Taxpayers argue that the cases in which selling expenses have been treated as offsets to the proceeds of sale in arriving at the amount realized have involved exceptional or isolated sales rather than those in the course of business, and therefore the rule is not applicable to sales of a regular nature. The short answer to this is that if there are regular sales in the course of business usually the gain is ordinary income and makes no difference taxwise whether the selling expenses are deducted in arriving at the amount realized or the net income. This was pointed out *in Towanda Textiles, Inc. v. United States, supra,* 149 Ct. Cl, at 131, 180F. Supp. at 378:
Only in instances where the income received from the sale would be ordinary income to the taxpayer, and not capital gain, have the courts allowed the taxpayer to deduct the expenses incurred as "ordinary and necessary" in the conduct of its business. * * * In such case it makes no difference whether the deduction is allowed against the gain, in determining gross income, or is allowed as a deduction from gross income, to determine net income, but it does make a difference where a capital asset held for more than six months is concerned. [8]

However, there is no logical reason why expenditures ancillary to the sale of capital assets should be any less capital expenditures or the amount realized therefrom calculated differently when the sales of capital assets are not isolated or exceptional.

In the instant case the timber sales were of capital assets and the sales proceeds gave rise to long-term capital gains. The cost of the activities at issue were directly related to the completion of the sales of such capital assets and the receipt of the proceeds. The marking was to designate the timber to be sold. The scaling was the means of accounting for the quantity of timber removed by the buyer and to fix his liability for the proceeds. The contract supervision was to check the purchaser's compliance with the contract and to ensure full payment. The cost of the remaining items; the stipulated portions of the transportation, gas, oil, office supplies, telephone and clerical help, were similarly costs of activities directly related to completion of such sales. The partnership's forester-manager testified that the activities in question would not have taken place if the timber sales had not been made. Therefore, it is appropriate to treat their cost as direct selling expenses which offset the sales proceeds in arriving at the amount realized from the timber sales.

Plaintiffs contend that all of the partnership expenditures are deductible as ordinary and necessary operating expenses because the primary purpose of all of the partnership activities, including the sales, was timber management, preservation and growth; that none of the employees was employed for other than that primary purpose; and that the salaries of all of the employees would

have been paid irrespective of the absence of timber sales.

Plaintiffs have not clearly established the factual basis for this argument. It is not at all evident from the record that the Wilmon partnership did not have as a purpose the earning of profits on the sales, Wilmon's manager testified that one of the objectives of the sales was to earn income so that it could use the funds in defraying other expenses. When asked specifically as to whether or not the partnership had profits in the years at issue, he responded that he could not remember as to the years 1964 through 1969, but that there was a profit for 1970. Furthermore, he testified that the objective of the partnership was to operate the timber stand on a sustained yield basis whereby it would sell in each year the equivalent of the annual growth (obviously a profit-making plan), and the major reason why it had not been able to achieve that objective during the taxable years was that from 1954 to 1962 very heavy cuts had been made. Furthermore, it is not self-evident that if 12.9 to 28.7 percent of the expenditures (the portions attributed to the sales by the stipulation) had been eliminated, the same number of personnel or hours of service would have been required. Certainly there would have been no need for a timber scaler.

However, even under the facts alleged by the taxpayers the law bars the deductions at issue. The pertinent Code provisions are §§ 161. 261 and 263. Section 161 provides that in computing taxable income there shall be allowed as deductions the items specified in part VI "subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible)." (Part VI deals with business expenses, interest, taxes, losses, bad debts, depreciation, etc.) Section 261 in turn prescribes that in computing taxable income "no deduction shall in any case be allowed in respect of the items specified in this part." And § 263(a) states as one such item the general rule that no deduction shall be allowed for capital expenditures, [8a]

These sections 161 and 261 constitute a "priority-ordering directive" which "requires that the capitalization provision of § 263(a) take precedence" over a section allowing a deduction, and--

> The clear import of § 161 is that, with stated exceptions * * *, an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI. *[Commissioner v. Idaho Power Co.* [74-2 USTC ¶ 9521], 418 U.S. 1, 17 (1974).]

A "primary purpose' test has no application here" and "ancillary expenses incurred in acquiring or disposing of an asset" are capital expenditures irrespective of their primary purpose. *Woodward v. Commissioner, supra,* 397 U.S. at 576, 577.

The net result in a case like the instant one is, therefore, that if a particular expenditure serves dual purposes, capital and expense, the Code requires allocation to each. Just such resolution was required in *Commissioner v. Idaho Power Co., supra; Southern Natural Gas Co. v, United States,* t88 Ct. Cl. 302,372-80 [69-2 USTC ¶ 9473], 412 F. 2d 1222, 1264-69 (1969); and *Great Northern Ry. v. Commissioner* [2 USTC ¶ 504], 40 F. 2d 372 (8th Cir.), *cert. denied,* 282 U.S. 855 (1930).

The Idaho Power Co,, an electric public utility company, from time to time used portions of its

regular operating transportation equipment (cars and trucks)part time in the construction of improvements and other capital facilities. On its income tax return it claimed as a deduction from gross income the entire year's depreciation on such equipment on the theory that I.R.C. § 167 [9] unqualifiedly allowed such a deduction irrespective of any part-time use for capital assets construction purposes. The Court held, however, that § 167 did not lessen the reach of § 263 barring deductions for capital expenditures and therefore "the equipment depreciation allocable to taxpayer's construction of capital facilities is to be capitalized." *Idaho Power Co., supra,* 418 U.S. at 19.

Similarly, the Southern Natural Gas Co., a gas producing and transporting company, used certain automotive equipment for purposes primarily relating to the operation and maintenance of its pipeline system, but from time to time it utilized it in its construction operations on a part-time basis. The court held that because of the force of the 1939 Code predecessor of § 263, ,'the part of the depreciation represented by the time the equipment was devoted to construction purposes should be allocated to the project costs." *Southern Natural Gas Co., supra,* 188 Ct. Cl. at 374, 412 F. 2d at 126.

In constructing capital improvements, on some occasions the Great Northern Railway Co. transported its workmen to the construction site on its regular passenger trains and shipped its materials on its regular freight trains. The taxpayer contended that it should not be required to reduce its operating expenses by capitalizing the cost of carrying such workmen and materials, because it was put to almost no additional equipment or service expense, the trains would have been run in the same way whether the workmen were carded or not and there was only insignificant additional cost for the freight. The court nevertheless held that the costs for transporting the men and material was necessarily included in the taxpayer's operating expenses and that it was required to estimate them, exclude them from operating expenses and allocate them to its capital account. *Great Northern Ry., supra,* was cited with approval by this court in *Southern Natural Gas Co., supra.*

In *Idaho Power Co.,* and *Southern Natural Gas Co.,* as in *Great Northern Ry.,* the allocations to capital account were not correlated or limited to the value of additional equipment purchased for any capital project or projects. The underlying rationale of all three decisions is that if a taxpayer incurs an expenditure which pays for both its operating expenses and the cost or proceeds of a capital asset recognition of the benefit conferred by the latter precludes deduction of the entire amount as an expense. [10]

Accordingly, since the employees of plaintiffs' partnership spent a measurable (though lesser) portion of the time for which the partnership paid them in activities directly related to the sale of the partnership's capital assets, a portion of the partnership's payments must be treated as capital expenditures to be allocated to the cost or proceeds of sale of the assets.

Plaintiffs rely on this court's decision in *Union Bag-Camp Paper Corp, v. United States* [64-1 USTC ¶ 9122], 163 Ct. Cl. 525,544-50, 325 F. 2d 730, 741-44 (third issue) (1963) as controlling authority to the contrary of the foregoing. There the taxpayer owned and leased timberlands and sold timber to others under cutting contracts, from which it realized gross proceeds during 1949

of $364,592. It deducted from income total land management expenses of $385,387, composed for the most part of salaries, depreciation, supplies, repairs, travel, entertainment and insurance. After audit the Commissioner of Internal Revenue determined that 5 percent of the total receipts was a fair estimate of that part of management expense properly attributable to the negotiation and supervision of the cutting contracts. Therefore, he reallocated $18,229 (5 percent of $364,592) from management expense and charged it against the timber sales proceeds as a direct-selling expense. In the suit for refund of the resulting tax deficiency the court decided that the entire management expense was deductible and no part had to be treated as a capital expenditure. The opinion contains two separate lines of reasoning to support the decision:

The first rationale is that (a) "the record discloses no recognizable part" of the management expenses "to be directly related to timber sales under cutting contracts"; [11] (b) the taxpayer's employees spent only a small part of their time negotiating sales prices, designating areas to be cut, marking trees, making checks as to quantity of timber cut and inspecting the area after cutting; (c) the contract activities of the plaintiff's employees were only incidental to their forest management duties; and (d) at best they had but nominal effect on plaintiff's payroll and other management expenses.

For several reasons such rationale cannot be controlling in this case. To the extent that it is factual and is based on the record in *Union Bag,* it patently is not determinative of the facts herein. The expenses at issue here were from 12.9 to 28.7 percent of the management expenses in the various years from 1964 through 1970. They were derived from a specific allocation of the portion of each activity or expenditure deemed directly related to the sales. Thus, they were recognizable and hardly nominal. To the extent that the *Union Bag* rationale is based on the legal premise that a capital expenditure can be deductible as an expense if it is incidental to the furtherance of the taxpayer's ordinary business activities, it must be deemed overruled by the subsequent holding in *Woodward v. Commissioner, supra,* that the bar to deduction of capital expenditure in I.R.C. § 263 admits of no primary purpose test. And to the extent that *Union Bag* assumes that allocation of dual purpose expenditures is not permissible, it must be deemed inconsistent with the later decisions in *Commissioner v. Idaho Power Co., supra,* and *Southern Natural Gas Co. v. United States, supra.*

The second line of reasoning underlying the *Union-Bag Camp Paper Corp.* decision is that the intent of I.R.C. § 631(b) itself is to allow deduction of all timber management expenses even if they are otherwise capital in nature. The decision noted that the predecessor of §631(b) (§ 117(k) of the 1939 Code) was enacted in the Revenue Act of 1943 (58 Stat. 46) to grant all timber owners relief in the form of capital-gains treatment on their sales or disposals because Congress wanted to eliminate the inequity whereby an investor who sold standing timber outright was entitled to capital gain treatment on the proceeds whereas a timber owner who either cut timber for use in his business or sold it to others to cut but with retained economic interest had to include his gains in ordinary income. The decision then set forth the inference that, because the new section contained nothing that would prohibit the deduction from income by a timber dealer of his ordinary and necessary expenses incurred in the growing or selling of his timber or which would require him to offset such expenses only against capital gains realized on timber sales or disposals, Congress did not intend with one hand to grant a special tax benefit but with the other take back

part of the benefit through the medium of disallowing a deduction to which the taxpayer had previously been entitled.

The *Union Bag* decision also found support for this conclusion in the facts that the initial draft of the 1954 Code passed by the House of Representatives contained a provision which would have been denied a deduction for the expenses at issue but that it was eliminated by the Senate and deleted from the bill as finally passed.

This second line of reasoning has been commented on adversely in two subsequent decisions, the second by this court itself. In *United States v. Regan* [69-1 USTC ~ 9369], 410 F. 2d 744 (9th Cir.), *cert. denied,* 396 U.S. 834 (1969), holding that expenditures by a joint venture for the construction of access roads to enable the disposal of its timber under cutting contracts were not ordinary business expenses but capital expenditures to be offset against capital gains on the disposition of the timber, the court stated (at 746):

> We are aware that dicta in *Union Bag-Camp Paper are* not in harmony with our holding, but we are not persuaded, as was the court of Claims, that Congress intended to give timber cutters a tax bonanza, instead of a capital gain benefit, when it rewrote the timber section of the tax law in 1944. [12]

In *Casey v. United States,* 198 Ct. Cl. 232, 459 F. 2d 495 (1972) involving another member of the same joint venture as in *Regan* and on identical facts, this court reached the same result as in *Regan,* and it likewise indicated doubts as to the soundness of the second ground for decision in *Union Bag-Camp Paper.* [13] *The* court expressed the thought that the intend of the 1944 Congress in the enactment of § 631 to afford to those selling timber by cutting contract capital gain treatment equivalent to that allowed to investors selling timber outright was more accurately effectuated by disallowing business expense deductions for expenditures incurred to acquire capital gain rather than the contrary. It stated (198 Ct. Cl. at 237-38, 459 F. 2d at 497-98):

> A further reason for our conclusion is found in the intent behind the enactment of § 631(b) and its predecessor which was to allow taxpayers who dispose of timber or cutting rights with a retained economic interest to receive capital gain treatment, thus putting them on an equal footing with those taxpayers who sell their timber stands outright. *S. Rep. No.* 627, 78th Cong., 1st Sess. 25-26, (1943), 1944 *Cum, Bull.* 993. To adopt plaintiffs' argument is to create another state of unequal treatment, the converse of the earlier undesirable situation, because it would confer an even greater benefit on those who dispose of their property with a retained economic interest. We cannot allow such a result where there is such a clear Congressional intent to the contrary.

Although there are differences between the expenditures for construction of the access road in *Casey* and the selling expenses at issue here, the significant Common denominator is the fact that both were directly incurred to acquire capital gain and they would not have been incurred except for the sales for capital gain.

In reinforcement of the views expressed in *Regan* and *Casey,* it is also worth noting that in the

enactment of § 117(k)(2) of the Internal Revenue Code of 1939 in 1944 (the predecessor of § 631(b)) Congress did have occasion to consider the allowance of expense deductions for the expenses ancillary to the capital gains it enacted for timber sales and it rejected it.

The initiative and sponsorship for the measure came from the Forest Industries Committee on Timber Valuation and Taxation. On February 17, 1943, the Internal Revenue Service had issued an instruction to revenue agents that timber cutting contracts where the owner grants to another the right to enter upon the land and cut and remove timber over a given period with payment on the basis of rates per thousand board feet or other unit were similar to oil and gas leases, and the amounts received therefrom should be treated as ordinary income subject to depletion allowance rather than proceeds from the sale of capital assets. In response to this members of the Forest Industries Committee urged Congress to overrule the IRS and to restore the preexisting capital gain treatment which they said had been the rule for many years prior to 1943.[14] They submitted to Congress their draft of § 117(k)(2) which would accomplish that result.

At the same time, anticipating that the Internal Revenue Service would disallow the deduction as business expenses of amounts expended to acquire such capital gain, they submitted a second new Code provision to thwart such action, explaining:

> It is proposed, in the second place, to amend section 23(a)(1) of the Internal Revenue Code (dealing with the deduction of necessary business expenses) by adding a new paragraph thereto giving to tile taxpayer the option to charge certain forest development and protection expenditures to expense, even though the Bureau might hold that under present law some of these expenditures should be capitalized.

(House Hearings before the Committee on Ways and Means on Revenue Revision of 1943, 78th Cong,, 1st Sess., October 14, 1943, 805; and see also 797-98.)

However, while Congress enacted the substance of the proposed § 117(k)(2), it did not adopt the proposed amendment to § 23(a)(1), nor any provision similar to it.

Finally, plaintiffs amplify the argument briefly adverted to in *Union Bag-Camp Paper,* that legislative intent to allow ordinary deductions for expenditures directly incurred to obtain capital gains may be inferred from congressional statements and conduct with respect to a measure which Congress failed to enact in the 1954 Code. As it passed the House, the 1954 Code contained a new section which would have provided:

SEC. 272. CUTTING OF TIMBER AND DISPOSAL OF COAL OR TIMBER.

> (a) Where the cutting of timber by a taxpayer is considered a sale or exchange under section 63I(a), no deduction shall be allowed for administrative and other expenses, incurred in the taxable year such timber is cut, in connection with the holding and quantity measurement of such timber.
> (b) Where the disposal of coal or timber by the taxpayer is covered by section 631(b), no deduction' shall be allowed for expenditures attributable to the making and administering

of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract. This subsection shall not apply to any taxable year during which there is no production, or income, under the contract.

An additional provision in section 631(b) would correspondingly have added to the basis of the timber sold "the deductions disallowed for the taxable year under section 272." However, after representatives of the forest industries strongly opposed the measure in Senate Finance Committee hearings, the Senate committee deleted it and Congress did not adopt it.

From this sequence of events, the plaintiffs, as well as the opinions in *Union Bag-Camp Paper* and *McMullan v. United States,* Ct. Cl. No. 130-76, decided by the trial judge August 1, 1978, drew the inference that Congress understood and approved the pre-existing and present law as allowing deduction of selling expenses though directly incurred for the production of capital gains.

In my opinion no such inference is warranted.

The House committee sponsoring the measure explained the purpose of the provision (H. Rep. No. 1337, 83d Cong., 2d Sess. 59 (3 U.S. Code Cong. & Admin. News 4017, 4085 (1954))):

> Under present law a taxpayer who owns or has contract rights to cut timber may elect to treat the cutting of 0f timber as a sale or exchange. Similarly a taxpayer who owns timber or who receives coal royalties may treat his receipts from the disposition of timber and coal as capital gain. *There has been uncertainO, as to the tax treatment of expenses incurred in connection with the capital gains arising from such timber or coal royalties.* In some cases the taxpayer may have no income except capital gains, and the right to deduct business expenses from ordinary income is of no avail to him. Your committee has adopted a provision identifying the expenses in connection with the sales, or with the receipts of royalties from leases, which are proper offsets against capital gain and which are properly applicable against ordinary income. [Emphasis supplied.]

In resolving the uncertainty the House committee did not limit itself to disallowance of deductions for direct selling expenses. Where the disposal of the timber was covered by § 631, it would have barred deductions not only for expenditures "attributable to the making and administration of the [disposal] contract," "the expenses of measuring and checking quantities disposed of under the contract" and for "the preservation of the economic interest retained," but also for flood control and--

> ad valorem taxes imposed by State or local authorities, costs of fire protection (including patrolling, sign-posting, building of firebreaks, costs of communication facilities necessary to such fire patrolling, equipment necessary for fire prevention or control, development of water facilities for fire fighting), insurance costs of all kinds relating to the property (not including liability insurance), costs incurred in administering a timber lease (including costs of bookkeeping and technical supervision), costs of timber measurement (including surveying), and interest on loans attributable to the timber.

H. Rep. No. 1337, 83d Cong., 2d Sess. A 67-68 (3 U.S. Code Cong. &: Admin. News 4017, 4204-05 (1954)).

Plaintiffs attribute to the House the belief that absent the disallowances it prescribed in its bill existing law provides ordinary deductions for the entire catalog of quoted expenditures, because the House Committee Report then added (at A 68)(3 U.S. Code Cong. & Admin. News at 4205):

> If there is no production of income under the contract, section 272(b) will not be applicable, and *as under present law,* such expenses may be deducted from other income as a business expense * * *. [Emphasis supplied by plaintiffs.]

Plaintiffs then attribute similar intent to the Senate because the Senate Finance Committee stated that its elimination of "the specific House requirement for allocation of expenses * * * in effect continues the treatment of such expenses which is provided under present law and regulations." S. Rep. No. 1622, 83d Cong., 2d Sess. 81 (3 U.S. Code Cong. & Admin. News 4621, 4713 (1954)).

But the House committee did not say that all of the expenses were deductible under present law. It stated that *if there is no production of income* under the cutting contract such expense may be deducted under present law. The apparent assumption was that in the absence of sales there would be no selling expenses to offset against sales proceeds. Plaintiffs' interpretation of the sentence in the House Committee Report as an unconditional construction of clear existing law with respect to deductibility of all of the enumerated expenses it would disallow is hardly consistent with the same committee's statement as to the purpose of the provision (quoted at 27, *supra,* that "[t]here has been uncertainty as to the tax treatment of expenses incurred in connection with the capital gains arising from such timber * * * royalties."

Even if the words upon which plaintiffs rely for the House committee's understanding of preexisting law could be interpreted as plaintiffs assert, it would be merely an expression of opinion on the meaning of an earlier law, and such an expression has been held to have little, if any, significance. *Hart v. United States,* 218 Ct. Cl.--, [78-2 USTC ¶ 9751] 585 F. 2d 1025, 1035 (1978). Moreover, there is nothing to indicate that even if the House found it was mistaken as to existing law it still intended to perpetuate its interpretation for the future--particularly when the section it proposed was to the contrary.

Plaintiffs' argument that the Senate concurred in plaintiff's view of existing law when it deleted the House provisions for disallowances has even less to support it, since the Senate Committee expressly stated (at 81) (3 U.S. Cong. & Admin. News at 4714 (1954)):

> Since your committee was considering only the problem of taxing coal, timber and iron ore in 1954 and future years, no inference should be drawn from your committee's action as to the meaning of present law.

* * * * * * *

["Findings of Fact" and "Conclusion of Law" omitted.]

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*The trial judge's recommended decision and conclusion of law are submitted in accordance with Rule 134(h).

1 Since the wives are parties only because they signed joint tax returns with their husbands, for purposes of this opinion references to the taxpayers or the plaintiffs will not refer to the wives unless the context requires it.

2 After the briefs were filed, defendant filed an amended answer conceding that the Wilmon Timberlands sales of timber in 1967 and 1970 were made under contracts qualifying for capital gain treatment under I.R.C. § 631, issues previously disputed. See finding 29.

3 All reference to the Internal Revenue Code or I.R.C. are to the Internal Revenue Code of 1954 unless otherwise stated.

4 In 1970 only the partnership also employed an average of seven or eight additional men in connection with its own logging operations.

5 Defendant also asserts in its brief that the direct-selling expenses for the prior years are calculated in the same proportions. Plaintiffs do not deny it in their reply brief.

6 Section 631(b) is derived from § l17(k) of the Internal Revenue Code of 1939 as added by § 127 of the Revenue Act of 1943 (58 Stat. 46), The Senate Committee Report on that section states *(S. Rep. No. 627,* 78th Cong., 1st Sess., 25-26 (1944-1 C. B. 973,993)):

"The taw discriminates against taxpayers who dispose of timber by cutting it as compared with those who sell timber outright. The income realized from the cutting of timber is now taxed as ordinary income at full income and excess profits tax rates and not at capital gain rates. In short, if the taxpayer cuts his own timber he loses the benefit of the capital gain rate which applies when he sells the same timber outfight to another. Similarly, owners who sell their timber on a so-called cutting contract under which the owner retains an economic interest in the property are held to have leased their property and are therefore not accorded under present law capital-gains treatment of any increase in value realized over the depletion basis.

"In order to remedy this situation, it is proposed to amend the existing law as follows:

"If the taxpayer so elects upon his return, the cutting of timber during the year by the taxpayer who owns or has a contract right to cut such timber is treated as a sale or exchange of the timber cut during the year and such cut timber is considered property used in a trade or business of the taxpayer for the purpose of section 1170) of the Internal Revenue Code provided the taxpayer has owned such timber or held such contract fight for a period of more than six months prior to the beginning of such year * * *

"If an owner of timber disposes of it under a contract by virtue of which he retains an economic interest in such timber, the amount received by such owner is to be treated in a similar manner."

7 Tax Reform Act of 1976 § 1402(a) and (b)(1)(l) (90 Stat. 1520, 1732, 1733) amending I.R.C. §§ 631 and 1222.

8 See also *Spreckels v. Commissioner* [42-1 USTC¶ 9345], 315 U.S. 626, 630 and n. 11 (1942).

8a The bar of § 263(a) is not limited to the capital expenditures it lists. *Commissioner v. Lincoln Savings & Loan Ass'n* [71-t USTC¶ 9476l, 403 U.S. 345,358 (1971); *Southland Royalty Co. v. United States* [78-2 ustc¶ 9567], 217 Ct. Cl.--, *582 F. 2d 604,* 606 (1978).

9 I.R.C. § 167(a) provides:

"(a) General rule.--There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--
(1) of property used in the trade or business, * * *"

10 For other instances in which this court has required allocation of dual-purpose expenditures between deductible expenses and others, see *Carpenter v. United States,* 168 Ct. Cl. 7, 338 F. 2d 366 (1964), and *Matthews v. United States,* 191 Ct. Cl. 674, [70-1 USTC ¶ 9346] 425 F. 2d 738 (1970) (allocation of portions of attorneys' fees to deductible tax advice)', *Knapp-King Size Corp. v. United .States* [76-1 USTC¶ 9128], 208 Ct. Cl. 533, 527 F. 2d 1392 (1975) (allocation of purchase price between deductible inventory and non-deductible goodwill).

11 *Union Bag-Camp Paper Corp. v. United States[64-1* USTC¶ 9122], 163 Ct. Cl. *525,* 546 at n. 26, 325 F. 2d 730, 742 at n. 26.

12 The Revenue Act of 1943 was enacted February 25, 1944 (58 Stat. 21).

13 The court stated in *Casey v. United States,* (198 Ct. Cl. 232,238, [72-1 ustc ¶ 9419] 459 F. 2d 495, 498 (1972):

"Lastly, taxpayer cites certain language of the Trial Commissioner in *Union Bag,* 163 Ct. Cl. at 549, 325 F. 2d at 744, to the effect that the Government's position would take away benefit previously available. The Government did not take exception to that language, so it was not argued before this court. We believe that this was dictum having no bearing on the present controversy. To whatever extent it is applicable, it should be confined to the type of management expenses involved in *Union Bag."*

14 The industry committee stated:

"(a) For many years the owner of timber, whether he sold it en bloc or whether he sold it under a cutting contract or under some similar form of contract by virtue of which he retained an economic or investment interest in such timber, has been accorded capital gain treatment as to the difference between the amount received and the adjusted depletion basis of such timber. Recently the Bureau of Internal Revenue has proposed a new treatment taking away the fight to capital gain treatment in such cases on the theory that the owner has retained an economic interest in such timber. The purpose of this paragraph is to provide by law for the continuation of the rule followed for many years * * * ." House Hearings before the Committee on Ways and Means on

Revenue Revision of 1943, 78th Cong., 1st Sess. October 14, 1943, 805; and see also 795-98.