WILSON v. COMMISSIONER
26 T.C. 474 (1956); Nonacq. 1962-2 C.B. 7.

Editor's Summary

Key Topics

DISPOSAL WITH A RETAINED ECONOMIC INTEREST
• Ownership of timber
•• Conditional vendee as owner
•• Local law determinative
• Effect of cutting arrangement being terminable by mutual consent

Facts

A partnership agreed in 1946 to purchase timber under a contract which required it to pay the seller a specified price per thousand board feet, to complete removal within six years and to pay the taxes on the timber. Title to the logs was to remain in the seller until paid for. In 1948, the partnership agreed with a controlled corporation that the latter would cut and remove the timber, paying the partnership a specified price per thousand board feet. This arrangement could be discontinued at any time by mutual consent of the parties. The corporation hired an independent logger to do the actual logging, delivered the logs to the mill, received payment for them, and paid the agreed price to the partnership. The partners reported their distributive shares of income from this operation as long-term capital gain under section 117(k)(2), or alternatively under section 117 (a). The Commissioner denied the applicability of section 117(k)(2) on the grounds that the partnership was not the owner of the timber and that its transaction with the corporation was not a disposal within the meaning of section 117(k)(2). He also denied applicability of section 117(a) on the ground that the partnership had not sold the cutting contract to the corporation.

Tax Court

Held: For the taxpayer. Under state law, controlling for purposes of determining property interest, the partnership's contract with the seller of the timber gave it equitable title. The seller retained title only as a security interest: Hence the partnership qualified as owner of the timber within the meaning of section 117(k)(2]. [NOTE: By statutory definition the holder of a contract to cut qualifies as an "owner" under section 631 (b} of the 1954 Code. Cf. *Jantzer,* p. 812.] Its arrangement with the corporation was a disposal as the partnership agreed to sell stumpage at a specified price. The fact that the arrangement could be terminated by mutual consent was not controlling the retention of an economic interest was evidenced by the fact that the partnership had to look to a severance of the timber for there turn of its investment. The Court agreed with the Commissioner that the partnership had not sold its purchase contract to the corporation, so as to qualify under section 117(a), but its holdings on the 117(k)(2) issue made this point moot.

Case Text

The respondent determined deficiencies in income tax of petitioners, for the taxable years 1948 and 1949, in the mounts of $9,482.04 and $8,925.13, respectively.

The issues framed by the pleadings are (1) Whether petitioners' distributable share of the profits realized by a partnership, of which they were members, from a transaction involving the cutting of certain timber, which transaction was with a corporation, 50 per cent of the stock of which was held by petitioners, is properly taxable as long-term capital gain and-if not, (2) whether petitioners' action m so reporting such gain, thereby eliminating from gross income 50 per cent thereof, the amount thus eliminated being in excess of 25 per cent of the gross income reported, constitutes the omission from gross income of such amount within the intendment of section 275 (c), Internal Revenue Code of 1939. A collateral issue of procedure is whether respondent's assertion in his amended answer that certain transactions resulted in ordinary income rather than Short-term capital gain, as stated in his notice of deficiency, such assertion having no effect on the amount of the deficiencies determined, serves to shift the burden of Proof to respondent.

FINDINGS OF FACT

The partial stipulation of facts filed by the parties, with exhibits attached, is adopted and, by this reference, made a part hereof.

Petitioners, L. D. Wilson (hereinafter referred to as Wilson) and Jane Wilson, are husband and wife, and at the times herein pertinent, their residence and place of business was John Day, Oregon. They filed joint income tax returns for the taxable years 1948 and 1949 with the then collector of internal :revenue for the district of Oregon. Petitioners were members of a partnership known as Valley Lumber Company (hereinafter referred to as the partnership), consisting of petitioners and Lee and Goldie Evans, husband and wife, as partners, each of such persons having a 25 per cent interest therein. Partnership returns of income, Form 1065, were filed on behalf of the partnership for the fiscal years ended October 31, 1948, and October 31, 1949, with the then collector of internal revenue for the district of Oregon.

On or about May 20, 1946, Jack and Minnie Vaughan, as parties of the first part, entered into an agreement (hereinafter called the Vaughan contract) with the partnership, as party of the second part, which agreement provides in material part as follows:

> THAT the parties of the first part do hereby agree to sell and the party of the second part does hereby agree to buy all of the live, merchantable, standing Ponderosa Pine timber growing upon any of the following described premises now owned by the parties of the first part * * *, and the party of the second part does hereby agree to pay therefore *[sic] the* sum of $4,50 per M upon the log scale for logs delivered at the mill, said logs to be scaled as they are delivered at the mill, and the party of the second part agrees to pay for all such logs as scaled on or before the 10th of each month for all logs delivered at the mill during the previous month. The parties of the first part do hereby acknowledge receipt of the sum of $2,500.00 which shall apply upon the purchase price for the last timber cut

upon the above described property, and second party is to pay an additional sum of $2,500.00 before starting to cut the timber, to be likewise applied on the purchase price for last timber cut.

* * *

AND IT IS FURTHER UNDERSTOOD AND AGREED That the parties of the first part are the true and lawful owners of the timber and have a good right to sell the same together with the right to remove the same,

AND IT IS FURTHER UNDERSTOOD AND AGREED That in cutting said timber the party of the second part will cut the same with reasonable regularity, taking all the merchantable timber clean as it goes, and will not cut the timber promiscuously, and that as said timber is cut the same will be promptly delivered to the mill in order that the same may be paid for within a reasonable time and not left in the woods to deteriorate.

* * *

AND IT IS FURTHER UNDERSTOOD AND AGREED That the party of the second part may enter upon said laud and cut and remove said timber at any time they [sic] may desire, except that it is expressly understood and agreed that the party of the second part shall completely remove and pay for said timber on or before the six years from the date hereof. And it being further understood that once the party of the second part has logged the premises its rights herein shall cease and nothing herein contained shall give it the right to relog any of said premises.

IT IS FURTHER UNDERSTOOD AND AGREED That the party of the second part will take due caution to prevent injury to any livestock that the parties of the first part may graze upon any of the above described property; and that should injury be occasioned by any thereof due to the logging operations of the party of the second part, that it will promptly reimburse the parties of the first part therefore *[sic]*.

AND IT IS FURTHER UNDERSTOOD AND AGREED That the party of the second part covenants and agrees that it is to assume all liability and responsibility of every kind or nature with respect to the laws, rules and regulations with regard to the piling of brash and the burning of slash in accordance with the laws, rules and regulations of the State Fire Marshall, the United States Forester and the United States Forest Service, and the party of the second part covenants and agrees that it will be especially careful with fire, and that should any fires be occasioned upon the property after logging operations are commercial and until fully relieved of such responsibility by any of the above named agencies, the party of the second part is to assume all liability for any fires occasioned through its operations and save the parties of the first part harmless from any claims for damages therefore *[sic]*, and to further reimburse the Parties of the first part for any damage to theft own timber so occasioned.

AND IT IS FURTHER UNDERSTOOD AND AGREED That the party of the second part will promptly pay for all materials and labor used in connection with its logging operations so as to save the parties of the first part harmless from any Liens that might attach to said timber or lands by reason of any unpaid bills or accounts,

AND IT IS FURTHER UNDERSTOOD AND AGREED That the rifle to the timber or logs shah not pass to the party of the second part until such timber and logs are fully paid for as herein provided.

AND IT IS FURTHER UNDERSTOOD AND *AGREED* That the parties of the first part will pay all taxes upon such timber until the lst day of July, 1946, but that thereafter any and all taxes due upon such timber shall be paid by the party of the second part promptly when due and before the same become delinquent.

AND IT IS FURTHER UNDERSTOOD AND AGREED That time and specific performance is hereby made the essence of this agreement and should the party of the second part well and truly complete and perform each and every one of the terms of this agreement, then this agreement shall continue in full force and effect and the party of the second part shall be entitled *[sic]* to all the benefits, rights and privileges hereunder, but should the party of the second part fail to keep and perform each and every one of the terms of this agreement or fail to make the payments herein provided at the times and in the manner herein provided, then all rights of the party of the second part in and to this agreement and the timber herein described shall absolutely cease and terminate and the parties of the first part may enter into and take possession of said premises forcibly or otherwise, ,and may keep and retain any advance payments made by the party of the second part as liquidated damages but not as a penalty for breach hereof.

* * *

AND IT IS FURTHER UNDERSTOOD AND AGREED That this agreement shall be binding upon the heirs, executors, administrators and assigns of the parties hereto.

Under the foregoing contract, the partnership was entitled and obligated on or before 6 years from the date of the Vaughan contract to cut, remove, and pay for all the merchantable timber located on the premises described therein.

During the years in question, the timber was cut and removed by a corporation called Valley Pine Co., Inc. (hereinafter called the corporation). The corporation paid the partnership a specified price per thousand board feet for the timber cut and removed by the corporation. The logging was done by Alton McBride, who was an independent logger hired and paid by the corporation to log the timber. McBride furnished the equipment, built the roads, and furnished the necessary employees to perform the logging operations. Such operations were supervised by Wilson. The corporation paid the partnership for the logs it cut at prices fixed by Wilson and Lee Evans in an amount to insure its making a profit. The prices charged depended upon the log price received by the corporation from the mills. After the Vaughan tract was logged by McBride, the logs were delivered by the corporation to the Fox Mill, the Blue Mountain Mill, and the Waterbury Mill, payment therefor being made by these mills to the corporation.

The minutes of a special meeting of the board of directors of the corporation held on April 15, 1948, read in part as follows:

WHERE AS the Valley Pine Co., Inc. is in need of timber which it can log and sell to the

Fox Valley Lumber Company as logs; and,
WHERE AS the Valley Lumber Company has offered to sell stumpage to this corporation for a price of $20.00 per thousand for Pine and $12.00 per thousand for Fir and Larch stumpage; and,
WHERE AS in the opinion of this Board said prices are fair and not in excess of the fair market value of such stumpage.
NOW THEREFORE, BE IT RESOLVED That the Valley Pine Co., Inc. accept the proposal of the Valley Lumber Company for the sate of timber and that this corporation purchase said timber on a stumpage basis as needed for a price of $20.00 per thousand for Pine and $12.00 for Fir and Larch stumpage, said price to continue so long as the corporation continues to sell logs to the Fox Valley Lumber Company or until said arrangement is discontinued by mutual consent.

The foregoing covers the timber included under the Vaughan contract. The prices of $20 per thousand for pine and $12 per thousand for fir and larch were not observed during 1949. During that year, because of adverse market conditions, the parties reduced the prices to $12.50 for pine and $7.50 for fir and larch.

The corporation was formed by petitioners, and Lee and Goldie Evans, on January :23, 1947. Each of the petitioners and the Evanses owned 25 per cent Of the stock of the corporation during the years in question. Lee Evans was vice president of the corporation throughout its existence. Evans is also one of the petitioners in a proceeding pending before this Court at Docket No. 55250, which case involves the same issues as are here presented. The corporation was formed in order to take in a third part, who could assist in the lumber operation. The organizers also desired to divide the liability between the partnership and the corporation, as well as to draw corporation salaries, thereby obtaining Social Security benefits for themselves. The corporation took over all of the administrative functions, ail of the buying, transporting, concentrating, sorting, handling, selling, and distribution of lumber. The partnership retained only the timber holdings. The corporation paid the partnership at the aforementioned rates, payment to the Vaughans therefor was made by the partnership at the rate of $4.50 per thousand feet. The difference between the amounts paid the partnership and the amounts paid to the Vaughans represents a profit to the partnership for 1948 and 1949, which profit was reported as a long-term capital gain by the partnership. The corporation was liquidated subsequent to the years in question. There still remained some timber on the Vaughan tract and the partnership disposed of same, together with other timber, under an agreement dated March 21, 1950, between the partnership and C. H. Waterbury,

Petitioners were entitled to one-half of the profits of the partnership, which included one-half of any long-term capital gain or other gain. In their individual income tax return for the calendar year 1948, petitioners reported at line 7 of Schedule D the sum of $66,191.38, being the full amount of their share of the gain or profit reported by the partnership, as long-term capital gain, for the fiscal year ended October 31, 1948. In their individual income tax return for the calendar years 1949, petitioners reported at line 7 of Schedule D the sum of $53,724.32, being the full amount of their share of the gain or profit reported by the partnership, as long-term capital gain, for the fiscal year ended October 31, 1949, plus $659.95 as long-term capital gain from another source. These

sums, as shown on line 7 of Schedule D in petitioners' 1948 and 1949 returns, included in full the petitioners' share of the total partnership gain in the amounts of $79,251.23 for the fiscal year ended October 31, 1948, and $72,123.49 for the fiscal year ended October 31, 1949, resulting from the amount paid by the corporation to the partnership for the timber cut and removed from the tracts covered by the Vaughan contract, petitioners' share of such gain being $39,625.61 for 1948 and $36,061.75 for 1949. These sums of $39,625.61 and $36,061.75 were reported in petitioners' income tax returns for 1948 and 1949, respectively, as long-term capital gain. These amounts are not in controversy, and the deficiencies determined in the notice of deficiency results from the Commissioner's determination that the sums are not properly to be reported as long-term capital gain.

The Vaughan contract was involved in a suit by Jack Vaughan and Minnie Vaughan, plaintiffs, against L. D. Wilson, Howard Southwick, and Lee Evans, d/b/a Valley Lumber Company, and Alton McBride in the Circuit Court of the State of Oregon for the County of Grant, in which action the plaintiffs sought rescission of the contract by reason of the breach thereof by defendants. Wilson testified in the proceeding that the partnership sold the logs to the corporation; that there was no assignment of the Vaughan contract thereto. The decision of the court set forth in its opinion of April 20, 1953, wherein only minor damages were awarded plaintiffs and rescission of the contract refused, was appealed by the plaintiffs. The opinion of the Supreme Court of Oregon, affirming the lower court, was entered in February 2, 1955, in *Vaughan v. Wilson,* 203 Ore. 243, 279 P. 2d 521, and reads, in part, as follows:

> Only one other matter need be mentioned. It is contended that defendants assigned the contract to a corporation called Valley Pine Inc., and that this was a breach warranting a decree of rescission. Valley Pine Inc. was organized by the defendants Wilson and Evans and the wife of Evans. They owned the stock of the corporation. The defendants entered into a contract to sell stumpage to Valley Pine Inc. at $20 a thousand for pine and $12 a thousand for fir and larch. The lands on which the timber so sold was standing were not described. Whether this transaction amounted to an assignment of this contract is highly questionable. This apart, defendants had the right to assign it. The contract provides "that this agreement shall be binding upon the heirs, executors, administrators and assigns of the parties hereto." The use of the word "assigns" constitutes an express consent to the assignment or subletting of the contract. *West v. Backus,* 97 Or 116, 120, 189 P 645. See, also, *Harlow v. Oregonian Pub. Co., 53* Or 272, 275, 500 P 7. While this rule is not inflexible and may be inapplicable in the case of a contract where a relation of personal confidence is contemplated (4 Am Jur 235, 236, Assignments § 7), there is no such relationship disclosed by the contract or the evidence in this case. It is not a contract for personal services, and the rule against assignability of such contracts has no application here.

OPINION

VAN FOSSAN, Judge: The issue here involves the proper tax treatment to be accorded petitioners' shares of the partnership profits realized from the cutting of timber by its controlled corporation. That is to say, the question is whether such shares are properly taxable as long-term

capital gains, as returned by the petitioners, as short-term capital gains, as determined by respondent, or as ordinary income as now maintained by respondent. Petitioners' position is twofold. In summary, their contention is that the partnership's transaction with the corporation, from which transaction the profits in dispute arose, comes within the scope and intendment of section 117 (k) (2) of the Internal Revenue Code of 1939, [1] as a "disposal" of timber within the meaning thereof. Alternatively, petitioners advance the theory that such transaction constituted the sale of the Vaughan contract to the corporation and that, the Vaughan contract being a capital asset in the hands of the partnership, held for more than 6 months, the profit derived from such sale represented long-term capital gain.

Respondent does not question the status of the profits in question as long-term capital gains if section 117 (k)(2), *supra,* is found to be applicable. But, respondent denies such applicability. In this connection, respondent insists that the partnership, as the holder of a contract to cut timber on land located in Oregon, pursuant to which contract it was obligated to cut, remove, and pay for such when and as cut, was not the "owner" thereof within the meaning of the cited statute. And even if this were not true, respondent continues, the partnership's transaction with its controlled corporation, wherein the latter agreed to cut the timber in dispute, paying a specified price therefor upon cutting, does not constitute a "disposal" thereof as contemplated by the statute, but, rather, resulted in the sale of logs, the profit from which represents ordinary income to the partnership. No question is raised regarding the reality of the corporation or of its transaction with the partnership. At this juncture it is to be noted also that respondent has completely abandoned his determination that such profits were short-term capital gains. Finally, respondent, pointing to the case of *Vaughan v. Wilson,* 279 P. 2d 521, which case involved the same contract as is now before us, asserts that there was, in fact, no sale or assignment Of the Vaughan contract by the partnership.

With respect to this last point, the facts herein would appear to corroborate respondent's view that no actual sale or assignment of the Vaughan contract by the partnership was ever effected. However, we disagree with respondent On both counts regarding the applicability of section 117(k) (2) to the instant situation.

Since the Vaughan contract involved property located within the State of Oregon, the terms thereof and the property rights of the parties thereto in and to the timber in dispute are governed by the laws of that State. Moreover, Under the laws of Oregon; both statutory and case law, it appears that the partnership would be deemed the conditional vendee of the timber with legal title retained in the Vaughans as conditional vendors to secure the performance of certain conditions subsequent, namely, the cutting and removal of the timber within the time specified and .payment therefor at a specified rate. 'That this was the intent of the parties is clearly manifested in the terms of the contract which are consistent throughout with the idea of such a sale. Cf. *Elliott* v. Bloyd, 40 Ore. 326, 67 Pac. 202. See, also, Brown, The Law of Personal Property (2d ed.), p. 226. This being true, the partnership is to be deemed the owner in equity, such estate being subject to being defeated by the partnership's failure to perform its contractual obligations. Cf. *Flannigan Estate v. Great Cent. Land Co.,* 45 Ore. 335, 77 Pac. 485; *Anderson v. Miami Lumber Co.,* 59 Ore. 149, 116 Pac. 1056; *Petition of Edw. Hines Lumber Co.,* 196 Ore. 420, 248 P. 2d 720; *Hink v. Bowlsby,* 199 Ore. 288, 260 P. 2d *1091; Rayburn v. Crawford* 187 Ore. 386, 21i P. 2d 483. See,

also, *S. R. A., Inc. v. Minnesota,* 327 U. S. *558; New Brunswick v. United States,* 276 U. S. 547. In substance; the partnership might be said to be in the place of a mortgagor and is to be considered the owner of the property whether such property be thought of as realty or personalty. Cf. *Harden v. City o] Springfield,* 192 Ore. 676, 236 P. 2d *432; Barr v. Lynch,* 163 Ore. 607; 97 P. 2d 185. See, also, Ore. Comp. L. Ann. sees. 110-104 through 110-109; Brown, *supra,* sec. 72, p. 246; Ore. Comp. L. Ann. sees. 71-119, 71-176, 71-201.

It follows, therefore, that the partnership qualifies as "owner" of the timber in dispute for the purposes of the statute with which We are here concerned. Such conclusion is corroborated by the definition of the term "owner" contained in section 631(b)of the 1954 Code, the counterpart of section 117(k)(2), to the effect that such term "means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber."

As for the question of whether the partnership's transaction with the corporation constitutes a "disposal" within the statutory concept, the facts herein disclose that the partnership agreed to sell stumpage to the corporation at a specified price as needed, such arrangement to continue until the happening of a designated contingency or until it was discontinued by mutual consent. The partnership's retention of an economic interest in the timber under this arrangement is evidenced by the fact that it looked to a severance of the timber for a return of its investment. That the contract was not of a permanent type and would terminate automatically upon the happening of a specified event or could be terminated at any time by consent of the parties is not controlling. Albeit the description of the property in the corporate minutes, which is the only written evidence of the contract, might be insufficient to meet the requirements of the Oregon statute of frauds, it seems' clear that in view of the Vaughan contract the timber in question would, under Oregon law, be considered personalty. Compare *Reid v, Kier,* 175 Ore. 192, 152 P. 2d 417, and *Oregon Lumber Co.,* 20 T. C. 192, with *Hink v. Bowlsby, supra.* We believe the statute is satisfied.

It is our conclusion, therefore, that the timber cuffing arrangement which the partnership had with the corporation meets the statutory requirement of a "disposal of timber (held for more than 6 months prior to such disposal) by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber." This being true, petitioners' distributable shares of the partnership's profits from such disposal are properly to be taxed as long-term capital gains. Respondent's determination to the contrary is reversed.

In view of the above holding, it becomes unnecessary to consider
the collateral issues raised.

Decision will be entered for the petitioners.

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l SEC.] 17. CAPITAL GAINS AND LOSSES.

(k) GAIN OR LOSS UPON THE CUTTING OF TIMBER.--

(2) In the case of the disposal of timber held for more than six months prior to such disposal) by the owner thereof under any form or type of contract by virtue oz which the owner retains an economic interest m such timber, the difference between the amount received for such, timber and

the adjusted depletion basis thereof shah be considered as though it were a gain or loss, as the case may be upon the sale of such timber,