

Zemurray Foundation v. United States
84-1 USTC ¶ 9246, 53 AFTR2d 84-842 (1984) (D.C. La.) on rem.

[Code Sec. 4940]

Private foundations: Excise tax on net investment income: Sale of capital asset: Property of a type which generally would produce interest, dividends, rents, or royalties. Although the U. S. Court of Appeals for the Fifth Circuit upheld the validity of a regulation which the District Court considered to be overly broad (Reg. § 53.4940(f) (1)) and stated that under this regulation property sold by a tax-exempt private foundation need only be of a type which generally produces income in one of four categories, (interest, dividends, rents, or royalties) and need not actually to have been used for the production of one of those four categories of income (as originally held by the District Court) in order for the gain resulting from the sale of such property to be subject to the net investment income excise tax, on remand the District Court, under this new test, determined that the timberland sold by the private foundation was also not the type of property that generally produced interest, dividends, rents, or royalties. Consequently, it again held that the foundation was not liable for the excise tax on net investment income (which includes both gross investment income and capital gains earned from the sale or disposition of property used for the production of (or of a type which would generally produce) interest, dividends, rents, or royalties) on the sale of the property. Also, the fact that the timberland fell within a fifth category (property of a type which generally produces capital gains through appreciation) contained in Reg. §53.4940-1(f)(1), but not in Code Sec. 4940, did not, by itself, make the property subject to the excise tax. The District Court interpreted the Fifth Circuit's opinion as upholding the validity of the fifth category only to the extent that it encompassed property properly includable in one or more of the first four categories. Back reference: ¶ 4953D.20.

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Findings of Fact and Conclusions of Law MENTZ, District Judge: This civil action for recovery of excise taxes assessed and collected by the Internal Revenue Service ("IRS") from the Zemurray Foundation ("Foundation") for calendar year 1974 is now before the Court on remand from the Fifth. Circuit Court of Appeals. At first blush, the scope of our inquiry appears to be narrow. The Court is to:

. . . make a factual determination on whether [Zemurray Foundation] timberland is the type of property which generally produces interest, dividends, rents or royalties. *Zemurray Foundation v. United States* [82-2 USTC ¶ 9609], 687 F.2d 97, 103 (5th Cir. 1982).

Initially the Court will restrict its inquiry to this limited issue.¹

In 1961, Samuel Zemurray died. His estate consisted in part of an undivided one-half interest in 12,746 acres of timberland in Tangipahoa Parish, Louisiana.² The naked ownership of the undivided one-half interest in this timberland was bequeathed to the Foundation, a tax-exempt organization established under the provisions of 26 U. S. C. 501(a); the usufruct interest went to

Zemurray's wife, Sarah. On February 16, 1974, Mrs. Zemurray donated her usufruct interest in the property to the Foundation, thereby giving the Foundation full ownership of an undivided one-half interest in the timberland. Five days later, the Foundation entered into an agreement to sell the timberland to an unrelated third party, and the sale was consummated in June, 1974. Although Mrs. Zemurray had frequently sold timber from the land between 1961 and 1974,³ the Foundation did not receive any income from the sale of timber during the period of its full ownership.

After the sale, the Commissioner of the IRS assessed a tax deficiency against the Foundation for \$112,317, plus interest and penalties. The Commissioner claimed that this sum was owed by the Foundation pursuant to the provisions of 26 U. S. C. §4940 and Treas. Reg. 53.4940-1, both of which provide for the assessment of an excise tax in the amount of four percent on the net investment income earned by a private foundation. The Foundation paid the tax and filed suit for a refund. This Court held for the taxpayer. *Zemurray Foundation*, 509 F. Supp. at 981. The Fifth Circuit reversed and remanded the case to this Court for the purpose of making the further factual findings mentioned above and discussed below. *Zemurray Foundation*, 687 F. 2d at 103.

Was the timberland the type of property which generally produces interest, dividends, rents or royalties?

Section 4940 of the Internal Revenue Code of 1954 provides for the taxation of net investment income earned by tax-exempt foundations. Net investment income includes both gross investment income (i.e., income earned from any interest, dividends, rents or royalties produced by property held by a foundation)⁴ and capital gains earned from the sale or disposition of property used for the production of interest, dividends, rents, or royalties.⁵ The Foundation did not earn interest, dividends, rents, or royalties from the timberland. Thus, the critical question at this point is whether the property sold by the Foundation is taxable as a net capital gain. In other words, the Foundation is liable for the excise tax on the capital gain if the timberland was the type of property used for the production of interest, dividends, rents, or royalties. 26 LT. S. C. § 4940.

Treas. Reg. § 53.4940(f)(1) interprets the statutory provisions of §4940(c)(4)(a) by providing that

property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which *generally produces* interest, dividends, rents, royalties, or capital gains through appreciation. (Emphasis added.)

The Fifth Circuit has upheld the validity of the language in the regulation, at least to the extent that the property need only be of a type which generally produces interest, dividends, rents, or royalties,⁶ *Zemurray*, 687 F. 2d at 99-102. Moreover, the Fifth Circuit has apparently eschewed the approach taken by other courts that have focused on whether real estate as distinguished from other kinds of property is the type of property which produces the applicable types of income.⁷ Instead, the Fifth Circuit inquiry is more limited in scope: The appropriate question is whether the particular timberland at issue was the type of property that generally produced interest, dividends, rents, or royalties.

Bound as this Court is by the mandate from the Fifth Circuit, we find that the specific timberland in question was not the type of property which generally produced rents or royalties.⁸ The government contends that the Foundation's property was susceptible of producing rents or royalties in four specific ways: (1) through the procurement of timber leases; (2) through the procurement of hunting leases; (3) through the procurement of cattle-grazing leases; and (4) through the procurement of mineral leases. While it is perhaps true that the timberland could have been leased for any of these purposes at *some* price, the evidence clearly indicates that these possible alternative uses would not have been economically viable.⁹

The parties agree that the highest and best use of the land at issue was for the production of timber. The critical question, then, is whether this land was of a type that generally produced rents or royalties through timber leases between 1969 and 1974.¹⁰ Plaintiff's expert in forestry and real estate, Mr. Louis C. Peters, stated that while long-term timber leases did exist in 1974, such leases were uncommon. In fact, Mr. Peters testified that out of approximately 1,786,000 acres of Louisiana commercial timberland east of the Mississippi River, less than three percent of this land was actually leased for timber operations in 1974. Moreover, he stated that those tracts that had been leased under a long-term agreement had all proved to be economic disasters for the landowners. As in the case of this particular timberland, most timber in the area was sold by the landowner to a purchaser pursuant to a contract of sale. The Court considers the testimony of Mr. Peters to be credible. Thus, it finds that the timberland was not the type of property that generally produced rents or royalties from timber leases during the period in question.

Likewise, the Court is of the opinion that the timberland was not the type of property that feasibly could have been leased for hunting or cattle-grazing. First, the Court notes that approximately one-half of the Zemurray tract was being used as a game preserve pursuant to an agreement with the state. Moreover, the testimony of Mr. Peters and James L. Phillips, an expert witness for the government, indicated that while the timberland was actually used for hunting and cattle-grazing, there was plenty of open territory in the area that was available for such use. Typically, landowners did not receive compensation in the early 1970's for hunting and grazing activities conducted on their land. Thus, because of the low demand during the relevant time period, the Court finds that this timberland was not the type of property that generally produced rents or royalties from grazing or hunting leases.

Finally, the Court concludes that the timberland was not the type of property that generally produced mineral royalties. The uncontroverted testimony of Mr. Peters was that there was very little mineral production or activity in Tangipahoa Parish in the early 1970's.

Can the excise tax be leveled against the Foundation because the timberland was the type of property which generally, produces "capital gains through appreciation"?

The Court has found that the timberland was not the type of property that generally produced interest, dividends, rents or royalties during the relevant period. Unfortunately, however, the inquiry cannot end here. It is now necessary to scrutinize the language in Treas. Reg. § 53-4940-1(f) (1) that seemingly extends the reach of the excise tax to a fifth category of property--namely, "property of a type which generally produces . . . capital gains through appreciation." Previously

this Court made the factual determination that the timberland was the type of property that generally produced capital gains through appreciation. *Zemurray Foundation*, 509 F. Supp. at 977. But in so holding, the Court reasoned that this fifth category of taxable property, included in the regulation but not in the statute, was invalid. *Zernurray Foundation*, 509 F. Supp. at 980-981. The Fifth Circuit rejected this reasoning and upheld the validity of the regulation. *Zemurray Foundation*, 687 F. 2d at 102. In spite of their decision, however, the Fifth Circuit remanded the case, stating:

Even if the timberland is property held for capital gains through appreciation, the district court should treat it as property used for interest, dividends, rents or royalties if the property is susceptible for use in this manner.

In view of the remand, this Court is somewhat perplexed as to what significance it should assign to this fifth category of property.¹¹ However, in *Zemurray Foundation*, the Fifth Circuit clearly meant to uphold the validity of the fifth category only to the extent that that category encompasses property properly includable in one or more of the first four categories. Of course, this strained interpretation has the effect of excluding the fifth category as an independent basis for taxation. Still, this result is dictated by the language in the Fifth Circuit opinion which states:

A narrow reading of the phrase "... if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interests, mortgages, and securities)" appears to underscore the interpretation previously made by this Court of the word "used." The regulation simply recognizes that property usable for interest, dividends, rents, or royalties may sometimes be held simply for capital gains through appreciation. Growth stocks would be a prime example, *see Friedman Foundation, supra*, and the regulation lists Several others. Interpreted in this manner, this phrase in the regulation is neither unreasonable nor inconsistent with 26 U. S. C. §4940(c)(4), and, therefore, must be presumed valid. *Portland Cement, supra*.

Zemurray Foundation, 687 F. 2d at 102. Therefore. the fact that the timberland falls within the fifth category of the regulation does not, by itself, make the property subject to the §4940 excise tax. This is so because the timberland fails to satisfy the requirements of any one of the first four categories.

Accordingly, IT IS ORDERED that judgment be entered in accordance with this opinion, in favor of plaintiff, the Zemurray Foundation, and against the defendant, the United States of America, in the amount of \$136,876.73,¹² plus statutory interest thereon from the dates of payment.

1 A detailed statement of facts is contained in the district court's original opinion. *Zemurray Foundation v. United States* [81-1 USTC ¶ 9419], 509 F. Supp. 976 (E.D. La. 1981). *rev'd* [82-2 USTC ¶ 96091, 687 F. 2d 97 (1982)]. Thus, it is necessary only to recount the most basic facts here.

2 Sarah Zemurray, the deceased's *wife*, had full ownership of the remaining one-half undivided interest in the timberland.

3 In fact, the only income produced by the land from 1960 through 1974 was from timber sales.

4 Section 4940(c)(2) provides:

"Gross investment income. For purposes of paragraph (1), the term "gross investment income" means the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties, but not Including any such income to the extent included in computing the tax imposed by section 511."

5 Section 4940(c)(4) provides:

Capital gains and losses. For purposes of Paragraph (1) in determining capital gain net income-

(A) There shall be taken into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of income included in computing the tax imposed by section 511 (except to the extent gain or loss from the sale or other disposition of such property is taken into account for purposes of such tax).

(B) The basis for determining gain in the case of property held by the private foundation on December 31, 1969, and continuously thereafter to the date of its disposition shall be deemed to be not less than the fair market value of such property on December 31, 1969.

(C) Losses from sales or other dispositions of property shall be allowed only to the extent of gains from such sales or other dispositions, and there shall be no capital loss carryovers.

6 The significance of the inclusion of a fifth category of property in the regulation, that is "property of a type which generally produces . . . capital gains through appreciation," will be discussed below.

7 The court in *Balso Foundation v. United States* [83-2 USTC ¶ 9639], F. Supp. - (D. Conn. 1983), stated:

The question is not whether this [tract of unimproved woodland] is the type of land which generally produces rents. The question . . . is whether land is the type of property which generally produces rents. The distinction is not between different types of land, but between land and other types of property.

This analysis appears to have merit and is consistent with other sections of the Internal Revenue Code. For example, 26 U. S. C. § 1031, which deals with like-kind exchanges, treats all real property as being of a like-kind. However, a review of the Fifth Circuit's opinion in *Zemurray* indicates that we are to focus on whether the particular timberland in question was the type of real property that generally produced the applicable revenues. 687 F. 2d at 102,

8 The parties have stipulated that the timberland was not the type of *o!* property which generally produced interest or dividends.

9 A basic tenet of the law of supply and demand is that any Property can be leased for a particular use at some price. However, the fact that the timberland was theoretically susceptible of producing rents or royalties does not mean that it was the type of property that generally produced these kinds of revenues. By use of the term "generally," Treas. Reg. § 53.4940-(1)(f)(1) requires that it be at least economically prudent or reasonable for a landowner to use the property in a way that will cause it to produce the types of revenue specified in the regulation. Otherwise, the property cannot be subject to the excise tax.

10 Neither § 4940(c) (4) nor Treas. Reg. § 53.4940(f)(1) specifies the time period during which the Property must be of a type generally capable of generating the applicable kinds of revenue. The Tax Court, however, has held that the provisions of § 4940(c)(4)(a) apply to property used either *by the foundation or by* the donor 'for the production of Interest, dividends, rents, or royalties. *Friedman Foundation, Inc. v. Commissioner* [CCH Dec. 35,476]. 71 T. C 40 (1978). Accordingly, this Court will consider the relevant time period to be the period during which Sarah Zemurray had a usufruct interest in the property as well as the period during which the Foundation held a full ownership Interest in the timberland.

11 Judge Gee discusses the dilemma this Court now faces in footnote 1 of his dissent in *Zemurray Foundation*. There, he incisively comments:

The-regulation upon which the majority travels also adds to the law's listing of assets used to produce "interest, dividends, rents and royalties" a fifth category "property of a type which, generally produces; capital gains through appreciation." Treas. Reg. § 53.4940-1(f) (1). Judge Gordon specifically found that the property in question was of the type added by this fifth category but held this an invalid expansion of the law's reach. The majority holds that he erred in so ruling (MS p. 9) but declines, to uphold the Imposition of tax on that basis, I confess that I do not understand this action.

If Judge Gordon erred and the added-category is valid, it seems to me that the majority should reverse, and-uphold the imposition of the tax, obviating the need for a remand. Judge Gordon's factual finding that this timberland is included in the fifth category is reviewable by us under the "clearly erroneous" standard of. Fed. R. Civ. P. 52. As the Supreme Court recently held "clearly erroneous means precisely that, see *Pullman-Standard v. Swint*. --U. S. --, 102 S. Ct. 1781, 72 L. Ed 2d 66 (1982), and the majority falls to demonstrate that the trial courts finding meets this standard.

I do not think the category valid, however, since it adds' to the list a type of property that the law plainly omits. As an example, assume the charity was given a jade figurine or an ornate silver chalice. These do not generally produce "interest, dividends, rents [or] royalties." Thus the law as enacted by Congress would not tax. their disposition. For similar reasons to those that I state, in text below, I think such an inclusion of' new and entirely different-categories- of property an inclusion that converts a limited list of type of assets to an all inclusive one that could more simply be phrased as "all capital assets"—is not regulation but rather legislation.

Zemurray Foundation, 687 F.2d at 103 n. 1.

12 This figure represents the deficiency assessment plus penalties and interest paid by Zemurray

Foundation to the IRS.