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Revenue Code as Related to Timber
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by

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The "Primarily for Sale" Provisions of Sections 1221 and 1231 of the Internal Revenue Code as Related to Timber Transactions

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I. INTRODUCTION

The sixteenth amendment to the United States Constitution, ratified on February twenty-fifth, 1913, established the constitutional basis for a federal income tax.¹ The tax was implemented four days later when the 1913 Revenue Act became law.² Since the Act's inception, standing timber has in certain circumstances been recognized as a capital asset for federal income tax purposes. For example, when a timber owner makes an outright, lump-sum sale³ of standing timber, the proceeds are accorded the same federal income tax treat-

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1. U.S. CONST. amend. XVI. The amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

2. Only after adoption of the sixteenth amendment and passage of the 1913 Revenue Act did the federal income tax assume full legal status. A federal income tax had been imposed and legally upheld during the Civil War, but a later, 1894, federal tax was declared unconstitutional on the ground that discrimination among persons in accordance with income violated the constitutional requirement that all direct taxes be uniformly distributed among the states in proportion to population. The sixteenth amendment specifically remedied the constitutional barrier. See generally J.M. BUCHANAN, *THE PUBLIC FINANCES* (1960); H.M. GROVES, *FINANCING GOVERNMENT* (1964).

3. For the purpose of this article, a *lump-sum sale* is defined as an outright disposal of standing timber for a single, fixed price not contingent upon a per volume or a per acre basis.

ment as receipts from the disposal of other capital assets. That is, profit from the sale can be claimed as capital gains rather than ordinary income if the taxpayer is an investor, or merely uses standing timber within his business, but is not in the timber selling business.⁴ Furthermore, for timber held the required length of time, the gains are long-term,⁵ and thus taxed at considerably lower effective rates than either short-term capital gains or ordinary income.⁶ If, however, the taxpayer is in the timber selling business, lump-sum sale proceeds are treated as ordinary income.⁷ The determination as to whether an owner is eligible for capital gains treatment hinges on a finding that the timber is a "capital asset" within the meaning of the Internal Revenue Code.

Prior to 1943, with regard to other than lump-sum sales, the Internal Revenue Service took the position that proceeds from contracts which provided for payment on a unit volume basis as the timber was cut and measured were ordinary income. It made no difference whether or not the seller was in the business of selling timber. The Treasury Department contended that stumpage payments made on a unit volume basis were equivalent to royalty payments received by a landowner who had leased his land for oil, gas, or other mineral development.⁸ This position created an obvious incentive for timber

4. C.W. BRIGGS & W.K. CONDRELL, *TAX TREATMENT OF TIMBER* 5 (6th ed. 1978).

5. For assets acquired before June 23, 1984, the long-term capital gain holding period is 12 months. For acquisitions between June 23, 1984 and December 31, 1987, however, the holding period was lowered to six months by the 1984 Tax Reform Act. Under present law, the holding period will revert to 12 months on January 1, 1988, for assets acquired on or after that date. I.R.C. § 1222(3) (West Supp. 1985).

6. For noncorporate taxpayers only 40% of the excess of net long-term capital gains over net short-term capital losses are included in gross income. I.R.C. § 1202(a) (1982). There is no such treatment for noncorporate net short-term capital gains. These are taxed in their entirety, as is net ordinary income. For corporate taxpayers the tax rate on net long-term capital gains is 28%. I.R.C. § 1201(a)(2) (1982). This compares with a rate of 46% for net ordinary corporate income in excess of \$100,000. I.R.C. § 11(b)(5) (1982).

7. I.R.C. §§ 1221(1), 1231(b)(1)(B) (1976). See also C.W. BRIGGS & W.K. CONDRELL, *supra* note 4, at 58.

8. The position of the IRS was stated in Bureau of Internal Revenue Field Procedure Memorandum No. 249 (Feb. 17, 1943) which reads:

Treatment of Income from Timber Cutting Contracts

owners to make lump-sum sales, or even to liquidate their holdings, in order to obtain capital gains eligibility. It was to the taxpayer's distinct monetary advantage to do so. Due to the higher rates imposed on ordinary income, the owner who tried to manage his lands properly and mark individual trees for cutting rather than make a lump-sum sale was, in effect, penalized under existing tax laws. This result was having an adverse impact on the nation's long-term timber supply, as evidenced by low levels of forest management, considerable economic instability in timber areas, and little forestry investment.⁹ United States Forest Service surveys prior to World War II continually showed that the nation's private commercial forests could generally be characterized by forest devastation.¹⁰

In response to growing complaints, Congress, through passage of the 1943 Revenue Act, added section 117(k)(2)—now section 631(b)—to the Internal Revenue Code.¹¹ This legislation extends capital gains treatment to those owners who sell under a contract whereby they retain an economic interest in the timber. The typical situation meeting this requirement is one in which the owner sells standing timber on a

1. It is the position of this office that amounts received by the owner of timber land under the terms of the usual type of timber cutting contract (whereby the owner grants to another the right to enter upon the land and to cut and remove timber over a given period for which the owner is to be paid at stated intervals on the basis of certain rates per thousand feet or other unit) should be treated as ordinary income rather than proceeds from the sale of capital assets. The landowner's capital investment in such timber is returned tax free through allowable deductions for depletion. (See G.C.M. 22730, C.B. 1941-1, 214 dealing with the status of oil and gas leasing transactions for income tax purposes.)

2. In any case involving timber cutting contracts the examining officer should obtain from the taxpayer copies of the contracts. If it is the usual type of timber cutting contract, as described in the preceding paragraph, it should be treated as a leasing agreement, and the income received by the lessor should be taxed as ordinary income subject to depletion allowance.

9. C.W. BRIGGS & W.K. CONDRELL, *supra* note 4, at 6.

10. STANFORD RESEARCH INSTITUTE, *ECONOMIC CONSIDERATIONS RELATING TO CAPITAL GAINS TAXATION OF TIMBER* 3 (1963).

11. I.R.C. § 631(b) (1976). For a detailed discussion of the legislative history of section 117(k), see Siegel, *Historical Development of Federal Income Tax Treatment of Timber*, *Proceedings of the Forest Taxation Symposium*, 1978 VA. POLYTECH. INST. & ST. U. 17 (1978), and Steen, *Capital Gains for Forest Lands: Origins of the 1944 Tax Legislation*, 22 *FOREST HISTORY* 146 (1978).

per unit volume basis with payment contingent upon the scaled (measured) volume of the cut trees. The owner retains title to the timber until it is either severed or scaled, and he bears the risk of loss until title passes.¹² Such owners are treated the same for tax purposes as those not in the timber selling business who sell their timber in a lump-sum transaction. In other words, unit volume sales of timber in which the owner retains an economic interest are now also eligible for capital gains treatment. All sellers retaining an economic interest in the timber basically qualify for inclusion under section 631(b), whether or not they are considered to be in the timber selling business.¹³

As previously mentioned, if a taxpayer makes a sale without retaining an economic interest in the timber, he is entitled to capital gains treatment only if the timber is a "capital asset" within the meaning of section 1221 of the Internal Revenue Code or is treated as a "capital asset" under section 1231.

II. SECTIONS 1221 AND 1231

Section 1221 provides a negative definition of a capital asset by specifically excluding certain categories of property. The exclusions applicable to timber are:

- (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; [and]
- (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business.¹⁴

12. C.W. BRIGGS & W.K. CONDRELL, *supra* note 4, at 42. But, other types of contracts will also suffice in some instances to retain an economic interest. For instance, a 100% cruise of trees marked for cutting is an accurate determination of the quantity of timber for the purpose of meeting section 631(b) requirements. Rev. Rul. 78-104, 1978-1 C.B. 194. In Rev. Rul. 78-104 the trees were measured as they were marked. Payment was based upon the original cruised volume minus the quantity determined from a followup cruise of uncut marked trees.

13. Treas. Reg. § 1.631-2(a)(2), T.D. 7728 (1980).

14. I.R.C. § 1221(1)-(2) (1976).

Thus, gains from the sale or exchange of certain *depreciable and nondepreciable* property used in a trade or business, as well as gains from the compulsory or involuntary conversion¹⁵ of such property, are not accorded capital asset status under section 1221. They can, however, be treated as capital gains under section 1231 to the extent that they exceed associated losses.¹⁶ Timber is specifically included in the Code as being basically eligible for such treatment.¹⁷ Like section 1221, though, section 1231 also excludes from eligibility:

- (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, [and]
- (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.¹⁸

Under both sections property held primarily for sale to customers in the ordinary course of a trade or business is not a capital asset. This means that capital gains treatment is not available in the case of an outright lump-sum sale of standing timber if the timber is being held by the taxpayer primarily for sale as part of an ongoing business. Furthermore, reading the sections together also leads to the conclusion that unless timber is disposed of under a valid section 631(b) contract, timber sales or involuntary conversions are eligible for capital gains treatment only if (1) the timber is being held for investment purposes, or (2) it is being held for *use*, not sale, in a trade or business.

15. A "compulsory or involuntary conversion" is the conversion of property into money or other property as a result of complete or partial destruction, theft, or seizure, or an exercise of the power of requisition or condemnation, or the imminence thereof. I.R.C. § 1231(a)(3)(A)(ii) (1976).

16. Associated losses include recognized losses from sales or exchanges of property used in a trade or business, losses from compulsory or involuntary conversion of such property, and losses from compulsory or involuntary conversion of capital assets which have been held for more than six months in connection with a trade, business, or transaction entered into for profit. I.R.C. § 1231(a)(3) (1976).

17. I.R.C. § 1231(b)(2) (1976).

18. I.R.C. § 1231(b)(1)(A)-(B) (1976).

III. TAXPAYER PROBLEMS CAUSED BY SECTIONS 1221 AND 1231: A FACTOR ANALYSIS

Congress clearly intended to create a management incentive for timber owners through the mechanism of section 631(b).¹⁹ Those in the business of selling standing timber—e.g., dealers—may still qualify for capital gains treatment by meeting 631(b) requirements, even though they are not eligible under sections 1221 or 1231. This is not always a straight forward or feasible approach, however. The prerequisites for qualifying under section 631(b) are much stricter and more difficult to satisfy than those for sections 1221 and 1231. Meeting the “retained economic interest” requirement of section 631(b) is not always an easy matter.²⁰ Neither the Code nor the regulations give a precise definition of the term “retained economic interest” with respect to timber contracts.²¹ No revenue rulings have directly addressed the point. Nevertheless, the Internal Revenue Service has challenged many 631(b) contracts as being defective, and considerable litigation, in which the taxpayer often loses, has arisen on this point.²²

19. In enacting § 117(k)(2)—currently § 631(b)—in 1944, Congress was fully appreciative of the impact of taxes upon forest practices and was greatly influenced by the necessity of stimulating the production of timber, a critical natural resource. See 90 CONG. REC. 1949-50, 1965 (1944) (remarks of Senator George and Senator Barkley).

20. See generally Siegel, *Avoid Any Gambles With Your Capital Gains Eligibility*, 44:2 FOREST FARMER 14 (1984).

21. Both the Code and the regulations refer only to disposal by “any form or type of contract whereby the owner retains an economic interest in the timber,” without elaborating further. I.R.C. § 631(b) (1976); Treas. Reg. § 1.631-2(a), T.D. 7728 (1980).

22. See *Ah Pah Redwood Co. v. Comm’r*, 251 F.2d 163 (9th Cir. 1957); *Jantzer v. Comm’r*, 284 F.2d 348 (9th Cir. 1960); *Lowes Lumber Co. v. Comm’r*, 19 T.C.M. (CCH) 727 (1960); *Forbes v. United States*, 75-1 U.S. Tax Cas. (CCH) ¶ 9126 (E.D. Tenn. 1974); *Ray v. Comm’r*, 32 T.C. 1244 (1959), *aff’d per curiam*, 283 F.2d 525 (5th Cir. 1960); *Springfield Plywood Corp. v. Comm’r*, 15 T.C. 697 (1950); *Boeing v. United States*, 98 F. Supp. 581 (Ct. Cl. 1950); *Indian Creek Lumber Co. v. Comm’r*, 43 T.C.M. (CCH) 841 (1982). Two recent decisions aptly illustrate the pitfalls associated with structuring a § 631(b) contract. Both indicate that such agreements must be carefully drafted to qualify for capital gains treatment. In one decision, the contract guaranteed a minimum annual payment to the timber owner over the life of the contract. In years of light cutting, the portions of some payments became advance payments, with adjustments made later. The IRS took the position that none of the guaranteed income, including those portions attributable to timber actually cut, was capital gain. The Federal District Court for the Northern District of Alabama held for the government, ruling

For a timber disposal to qualify under section 631(b), payment must be derived out of the actual severance of the timber. Proceeds in the form of land rentals, or other payments for land use not referable or attributable to the cutting of timber existing or to be grown upon the land, are not entitled to capital gain or loss treatment.²³ The contract must be written so that the total payment under it is entirely dependent upon timber that has been cut during the life of the contract, and payment must be based on a unit volume basis. An economic interest is not retained if all of the purchase price under the contract, or, in some instances, even part of the purchase price, is to be paid regardless of whether timber is cut.²⁴ Payments to the owner may be made gradually as the timber is cut or in advance of cutting²⁵ if the rules set forth in the regulations are followed to the letter.²⁶

Another consideration bearing on the use of 631(b) contracts is that many foresters advise landowners that a lump-sum timber sale will produce more income than one qualifying under section 631(b). Timber purchasers are often reluctant to negotiate other than on a lump-sum basis. Then again, landowners may be unaware of section 631(b). Accordingly,

that since the purchaser had no obligation to cut any timber at all if it chose not to do so, the advance payment provisions of the regulations did not apply to the guaranteed portion of any income received because the taxpayer did not retain an economic interest. The Eleventh Circuit Court of Appeals upheld the district court. *Plant v. United States*, 81-2 U.S. Tax Cas. (CCH) ¶ 9661, 48 A.F.T.R.2d (P-H) ¶ 81-5936 (N.D. Ala. 1981), *aff'd*, 682 F.2d 914 (11th Cir. 1982), *cert. denied*, 460 U.S. 1082 (1983). The second decision, a 1984 Tax Court case, involved essentially the same situation. The Tax Court also upheld the government's position, pointing out that for § 631(b) to apply, the purchaser must actually have an obligation under the contract to cut timber at some subsequent date. *Godbold v. Comm'r*, 82 T.C. 7 (1984).

23. *Lawton v. Comm'r*, 33 T.C. 47 (1959).

24. *Wineberg v. Comm'r*, 20 T.C.M. (CCH) 1715, 30 T.C.M. (P-H) ¶ 1874 (1961), *aff'd per curiam*, 326 F.2d 157 (9th Cir. 1963). See generally *Plant v. United States*, 81-2 U.S. Tax Cas. (CCH) ¶ 9661, 48 A.F.T.R.2d (P-H) ¶ 81-5936 (N.D. Ala. 1981), *aff'd*, 682 F.2d 914 (11th Cir. 1982), *cert. denied*, 460 U.S. ¶ 1082 (1983); *Godbold v. Comm'r*, 82 T.C. 7 (1984).

25. If payment is made to the timber owner before the timber is cut, the owner may elect to treat the date of the payment as the date of disposal of the timber in order to qualify for capital gain or loss treatment. I.R.C. § 631(b) (1976).

26. *Treas. Reg.* § 1.631-2(b) to -2(d). For an in-depth discussion of § 631(b) requirements, see C.W. BRIGGS & W.K. CONDRELL, *supra* note 4, at 42.

many timber transactions do not qualify as sales with a "retained economic interest."

Problems develop when a timber transaction is outside the scope of section 631(b). A question arises as to when the proceeds from such sales are eligible for long-term capital gains treatment under either section 1221 or 1231. The answer rests upon a determination of whether the owner is holding the timber primarily for sale to customers in the ordinary course of his trade or business; if so, an owner may not claim capital gains treatment. The regulations interpreting sections 1221 and 1231 are of little help in making this determination.²⁷ No revenue rulings have been issued on this point. Hence, a substantial amount of litigation—in both timber and non-timber situations—has developed around the meaning of the terms "capital asset" and "primarily for sale" in sections 1221 and 1231. The courts have generally looked to the basic statutory language itself as the principal source for resolving the issue.

By examining sections 1221 and 1231,²⁸ a general rule may be formulated to discern when timber sales are *not* eligible for capital gains treatment. Because both sections exclude timber from capital gains eligibility if it is being held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business, the rule may be stated in like manner. That is, *if the timber is held (owned or otherwise) by the taxpayer²⁹ primarily for sale to customers in the ordinary course of a trade or business, it does not qualify for capital gains treatment.*

27. Treas. Reg. § 1.1221-1 (1975) contains no reference to timber. Treas. Reg. § 1.1231-1 (1982) refers to timber only in terms of § 631.

28. See *supra* text accompanying notes 14, 18.

29. Neither § 1221 nor § 1231 defines "held". No mention is made as to whether the term extends beyond actual ownership. However, under § 631(b) the right to elect capital gain or loss treatment is extended both to taxpayers who are owners of standing timber as well as to those who, while not qualifying as owners, nevertheless have a "contract right to cut" standing timber. The Code reads: "For purposes of this subsection [§ 631(b)], the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract right to cut timber." I.R.C. § 631(b) (1976). In the absence of authority to the contrary, it would seem that such timber interests would also qualify under the term "held" for purposes of § 1221 and § 1231.

Various courts have elaborated further. For example, in *Suburban Realty Co. v. United States* the analysis was said to demand these inquiries: "1) was [the] taxpayer engaged in a trade or business, and, if so, what business? 2) was [the] taxpayer holding the property primarily for sale in that business? 3) were the sales contemplated by [the] taxpayer 'ordinary' in the course of that business?"³⁰ The United States Supreme Court in *Malat v. Riddell* defined "primarily" to mean "of first importance" or "principally," rather than "substantial" as urged by the Internal Revenue Service.³¹ Prior to this holding, the IRS had used the dual purpose doctrine to argue that property could be held for both investment and ordinary sales purposes, depending on what proved to be more profitable. Neither purpose had to exceed the other so long as both were "substantial." The Supreme Court disagreed by stating that the purpose of section 1221(1) "is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand . . . and 'the realization of appreciation in value accrued over a substantial period of time' on the other."³² In short, the section attempts to differentiate between ordinary sales and sales of investments.

In *Peebles v. Commissioner*³³ the Tax Court pointed out that the words "to customers" in sections 1221 and 1231 distinguish investments and property used in the trade or business from property normally held for sale. Although a view toward eventual resale is inherent in most investments, such resales are not made to customers in the ordinary course of a business.

Hence, the analysis actually boils down to a determination as to whether the sales are in the ordinary course of the taxpayer's business. If they are, of course, then the proceeds from the sales are not eligible for capital gains treatment. The court in *Suburban Realty Co. v. United States* addressed the "ordinary course" aspect of the analysis by stating: "The con-

30. 615 F.2d 171, 178 (5th Cir. 1980), *cert. denied*, 449 U.S. 920 (1980).

31. *Malat v. Riddell*, 383 U.S. 569, 572 (1966).

32. *Id.* at 572 (citations omitted) (quoting *Corn Products Co. v. Comm'r*, 350 U.S. 46, 52 (1955); *Commissioner v. Gillette Motor Co.*, 364 U.S. 130, 134 (1960)).

33. 5 T.C. 14 (1945).

cept of normalcy requires for its application a chronology and a history to determine if the sales of lots to customers were the usual or a departure from the norm."³⁴ In other words, a court must look to the past to determine if a present transaction is a normal one. Therefore, whether a sale is in the ordinary course of a business is a question of fact.

Of some aid in this determination is the Treasury Department's general definition of a business as "an activity carried on for livelihood or for profit . . . a profit must be present and some type of economic activity must be involved."³⁵ This definition, however, fails to assist in differentiating between a dealer in the ordinary business of selling timber and an investor in timber; even worse, the definition fails to distinguish dealers and investors in other enterprises. For this reason, the courts have identified a number of factors to examine in deciding whether a sale is in the ordinary course of a trade or business, and thus made by a dealer rather than an investor.³⁶ The most important of these with respect to timber transactions include:

1. The original purpose for which . . . [the taxpayer] acquired the timber, whether for sale or investment;
2. The number, continuity, and frequency of . . . [the taxpayer's] sales as opposed to isolated transactions;
3. [The taxpayer's] promotional activity with reference to the sales or of those acting under . . . [his] instructions or in . . . [his] behalf; and
4. Any other facts indicating that [the] sales or transactions were part of . . . [the taxpayer's] occupation.³⁷

The extent or substantiality of the transaction is also often listed as a key factor in differentiating between dealers and investors in timber sales.³⁸

34. 615 F.2d 171 (5th Cir. 1980), *cert. denied*, 449 U.S. 920 (1980) (quoting *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969)).

35. DEPARTMENT OF TREASURY, INTERNAL REVENUE SERVICE, PUB. NO. 334, TAX GUIDE FOR SMALL BUSINESS 3 (1981).

36. See *Dunlap v. Oldham Lumber Co.*, 178 F.2d 781 (5th Cir. 1950); *United States v. Winthrop*, 417 F.2d 905, 910 (5th Cir. 1969); *McManus v. Comm'r*, 65 T.C. 197, 211 (1975), *aff'd*, 583 F.2d 443 (9th Cir. 1978).

37. USDA FOREST SERVICE, AGRICULTURE HANDBOOK NO. 596, A GUIDE TO FEDERAL INCOME TAX FOR TIMBER OWNERS 16-17 (1982).

38. C.W. BRIGGS & W.K. CONDRELL, *supra* note 4, at 61.

Although the courts have identified these factors to help decide who is considered to be in the business of selling timber, in the final analysis, courts continue to rely upon the factual pattern of each particular case to supply the answer.³⁹ As a result, conflicting decisions have sometimes ensued. This tendency toward ad hoc determinations has contributed significantly to landowner uncertainty regarding the tax status of timber disposals. Moreover, a landowner who completes a timber transaction under a capital gains assumption but instead is subjected to ordinary income treatment may be reluctant to sell again. This situation could impact negatively on timber availability in the open market.

In view of the tax uncertainty, each proposed lump-sum timber sale must be examined closely for its probable after tax effects to determine if it really will be more advantageous than a sale with a retained economic interest. For example, suppose a landowner with a marginal noncorporate tax rate of fifty percent receives \$10,000 of taxable income from a lump-sum timber sale. If the transaction qualifies for long-term capital gains treatment, the effective tax rate is twenty percent, which results in net after tax income of \$8,000. On the other hand, if the taxpayer is deemed to be in the business of selling standing timber, his proceeds will be taxed as ordinary income, netting him only \$5,000. In that case even if, as some foresters maintain, a 631(b) sale would have grossed less income, it would have been to the taxpayer's advantage to negotiate such a sale. An erroneous determination of tax status in this particular situation would cost the taxpayer an additional \$300 per every \$1000 of pre-tax income.

The factors outlined above have been examined on numerous occasions by the courts in resolving questions of eligi-

39. The impossibility of formulating and applying a clearly defined test which would produce predictable results was noted by the Court of Appeals for the Fifth Circuit in *Biedenisarn Realty Co. v. United States*, 526 F.2d 409, 415 (5th Cir. 1976):

No one set of criteria is applicable to all economic structures. Moreover, within a collection of tests, individual factors have varying weights and magnitudes, depending on the facts of the case. The relationship among the factors and their mutual interaction is altered as each criteria increases or diminishes in strength, sometimes changing the controversy's outcome. As such, there can be no mathematical formula capable of finding the X of capital gains or ordinary income in this complicated field.

bility of timber sellers under sections 1221 and 1231. The unique factual pattern of each situation has sometimes resulted in the factors being weighed differently; however, the decisions do provide sufficient continuity to make useful generalizations. The remainder of this article examines the case law that has developed in this area and its interaction with the Code and regulations. Conclusions based on the overall analysis are set forth to assist timber owners in meeting the statutory requirements for capital gains treatment.

A. Frequency, Number, and Continuity of Sales

The frequency, number, and continuity of lump-sum timber sales are primary indicators of whether or not the activities fall within the ordinary course of a trade or business. A large number of sales, whether continuous and frequent or not, usually, but not always, point to a trade or business. In *Wineberg v. Commissioner*, 107 separate lump-sum timber transactions over a ten-year span by a taxpayer who had established a company solely to buy, sell, and exchange timber and woodland were considered sales to customers in the ordinary course of business.⁴⁰ The plaintiff not only employed a full-time staff for his sales activities, but also personally participated in sales efforts. The proceeds from his timber transactions constituted a significant portion of his income, and he had no other occupation. Although the taxpayer argued that his sales were disposals of investment property because he did not advertise his timber for sale, neither the Tax Court nor the Court of Appeals for the Ninth Circuit were convinced.⁴¹ Moreover, the Ninth Circuit held that the length of holding time, an average of some eight years, was not conclusive when coupled with the other facts of the case, although in other contexts it could be a significant factor in determining that sold property had been held for investment.⁴²

40. 326 F.2d 157 (9th Cir. 1963), *aff'g*, 20 T.C.M. (CCH) 1715, 30 T.C.M. (P-H) ¶ 1874 (1961).

41. 326 F.2d at 163. The fact that the plaintiff did not advertise was held to be of little significance because the plaintiff operated under a trade name with a regular staff of employees, and he was so well known in the industry as a seller and buyer of timber and timberlands that he did not have to advertise.

42. *Id.* at 163.

Similarly, in *Patterson v. Belcher*⁴³ ledger entries and billing indicating frequent, continuous, and substantial transactions over a six-year period easily demonstrated to the Court of Appeals for the Fifth Circuit that the sales were part of the taxpayer's normal business. The court was not persuaded by the taxpayer's argument that it should be accorded capital gains treatment because most of the sales were to a related corporation.⁴⁴

Irregular but clumped sales may also be indicative of frequency under certain conditions. In *Forbes v. United States*⁴⁵ the court disallowed capital gains treatment for the last two of four sales made in a six-year period, despite the plaintiff's irregular harvest history. The second and third sales were made only for the purpose of salvaging timber damaged by beavers and ice. Although the court recognized that with timber investments clumped sale patterns often result because of sporadic harvests, due to slow growth and natural hazards, it nevertheless ruled against the taxpayer. The court cited the professional manner in which the sales were planned and conducted, the sales in prior years, and the irregular availability of timber crops as all being indicative of an ongoing business.

A pattern of frequent and continuous lump-sum timber sales may not indicate an ongoing business, though, if the taxpayer does not promote the transactions, and the negotiations are initiated by the purchasers. In *Scott v. United States*⁴⁶ the Court of Claims allowed capital gains treatment under section 1221 even though sales of twenty-five tracts of timberland were made in fourteen separate transactions over an eight-year period. The court gave considerable weight to its finding that the owners never engaged in any advertisement or promotion of sales.⁴⁷ The court was also influenced by the fact

43. 302 F.2d 289 (5th Cir. 1962), *cert. denied*, 371 U.S. 921 (1962).

44. 302 F.2d 289. The court countered this position by stating simply that "there is nothing in the statute to provide that sales to a restricted number of customers are not to be considered as sales to customers." *Id.* at 294.

45. *Forbes v. United States*, 75-1 U.S. Tax Cas. (CCH) ¶ 9126 (E.D. Tenn. 1974).

46. 305 F.2d 460 (Ct. Cl. 1962).

47. *Id.* at 461-62. In this respect, the court stated: "Among the factors considered in reaching this conclusion are the criteria considered by this court in *McConkey v. United States*, 131 Court Claims 690, 130 F. Supp. 621 (1955). . . . The court said:

that no effort had been made to develop and improve the property, and no logging operations had ever been conducted. The court determined that the profits realized by the taxpayers were not due to any business activities on their part, but rather, resulted from the rapid rise in the price of timber.⁴⁸

Isolated, infrequent timber sales are usually held not to be business related because they establish no pattern of activity. Thus, the sale of 15,000 acres of timberland used in a sawmill's business of producing and selling timber products generated long-term capital gains under section 1231 when the company had only sold 672 acres in unsolicited sales in previous years.⁴⁹ Similarly, when timber originally purchased as an investment was sold in one lump-sum transaction to a timber operator, the Tax Court held the timber to be a capital asset in the hands of the taxpayer.⁵⁰ Although the evidence established that the timber was being held primarily for sale at some future date, there was no indication that it was being held for sale to customers in the course of any trade or business. The taxpayer had made no previous timber sales in his entire life, and the logging contractor could not be characterized as a customer. A demonstrated business purpose, however, will negate a finding that property held for resale can be an investment. Thus, woodland purchased for the sole purpose of resale constituted an asset from which sale proceeds were held by the Fifth Circuit to be ordinary income.⁵¹

'No one factor, obviously, is determinative of whether or not property is held primarily for sale to customers in the ordinary course of one's trade or business. But, among the factors regarded by the courts as important are the activities of the taxpayer, or his agents, in promoting sales'" 305 F.2d at 461 (citations omitted) (quoting *McConkey v. United States*, 130 F. Supp. 621, 622 (Ct. Cl. 1955)).

48. 305 F.2d at 462.

49. Letter Rul. 7741021 (1977).

50. *Peebles v. Comm'r*, 5 T.C. 14 (1945).

51. *Crosby v. United States*, 414 F.2d 822 (5th Cir. 1969). Here the facts revealed that the taxpayers purchased timberland for the express purpose of resale to a paper company, which resale they subsequently carried out in three separate transactions. Even though two of the taxpayers had never bought nor sold timber or timberland previously, neither the district court nor the Fifth Circuit was convinced that the property was being held for anything other than a business purpose.

B. Substantiality of Sales

Substantiality is another key indicator of whether a lump-sum timber sale is an ordinary business transaction. Measurement is usually made with reference to the seller's personal situation, and may in some cases counterbalance a pattern of little prior sale activity. Proceeds that comprise a significant portion of the taxpayer's income, particularly when he has no other occupation, point to a regular business activity. Thus, in *Wineberg v. Commissioner* lump-sum sales over a ten-year period that constituted less than eight percent of the taxpayer's timber holdings, but which totaled two and one-half million dollars, were held not to be disposals of capital assets.⁵² The taxpayer in *Wineberg* had no other occupation, and the sale proceeds constituted a significant portion of his income. Similarly, a woodland owner's timber proceeds that exceeded a total of one hundred thousand dollars from sales in each of four years were held by the Fifth Circuit to be ordinary income.⁵³ The court placed little importance on the plaintiff's lack of sales activity, the fact that he devoted only a small amount of time to his timber activities, and the fact that he was engaged in several other diverse occupations which occupied most of his time. Rather, the court placed considerable weight on its finding that when the taxpayer acquired his property he did so with full knowledge that substantial stands of timber were on the land, and he subsequently proceeded with an orderly plan to liquidate the timber. However, in another case, a twelve million dollar isolated sale of timberland used in the taxpayer's business, when there was a history of only a few previous small sales, did not nullify capital gains treatment.⁵⁴ On the other hand, if a number of lump-sum timber sales over a period of time are substantial in total amount, the Tax Court has held that it does not matter that the sales are only made to one customer.⁵⁵

52. *Wineberg v. Comm'r*, 326 F.2d 157 (9th Cir. 1963).

53. *Rutland v. Tomlinson*, 63-1 U.S. Tax Cas. (CCH) ¶ 9173, 11 A.F.T.R.2d (P-H) ¶ 500 (M.D. Fla. 1962), *aff'd per curiam*, 327 F.2d 668 (5th Cir. 1964).

54. Letter Rul. 7741021 (1977).

55. *Belcher v. Comm'r*, 24 T.C.M. (CCH) 1 (1965). *But see Snider v. Comm'r*, 34 T.C.M. (CCH) 530 (1975) (where the Tax Court ruled that the sale of a number of

In examining the substantiality factor, courts sometimes look at the reason for a large profit. For instance, a rapid rise in the price of timber purchased as a capital asset which was not due to any business activity of the owner reduced the substantiality of the lump-sum sale in the eyes of the Court of Claims.⁵⁶ But a great increase in timber prices at the onset of World War II did not influence the Court of Appeals for the Ninth Circuit in view of the large number of separate sales of timber and land by the taxpayer.⁵⁷

Exceptions have also been made by the courts when substantial lump-sum timber sale proceeds account for only a small percentage of the taxpayer's total gross income. Such situations will often negate an "ordinary course of business" finding. Thus, lump-sum timber sales totalling approximately \$120,000 in 1959 were held to be capital asset transactions when the aggregate sale receipts were only 1.3 percent of all the plaintiff's income for the year.⁵⁸

C. Interactions

Some generalizations can be made regarding the several major factors. Frequency, number, and continuity of sales are the most significant indicators of ordinary business activity. A large number of frequent and continuous lump-sum sales will almost certainly preclude capital asset status. Substantial sales are also usually indicative of ordinary business activity. Therefore, where several or all of these four factors—number, frequency, continuity, and substantiality—are present, the courts likely will rule that lump-sum sale proceeds are ordi-

timber cutting contracts over a four-year period to the same purchaser for a substantial total amount did constitute the sale of capital assets).

56. *Scott v. United States*, 305 F.2d 460 (Ct. Cl. 1962). Here the price of standing timber rose so rapidly at the end of World War II from 1946 until 1952 that it was possible to sell timberland at a substantial profit after much shorter holding periods than anticipated when the tracts were purchased.

57. *Wineberg v. Comm'r*, 326 F.2d 157 (9th Cir. 1963).

58. *Kirby Lumber Corp. v. Phinney*, 412 F.2d 598 (5th Cir. 1969). *See also* *Camp Manufacturing Co. v. Comm'r*, 3 T.C. 467 (1944) (where the lump-sum sale of nearly two million board feet of standing timber to unsolicited purchasers was held to be the sale of a capital asset. The taxpayer's previous sales had only averaged \$500 a year contrasted with its purchases of over \$1,000,000 worth of standing timber for use in its manufacturing facility).

nary income.⁵⁹ On the other hand, an isolated transaction accompanied by substantial sale income may simply indicate liquidation of an investment. And, as the substantiality of lump-sum timber sales increases, other businesses or occupations in which the taxpayer is involved become more important in supporting a capital asset determination. Finally, in the case of clumped and irregular sales, as continuity is absent and frequency difficult to determine, other factors, such as the use of professional advice in conducting the sales, may persuade a court that such transactions are in the ordinary course of business.

D. Other Factors

A number of secondary factors are also important in determining whether a lump-sum timber sale has been made to customers in the ordinary course of business. These include sales activity of the landowner or his agent, the extent of improvements made to the property, the purpose for which the property was acquired, and the purpose for which it was sold.

1. Sales Activity

Solicitation of purchasers and advertising are the most common forms of timber sale activity. Such actions by the seller may be used to support denial of capital gains treatment for lump-sum sales. Thus, active personal involvement by a landowner in promoting a sale may well indicate an ordinary

59. *But see* *Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983). In this case the Fifth Circuit, because of what the court perceived as a newly imposed, less stringent standard of review, recently upheld a district court's finding that 22 sales of realty over a three-year period for a total gain of \$3.4 million were capital gains transactions. The properties had been held for an average of only seven months. Apparently, the basis for the unreported district court decision was that factors indicative of dealer status, previously set forth by the Fifth Circuit in *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969), were absent. That is, the taxpayer did not initiate the sales; he did not advertise, have a sales office, or enlist the aid of brokers; and he did not improve or develop the properties. The absence of these factors, according to the district court, overcame the frequency and substantiality of the sales. The court of appeals strongly indicated that if it had been called upon to retry the facts, it might have come to a different conclusion than did the district court. However, the court of appeals concluded that it could not because of the guidelines for appellate review recently established by the Supreme Court in *Pullman-Standard v. Swint*, 456 U.S. 273 (1982).

business transaction.⁶⁰ Moreover, solicitation and advertising by a broker or agent, in the absence of personal involvement by the taxpayer, will not, in and of itself, shield the taxpayer from ordinary income treatment.⁶¹ Delegated authority is included under the umbrella of seller activity. Hiring a staff to seek purchasers for lump-sum sales of timber and timberland has been held to be indicative of being in the business.⁶² Likewise, timber and log sales planned and conducted by a consulting forester who acted as the landowner's agent supported an ordinary course of business finding in *Forbes v. United States*.⁶³ The forester in *Forbes* advertised the lump-sum sales and solicited purchasers. Where the taxpayer is in several businesses, time devoted to timber sales will be of little import when the taxpayer nevertheless actively promotes sales and solicits purchasers.⁶⁴

On the other hand, the absence of sales activities has sometimes been influential in a finding that timber was not held primarily for sale in the ordinary course of the taxpayer's business. In *Kirby Lumber Corp. v. Schofield*⁶⁵ a firm had a corporate policy of discouraging and avoiding land and timber sales. It maintained no sales force, and neither advertised nor solicited. The few sales which did occur were the result of external factors. Consequently, the court found that the company was not in the business of selling land and timber.⁶⁶

60. *Rutland v. Tomlinson*, 63-1 U.S. Tax Cas. (CCH) ¶ 9173, 11 A.F.T.R.2d (P-H) ¶ 500 (M.D. Fla. 1962), *aff'd per curiam*, 327 F.2d 688 (5th Cir. 1964). Here the taxpayer did not employ a broker or advertiser. However, he actively solicited purchasers through personal contact.

61. *Biendeharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir. 1976).

62. *Wineberg v. Comm'r*, 326 F.2d 157 (9th Cir. 1963).

63. *Forbes v. United States*, 75-1 U.S. Tax Cas. (CCH) ¶ 9126 (E.D. Tenn. 1974).

64. *See* *Rutland v. Tomlinson*, 63-1 U.S. Tax Cas. (CCH) ¶ 9173, 11 A.F.T.R.2d (P-H) ¶ 500 (M.D. Fla. 1962), *aff'd per curiam*, 327 F.2d 688 (5th Cir. 1964). The Federal District Court for the Middle District of Florida stated that "little importance can be attached to the fact that Plaintiff devoted a relatively small amount of time to his timber activities. The growth and sale of timber requires less time than the cultivation of annual crops [or] the production of citrus. . . ."

65. 89 F. Supp. 102 (W.D. Tex. 1950).

66. *Accord* *Kirby Lumber Corp. v. Phinney*, 412 F.2d 598 (5th Cir. 1969); *Scott v. United States*, 305 F.2d 460 (Ct. Cl. 1962); *Camp Mfg. Co. v. Comm'r*, 3 T.C. 467 (1944) (where lack of sales activity on the taxpayers' part contributed to findings that lump-sum sales of timber and timberland were disposals of capital assets).

2. Improvements

Improvements noted by the courts as bearing on the capital asset question take two forms. The first type of improvement involves changing the character of the woodland, such as developing and subdividing it into lots for individual sale. Such sales have been held to be made in the ordinary course of a business.⁶⁷

The second type of improvement is that associated with a managed tree farm and the use of sound forestry practices. Several courts have referred to such activities as being associated with a trade or business. Commitment to a new tree crop as evidenced by an extensive site improvement and reforestation program, coupled with advertising and yearly timber sales, convinced the Court of Appeals for the Fifth Circuit that the taxpayer's activities were in the ordinary course of a business.⁶⁸ Similarly, the district court in *Forbes v. United States*,⁶⁹ ruling against capital asset status, gave considerable weight to the fact that some of the timber sales in question were made for stand improvement purposes upon the recommendation of a professional forester. And, in *Scott v. United States*⁷⁰ the Court of Claims was influenced by the fact that the taxpayers had conducted no forestry improvement practices during their long ownership of the property. The court implied that a history of such activities would have indicated an ordinary business purpose, but, in their absence, a capital asset finding was more appropriate.⁷¹

There is considerable authority, though, in support of the contention that the practice of good forestry in and of itself does not necessarily indicate a trade or business. For example, a timber investor who pursues an intensive timber management program could very well be doing so for the primary purpose of maintaining and enhancing his investment. Although this argument is strengthened if there is no regular timber sale pattern, sales alone do not necessarily denote a

67. *Thrift v. Comm'r*, 15 T.C. 366 (1950).

68. *Huxford v. United States*, 441 F.2d 1371 (5th Cir. 1971).

69. *Forbes v. United States*, 75-1 U.S. Tax Cas. (CCH) ¶ 9126 (E.D. Tenn. 1974).

70. *Scott v. United States*, 305 F.2d 460 (Ct. Cl. 1962).

71. *Id.* at 462.

noninvestment purpose. To illustrate, foresters often recommend that harvests be made to thin the stand, to otherwise improve the stand, or to salvage damaged timber. These are all good forestry practices which in the long run add value to the residual stand and enhance the investment. Under such circumstances, the fact that a sale is being made is secondary in purpose.

The Tax Court faced this issue squarely in *Powe v. Commissioner*.⁷² The taxpayer had made lump-sum timber sales in thirteen of sixteen years for approximately one-half million dollars. The net receipts were reported as long-term capital gains under section 1221. The IRS contended that the sales had been made to customers in the ordinary course of business. After examining the facts of the situation, the Tax Court disagreed. The court noted that the plaintiff was an active investor not only in timber, but in other assets as well. He was a member of both the Mississippi Forestry Association and the American Tree Farm System, and had expended considerable sums over past years upon the recommendations of professional foresters to improve his woodlands. Many of the sales were shown to have been made as a matter of good forestry practice. Others were salvage sales necessitated by hurricane damage, and still others had been made in order to retire debt on other timberland. The taxpayer did not depend on the timber income for any part of his livelihood. Also, he did not maintain business cards, invoices, or stationery connected in any way with his timberland. The court determined that the sale proceeds were "the realization of appreciation in value accrued over a substantial period of time," citing *Commissioner v. Gillette Motor Co.*,⁷³ and not "the profits and losses arising from the everyday operation of a business," citing *Corn Products Co. v. Commissioner*.⁷⁴ The court concluded, "Mr. Powe is a retired businessman who takes reasonable steps to protect and improve his investments."⁷⁵

72. 44 T.C.M. (CCH) 933 (1983).

73. 364 U.S. 130, 134 (1960).

74. 350 U.S. 46, 52 (1955).

75. *Powe v. Comm'r*, 44 T.C.M. (CCH) 933, 944 (1983). In reaching its decision, the court found as a fact that all of the timber had been originally acquired as an investment. It then went on to note that such purpose "has no built-in perpetuity, nor a

The Court of Claims has also taken the position on several occasions that a timber sale may be made primarily to maintain and improve a timber investment rather than for the purpose of realizing business income.⁷⁶ A similar posture has also been reached by the Federal District Court for the Eastern District of Missouri.⁷⁷

3. Purpose of Acquisition and Sale

Both the purpose for which property is acquired and its resale purpose are important considerations in determining the tax status of sale proceeds. The original purpose at the time of purchase can create a strong inference as to the property's status at the time of sale. But, distinguishing between an investment and a business purpose may be difficult because a purchase decision often encompasses multiple objectives which overlap the business and investment characterizations. Also, the taxpayer has the burden of proof. Thus, income from the lump-sum sale of timber acquired for the announced purpose of resale for a profit was held to be taxable at ordinary rates.⁷⁸ Nevertheless, proceeds from timber sold in a lump-sum transaction after it had been purchased through a broker as an investment were accorded capital gains treatment where the taxpayer had done nothing inconsistent with an investment purpose, nor made any attempt to develop the prop-

guarantee of capital gains forevermore," citing *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409, 421 (5th Cir. 1976), and further noted that "while the purpose for which the timberland was acquired has evidentiary weight, 'the end question is the purpose of the holding at the time of the sale or sales,'" citing *Bynum v. Comm'r*, 46 T.C. 295, 299 (1966). After due consideration, the court determined that the investment purpose had not changed to a business purpose during the 30 years the woodland had been owned by the taxpayer.

76. *Union Bag-Camp Corp. v. United States*, 325 F.2d 730 (Ct. Cl. 1963); *McMullen v. United States*, 79-2 U.S. Tax Cas. (CCH) ¶ 9709 (Ct. Cl. 1979); *Wilmington Trust Co. v. United States*, 610 F.2d 703 (Ct. Cl. 1979). Although these decisions did not involve the "primarily for sale" question, they nonetheless indicate that the Court of Claims is convinced that intensive forest management practices in and of themselves do not change a timber investment into a timber business. The court in *Wilmington Trust* stated that the finding would be the same even if the facts involved a lump-sum sale under section 1221.

77. *Drey v. United States*, 61-1 U.S. Tax Cas. (CCH) ¶ 9116 (E.D. Mo. 1960).

78. *Crosby v. United States*, 414 F.2d 822 (5th Cir. 1969).

erty.⁷⁹ Timber originally acquired for use in the taxpayer's cooperage and stave mill, but subsequently sold in order to use the proceeds to purchase a closer supply of timber, was also ruled to be a capital asset.⁸⁰ Likewise, the sale of woodland after repeated unsuccessful efforts to cut the timber was held to be disposal of a capital asset.⁸¹ Testimony indicated that the purpose of acquiring the timber was to cut it, as distinguished from resale in the ordinary course of a trade or business.

The original purpose of acquisition is not always conclusive, however. The courts have recognized that the purpose may change during the life of an investment. Thus, when timber purchased for internal use in a naval stores operation was converted to a tree farm for the purpose of making stumpage sales, the Fifth Circuit held that the lump-sum sales were being made to customers in the ordinary course of the taxpayer's business.⁸² The Fifth Circuit later reiterated this position by stating that transformations in purpose ensuing from "voluntary responses to increased economic opportunity—albeit externally created—in order to enhance . . . gain" will lead to an ordinary income conclusion.⁸³

On the other hand, when property has been acquired for investment purposes, or for the purpose of using the asset within a business, such purposes usually endure if subsequent sales activity results from unanticipated, externally induced factors making impossible the original use of the property. The Fifth Circuit considers such factors to include acts of God, condemnation of property, new and unfavorable zoning regulations, an emergency need for funds, illness, old age, liquidation of a partnership resulting from a partner's death, and other events forcing alteration of the taxpayer's original plans and necessitating a sale.⁸⁴ In *Estate of Barrios v. Commis-*

79. *Scott v. United States*, 305 F.2d 460 (Ct. Cl. 1962).

80. *Reese v. Comm'r*, 13 T.C.M. (CCH) 823 (1954).

81. *Estate of Broadhead v. Comm'r*, 391 F.2d 841 (5th Cir. 1966).

82. *Huxford v. United States*, 441 F.2d 1371 (5th Cir. 1971).

83. *Biedenham Realty Co., Inc. v. United States*, 526 F.2d 409, 422 (5th Cir. 1976).

84. *Id.* at 421 & n.40.

sioner⁸⁵ farmland was rendered agriculturally unfit because of drainage problems created by the construction of an inter-coastal canal. The farmland was subsequently subdivided, improved, and gradually sold. The Fifth Circuit held that the taxpayer liquidated a capital asset. This issue was also addressed by the court in a timber sale situation in *Kirby Lumber Corp. v. Schofield*.⁸⁶ There the court ruled that lump-sum timber sales resulting from government pressure, timber trespass, and right-of-way appropriation by utility companies were not made by the taxpayer in the ordinary course of his business when that business was primarily the manufacturing and selling of wood products.

The authorities are split, however, as to the treatment of proceeds from condemnation sales of property clearly held primarily for sale to customers. The Tax Court, upheld by the Tenth Circuit, has held that such property is investment property if, after condemnation, the property can only be sold to the government or other entity exercising the power of condemnation.⁸⁷ The sales proceeds are then eligible for capital gains treatment. The Third and Sixth Circuits disagree. The Sixth Circuit in *Case v. United States* stated:

We reject the suggestion that, for federal tax purposes, mere receipt of a condemnation notice automatically transforms property held "primarily for sale" into investment property. Ordinarily the characterization of an asset as capital or "non-capital" requires an analysis of several factors The addition of a condemnation notice to this calculus merely injects one more element to be considered; it does not eliminate the calculus altogether.⁸⁸

The Third Circuit, in reversing the Tax Court, has simply stated that "a condemnation notice does not change land held primarily for sale to customers in the ordinary course of business into a capital asset."⁸⁹

85. *Estate of Barrios v. Comm'r*, 265 F.2d 517 (5th Cir. 1959).

86. *Kirby Lumber Corp. v. Schofield*, 88 F. Supp. 102 (W.D. Tex. 1950).

87. *Commissioner v. TRI-S Corp.*, 400 F.2d 862 (10th Cir. 1968).

88. *Case v. United States*, 633 F.2d 1240, 1246 (6th Cir. 1980).

89. *Juleo, Inc. v. Comm'r*, 483 F.2d 47, 49 (3d Cir. 1973), *cert. denied*, 414 U.S. 1103 (1973) (citing *Stockton Harbor Indus. Co. v. Comm'r*, 216 F.2d 638 (9th Cir. 1954)).

Another related factor sometimes addressed by the courts is the method of acquiring property, whether by inheritance, gift, or purchase, that is subsequently resold. In the final determination, however, this factor seems to bear little weight. The inquiry as to whether property is being held primarily for sale usually centers around the taxpayer's subsequent actions after passage of title, rather than how the taxpayer obtained title.⁹⁰

The question of liquidating an investment also arises in the debate surrounding the "held primarily for sale" issue. Although some would argue that there is a separate liquidation rule, the better interpretation is that "the question of liquidation of an investment is simply the opposite side of the inquiry as to whether or not one is holding property primarily for sale in the ordinary course of his business."⁹¹ The Court of Appeals for the Fifth Circuit held for the taxpayer in *Consolidated Naval Stores v. Fahs*,⁹² where Consolidated sold its timberlands after ceasing naval store operations. The evidence indicated the company liquidated its property after shifting to other enterprises, which allowed the court to conclude that the woodland had not been bought for resale, but rather, was acquired for the production of timber products. The Fifth Circuit also ruled similarly on the same issue fourteen years later.⁹³ There the court agreed that disposal of the plaintiff's hardwood timber in a large number of separate lump-sum sales constituted liquidation of a hardwood forest investment. As the hardwood cutting was followed by conversion to pine under a sustained yield management program, capital gains treatment for the hardwood sales was allowed.⁹⁴

90. See *Dunlap v. Oldham Lumber Co.*, 178 F.2d 781, 784 (5th Cir. 1950).

91. *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409, 417 (5th Cir. 1976).

92. *Consolidated Naval Stores v. Fahs*, 227 F.2d 923 (5th Cir. 1955).

93. *Kirby Lumber Corp. v. Phinney*, 412 F.2d 598 (5th Cir. 1969).

94. *But see Huxford v. United States*, 441 F.2d 1371 (5th Cir. 1971). The Fifth Circuit in this case rejected the liquidation exception argued by the taxpayer. In *Huxford* a tree farm was established after turpentine was no longer profitable. The trees subsequently sold from the tree farm were not those originally acquired for turpentine, and thus, the court ruled that they were held primarily for sale pursuant to the tree farming business.

IV. CONCLUSIONS AND RECOMMENDATIONS

If a taxpayer meets the requirements of section 631(b) of the Internal Revenue Code when disposing of standing timber, he is assured of long-term capital gain or loss treatment provided the holding period has been met. This follows whether or not he was holding the timber for sale to customers in the ordinary course of business. Any number of sales will not disqualify sellers under 631(b) cutting contracts.

However, if a taxpayer makes an outright sale of timber without retaining an economic interest as required by section 631(b), he is entitled to capital gain or loss treatment only if the timber can be shown to be a capital asset within the meaning of section 1221 or is treated as a capital asset under section 1231. Under both sections capital gain or loss treatment is not available for gains or losses on "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."⁹⁵ Nevertheless, taxpayers, for various reasons, may find it more advantageous to make outright timber sales without retaining an economic interest rather than structure them under section 631(b). In making this decision, however, a number of things need to be kept in mind. First and foremost, of course, is the risk of being compelled to pay a considerably higher income tax if the transaction is determined not to be the sale of a capital asset. The burden is on the taxpayer to overcome the presumption of correctness of such a finding by the Internal Revenue Service. Although this presumption can be met by a "preponderance of the evidence,"⁹⁶ it may involve a difficult proof problem for some taxpayers.⁹⁷ While it is true there is no one factor determinative of the issue, certain steps can be taken which may serve to increase the odds in the taxpayer's favor.

95. I.R.C. §§ 1221(1), 1231(b)(1)(B) (1976).

96. *Municipal Bond Corp. v. Comm'r*, 382 F.2d 184 (8th Cir. 1967).

97. As an indication of how close the question can be, see *Estate of Broadhead v. Comm'r*, 31 T.C.M. (CCH) 951 (1972), *rev'd on rehearing*, 32 T.C.M. (CCH) 1047 (1973). In 1972, the Court of Claims found that the timberland in question had been held "primarily for sale." In 1973, however, ruling on the taxpayer's motion to reconsider, the court reversed its decision. It gave no reason for its reversal other than stating: "After reviewing again the evidence in the record with respect to this factual issue, we think our prior conclusion was incorrect." 32 T.C.M. (CCH) 1047, 1048 (1973).

When timberland is held for investment, explicit records should be maintained which include the reason for acquisition and the reason for sale. These records should be maintained separately from the taxpayer's other business records. If the woodland is held in joint ownership form, less active co-owners should be cognizant of the nature of the activities of active co-owners with respect to transactions and management involving the property.

Taxpayers who have no other occupation should not be in the position of relying to any great extent on timber income for their support and livelihood. If other sources of income are not present, multiple timber sales should be avoided unless those after the first several are made under section 631(b). Sales should be handled by the taxpayer alone, with as little solicitation and sales activity as possible. The logging contract should give the vendee ownership of the timber at or before severance. If not, the logger might be deemed an agent of the taxpayer, and the logger's subsequent sales of the harvested timber (which may be to a number of different purchasers) could be imputed to the taxpayer.

All timber sales, to the extent possible, should be associated with good forestry practices as set forth in a timber management plan. Careful records should be maintained linking the sales with improvement and enhancement of the forest investment rather than with the mere realization of income.

Finally, it should be kept in mind that all difficulties may be safely avoided if the timber is disposed of under section 631(b).