Longview Fibre Co. v. Commissioner, 71 T. C. 357 (1978)

In computing the commission income of a DISC under the intercompany pricing rules, the cost of goods sold must include the fair market value of timber as determined under Section 631(a), not the taxpayer’s basis.

Summary

Longview Fibre Co. sought to maximize its DISC commission by using its basis in timber as the cost of goods sold instead of the fair market value as required by Section 631(a). The Tax Court held that the fair market value of timber must be used in calculating the combined taxable income for DISC commissions, ensuring that the regulations under Section 994 were applied correctly. This decision prevents double benefits from the Section 631 election and reinforces the integrity of the DISC pricing rules.

Facts

Longview Fibre Co. owned land on which it grew timber, which it cut and sold as logs through its DISC subsidiary, Longview Fibre Co. International. The company elected to treat the cutting of timber as a sale under Section 631(a), resulting in capital gain calculated using the difference between the fair market value at the beginning of the year and its adjusted basis. When computing the DISC’s commission income under Section 994(a)(2), Longview used its basis in the timber rather than its fair market value as the cost of goods sold.

Procedural History

The IRS issued a notice of deficiency, adjusting the DISC commission by using the fair market value of the timber as the cost of goods sold, resulting in a reduced commission deduction for Longview Fibre Co. The case was appealed to the United States Tax Court, which upheld the IRS’s position and confirmed the validity of the regulations.

Issue(s)

1. Whether the cost of goods sold in calculating the DISC commission under Section 994(a)(2) should be the taxpayer’s basis in the timber or the fair market value of the timber as determined under Section 631(a)?

Holding

1. No, because the regulations under Section 994(a)(2) require the use of the fair market value of the timber as the cost of goods sold, as determined under Section 631(a), to compute the DISC’s commission income.

Court’s Reasoning

The Tax Court analyzed the intercompany pricing rules under Section 994 and the specific regulations governing the calculation of combined taxable income for DISC commissions. The court emphasized that Section 1. 994-1(c)(6)(ii) of the Income Tax Regulations explicitly requires the use of the fair market value of timber as cost of goods sold when a Section 631(a) election is in effect. The court rejected Longview's argument that the fair market value was not a necessary factor in calculating the combined taxable income, asserting that it is essential for determining the income derived from export sales. The court also found that using the basis instead of the fair market value would result in an improper double benefit from the Section 631(a) election, which was not intended by the DISC provisions. The regulations were deemed valid and consistent with the statutory intent to prevent such double benefits.

Practical Implications

This decision clarifies that taxpayers must use the fair market value of timber as cost of goods sold when calculating DISC commissions under Section 994(a)(2), in accordance with Section 631(a). It underscores the importance of adhering to the specific cost allocation rules when applying the intercompany pricing rules for DISCs. Practitioners should ensure that their clients' calculations align with these requirements to avoid disallowed deductions and potential tax deficiencies. The ruling also impacts how similar cases involving the intersection of capital gains and DISC income should be analyzed, emphasizing that the tax benefits of the DISC provisions cannot be combined with other tax elections to create unintended advantages.