

SPECIAL CAPITAL GAINS TREATMENT FOR FARMERS

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The focus of this article is upon the proceeds of those common transactions of farmers involving livestock, growing crops in conjunction with sale of land, and timber which, although they do not involve capital assets, nevertheless qualify to be treated as capital asset gains and losses.

Our principal statutory reference is, therefore, INTERNAL REVENUE CODE OF 1954, SECTION 1231.¹

LIVESTOCK

A look at where we have been in this area will perhaps let us better understand where we now are.

Assume Businessman is engaged in the business of producing small stamping machines "primarily for sale to customers in the ordinary course of his trade or business." To produce them he uses several large stamping machines which convert metal into a principal component part of the small machines. At rather regular, predictable intervals of more than six months he removes the large machines from the production line because they have outlived their economic usefulness to him as large stamping machines. He purchases new large stamping machines to replace them. He sets the old ones aside, refurbishes them preparatory to sale and later sells them for the best price obtainable. No one would seriously assert that the large stamping machines were capital assets under the always negative definition of such assets. Nor would anyone seriously deny that they qualified for capital asset treatment under the original Section 117(j) (the forerunner of present Section 1231) which became

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¹ INT. REV. CODE OF 1954, §1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) GENERAL RULE.—If, during the taxable year the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversion, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection—

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that Section 1211 shall not apply; and

(2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital

a part of the Internal Revenue Code of 1939 in 1942,² even though that section was silent about stamping machines. They meet the affirmative requirements of the section as "property used in the trade or business" because they (a) are used in the business of producing small stamping machines, (b) are of a character subject to allowance for depreciation, and (c) were held for more than six months. They meet the negative requirements of the section because they (a) are not property properly includible in inventory, (b) are not held primarily for sale in the ordinary course of taxpayer's business, and (c) are not a copyright or similar property.

assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(b) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS. For purposes of this section—

(1) GENERAL RULE.—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(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,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(2) TIMBER OR COAL.—Such term includes timber and coal with respect to which section 631 applies.

(3) LIVESTOCK.—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) UNHARVESTED CROP.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

² INT. REV. CODE OF 1939, §117 (j), 56 STAT. 846 (j). GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OR EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS.

(1) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS.—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (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, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) GENERAL RULE.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade

Next, assume cash basis Farmer is engaged in the business of producing fat market-type hogs for slaughter "primarily for sale to customers in the ordinary course of his trade or business." To produce them he uses several sows to give birth to and to suckle little pigs. At rather regular predictable intervals of more than six months he removes the sows from the breeding operation because they have outlived their economic usefulness to him as sows. He sets them aside, fattens them preparatory to sale and later sells them for the best price obtainable. He purchases new sows to replace them. No one would seriously assert that the sows were capital assets, for the precise reason that the large stamping machines were not capital assets. Curiously, the Commissioner *did* deny that the sows qualified for capital asset treatment under the original Section 117(j) which, of course, was as silent about sows as it was about large stamping machines. The reasoning behind the denial seemed to be that because Farmer was in the business of producing fat market-type hogs, and because he rather regularly sold his breeding sows for slaughter he, therefore, held the sows primarily for sale to customers, at least during the interval of fattening preparatory to their sale. The reasoning overlooked facts basic to Farmer's business of producing fat market-type hogs. The fattened sow is a distinctly different commodity from the fat market-type hog and is so treated in the market place as a glance at any livestock market page quotation will readily show, just as Businessman's refurbished large stamping machine is a different commodity from the new small machines made in his business. The sale of the average farmer's sows is traditionally a salvage operation in his business as is the sale of Businessman's used machine. Both are ultimately sold but the one is held primarily for breeding and the other primarily for stamping. Like the refurbishing, the fattening preparatory to sale is incidental to the primary purpose for which held and used. The plain economics of the average farmer's hog producing business is such that no farmer would long remain solvent if he looked to the sale of the sows—separate from their progeny—for his profit. In this respect he is in the same position as Businessman with his large stamping machines.

or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

In applying the original Section 117(j) to gains and losses from the sale or exchange of livestock acquired or raised and retained for draft, breeding or dairy purposes, the Treasury by ruling issued in 1944 held that it did not apply to "animals culled from the breeding herd as feeder or slaughter animals in the regular course of business."³ In 1945 the Treasury sought to explain the phrase "culled from the breeding herd" and set out a prima facie test of whether or not a given sale was an unusual or abnormal one in taxpayer's business as, for example, a sale that effected a reduction in the normal size of the breeding herd.⁴ Conflicting interpretations were placed upon these rulings by various segments of the draft, dairy and breeding livestock industry on the one hand and the Commissioner of Internal Revenue on the other. Finally in 1949 the landmark case of *Albright v. United States*⁵ came before the United States Court of Appeals for the Eighth Circuit. In reversing, the Court held that the sale of cows removed from the dairy herd and the sale of an entire herd of breeding hogs conditioned for marketing, qualified for Section 117(j) treatment. The interpretations of the Commissioner were held to be "contrary to the plain language of Section 117(j) and to the intent of the Congress expressed in it."⁶ To the Court the proper test was not one of normal or abnormal sales. Rather, the test was whether or not the dairy cattle and breeding hogs used in taxpayer's business were held primarily for sale in the ordinary course of his business. The retirement of the breeding herd to condition it for marketing did not change the *primary* purpose for which held. Nor should that be startling. Surely Businessman can abandon the stamping use of his machine and thereafter hold it for sale, refurbished or not, without bringing upon his head the assertion that he held it primarily for sale in his business within the meaning of the statute. Of course, he holds it primarily for sale after the stamping function has been abandoned, as does Farmer the sow after he has abandoned her mother function. What other reason could they have? But to contend that any such refined meaning was intended by the section would leave precious few assets eligible.

Despite the decision, the Treasury held to its position. More litigation was produced⁷ with the decisions in the main agreeing with *Albright*.

In 1951 the Treasury, taking note of some of these decisions, issued Mimeograph 6660,⁸ revoking I.T. 3666⁹ and I.T. 3712,¹⁰ but setting

³ I.T. 3666, CUM. BULL. 270, 272 (1944).

⁴ I.T. 3712, CUM. BULL. 176 (1945).

⁵ 173 F. 2d 339, 37 A.F.T.R. 1125, 49-1 U.S.T.C. ¶9215 (8th Cir. 1949).

⁶ *Id.* at 344.

⁷ See, e.g., *Commissioner v. Fawn Lake Ranch Company*, 12 T. C. 1139, *dismissed* 180 F. 2d 749 (8th Cir. 1950); *United States v. John M. Bennett*, 186 F. 2d 407, 40 A.F.T.R. 74, 51-1 U.S.T.C. ¶9130 (5th Cir. 1951); *Miller v. United States*, 98 F. Supp. 948, 40 A.F.T.R. 1151 (D.C. Neb. 1951).

⁸ CUM. BULL. 60 (1951-2).

⁹ CUM. BULL. 270 (1944).

¹⁰ CUM. BULL. 176 (1945).

up a new test that taxpayer must establish "that the particular animals sold were actually used for dairy, draft or breeding purposes for substantially their full period of usefulness."¹¹

Congress in the Revenue Act of 1951 then stepped in to end the confusion and retroactively amended Section 117(j) making the term "property used in the trade or business" specifically inclusive of "livestock, regardless of age, held by the taxpayer for draft, breeding or dairy purposes, and held by him for 12 months or more from the date of acquisition."¹² Poultry was excluded. The extension of the holding period from six to twelve months was made applicable to taxable years beginning after December 31, 1950. Thereafter in 1952 the Treasury issued Mimeograph 6776,¹³ revoking Mimeograph 6660 but provided that such revocation did not reinstate the earlier I.T. 3666 and I.T. 3712.

Section 117(j) as thus amended became the present Section 1231 with—for our purposes here—no change.

At present, therefore, that part of a farmer's livestock, excluding poultry, will qualify for Section 1231 treatment which meets all of the following conditions:

- (1) is held by him for draft, breeding or dairy purposes
- (2) is of a character subject to depreciation
- (3) is held by him for 12 months or more from the date of acquisition
- (4) is not held primarily for sale to customers in the ordinary course of his business
- (5) is not of a kind properly includible in inventory if on hand at the close of the taxable year

As to the fourth and fifth conditions it seems clear that they were intended to prevent capital asset treatment being claimed for the products of the business—in our example, the small stamping machines and the market-type fat hogs. As to the fourth, or "not held primarily for sale" condition, it might be argued that this can be ignored because Section 1231(b)(3)¹⁴ specifically defines the livestock to be included with no reference to that condition. Such a position would seem to ignore the history of the problem in both the courts and Congress. Moreover, in *Deseret Livestock Company*,¹⁵ because the animals were found not to be held primarily for sale in the course of business, resulted in their being entitled to the preferred treatment.

Several points should be noted. First, the age of the animal is immaterial because the statute so states. Obviously the animal must be 12

¹¹ CUM. BULL. 60, 61 (1951-2).

¹² INT. REV. CODE OF 1939, §324, 65 STAT. 501.

¹³ CUM. BULL. 71 (1951-2).

¹⁴ INT. REV. CODE OF 1954, §1231(b)(3) "Livestock.—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry."

¹⁵ P-H 1953 T.C. Mem. Dec. ¶53,093.

months old to qualify. Second, there is no requirement that the animal be actually *used* for one of the listed purposes even for any part of the holding period. The statute uses the terms "held" and "purposes", not "used." For example—a farmer acquires a boar for breeding purposes. Because of sterility he never actually uses that boar for breeding during a 12 month holding period. Thereafter he sells him. The boar qualifies,¹⁶ providing only that the purpose and holding period tests are met. The date at which the animal is actually put to draft, dairy or breeding use is not important in reckoning the holding period. It is the date of *acquisition* for the required purposes which matters, as the statute states.¹⁷ For example, a farmer raises some calves and holds one of them to become a breeding cow. After she has a single calf he sells her. More than 12 months expire between birth and sale. For part of the holding period she is a possible mother, later she is a prospective mother, next a mother, then a mother suckling her young, then a retired mother held for sale and finally she is sold. Manifestly, she performed the actual mother function for less than 12 months, but the purpose and holding test are clearly met. Examples could be multiplied into draft, dairy and other breeding categories and species. But the foregoing when applied to those other categories and species will leave no doubt as to whether or not most of the average farmer's livestock qualify for Section 1231 treatment.

Draft animals, dairy cows, breeding cows, bulls, horses, boars, sows, rams, ewes, held for more than 12 months and actually used as draft, dairy or breeding animals—these all qualify today as readily as the farmer's tractor except that the tractor need be held only six months.

There remain, as in any area of the law, borderline fact situations which continue to produce difficulty. A look at a few of the cases yields a feeling of the problems encountered in applying Section 1231 to borderline cases but no magic standard by which all situations can be conclusively judged without submission to a trier of fact. In essence, these cases turn upon the question of whether or not the livestock is held for draft, breeding or dairy purposes within the meaning of the statute.

In *Deseret Livestock Company*,¹⁸ taxpayer was in the business of raising and selling cattle, sheep and wool. He maintained large breeding herds. He raised or maintained no heifers in the ordinary course of business except for breeding purposes and regarded all female calves from time of birth as members of the breeding herd. Due to drought and need for range rehabilitation after the drought, unusually large numbers of raised yearling and two year old heifers, aged 19 to 32 months, were sold during the tax years in question. The court held, under the facts, that the heifers were not held primarily for sale to customers in the

¹⁶ U. S. Treas. Reg. 118, 839.117(j)-2(c) (1953).

¹⁷ INT. REV. CODE OF 1954, §1231(3) ". . . held . . . from the date of acquisition."

¹⁸ P-H 1953 T.C. Mem. Dec. ¶53,093.

ordinary course of its business and permitted Section 1231 treatment. The court suggested without holding that livestock of any age qualify as a part of a breeding herd when acquired if "accompanied by an intent to introduce them into the breeding herd."¹⁹

In *Fox v. Commissioner*,²⁰ taxpayers were in the business of raising high grade Aberdeen Angus Cattle of a distinctive type and maintained a producing unit the offspring of which they customarily sold. They made no showing of the numbers of such offspring they chose to retain and place in the producing unit, nor was there any showing that any of the share sold were a part of the producing unit, but it was clear to the court that the number of such animals was limited. Further, the practice was to sell most of them before their breeding qualities were even tested. From this the court concluded that they were raised for the purpose of being sold and not for inclusion in the breeding herd.

In *James M. McDonald v. Commissioner*,²¹ the taxpayer owned a dairy and breeding herd of purebred cattle. The herd had been built to a high standard by 13 years of selective breeding. In practice taxpayer culled out the calves as soon as possible which did not measure up to herd standards, some being rejected at birth, others after unsatisfactory characteristics appeared in an animal's offspring. Of the calves each year, he retained only those suitable, never a fixed percentage. He purchased some animals to improve the herd. In the year in question he sold 201 animals of varying ages, some purchased, some raised. Proceeds from those held less than six months were reported as ordinary income and those more than six months as capital gain. All of the cattle involved had initially been retained with the hope that they would measure up to herd standards. Yet in taxpayer's business it was always predictable that substantial numbers of them would eventually be culled and sold. That predictability led the Tax Court to hold that the young animals were held for sale up to the point where their breeding qualities had been tested by examination of their offspring. This period of time being fixed at 24 months, the proceeds from those younger than that were held to be ordinary income. In reversing, the Second Circuit stated that the "question of purpose for which an animal is held is essentially one of fact."²² The court reasoned that while an affirmative judgment that an animal is superlative cannot be made until examination of its offspring, a negative judgment can be sooner made by one with necessary skill. The court said that until it had thus been weeded out the animal was a part of the breeding herd held for breeding purposes. The court emphasized that "motive"²³ for the retention was controlling and stated that taxpayer

¹⁹ *Id.* at 303.

²⁰ 198 F. 2d 719, 42 A.F.T.R. 544, 52-2 U.S.T.C. ¶9423 (4th Cir. 1952).

²¹ 214 F. 2d 341, 45 A.F.T.R. 1723, 54-2 U.S.T.C. ¶9488 (2d Cir. 1954).

²² *Id.* at 342.

²³ *Id.* at 343.

had made a convincing record that the retention of calves was necessary to building his champion herd.

In *Robert B. Gotfredson v. Commissioner*,²⁴ taxpayer was a dairy farmer. In maintaining and improving his herd he culled out the less desirable animals and replaced the older animals whose production had dropped with younger animals raised on the farm. He intended to retain as many as he could use. The court noted that before a heifer can become a milker she must drop a calf, that taxpayer's heifers were first bred between 15 and 18 months of age and that with a nine month gestation period they would be between 24 and 27 months of age at first calving. The Tax Court²⁵ held that cows under 36 months of age and bulls under 48 months of age could not have attained this taxpayer's minimum standard for retention and, therefore, were not held for dairy purposes, but were held for sale to customers in the ordinary course of business. In affirming, the Sixth Circuit construed "regardless of age" in the statute to mean "that the sale of cattle from the herd, *after having served in the herd*, is the sale of a capital asset even though the animal is still comparatively young, has not exhausted its usefulness and is sold at a younger age than is usually the case."²⁶ The court noted that in this case the cattle had not yet qualified to become a part of the herd by taxpayer's own standards. Here the intention at all times to sell a substantial portion of the new born animals was carried out *before* they became a part of the herd. The court also noted that by taxpayer's advertising and letterhead, selling a certain portion of the young cattle was a regular part of the business. The court conceded that many factors might cause a change of holding purpose before actual use for dairy purposes, agreed that the ultimate use was the only evidence of purpose for which held and that young animals could be held for dairy purposes without being so used.

The court noted that *McDonald* had reached a different result from *Fox* on what it saw as similar fact situations, and added that if it had the matter before it in a trial de novo, the *McDonald* reasoning would be persuasive. But treating the basic question as one of fact, it was unable to say that the facts did not support the Tax Court's finding or that such finding was clearly erroneous. The court noted that in *Fox* the age at which the young animals were sold depended on the varying preferences of the purchaser, whereas here the practice was to cull animals for sale as rapidly as they showed undesirable characteristics.

Thus, whether an animal is held for draft, breeding or dairy purposes is a question of fact. As with all such questions it is not surprising that in a close case one trier of fact might reach a different conclusion than another on similar facts.

²⁴ 217 F. 2d 673, 46 A.F.T.R. 621, 53-1 U.S.T.C. ¶9391 (6th Cir. 1954).

²⁵ P-H 1953 T.C. Mem. Dec. ¶53,289.

²⁶ *Supra*, note 24 at 676.

A court and the regulations²⁷ may cast its language in terms of "intention" or "intended", another in terms of "motive", others "purpose." This writer attaches no significance to that varying choice of words. For purposes of determining whether a given fact situation will produce a "held for draft, breeding or dairy purpose" result, they all seem to mean the same thing. The problem in a doubtful case returns always to where Congress left it and, in the nature of the thing, perhaps the only ultimate place it could be left—a question of fact.

But a few general observations can perhaps be made as tentative guides in a close case. Obviously, it is the character of holding by the taxpayer prior to disposal of the animal which is being probed, not that of the subsequent holder. When taxpayer is called upon to prove objectively the kind of holding many things become relevant even though not always singly determinative. The age of the animals in issue, the taxpayer's business practice over a period of years with respect to that type of animal, whether or not a given sale was of a usual type and for the usual reason or due to unusual reasons such as financial reverses, disability of the animal, weather, shortage of help or unusual price are some of the factors which must be considered. To make an effective showing of his facts there is no substitute for adequate records, a department in which farmers are too often lax.

The accounting aspects of the farmer's tax problems are not within the scope of this paper, being treated elsewhere. But a point or two with respect to livestock should be noted in passing. First, the farmer does not gain or lose Section 1231 treatment because of his method of accounting so long as his method is an acceptable one generally. Also, both raised and purchased livestock qualify. The Treasury recognized even before old Section 117(j) was amended in 1951 that the application of the section did not turn on whether a farmer was on the cash basis, accrual basis or whether the animals were raised, purchased or inventoried.²⁸ The fact that an animal was raised with a cost basis of zero because the costs of raising had been deducted currently still left it as being of a depreciable *character* because the farmer could have elected to capitalize the costs of raising if he chose to do so.²⁹ He was permitted to deduct the raising costs currently because of the practical difficulty in segregating the various costs.

The accrual basis farmer was required to place all livestock, raised or purchased, for sale in inventory but as to livestock acquired for draft, dairy and breeding, he was given the option of placing them in inventory as a convenience of accounting or treating them as assets subject to depreciation. The fact that taxpayer was permitted to inventory them did not make them property "properly includible in inventory" for

²⁷ U. S. Treas. Reg. 118, §39.117(j)-2(c) Example (1) (1953).

²⁸ I.T. 3666, CUM. BULL. 270 (1944).

²⁹ *Ibid.*

purposes of the statute.³⁰ The Treasury continues to recognize these principles.

However, the net tax benefit of Section 1231 for eligible livestock is normally larger to the cash basis farmer who deducts raising costs than to one on the accrual system. The cash basis raised animal has a basis of zero when sold and capital asset treatment applies to the entire sales price. But when the animal carried in inventory is transferred to capital asset schedule upon sale, its inventory basis goes with it in computation of gain or loss. Also, by recent ruling³¹ accrual basis farmers must add in the "normal costs"³² incurred during the taxable year with respect to the animal. These additional normal costs must be eliminated from expenses for such year. What the ruling says is clear enough but for the average farmer the computation of the "normal costs" can be no more than a reasonably good guess. If it was right to issue the ruling as to accrual basis farmers, then it is not clear why the "normal costs" part of the ruling should not have been made applicable to the cash basis farmers as well. What is clear is that if a similar ruling should in the future be made to apply to the cash basis, then some of the benefit of Section 1231 as to draft, dairy and breeding livestock will be a thing of the past. We should observe in passing that, analytically, there is as much reason to require the farmer to capitalize the costs of raising a Section 1231 animal as there is to require a manufacturer to capitalize the costs of a Section 1231 asset he fabricates from materials produced by him.

GROWING CROPS IN CONJUNCTION WITH SALE OF LAND

Prior to the enactment of the Revenue Act of 1951, when taxpayer sold land with an unharvested crop thereon, there was for a time uncertainty as to whether the gain attributable to the crop was ordinary income or whether the crop should be regarded as part of the land and receive capital gain treatment under old Section 117(j). The Treasury held to the view that the gain was ordinary income in which view it was ultimately confirmed by the United States Supreme Court.³³

Meanwhile, Congress in 1951 specifically provided for capital gain and loss treatment for such crops by adding old Section 117(j)(3) which became Section 1231(b)(4) of the 1954 Code³⁴ with no important change.

Thus, for taxable years beginning after December 31, 1950,³⁵

³⁰ *Ibid.*

³¹ Rev. Rule 55-188, 1955 INT. REV. BULL. No. 14 at 10, 1955 P-H ¶77,060.

³² *Ibid.*

³³ *Watson v. Commissioner*, 345 U. S. 544, 43 A.F.T.R. 621, 53-1 U.S.T.C. ¶9391 (1953).

³⁴ INT. REV. CODE OF 1954, §1231(b)(4). "UNHARVESTED CROP.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as property used in the trade or business."

³⁵ INT. REV. CODE OF 1939, §323(b)(1) 65 STAT. 501.

the proceeds of sale of unharvested crops which qualify are entitled to Section 1231 treatment. In order to qualify the following statutory conditions must be met:

- (1) The unharvested crop must be on land used in the taxpayer's trade or business.
- (2) The land must be held for more than six months.
- (3) The unharvested crop and land must be sold or exchanged at
 - (a) the same time, and
 - (b) to the same person.

Also, by regulation³⁶ the following condition must be met:

- (1) No right or option (other than one customarily incident to a mortgage or other security transaction) is retained by the taxpayer to reacquire, directly or indirectly, the land.

It should be noted that a leasehold or estate for years is not land for purposes of Section 1231 treatment. The period for which the crop is held is immaterial.³⁷

In general, few difficulties are encountered in applying Section 1231(b)(4) to a given set of facts. The requirement that the land be used in the trade or business is readily met if there is almost any kind of tillage or crop growing activity being carried on. This may be done by taxpayer in his capacity as owner, operator, landlord³⁸ or employer. It is long since elementary that for purposes of income taxation taxpayer may be simultaneously engaged in many "trades or businesses", some major, some minor. It should be noted that while there is a required holding period for the land, none is specified for the crop. If a lawyer buys an unimproved tract of land on which wild hay is then growing the hay qualifies upon sale of the land and hay to the same person at the same time providing the land was held by him for more than six months. The business of raising hay is, by hypothesis, a most minor one to the lawyer, but every test of the statute is met.

The requirement that the crop and land must be sold or exchanged at the same time and to the same person is clear enough as is the condition requiring no right or option to reacquire the land.

If the unharvested crop does not qualify he then has ordinary income to the extent of the proceeds attributable to the crop and he must allocate a part of the sales price of the crop. This allocation can best be accomplished by spelling it out in the contract of sale. However, if it is to stand up, the amount allocated had best result from arms length bargaining between the parties. There can be no rigid standard by which to judge the price agreed upon between a given buyer and seller in the very nature of the problem. Crops are of varying kinds, in varying stages of growth, subject to the vagaries of weather and insects. The Commissioner

³⁶ U. S. Treas. Reg. 118, §39.117(j)-1(d) (1953).

³⁷ Hazard v. Commissioner, 7 T.C. 372 (1946).

³⁸ U. S. Treas. Reg. 118, §39.117(j)-1(d) (1953).

has not been notably successful in sustaining his allocation when it differed from the allocation of taxpayer.³⁹

There remains the situation where the crop and land are neither sold or exchanged but are "compulsorily or involuntarily converted."⁴⁰ One can only speculate as to the effect of the phrase being in parenthesis as it is. Is it that if the conversion occurs, it need not be to the same person at the same time? The Congressional Reports give no clue. By reference to the general rule of the section, seizure, requisition and condemnation are eligible kinds of conversion but must they occur to the same person at the same time as with a sale or exchange transaction? Probably so, but it might be argued otherwise.

If the crop qualifies for 1231 treatment, then no expenses incident to production of the crop, which normally would be deductible, may be deducted. Instead, such expenses are added to the basis of the crop.⁴¹ This will require the amendment of a return filed in a prior year if the expenses were deducted in a year prior to the sale. For example, taxpayer sells land early in 1955 on which there is an unharvested crop of winter wheat planted in the fall of 1954. Seed, plowing and other expenses incurred in 1954 attributable to the wheat were deducted on the 1954 return. The 1954 return must be amended, eliminating the expenses claimed incident to the wheat and they will be added to basis of the wheat when computing gain or loss on the sale transaction in 1955.

TIMBER

Timber, with respect to which Section 631 of the 1954 Code applies, is specifically included within the definition of "property used in the trade or business" for purposes of Section 1231 treatment.⁴² Three categories of timber are thus given capital asset treatment. First, timber owned by taxpayer.⁴³ Second, timber which he has a contract right to cut.⁴⁴ These two categories qualify if the following conditions are met:

- (a) Taxpayer must cut the timber for sale or use in his business and have the right thereafter to sell or use it.
- (b) He must elect on his return for the taxable year to consider the cutting as a sale or exchange of such timber cut during the year.
- (c) He must own such timber or have held such contract right for more than six months before the beginning of the year in which cut.

Because he must cut the timber and thereafter have the right to sell or use it, it follows that timber sold outright does not qualify. If he cuts

³⁹ See, *e.g.*, *Watson v. Commissioner*, *supra* note 33; *Marian L. Blaxom*, P-H 1952 T.C. Mem. Dec. ¶52,079.

⁴⁰ INT. REV. CODE OF 1954, §1231(b)(4).

⁴¹ INT. REV. CODE OF 1954, §1016(a)(11).

⁴² INT. REV. CODE OF 1954, §1231(b)(2).

⁴³ INT. REV. CODE OF 1954, §631(a).

⁴⁴ *Ibid.*

timber in March of 1955, for example, it will not qualify unless he owned it or had the contract right to cut at least since June 30, 1954. The election is made on the return without permission of the Commissioner and without formal notice.⁴⁵ The election applies to all timber owned as well as to all timber which he has a contract right to cut.⁴⁶ The election is binding for the taxable year and all subsequent years unless, upon a showing of undue hardship, the Treasury permits revocation. Such revocation precludes any further election except with the consent of the Treasury.⁴⁷

The gain or loss recognized will be equal to the difference between the fair market value of such timber as of the first day of the taxable year in which it is cut and the adjusted basis for depletion of the timber in the hand of the taxpayer. That same fair market value thereafter is considered as the cost of the cut timber whenever cost is a necessary factor.⁴⁸

The adjusted basis for depletion is troublesome to the average farmer. As a practical matter, few if any farmers who have some timber standing on what is primarily a grain or livestock farm keep timber accounts as required nor know of timber depletion in the tax sense. But if the purchase price of the property is fairly allocated between land and timber and the timber reduced to board feet, the unit cost basis will be readily arrived at. When the cut timber is sold as timber or as products from it, the profit reported is the difference between the fair market value on the first day of the year in which cut and the price received, and is ordinary income.⁴⁹ Evergreen trees more than six years old at the time severed from the roots and sold for ornamental trees are specifically included.⁵⁰

The third category is timber held for more than six months and disposed of by the owner under a contract under which he retains an economic interest in the timber⁵¹—a “cutting contract” of standing timber, a common feature of which is royalty payments. The date of disposal is deemed to be the date cut. However, if payment is made to the owner under the contract before the date of cutting, the owner may elect to treat the date of payment as the disposal date,⁵² an election new in the 1954 Code. The term “owner” means any person owning an interest in the timber including a sublessee and a holder of a contract to cut

⁴⁵ *Ibid*; U. S. Treas. Reg. 118, §39.117(k)-1-(a)-(1) (i) (1953).

⁴⁶ INT. REV. CODE OF 1954, §631(a); U. S. Treas. Reg. 118, §39.117(k)-1-(a)-(1) (ii) (1953).

⁴⁷ *Ibid*.

⁴⁸ INT. REV. CODE OF 1954, §631(a); U. S. Treas. Reg. 118, §39.117(k)-1-(a)-(2) (1953).

⁴⁹ U. S. Treas. Reg. 118, §39.117(k)-1-(a)-(2) (v) (1953).

⁵⁰ INT. REV. CODE OF 1954, §631(a).

⁵¹ INT. REV. CODE OF 1954, §631(b).

⁵² *Ibid*.

timber.⁵³ Evergreens, described above, also qualify for this category.⁵⁴ The difference between its adjusted depletion basis and the amount realized from its disposal is considered as though it were gain or loss on the sale of the timber.⁵⁵ Here again, adjusted depletion basis can be arrived at simply by allocating the cost of timber and land.

Note that standing timber on land held for *investment* does not qualify for Section 1231 treatment because Section 631 has no application to it. The proceeds of its sale are capital gains and losses because the timber is a capital asset. If instead of standing, the timber is dead and down, it is, of course, also a capital asset.⁵⁶

COMPUTING NET SECTION 1231 GAINS AND LOSSES

Except for Partnership Form 1065, the tax forms contain no special schedule for Section 1231 gains and losses. It is only when recognized Section 1231 *gains* exceed recognized Section 1231 *losses* that such gains and losses are treated as long term capital gains and losses.⁵⁷ If there is a net Section 1231 loss, they are treated as ordinary gains and losses and not subject to the \$1000.00 limitation for capital losses. The initial computation should therefore segregate Section 1231 transactions from capital asset transactions. In making the computation, gains and losses are taken into account 100%.

If a net gain results they are shown as long term capital gains and losses. If a net loss results they are shown as ordinary gains and losses and the full benefit of the loss can be had.

⁵³ *Ibid.*

⁵⁴ *Ibid.*

⁵⁵ *Ibid.*; U. S. Treas. Reg. 118, §39.117(k)-(1)-(b) (1953).

⁵⁶ John W. Blodgett, 13 B.T.A. 1388 (1928).

⁵⁷ INT. REV. CODE OF 1954, §1231(a).