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Kentucky Law Journal

Volume 44 | Issue 4 Article 2

1956

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Recommended Citation

Roberts, W. Lewis (1956) "Taxation of Gains from Sale of Livestock, Unharvested Crops, Timber, Coal & In-Oil Payments," *Kentucky Law Journal*: Vol. 44 : Iss. 4 , Article 2.
Available at: https://uknowledge.uky.edu/klj/vol44/iss4/2

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Taxation of Gains from Sale of Livestock, Unharvested Crops, Timber, Coal & In- Oil Payments

By W. LEWIS ROBERTS*

SECTION 1231 (B) OF the Internal Revenue Code of 1954 defines and singles out for capital gain treatment property used in a trade or business as property "of a character which is subject to the allowance for depreciation provided in Section 167, held for more than 6 months," and specifically considers the gains or losses from the sale of livestock, timber or coal and unharvested crops. Section 1231 (b) corresponds to Section 117 (j) of the Revenue Act of 1939, as amended in 1942, and, for the most part, is the same as the earlier Act.

Livestock

The decisions under these sections that have been decided in the federal courts are both interesting and worthy of careful consideration. This is especially true of those dealing with livestock. The taxpayer in each case is interested that any gain from the sale of his livestock be given capital gain treatment, which results in a lower tax than the tax on ordinary income. The decision in most of those cases has turned upon the particular facts of the case. In the case of *Albright* v. *United States*[1] the Court laid down certain tests to determine whether the taxpayer comes within Section 117 (j). It said the burden was on the taxpayer to show that the animals sold (1) were used in his trade or business; (2) were subject to allowance of depreciation; (3) were held for

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[1] 173 F. 2d 339 (8th Cir. 1949), reversing D.C. 76 F. Supp. 532 (D.C. 1948).

more than six months; (4) were not property includable in taxpayer's inventory of the taxable years and (5) were not held principally for sale to customers in the ordinary course of the taxpayer's trade or business.

Where the taxpayer kept two accounts, cows and bulls were classified under one as cattle kept for breeding purposes. Steers and heifers, until two years old, were classified in the ordinary cattle account. When heifers became two years old, they were transferred to the breeding cattle herd. Proceeds from the breeding herd were reported as long-term capital gain. The Tax Court followed the holding of the *Albright* case and rendered judgment for the taxpayer.[2]

Farmers who sold certain stock from their dairy and breeding herd were allowed capital gain under Section 117 (j). The sales did not result in reducing the size of their herd.[3] A taxpayer who operated a cattle ranch in Kansas purchased cattle each fall, fed them for several months and sold them for beef. Some of the cows bred in Texas were held over for the spring calves and were then conditioned and sold to the beef market. They were sold to customers in the regular course of the petitioner's business, the Court held, and were subject to ordinary income treatment.[4]

In *Fox* v. *Commissioner,*[5] part of the cattle sold by the taxpayer in the years 1944 to 1946 were classed as a part of a breeding herd and subject to capital gains rates, and it was claimed that the rest of the cattle were sold in the course of his ordinary trade and business and taxable as ordinary income. The Commissioner claimed all were taxable at ordinary income rates. The problem was whether part of a herd used for breeding purposes was taxable at capital gain rates under Section 117 (j). It was argued that upon registration cattle automatically became part of a breeding herd. On the other hand, they said, at most these heifers were merely potential members of that herd. The Court said that mere registration did not establish the calves as part of the breeding herd, nor did the fact that an animal is bred establish it as part of the breeding herd. The Court concluded that heifers,

[2] Fawn Lake Ranch Company v. Commissioner, 12 T. C. 1139 (June, 1949).
[3] Emerson v. Commissioner, 12 T. C. 875, May, 1949; Flato v. Commissioner, 14 T.C. 1241 (June, 1950).
[4] Kline v. Commissioner, 15 T. C. 998 (Dec., 1950).
[5] 16 T. C. 854 (1951).

registered and sold before they dropped a calf should not be regarded as part of the breeding herd and that heifers that dropped a calf while still owned by the petitioners should be included in the breeding herd, and that bulls thirty-four months old should also be classed as part of the breeding herd.

In *Laflin* v. *United States*,[6] the Court found that part of the animals sold were not held for breeding purposes, the plaintiff having failed to sustain the burden of proof imposed upon him by the applicable statutes. It quoted from the Treasury Department bulletin of June 17, 1951:

> Gains derived from the sale of breeding animals which were used for the production of only one offspring or litter will not be subject to the capital gains treatment prescribed by Section 117 (j) of the Code.

Judge Hutcheson of the Fifth Circuit held that profits received from the sale of culls from breeding herds on ranches of taxpayers were entitled to capital gains treatment. He cited with approval the *Albright*,[7] *Emerson*,[8] and *Fawn Lake Ranch Co.*[9] cases as supporting his holding.[10] The same result was reached in *Mitchell* v. *United States*[11] and *Miller* v. *United States*.[12]

That the statute is not confined to the sale of cattle is brought out in the Court's opinion rendered in the case of *Davis* v. *United States*.[13] The District Court there held that breeding sows constituted capital assets within the meaning of Internal Revenue Code. The taxpayer in that case sold sows after their pigs had run with them two months after birth. The taxpayer was held entitled to capital gain treatment under sec. 117(j) (now sec. 1231). The same result was reached in *Retz* v. *Birmingham*,[14] *United States* v. *Pfister*,[15] and *McDonald* v. *Commissioner*.[16] In the last of these cases, the Court pointed out that the taxpayer had made a convincing record that his retention of calves was a necessary factor

[6] 100 F. 2d 353 (1951).
[7] *Supra* note 1.
[8] *Supra* note 3.
[9] *Supra* note 2.
[10] United States v. Bennett, 186 F. 2d 407 (8th Cir., 1951).
[11] 96 F. Supp. 473 (1951).
[12] 98 F. Supp. 948 (1951).
[13] 96 F. Supp. 785 (1951).
[14] 98 F. Supp. 322 (1951).
[15] 205 F. 2d 538 (8th Cir., 1953).
[16] 214 F. 2d 341 (2d Cir., 1954).

in building his champion herd. He had culled those calves as rapidly as it was possible to determine those that did not measure up to the high standard of his herd of Guernseys.

On the other hand, where the culls were sold before they became a part of the taxpayer's dairy herd, the returns from their sale as beef cattle were not given capital gains treatment but were held ordinary income in the case of *Gotfredson* v. *Commissioner*.[17]

The Internal Revenue Code of 1954, Section 1231 (b) (3) follows the 1939 Code, Section 117 (j). Livestock must be held for twelve months or more from the date of acquisition to come within the capital gains provision. The term "livestock" included fur-bearing animals and other mammals as well as the usual farm animals, but does not include poultry, fish and the like.[18]

Since the adoption of the 1954 Code, several cases have reached the Tax Court concerning the treatment of amounts received from the sale of horses. In *Estate of C. A. Smith*[19] capital gain was allowed on animals from a breeding herd that were displayed at exhibitions and sold. Where a taxpayer sold bulls less than eleven months old and heifers less than twenty-four months old, the Court said that an animal's age was only one factor in determining whether it was a capital asset.[20]

Two recent decisions dealing with the sales of show and trotting horses are *Collins' Estate*[21] and *Robert B. Jewell*.[22] In the first the taxpayer was engaged in the business of breeding, training and selling show horses. In 1947 he sold four mares that he had frequently shown. The Court allowed capital gains treatment since the mares had been held for breeding purposes. In the latter case trotting horses were sold. The owner changed from selling his colts as weanlings to holding them until they were yearlings. Eleven horses were sold as yearlings in the taxable year. None had been used for breeding purposes or racing. The taxpayer had only a partial interest in three of them. The Court ruled that three were held primarily for breeding purposes and

[17] 217 F. 2d 673 (2d Cir., 1954).
[18] Crabtree, T. C. M., 1955–275.
[19] 23 T. C.–No. 91 (1955).
[20] Biltmore Company, 129 F. Supp. 366 (4th Cir., 1955).
[21] — F. Supp. — (D.C., Ky., 1955).
[22] 25 T. C. —, No. 18 (1955).

were property used in the taxpayer's trade or business within Section 117 (j) (1) of the 1939 Code. It was not shown that others were so held at the time they were sold.

Unharvested Crops

Under Section 1231 (b) (4) of the 1954 Code unharvested crops on land used in a taxpayer's trade or business, held for more than six months, with the crops and land being sold at the same time and to the same person, are given a capital grains status in the seller's income tax return.

The Kansas courts have treated growing crops as part of the realty to which they are attached, thus making the proceeds from their sale subject to capital gains treatment. Acting under federal act, Section 117 (j) (1,3), the Federal Court treated the gains from the sale of a wheat crop in Kansas as part of the realty which was sold to the same buyer and refused to allocate the gain from the sale of the immature wheat crop from the gain received from the land.[23]

A similar rule prevails in Florida, namely, that crops of fruit growing on trees, whether mature or immature, are in general treated as part of the realty until severed. It was a capital gain under the Internal Revenue Code as it stood in 1944.[24] Where the immature crop alone is mortgaged, the Florida court regards it as personalty.[25] A case arose in California where the taxpayer had held an undivided interest in an orange grove and sold her interest in 1944, including the unmatured crop on the trees. It was carried to the United States Supreme Court. It was held under Section 117 (j), in effect in 1944, that she must treat the profits attributable to the unmatured crop as ordinary income and not as a capital gain. The statute was later amended, permitting sales of unharvested crops to be treated as capital gains after December 31, 1951.[26] Two lower Federal Courts have recently held that gains realized from unharvested crops sold with the land were to be treated as ordinary income. The causes of action in these cases arose prior to the 1951 amendment.[27]

[23] McCoy v. Commissioner, 192 F. 2d 486 (10th Cir., 1951).
[24] Owen v. Commissioner, 192 F. 2d 1006 (5th Cir., 1951).
[25] Gentile Brothers v. Bryan, 101 Fla. 233, 133 So. 630 (1931).
[26] Watson v. Commissioner, 345 U.S. 544, 73 S. Ct. 848 (1953).
[27] Miller v. Earle, — F. Supp. — (D.C. Ore., 1955) and Edwards v. Commissioner, 20 T. C. 615, aff'd 217 F. 2d 952, cert. denied 75 S. Ct. 581 (1955).

Timber, Coal and Mineral Interests

The 1945 Code also provides for including gains from the sale or exchange of timber and coal as capital gains in a taxpayer's income tax returns. Section 1231 (b) (2) and Section 631 specifically so provide. The results under the 1954 Code are practically the same as those under the old Code. As the Congressional Committee pointed out in its report on Section 631 (b), "the term 'timber' includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes."

Sales or transfers of oil, gas and other minerals in place have generally received capital gains treatment. Take the case of the sale of an interest in the production of an oil well. The owner may transfer the right to produce, taking in exchange a certain percentage of the oil produced, an oil payment as it is termed. Such transfers are very common and may cover a large part of the production in the principal oil-producing states. These oil payments are held to be real property in Texas[28] and also in California.[29] The Texas court holds that the assignment of oil payments is not an anticipatory assign of income and is not governed by the doctrine of *Lucas* v. *Earl*,[30] but a transfer of property as shown by a Tax Court decision.[31]

Several very recent decisions in the United States Tax Court have concerned the sale or transfer of these oil-payments rights. In *William Fleming*[32] the petitioners exchanged oil payments for land. The Court said the property was of unlike kind within the meaning of Section 112 (b) (1) of the 1939 Code and the gain was taxable as capital gain. The Court cited *Midfield Oil Co.*[33] for the proposition that an oil payment, limited in amount, is different within the meaning of Section 112 (b) (1) from an overriding royalty which continues as long as production lasts. Individual royalty payments have been held ordinary income.[34] In

[28] Tennant v. Dunn, 130 Tex. 285, 110 S.W. 2d 53 (1937).
[29] La Laguna Ranch Co. v. Dodge, 18 Cal. 2d 132, 114 P. 2d 351 (1941).
[30] 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731 (1930).
[31] Lester A. Nordon, 22 T. C. 1132, No. 137 (1954).
[32] 24 T. C. –, No. 93, C. C. H. Dec. 21,166 (July 29, 1955).
[33] 39 B. T. A. 1154 (Dec. 10, 1927).
[34] Burnet v. Hormel, 287 U. S. 103, 3 U. S. T. C. 1990 (1932); Pettit v. Commissioner, 118 F. 2d 816 (5th Cir., 1941).

Commissioner v. *Crichton*,[35] which was relied upon by the petitioners in the *Fleming* case, it was held that an exchange of an undivided interest in oil, gas and other minerals for an undivided fee in a parcel of improved realty was within the meaning of Section 112 (b) (1). In holding that there was a capital gain, the Court relied upon the decisions in *John David Hawn*,[36] *Lester A. Nordon*,[37] and *Caldwell* v. *Campbell, Jr.*[38] In the *Hawn* case the petitioners transferred their "right, title and interest in and to said oil payments," which had a face value of $1,000,000 but were valued at the time of the assessment at $854,993.25. The transferee was to receive all payments from the interest until he received $120,000, when the transfer was to terminate and the right was to revert to the transferor. In 1949 the petitioner received from the transferee the sum of $20,809.19. This was taxable as a capital gain and not as ordinary income. The G. C. M.[39] in force at the time provided that "where an assignment of an in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises." The Court took the view that the taxpayer had made more than an assignment of the income under the in-oil payment obligation to the church. He had transferred the property itself which produced the income.

The *Nordon* case was a transfer on an undivided interest in minerals in place until production should equal a stated amount. It was held that the transfer to the church was a gift and its fair market value at the time of the transfer was a contribution under Section 23 (o) of the 1939 Code, although payments from production were not available until the next year. The Commissioner contended the taxpayer had donated only a right to share future income. The taxpayer had retained only a reversionary interest.

In *A. J. Slagter, Jr.*,[40] the Tax Court was confronted with the problem of a family partnership, which owned interests in forty-five oil and gas leases and sold in-oil payments to the Ashland Oil & Refining Company, payable out of sixty interests for varying

[35] 122 F. 2d 181 (1941).
[36] 23 T. C. 516, C. C. H. Dec. 20, 725 (Dec. 23, 1954).
[37] 22 T. C. 1132 (1954).
[38] 218 F. 2d 567 (1953).
[39] I. T. 4003, C. B. 1950-1.10.
[40] 24 T. C. –, No. 104, C. C. H. Dec. 21, 201 (August 25, 1955).

periods in excess of six months prior to the date of the assignment. It was decided that the petitioners were entitled to treat the receipts from the transaction as capital gains under Section 117 (j) of the 1939 Code. The Ashland Company ordinarily purchased crude oil for refining purposes and the Commissioner contended this transaction should be held a sale by the partnership to a regular customer. The partnership was engaged in developing and operating oil properties. The Court said this was an oil payment assignment and not an agreement to sell oil if produced. It was the sale of a capital asset.

As already suggested, these "in-payment" transactions are not confined to the oil and gas business. In *W. F. Weed*[41] there was a transfer of sulphur payments carved out of the transferor's pooled royalty interests in sulphur produced from deposits in place. He had owned these royalty rights for several years. It was held that the proceeds from this transfer were taxable as long-term capital gains on the installment basis and not as ordinary "income."

The case of *William L. Albritton*[42] held that amounts received under a mineral lease involving the sale of sand and gravel on the petitioner's property were ordinary income. The Court said that it should regard "the realities" here, rather than the "formalities," and that "the use of the word 'royalty' could not change the true nature of this cash consideration. . . ." In these cases of sand and gravel, the Court worked out the theory that depletion compensated is a capital gain recovery.

Conclusion

In considering whether proceeds received from the sale or exchange of certain "property used in the owner's trade or business" are to be regarded as capital gains or ordinary income, we have found that in the case of livestock the animals sold must have been held for more than twelve months for draft, breeding or dairy purposes as set out in Section 1231 of the 1954 Code in order to receive capital gain treatment and that the burden is on the taxpayer to show that the animals sold come within the provisions of the Act.

[41] 24 T. C. –, No. 116, C. C. H. Dec. 21, 235 (1955).

[42] 24 T. C. –, No. 99 (August 16, 1955). See also Arthur S. Baker v. Commissioner, 24 T. C. –, No. 132 (Sept. 30, 1955) and Crowell Land & Mineral Corp., 25 T. C. –, No. 31 (Oct. 31, 1955), where the same result was reached.

We have found that the courts have given capital gain treatment to the amounts received for unharvested crops sold at the same time the land is sold, and both crops and land are purchased by the same buyer. No deduction is allowed, however, for cost of production, as is stated in Section 268 of the 1954 Code.

Gains from cutting timber or from sales of coal may come within the capital gains provisions of Section 1231. The provisions under the 1954 Code are practically the same as those under the older Code. In computing the cost basis, the cost of the land is not included—the fair market price of the land is excluded. A fair part of the original purchase price is allocated to the standing timber on the land at the time of purchase.

Where the owner of oil land grants away the right to drill for oil in consideration that he shall be given in return a percentage of the oil obtained, this in-oil payment becomes a valuable property interest that can be sold or used as security for loans. In-oil payment rights, it has been pointed out, are distinguished from royalty interests and operating costs into which the property interest in oil and gas in place is commonly divided, "whereas, an in-oil payment right is a right to income for a limited time or amount." In Texas these transactions in in-oil payments run into the millions of dollars and the determination of whether the increase in their value is to be treated as capital gain or ordinary income becomes very important. Today it is pretty well settled that it is a transfer of a capital asset and not an anticipatory assignment of income, and any gain from the sale is taxable as a capital gain under Section 117 (j) of the 1939 Act, which Sections 1231 and 1232 of the 1954 embody for the most part.

Payments in sulphur, where rights in sulphur deposits have been transferred, have been treated by the courts in the same way as in-oil payments and capital gains treatment applied. A different result, however, has generally been reached in the case of mineral leases involving the sale of the right to take sand and gravel from the lessor's property. It has been held in most cases that the lessor's gain is taxable as ordinary income, subject to allowance for depletion.

In all these cases the courts scrutinize the facts carefully in determining whether there is a sale of a capital asset or whether the transaction is part of the taxpayer's ordinary business.

KENTUCKY LAW JOURNAL

Vol. XLIV | Summer, 1956 | Number 4

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The *Kentucky Law Journal* is published in Fall, Winter, Spring and Summer by the College of Law, University of Kentucky, Lexington, Kentucky. It is entered as second-class matter October 12, 1927, at the post office, at Lexington, Kentucky, under the act of March 3, 1879.

Communications of either an editorial or a business nature should be addressed to *Kentucky Law Journal*, University of Kentucky, Lexington, Kentucky.

The purpose of the *Kentucky Law Journal* is to publish contributions of interest and value to the legal profession, but the views expressed in such contributions do not necessarily represent those of the *Journal*.

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