Florida Law Review

Volume 5 | Issue 3 Article 4

September 1952

Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop

William R. Frazier

Follow this and additional works at: https://scholarship.law.ufl.edu/flr

Part of the Law Commons

Recommended Citation
William R. Frazier, *Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop*, 5 Fla. L. Rev. 306 (1952).
Available at: https://scholarship.law.ufl.edu/flr/vol5/iss3/4

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Law Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact kaleita@law.ufl.edu.

Frazier: Income Tax Aspects of the Sale of a Citrus Grove and Unharvested

HEINONLINE

DATE DOWNLOADED: Thu Sep 8 11:50:28 2022
SOURCE: Content Downloaded from HeinOnline

Citations:

Bluebook 21st ed.
William R. Frazier, Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop, 5 U. FLA. L. REV. 306 (1952).

ALWD 7th ed.
William R. Frazier, Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop, 5 U. Fla. L. Rev. 306 (1952).

APA 7th ed.
Frazier, W. R. (1952). Income tax aspects of the sale of citrus grove and unharvested crop. University of Florida Law Review, 5(3), 306-325.

Chicago 17th ed.
William R. Frazier, "Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop," University of Florida Law Review 5, no. 3 (Fall 1952): 306-325

McGill Guide 9th ed.
William R. Frazier, "Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop" (1952) 5:3 U Fla L Rev 306.

AGLC 4th ed.
William R. Frazier, 'Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop' (1952) 5(3) University of Florida Law Review 306

MLA 9th ed.
Frazier, William R. "Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop." University of Florida Law Review, vol. 5, no. 3, Fall 1952, pp. 306-325. HeinOnline.

OSCOLA 4th ed.
William R. Frazier, 'Income Tax Aspects of the Sale of a Citrus Grove and Unharvested Crop' (1952) 5 U Fla L Rev 306

Provided by:
University of Florida / Lawton Chiles Legal Information Center

-- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at https://heinonline.org/HOL/License
-- The search text of this PDF is generated from uncorrected OCR text.
-- To obtain permission to use this article beyond the scope of your license, please use: Copyright Information

INCOME TAX ASPECTS OF THE SALE OF A CITRUS GROVE AND UNHARVESTED CROP

WILLIAM R. FRAZIER

Of particular importance to the Florida citrus industry is the problem of proper tax treatment of gain realized from the sale of a citrus grove at a time when an unharvested crop is on the trees. The precise problem is whether the part of the gain properly allocable to the unharvested crop may receive the preferred treatment as a capital gain[1] accorded by Section 117 (j) of the Internal Revenue Code[2] or whether it is taxable as ordinary income.

In 1946 the Bureau of Internal Revenue ruled that part of any gain realized in a transaction involving the sale of land with an unharvested crop must be allocated to the crop and treated as ordinary income.[3] The Tax Court has agreed with this ruling in four decisions,[4] but two federal district courts in refund proceedings have disagreed with the Bureau's position.[5] Moreover, opinion among the federal circuits is not uniform. The Courts of Appeals for the Fifth[6] and Tenth[7] Circuits, acting upon taxpayer's appeals, reversed two of the four decisions rendered by the Tax Court. The Court of Appeals for the Ninth Circuit, however, affirmed another of the decisions of the Tax Court.[8] The result is, of course, that a con-

---

[1]Although not technically correct, the term "capital gain" is used in this article to mean long-term capital gain unless otherwise indicated.

[2]INT. REV. CODE §117 (a) (1) excludes from the definition of capital assets both depreciable property and real property used in trade or business. Sec. 117 (j), enacted as §151 of the Revenue Act of 1942, applicable to taxable years beginning after Dec. 31, 1941, provides that net gains realized on the sale, exchange, or involuntary conversion of property subject to an allowance for depreciation and real property used in trade or business and held for more than six months shall be considered as capital gains. The rule is not invariable but depends on the net result of all Section 117 (j) transactions during the taxable year.

[3]I.T. 3815, 1946-2 CUM. BULL. 30.

[4]Estate of Harry L. Miller, P-H 1951 TC MEM. DEC. ¶51,064 (1951); Louise Owen, P-H 1950 TC MEM. DEC. ¶50,300 (1950); Thomas J. McCoy, 15 T.C. 828 (1950); Ernest A. Watson, 15 T.C. 800 (1950).

[5]Cole v. Smyth, 96 F. Supp. 745 (N.D. Cal. 1951); Irrgang v. Fahs, 94 F. Supp. 206 (S.D. Fla. 1950).

[6]Owen v. Commissioner, 192 F.2d 1006 (5th Cir. 1951).

[7]McCoy v. Commissioner, 192 F.2d 486 (10th Cir. 1951).

[8]Watson v. Commissioner, 197 F.2d 56 (9th Cir. 1952).

Frazier: Income Tax Aspects of the Sale of a Citrus Grove and Unharvested

flict on the point currently exists between the Fifth and Tenth Circuits on the one hand and the Ninth Circuit on the other. This conflict may eventually be resolved by the Supreme Court.

A recent amendment to Section 117 (j), applicable to taxable years beginning after December 31, 1950, in effect codifies the result reached by the Fifth and Tenth Circuits.[9] It specifically provides that an unharvested crop sold as a part of land used in trade or business and held for more than six months is to be considered property used in a trade or business and therefore subject to capital gain treatment.[10] If a loss is suffered in a single transaction, the entire loss is treated as an ordinary loss.

The purpose of this article is to analyze the various decisions that gave rise to the present conflict and to discuss the recent legislation on the subject and its application to the taxable years for which it is effective.

Law Prior to Revenue Act of 1951

The following discussion is confined to taxable years beginning prior to January 1, 1951. This limitation is necessitated by reason of the changes made by the enactment of Section 323 of the Revenue Act of 1951.[11] The provisions of the amendment will be developed in detail hereinafter.

Position of the Bureau of Internal Revenue

The controversy between the Bureau and the various taxpayers concerned began shortly after the Bureau published its ruling designated I.T. 3815.[12] This ruling provides in effect that in instances in which citrus groves are sold with fruit on the trees for a lump sum consideration a portion of the selling price must be allocated to the fruit and the balance to the land, trees, and other assets involved. Gain from the sale properly allocable to fruit on the trees would constitute ordinary income; gain from the sale of land and trees would

[9]Revenue Act of 1951, §323, 65 Stat. 497, 26 U.S.C.A. §117 (j) (1) (Supp. 1951).

[10]Throughout this article reference is made to the sale of a citrus grove and unharvested crop. The problems discussed, however, are equally applicable to the sale of any other type of farm property and growing crop.

[11]See note 9 *supra.*

[12]1946-1 Cum. Bull. 30.

Published by UF Law Scholarship Repository, 1952

be treated as capital gain under Section 117 (j),[13] assuming that the recognized gains from all such transactions coming within the purview of the section exceed the recognized losses thereunder.

The transactions covered by the ruling generally involve sales of land and trees bearing unharvested fruit for a lump sum consideration without prorating any part of the sales price to the various assets involved. Occasionally, however, the parties themselves agree to an apportionment of the sales price. Such an agreement, if reasonable, is binding in the event a controversy arises over the correct allocation. In the absence of an agreement by the parties the fair market value of the crop at the date of sale must be allocated as set forth in I. T. 3815.[14]

Position of the Tax Court

As might be expected, it was not long after the publication of I. T. 3815 that litigation testing the validity of the ruling was presented to the Tax Court. The first of several such cases was *Ernest A. Wat-*

[13]The relevant part of INT. REV. CODE §117 (j), prior to its amendment in 1951, provided that

"(1) . . . 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 (l), 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 . . . 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 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."

[14]Although not specifically mentioned in I.T. 3815, the ruling is implicitly grounded on the doctrine of Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945), in which Judge Learned Hand held that the sale of a going business for a lump sum is not to be considered the sale of a single asset, but instead must be comminuted into its fragments. Consequently, the total consideration must be broken down among the various assets involved in order to determine the proper tax treatment to be accorded the buyer and seller.

son.[15] The petition of the taxpayer was filed with the Tax Court on June 1, 1948, and the opinion of the court was promulgated December 7, 1950. The essential facts of the *Watson* case are typical of those found in this type of litigation. The taxpayer and two members of her family each owned a one-third undivided interest in a 115-acre tract of land, of which 110 acres were in oranges and 5 acres in peaches. On August 10, 1944, the taxpayer and her co-owners entered into a contract for the sale of this property, together with improvements, water rights, and the equipment thereon, for a lump sum consideration of $197,000. They had owned the property in question since December 31, 1941. The property was delivered on September 1, 1944, pursuant to the agreement of August 10, 1944, which treated the sale in its entirety as a sale of real property and made no allocation of the sales price. At the time of the sale the orange trees had a crop of immature fruit, which would not be ready for market for a minimum of three months. In determining the deficiency the Commissioner held that of the total selling price of $197,000 the sum of $122,500 was attributable to the fruit on the trees, and taxed one third of that amount, or $40,833.33,[16] to the taxpayer as ordinary income.

A majority of the Tax Court upheld in principle the Commissioner's determination. The taxpayer made two basic contentions. First, she argued that Section 117 (j) applied, for the reason that, if any part of the gain from the sale of the property as a whole was properly attributable to the oranges on the trees at the time of sale, it was nevertheless gain realized from the sale of real estate used in the business of owning and operating the orange grove property.[17] To support this contention the taxpayer further argued that the nature and character of the property rights in her case were governed by state law and that, under the law of California and the general law of most states, fruit growing on the trees at the time of sale of a grove constitutes a part of the realty.[18] The majority of the Tax Court re-

[15]15 T.C. 800 (1950).

[16]In this type of case the taxpayer will have invariably reported his entire profit on the sale as capital gain. In general, therefore, the deficiency determined by the Commissioner under I.T. 3815 will equal the tax on the gain attributable to the fruit treated as ordinary income, reduced by the amount of the tax that arose from treating such gain as capital gain.

[17]Ernest A. Watson, 15 T.C. 800, 807 (1950).

[18]The Supreme Court of Florida several years ago held that growing crops are a part of the realty and pass with a conveyance of the land unless expressly

jected the property theory and held that ". . . it is the purpose for which the property is acquired or held or the use to which it is put that supplies the answer."[19]

There is little to criticize in the majority's holding respecting this contention. The mere fact that under state law growing crops may be regarded as an integral part of realty, or the fact that sale of land plus growing crops is considered a sale of real property, appears insufficient in itself to justify capital gain treatment. The ultimate test of taxability under Section 117 (j) should, it is submitted, turn on whether the unharvested crop at the time of sale constitutes property held primarily for sale to customers in the ordinary course of business.

The second contention made by the taxpayer in the *Watson* case was that the oranges in this instance were not held primarily for sale to customers in the course of her trade or business, because she was not in the business of producing and selling green oranges.[20] The majority of the court rejected this contention also, apparently on the theory that the taxpayer's ultimate purpose in producing the crop in the first instance was to sell the fruit; the crop, whether mature or immature at the date of sale, constituted property held primarily for sale.

The dissenting opinion of Judge Black [21] took issue with the majority holding on the second contention. The position of the dissent was, in substance, that, although it is immaterial whether growing crops are considered realty or personalty, the fruit did not constitute property held *primarily* for sale in the ordinary course of business while in a state of immaturity.

Another issue raised in the *Watson* case is worthy of comment. The Commissioner, in determining the deficiency asserted, did not make any apportionment of the selling expenses between the fruit on the trees and the other assets sold. This had the result of increasing the effective tax attributable to the profit on the fruit. The majority of the Tax Court, however, in accordance with the Commissioner's concession on brief, held that the selling expenses should be allocated between the crop and other assets in the proportion that the

---

reserved by the seller, Adams v. Adams, 158 Fla. 173, 28 So.2d 254 (1946). For a discussion of this question and an extensive citation of authorities see 15 Am. Jur. 200; 25 C.J.S. 7.

[19] 15 T.C. 800, 812 (1950).

[20] *Id.* at 814.

[21] *Id.* at 816.

selling price allocable to each bore to the total selling price. Such an allocation of selling expense is a factor to consider should the whole question of the proper method of taxing pre-1951 sales of land and growing crops be ultimately decided against the taxpayer by the Supreme Court. If the conflict is resolved in favor of the taxpayer, then all selling expenses will be charged as an offset against the price realized on the sale of the property.[22]

The Tax Court, on the authority of its decision in the *Watson* case, upheld similar determinations of the Commissioner in the cases of *Thomas J. McCoy*,[23] *Louise Owen*,[24] and *Estate of Harry L. Miller*.[25] The only material factual distinction between these subsequent decisions and the *Watson* case is that the *McCoy* case involved the sale of a Kansas wheat farm and immature crop for a lump sum; and the *Owen* case was concerned with the sale of two Florida citrus groves and fruit, a substantial part of which was fully mature and ready for market at the time of sale.

Position of Fifth and Tenth Circuits

The taxpayer in the *Owen* case appealed to the Court of Appeals for the Firth Circuit. In reversing the Tax Court Judge Strum reasoned:[26]

> "Petitioner's ordinary business was selling citrus fruit as personalty, altogether severed from the realty. She was not in the business of selling groves . . . . While the fruit on petitioner's groves was intended to be eventually sold, it was not primarily held for sale until it became personal property by actual or constructive severance from the trees. While, as here, it was still in process of being grown, it was held only for a potential future sale. This unpicked fruit could not be included by petitioner in her inventory if on hand at the close of a taxable year. For all the reasons above stated it was not, at the time of these sales, property held *primarily* for sale in the *ordinary* course of her business. We repeat, there was no sale of the fruit as personalty severed from the freehold. The severance made

[22]Spreckels v. Commissioner, 315 U.S. 626 (1942).

[23]15 T.C. 828 (1950).

[24]P-H 1950 TC Mem. Dec. ¶50,300 (1950).

[25]P-H 1951 TC Mem. Dec. ¶51,064 (1951).

[26]Owen v. Commissioner, 192 F.2d 1006, 1009 (5th Cir. 1951).

by the Commissioner for tax purposes was purely an artificial one, which did not in fact occur."

This decision is subject to possible criticism on the ground that it goes too far in according capital gain treatment under Section 117 (j) to gain realized from the sale of fruit on trees without regard to the maturity of the crop when sold. The evidence in the *Owen* case disclosed that at the time the first grove in question was sold approximately 27 per cent of the fruit was fully mature, and at the time the second grove was sold approximately 63 per cent of the fruit was fully mature.

It would therefore appear that the fruit ready for harvest at the date the groves were sold constituted property, whether realty or personalty, held by the taxpayer *primarily* for sale to customers in the ordinary course of business. The profit realized on the sale of such property, whether the fruit was sold in an extraordinary or isolated transaction involving the sale of the entire grove or sold by the field box as picked, would logically constitute ordinary income and not capital gain under Section 117 (j).[27] The Bureau elected not to petition the Supreme Court for certiorari in the *Owen* case, and as of the date of this writing it is the law in states comprising the Fifth Circuit. The Bureau of Internal Revenue, needless to say, has not agreed with the decision and continues to reject claims for refund of tax paid pursuant to I. T. 3815 and to issue statutory notices of deficiency against taxpayers not reporting gains from the sale of land with unharvested crops. There are now pending disposition before the Bureau a large number of these "fruit on the tree" cases arising from grove sales in the citrus producing areas of Florida, California, and Texas. The question will, therefore, be of considerable concern to taxpayers until the controversy is finally put at rest by Supreme Court decision.

[27]For any taxpayer to qualify for the benefits of §117 (j), whether before or after the 1951 amendment, five facts must be shown:

1. The entire property sold was property used in trade or business.
2. The entire property sold was either real property or property of a kind subject to an allowance for depreciation.
3. The property was held for more than six months.
4. The property was not of a kind includible in the inventory of the taxpayer if on hand at the close of the taxable year.
5. The property was not of a kind held by the taxpayer primarily for sale to customers in the ordinary course of trade or business.

The Tenth Circuit likewise reversed the Tax Court in the *McCoy* case.[28] It reasoned in part, like the Fifth Circuit, that the taxpayer was not in the business of producing immature wheat and did not hold such wheat primarily for sale. In addition, the court embraced the property theory, saying:[29]

> "The words 'real property' are used without qualification. Neither is there anything in the legislative history . . . indicating that Congress used the term 'real property' in any other than its accepted and commonly understood meaning . . . . The sale was a unit sale of a piece of real estate . . . ."

The Bureau is apparently quite concerned over the fact that under the decisions of the Fifth and Tenth Circuits in the *Owen* and *McCoy* cases the taxpayer not only may treat the entire profit on pre-1951 sales as capital gain but he is also entitled to deduct in full the cost of raising the crop sold with the land. This means that one dollar of production costs in the case of sale by an individual will offset two dollars of capital gain realized on sale of the property as a unit.[30]

This result undoubtedly gives the taxpayer a well-deserved advantage, but one that is not unique in the type of sale under discussion. For example, a calendar-year taxpayer who on June 30th sells at a profit a truck used for several years in a trucking business is permitted to charge all allowable depreciation and all ordinary repairs made on the equipment during the year of sale against his ordinary income. That this construction of Section 117 (j) is correct is not questioned.

Position of Ninth Circuit

As previously mentioned, the Ninth Circuit has recently upheld the Bureau and the Tax Court in the *Watson* case. The court expressly agreed with the holding of the majority of the Tax Court that, regardless of whether fruit on the trees be considered personalty or realty and whether mature or immature, any profit realized on its sale for a lump sum as a part of the grove will not qualify for capital gain treatment under Section 117 (j). The rationale underlying this holding parallels that of the Tax Court; it is that the fruit on the

---

[28] McCoy v. Commissioner, 192 F.2d 486 (10th Cir. 1951).

[29] *Id.* at 488.

[30] INT. REV. CODE §117 (b), before amended by §322 (a) (2) of the Revenue Act of 1951.

trees, being at all times produced and held for ultimate sale by the taxpayer, necessarily constitutes property held primarily for sale, whether mature or immature and regardless of how sold.

The decision goes further than that of the Tax Court and presents a novel second ground upon which the decision rendered below is sustained. This theory was presented in answer to the taxpayer's contention that in May, 1944, she ceased to hold the oranges primarily for sale to customers when she and the co-owners of the grove elected to hold it with the fruit for a unit sale – a holding of the grove and crop for a sale not in the ordinary course of any business of the taxpayer. In rejecting this contention, the court said: "Assuming this decision to sell the property as a unit changed the character of the holding of the crop, §117 (j) (1) is not satisfied, for the crop was not held in the non-business sale character for the six months required by that section."[31]

The court seemed to base its conclusion on the theory that the benefits of Section 117 (j) do not apply, even though the other requirements of the section are met, unless the property sold is held for more than six months for a purpose other than sale to customers. Therefore the crop, while growing, was held for sale to customers, and, even granting that this purpose was changed before the sale, more than six months had not elapsed between the change of purpose and the eventual sale.

The court in this connection took direct issue with the Fifth Circuit ruling in the *Owen* case:[32]

> ". . . *Owen v. Commissioner* dealt with a Florida orange grove and treated the orange crop as appurtenant to the realty *when sold.* It reasoned that although the crop may have been held for sale in the course of trade or business up to a week before the day of the sale of the land with the crop on the trees, it is the character of the owner's holding on the day of sale which is determinative."

At best the theory applied in the *Watson* case is questionable. Section 117 (j) treatment is given to the sale of depreciable and real property used in trade or business and held for more than six months, which is not property held primarily for sale to customers. There is

[31]Watson v. Commissioner, 197 F.2d 56, 58 (9th Cir. 1952).
[32]*Ibid.*

nothing in the statute or its legislative history[33] to indicate that the six months holding requirement runs only from the time the property is held for purposes other than sale primarily to customers.

This interpretation of Section 117 (j) is perhaps a facet of a decision rendered by the Ninth Circuit earlier this year in *McGah v. Commissioner.*[34] A real estate rental company had decided to sell a part of its rental houses. The Tax Court held that the houses at the time of sale were held for sale to customers and denied Section 117 (j) treatment. On appeal the Ninth Circuit remanded the case to the Tax Court, with directions to make a finding of fact as to how long the houses had been held primarily for sale to customers. Apparently the court felt that the taxpayer had shown that all the requirements for reporting its share of the profits on the sale under 117 (j) had been met except the one requirement that the property must not be held primarily for sale to customers. In line with the decision in the *Watson* case, the court will presumably hold that if the properties in question had not been held for sale to customers for more than six months from the date of actual sale the gain would qualify for relief under Section 117 (j). If the reason for the Ninth Circuit's remand is correctly appraised, then this is an example of the theory of the Ninth Circuit operating to the taxpayer's advantage.

Another possible variation of the Ninth Circuit's theory would occur under the following hypothetical facts. Assume that a taxpayer converted to rental property on January 1st his personal residence, which he had purchased several years previously. Assume further that he succeeds in securing a tenant and then sells the property for a profit on May 31st of the same year. Presumably the Ninth Circuit would hold on the authority of the *McGah* and *Watson* cases that the sale would not qualify for capital gain treatment under Section 117 (j). This would seem to follow on the theory that the property, although used in trade or business and subject to an allowance for depreciation, had not been so held for more than six months. The result would therefore be that the entire gain is taxable as ordinary income. In the absence of the operation of Section 117 (j), Section 117 (a) expressly excludes from the definition of a capital asset property used in trade or business that is subject to an allowance for depreciation and

---

[33]See H.R. Rep. No. 2333, 77th Cong., 2nd Sess. 6159 (1942), 1942-2 Cum. Bull. 372, 445; Sen. Rep. No. 1631, 77th Cong., 2nd Sess. 7706 (1942), 1942-2 Cum. Bull. 504, 594.

[34]193 F.2d 662 (9th Cir. 1952).

real property so used, without regard to the length of time held.[35] The result assumed by the foregoing hypothetical factual situation undoubtedly runs counter to the thinking of most tax practitioners.

At the time this discussion was in preparation the taxpayer in the *Watson* case had not filed a petition for certiorari with the Supreme Court. Assuming this is done, the Supreme Court may refuse to hear the case, since the statutory rule governing such transactions for post-1950 years is clear. The novel interpretation of Section 117 (j), however, and the confusion that may arise because of this particular view, plus the conflicts between the circuits, may lead to review if requested.

Position of Two District Courts

Between the time of the Tax Court opinion in the *Watson* case and the Fifth and Tenth Circuit decisions in the *Owen* and *McCoy* cases, two district courts rejected the position of the Bureau in *Irrgang v. Fahs,* decided by Judge Barker of the Southern District of Florida, and *Cole v. Smyth,* decided by Judge Harris of the Northern District of California. Both of these cases involved transactions in which the fruit was wholly immature at the date of the sale of the property as a unit. In both cases the courts followed the theory that the growing crop was an integral part of the realty to which it was attached and that it was not held primarily for sale to customers; therefore any gain attributable thereto was taxable under Section 117 (j).

The Bureau filed appeals in both cases. In *Irrgang v. Fahs,* however, it dismissed its appeal on May 9, 1951.[36] The appeal in *Cole v. Smith*[37] at the date hereof is still pending before the Ninth Circuit and will in all probability be governed by the decision of that court in the *Watson* case, unless that decision is reversed by the Supreme Court.

Law for Taxable Years Beginning After December 31, 1950

Section 323 of the Revenue Act of 1951 amended Section 117 (j) so as to provide that an unharvested crop sold on land held for more

[35]See note 2 *supra.*

[36]P-H 1951 Fed. Tax Serv. ¶71,102 (1951).

[37]5 CCH 1952 Fed. Tax Rep. ¶44,056 (1952).

than six months is to be considered "property used in trade or business" if sold with the land to the same person at the same time.[38] Capital gain treatment is available also upon an exchange or involuntary conversion of the land and crop. The amendment, however, is applicable only to taxable years beginning after December 31, 1950. The length of time for which the crop, as distinguished from the land, has been held is immaterial. Under the new act no deduction is allowed which is attributable to the production of the crop, but the production costs are to be included in the basis of the property for computing gain or loss.

The requirement that production costs be capitalized applies to the year of sale or any prior years. Since most commercial crops mature on an annual basis, the expenses to be disallowed as ordinary

---

[38]Pub. L. No. 183, 82d Cong., 1st Sess. §323 (a) (Oct. 20, 1951):

"(a) TREATMENT OF GAIN OR LOSS.—Section 117 (j) (relating to sale or exchange of property used in the trade or business) is hereby amended—

(1) By inserting immediately before the period at the end of the second sentence of paragraph (1) thereof the following: 'and unharvested crops to which paragraph (3) is applicable'; and

(2) By adding at the end thereof a new paragraph to read as follows:

'(3) SALE OF LAND WITH 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 as described in paragraph (2)) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."'

"(b) TREATMENT OF DEDUCTIONS.—

(1) AMENDMENT OF SECTION 24.—Section 24 (relating to items not deductible) is hereby amended by adding at the end thereof a new subsection to read as follows:

'(f) SALE OF LAND WITH UNHARVESTED CROP.—Where an unharvested crop sold by the taxpayer is considered under the provisions of section 117 (j) (3) as "property used in the trade or business," in computing net income no deduction (whether or not for the taxable year of the sale and whether for expenses, depreciation, or otherwise) attributable to the production of such crop shall be allowed.'

(2) AMENDMENT OF SECTION 113 (b) (1).—Section 113 (b) (1) (relating to adjustments to basis) is hereby amended by adding at the end thereof a new subparagraph to read as follows:

'(L) for deductions to the extent disallowed under section 24 (f), notwithstanding the provisions of any other subparagraph of this paragraph.'

"(c) EFFECTIVE DATE.—The amendment made by subsection (a) shall be applicable only with respect to sales, exchanges, and conversions, occurring in taxable years beginning after December 31, 1950. The amendments made by subsection (b) shall be applicable to any taxable year for which a deduction is disallowed by reason of sales, exchanges, or conversions to which subsection (a) is applicable."

deductions will relate to the year of sale or the year immediately prior thereto. Apparently a cash basis seller will be forced to pay additional tax for the prior year during which deductions attributable to the immature crop sold were taken.

There are several quite troublesome problems which will unquestionably arise in the application of this feature of the recent amendment. One such problem involves determining at precisely what point a seller of a grove and unharvested crop must begin capitalizing his production costs in a sale governed by the act. The other involves determining what constitutes a deduction attributable to the production of the crop within the meaning of the amendment. The question of determining the precise time at which the seller must begin capitalization of production costs arises from the failure of Congress to define what constitutes a crop.

In the case of citrus property there are two possible stages of production in which a grove may be sold. One stage occurs during the period at or before the time the trees bloom, and the other after the fruit has set or is adhering permanently to the trees. All varieties of Florida citrus bloom at approximately the same time, either in February or March, although sometimes groves have a late June or July bloom because of climatic conditions. At best it is doubtful whether a grove can be said to have a crop at the time of bloom. There is always the possibility of severe droppage of bloom on account of dry weather conditions. It would appear that the logical time to commence capitalization of production cost is at the point the fruit has set, for this is in reality the beginning of the crop. Prior to that time the grove has only a potential crop. This view is in accordance with the Bureau's position set forth in I.T. 3815, which provides that "fruit on citrus trees has a potential value from the time the crop is set . . . until it is harvested, but its actual value cannot be determined until it is harvested and sold." Thus the seller, under I.T. 3815, was apparently not required to allocate any part of his selling price to the fruit unless the fruit had set at the date of sale. In other words, if the fruit had not set at the time of sale the transaction would not come within the purview of I.T. 3815, for the reason that only land and trees would have been sold. It is hoped that the Commissioner will issue regulations under the present amendment defining his position on this point.

The second facet of this problem involves a determination of precisely what is meant in the amendment by "a deduction (whether

or not for the taxable year of sale, and whether for expenses, depreciation, or otherwise) attributable to the production of such crop . . . ." In the case of citrus horticulture a significant part of all current expenses is attributable to the care and sustenance of the trees as opposed to the production of the crop itself. For example, would the expense of pruning the trees have to be capitalized? A part of all fertilizer and sprays put on the grove is for the care of the trees and not entirely for the production of the current year's crop. Again, would local property taxes assessed and levied against the grove, or interest paid on a purchase money mortgage encumbering the property, have to be capitalized in the year of sale? In other words, does the statute require the capitalization of all ordinary expenses paid in the year in which the grove is sold, or may the seller be required to capitalize only those parts of his current operating expenses directly attributable to the production the unharvested crop incurred or paid at the date of sale?

It is of interest to note that John W. Snyder, Secretary of the Treasury, has addressed a special letter to Senator Walter F. George, Chairman of the Senate Finance Committee,[39] recommending that legislation be enacted requiring sellers of breeding livestock to capitalize their direct production costs,[40] in line with the treatment accorded sellers of farm lands with an unharvested crop. Such a recommendation may be the forerunner of a general amendment to Section 117 (j) forcing all sellers of property used in trade or business to capitalize their currently deductible expenses attributable to the ownership and operation of such property in a year in which sold at a taxable profit. It is doubtful that the Treasury will ever be wholly reconciled to the present status of Section 117 (j) permitting one dollar of deductible expense to offset two dollars of long-term gain realized on the sale of property used in trade or business in all such transactions except the sale of farm land with an unharvested crop.

---

[39]5 CCH 1952 FED. TAX REP. ¶6240 (1952).

[40]Sec. 324 of the Revenue Act of 1951 includes livestock held for draft, breeding, or dairy purposes within the definition of property used in trade or business as defined in Sec. 117 (j) (1), providing the property is held for 12 months or longer. This was done to assure capital gains treatment on the sale of such animals without resort to litigation, Albright v. United States, 173 F.2d 339 (8th Cir. 1949). Inasmuch as no requirement was made in the amendment that the expense of raising such animals be capitalized, a cash basis livestock owner under existing law may deduct the current expenses of raising animals the profit from the sale of which qualifies for capital gains treatment.

It appears possible under Section 117 (j) as amended for the seller of land with growing crops to have a loss upon that portion of the selling price attributable to the crop, but such loss would be offset against any gain realized on the sale of the land and other assets. Section 323 originated in the Senate Finance Committee as an additional provision to H. R. 4473. The general reference to the amendment set forth in the report of the Senate Finance Committee explains the operation of the amendment quite clearly and justifies quotation in part:[41]

> "Your committee believes that sales of land together with growing crops or fruit are not such transactions as occur in the ordinary course of business and should thus result in capital gains rather than in ordinary income. Section 323 of the bill so provides.
>
> "Your committee recognizes, however, that when the taxpayer keeps his accounts and makes his returns on the cash receipts and disbursements basis, the expense of growing the unharvested crop or the unripe fruit will be deducted in full from ordinary income, while the entire proceeds from the sale of the crop, as such, will be viewed as a capital gain. Actually, of course, the true gain in such cases is the difference between that part of the selling price attributable to the crop or fruit and the expenses attributable to its production. Therefore, your committee's bill provides that no deduction shall be allowed which is attributable to the production of such crops or fruit, but that the deductions so disallowed shall be included in the basis of the property for the purpose of computing the capital gain."

The amendment is not materially retroactive and hence leaves the pre-1951 law in the same state of confusion that existed at the time the Senate Finance Committee considered the measure. The committee was fully cognizant of the split decisions of the Tax Court in the *Watson* and *McCoy* cases and the refusal of the several district courts to uphold the Bureau's position in *Irrgang v. Fahs* and *Cole v. Smyth.* The committee report is dated September 18, 1951, and was therefore compiled prior to the decisions of the Fifth Circuit in the *Owen* case and the Tenth Circuit in the *McCoy* case.

[41]SEN. REP. No. 781, 82d Cong., 1st Sess. 47 (1951).

There is little, if any, indication in the Senate Finance Committee's report as to whether the committee felt that the position of the Bureau and the majority of the Tax Court or that of the district courts correctly stated the law in the instant type of transaction. In the *McCoy* case the Tenth Circuit interpreted the 1951 amendment as one intended to clarify the law, not change it. The Fifth Circuit in the *Owen* case also mentioned the 1951 amendment in a footnote to its opinion, but only for the purpose of explaining that the controversy in issue was governed by the law as it existed in 1944, long prior to the effective date of the amendment.

The Ninth Circuit in the *Watson* case, however, took direct issue with the Tenth Circuit *McCoy* opinion, stating:[42]

> "The legislation states that it applies to tax years after December 31, 1950, and the Senate Report accompanying the bill states that when the amendment is effective there will be an annual loss in taxes collected of $3,000,000."

At best, it would appear that little or no assistance in resolving the pre-1951 conflict between the circuits can be gained from the 1951 amendment and the Senate Finance Committee Report accompanying the act. Equally plausible arguments can be made for or against the Bureau's position by reference to the amendment and committee reports.

Problems of the Purchaser

Although this article is primarily devoted to the tax problems of the seller of a grove with fruit on the trees, reference should be made to the problems of the purchaser created by the 1951 amendment. In extending the somewhat liberal provisions of Section 117 (j) to the seller of an unharvested crop, the purchaser of such property may be forced to pay a larger tax bill, at least in the year in which the crop matures and is sold.

The purchaser generally is interested in allocating a substantial part of his purchase price to the growing crop at the date of acquisition.[43] By doing this he can then sell the crop at maturity and re-

---

[42]Watson v. Commissioner, 197 F.2d 56, 58 (9th Cir. 1952).

[43]In so doing the purchaser will correspondingly diminish his basis for the land, trees, and other assets, if any.

port a relatively small gain on the sale of the crop.[44] This will enable him to recover a large percentage of the acquisition cost of the property, tax free, in the initial year of operation.[45] There is a rather old Bureau ruling, O.D. 714[46] published in 1920, dealing with the question of the purchaser's basis for computing gain or loss on the sale of a crop acquired in the purchase of farm land. The ruling provides that the gain or loss realized on the subsequent sale of such crop is the difference between the cost and the selling price realized, less the expenses of harvesting and marketing. In the absence of an allocation of the purchase price between the crop and the land, the fair market value of the growing crop at the date of purchase is recognized as the best basis of the crop. Of course the amount thus allocated to the crop must be deducted from the depreciable basis of the grove and the cost basis of the land. To date there has been no public expression by the Bureau indicating a deviation from the position expressed in O.D. 714.

The 1951 amendment to Section 117 (j) makes no reference to the proper treatment of these transactions from the purchaser's standpoint. Presumably he is still entitled to offset a portion of the purchase price attributable to the crop against the ordinary income realized from its eventual sale, subject, however, to the ultimate outcome of litigation now before the Tax Court.

There has been an apparent shift in the Bureau's position regarding O.D. 714, as evidenced by three recent cases. The first of these is *Marion L. Bloxon*.[47] The taxpayers bought a pear orchard in May of 1946 for $75,000 under an agreement that did not apportion any part of the amount paid to the land, personalty, growing crop, or other assets. The purchasers subsequently sold the crop and deducted $16,800 as the cost basis of the crop. The Commissioner in determining the deficiencies against the purchasers disallowed the $16,800 in its entirety. At the trial, however, he conceded that $3,257.97, representing a part of the purchase price, should be de-

[44]If a loss is incurred it can be used as a net operating loss carry-back for the preceding taxable year, and unless otherwise exhausted it can be used as a net operating loss carry over for each of the five succeeding taxable years under the provisions of INT. REV. CODE §§23 (s) and 122, as amended.

[45]For example, the purchaser in the *Watson* case attempted to allocate $120,000 out of a total purchase price of $197,000 to the growing crop, Brief of Petitioner, p. 8.

[46]3 CUM. BULL. 49 (1920).

[47]P-H 1952 T.C. MEMO. DEC. ¶52,079 (1952).

ducted. The case then turned solely upon the proper value to be assigned to the growing crop, which the court held to be $11,000. The point of significance in this case is that in so far as the statutory notice of deficiency was concerned the Commissioner made a determination directly contrary to O.D. 714.

The other two cases, *Triple E. Development Co.*[48] and *Louise H. Edwards,*[49] both involving Florida taxpayers, are pending before the Tax Court. The primary issue is the question of whether the purchaser of farm land may allocate any part of his cost to the growing crop in the year of acquisition. It is understood that the *Triple E.* case involves no dispute as to the value assigned the crop by the purchaser but solely as to the purchaser's right to allocate any part of his cost to the growing crop at the date of acquiring his grove. The *Edwards* case concerns not only the question of the purchaser's right to allocate a part of his cost to the growing crop but also raises alternatively the question of proper valuation of the crop should the court determine that the taxpayer has the right to make such an allocation. The cases were tried at the hearing calendar of the Tax Court held in Tampa in February, 1952, and decisions thereon will probably be rendered in the relatively near future.

It is not known on precisely what theory the Bureau is proceeding on the allocation issue in these two cases. The theory may be that the growing fruit is an inseparable part of the realty to which affixed, and that the purchaser does not acquire an item of separate property upon which to assign a part of his purchase price. Under this reasoning the only permissible allocation is between land and any other assets acquired. Such a position would be in direct conflict with O.D. 714, and it is apparently in conflict with the theory expressed by the Bureau in I.T. 3815 as that ruling affects the seller in such transactions.

If the fruit crop has reached a stage of maturity at which a realistic value can be assigned to it, it seems extremely doubtful that the courts will sustain the Bureau's attempt to prevent the purchaser from allocating a part of his total cost to the growing crop regardless of the Bureau's theory. The fragmentation rule expressed in *Williams v. McGowan*[50] is apparently too well entrenched in the law of federal taxation to permit a holding in direct conflict with that case.

[48]No. 26008.

[49]Nos. 24909-24914.

[50]See note 14 *supra.*

In the event that purchasers are successful in maintaining their right to allocate a part of their cost to the unharvested crop, in spite of the Bureau's attack there will nevertheless remain a great deal of room for controversy and litigation as to the proper value to be so allocated.[51]

CONCLUSION

In the absence of a reversal by the Supreme Court, taxpayers in the Fifth and Tenth Circuits are assured of capital gain treatment on the sale of land with growing crops despite the fact that such sales were made in years preceding 1951. In view of the Bureau's present attitude, such treatment cannot be secured without resorting to litigation, either in deficiency proceedings before the Tax Court or in refund actions before the local district courts. Should review of the decision of the Ninth Circuit in the *Watson* case be sought and granted by the Supreme Court in the coming term, cases in that circuit involving pre-1951 sales should be held open pending decision by the Supreme Court. If the Ninth Circuit is affirmed, there will still be considerable room for argument as to how much of the selling price is properly allocable to the crop from the seller's standpoint. Taxpayers making sales during taxable years beginning after December 31, 1950, will need only to follow the recent amendment to Section 117 (j) in order to secure capital gain treatment on any profit realized or to secure an ordinary deduction for any loss suffered. In view of the Bureau's apparent repudiation of O.D. 714, purchasers face the prospect of litigation over their right to allocate a part of their acquisition costs to an unharvested crop.

[51]The discussion of the valuation of unharvested citrus is beyond the scope of this article. Mention should be made, however, of the availability of two pamphlets which should be of assistance to practitioners involved with questions of valuing unharvested citrus in Florida. Savage, *Estimating the Value of Citrus Fruit As It Develops,* Agricultural Extension Service, University of Florida, Gainesville, sets forth an attempt at a method of approximating fruit value by months from bloom to mature fruit. Shuler and Townsend, *Florida Citrus Fruit Annual Summary 1951,* U.S. Dep't of Agricultural Economics, Orlando, Fla., contains a comprehensive statistical summary of the entire Florida citrus industry, covering production and prices by varieties for many years.

University of Florida Law Review

VOL. V FALL 1952 No. 3

EDITORIAL BOARD

ALBERT P. SCHWARZ
Editor-in-Chief

JOEL T. DAVES III
Note and Comment Editor

EVANS CRARY, JR.
Article and Book Review Editor

THOMAS C. MACDONALD, JR.
Case Editor

LEO WOTITZKY
Legislative Editor

JOHN T. ROGERSON, JR.
Research Editor

STAFF

WILLIAM D. BARROW
WILLIAM C. BENNETT, JR.
A. EUGENE CARPENTER, JR.
JUSTIN C. MONTGOMERY
EDWARD A. STERN
MILO I. THOMAS, JR.

BUSINESS STAFF

D. CHANSLOR HOWELL
Business Manager

ROYCE L. KILPATRICK
Assistant Business Manager

FACULTY ADVISORS

ROBERT B. MAUTZ GEORGE JOHN MILLER J. ALLEN SMITH