

2-1-1950

Ordinary Income or Capital Gain on the Sale of an Orange Grove

James P. Hill

Follow this and additional works at: <http://repository.law.miami.edu/umlr>

Recommended Citation

James P. Hill, *Ordinary Income or Capital Gain on the Sale of an Orange Grove*, 4 U. Miami L. Rev. 145 (1950)
Available at: <http://repository.law.miami.edu/umlr/vol4/iss2/2>

This Article is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized administrator of Institutional Repository. For more information, please contact library@law.miami.edu.

ORDINARY INCOME OR CAPITAL GAIN ON THE SALE OF AN ORANGE GROVE

JAMES P. HILL *

Since the early 1940's, the inflated price level has made the sale of citrus groves in Florida having a relatively low cost basis more and more attractive to grove owners.

Obviously, the income tax consequences of these sales to the owners of groves having substantial unrealized appreciation is of prime importance. There are, of course, numerous income tax problems, potential and actual, which grow out of the sale or exchange of any appreciated real estate.

This discussion will be limited to one highly important facet of these tax problems which deals with the question of whether or not the seller of citrus groves with growing fruit on the trees must, for federal income tax purposes, allocate a portion of the selling price to the land and trees, when such a sale is consummated on a lump sum basis.

The Bureau of Internal Revenue in 1946 ruled¹ that the seller of a grove with fruit on the trees was compelled for federal income tax purposes to allocate a portion of the selling price to the fruit and the balance to land and trees. The gain from the sale of the fruit will constitute ordinary income. The gain from the sale of the land and trees will be treated as capital gain under section 117(j) of the Internal Revenue Code, provided the recognized gains from all transactions coming within the purview of that section exceed the recognized losses thereunder.

When a farmer sells timber land which he has owned for more than six months at a profit of \$30,000.00, the entire profit is treated as long term capital gain and only \$15,000.00 is recognized gain for income tax purposes. On the other hand, if the Bureau of Internal Revenue is correct in its position under I.T. 3815, where a farmer sells his citrus grove which he has owned for more than six months at a profit of \$30,000.00 and the value of the fruit on the trees is \$20,000.00, the recognized gain for income tax purposes is \$25,000.00. Of this \$25,000.00 recognized gain, \$20,000.00 is treated as ordinary income, and the remaining \$5,000.00 as capital gain.

A great many people, perhaps with some justification, feel that the Bureau of Internal Revenue has no right to tax these two transactions differently. If the Bureau is in error, the error can be very costly to those engaged in the

* Member of Florida Bar—Jacksonville Bar Association.

1. I.T. 3815 46-2 CUM. BULL. 30.

business of producing citrus fruit. Eventually this question will be settled but it is far from being a settled issue now.

The extent to which rulings like I.T. 3815 are binding upon taxpayers is often a question of great difficulty. There are two general types of regulations or rulings issued by the Bureau. In some instances the ruling merely sets forth the Treasury's interpretation of the proper construction of the law. I.T. 3815 is that type of ruling, and it does not have the force and effect of law. The other type of regulation is that issued by the Bureau after Congress passes a statute in broad terms and specifically delegates to the Bureau power to promulgate regulations covering the details of the law. This latter type of regulation, if not unreasonable, will usually be deemed to have the force and effect of law.

The income taxable under the provisions of the Internal Revenue Code is a purely statutory net income and the Bureau's interpretation of the Code has not always been sustained by the courts. In approaching any tax question, and especially such a problem as the validity of I.T. 3815, the principal concern is what the Code provides with respect to that subject.

The statutory provision governing the question is section 117(j) of the Internal Revenue Code. That section permits a taxpayer to treat as capital gains profits from the sale of real or depreciable property used in the taxpayer's trade or business which he has held for more than six months. It excludes property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, and also excludes property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.²

Section 117(b) of the Internal Revenue Code provides that in the case of a taxpayer other than a corporation, only fifty per cent of the gain or loss recognized upon the sale or exchange of a capital asset, held for more than six months, shall be taken into account in computing net capital gain, net loss, or net income.

In order for a taxpayer to cast a transaction within the provision of section 117(j), permitting him to treat the sale of a grove for a lump sum as a sale of a capital asset, the burden is upon him to show all of the following facts:

- (1) That the grove sold was used in his trade or business;
- (2) Was real property or property of a kind subject to an allowance for depreciation;
- (3) Was held for more than six months;
- (4) Was not property of a kind includible in the inventory of the taxpayer if on hand at the close of the taxable year;

² U.S. Treas. Reg. 111, § 29.117-1 and § 29.117-7 (as amended by T.D. 5394), 1944 CUM. BULL. 274, 276).

- (5) Was property of a kind not held by the taxpayer primarily for sale to customers in the ordinary course of trade or business.

The material which follows will be an attempt to analyze the validity of the Bureau's ruling I.T. 3815 when tested against the five elements of a 117(j) transaction enumerated above.

1. TRADE OR BUSINESS

This requirement will give little or no difficulty for the taxpayer. The Bureau of Internal Revenue conceded in I.T. 3815 that the production of fruit from orchards or groves constitutes a trade or business and that section 117(j) of the Code is applicable to the sale of an orchard or grove.

2. PROPERTY SUBJECT TO AN ALLOWANCE FOR DEPRECIATION

This requirement, as the preceding one, will cause no difficulty. The Bureau of Internal Revenue long ago recognized that producing orchards are subject to depreciation.³

3. A PROPERTY HELD FOR MORE THAN SIX MONTHS

Nothing need be said of this requirement other than that the grove sought to be sold at long term capital gain rates must have been held more than six months prior to date of the closing of the sale.

4. PROPERTY NOT OF A KIND INCLUDIBLE IN INVENTORY

This requirement will cause the taxpayer considerably more concern than the preceding three, since the very essence of the problem is to get a long term capital gain on the sale of growing fruit as well as on the trees and land.

Section 22(c) of the Internal Revenue Code provides that, when inventories are necessary in order to determine the income of a taxpayer, the inventories shall be taken upon such basis as is prescribed by the Commissioner as conforming to the best accounting practice, and as most clearly reflecting income. Acting upon that authority the Bureau has ruled⁴ that farmers cannot inventory growing crops. The reason given was that the value of such crops could not be accurately determined. That ruling would appear to have the effect of law, and to eliminate fruit on the trees from that type of non-capital asset referred to in the Code as being "property includible in the inventory of the taxpayer."

3. O.D. 797 4 CUM. BULL. 214 (1921).

4. I.T. 1368 I-1 CUM. BULL. 72.

5. PROPERTY NOT HELD BY THE TAXPAYER PRIMARILY FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF TRADE OR BUSINESS

This requirement can readily be said to be the crux of the instant problem. It will be the one most difficult to meet, and the one most vulnerable to attack by the Commissioner of Internal Revenue.

It must be pointed out that section 117(j), as indicated by its title, deals with gains and losses from the sale or exchange of certain real and personal property used in trade or business.

The section is divided into two main paragraphs. Paragraph 1 defines property used in trade or business. Paragraph 2 explains the general rule which gives capital asset treatment to the sale of property used in trade or business as such property is specifically defined in paragraph 1. Paragraph 1 defines the term "property used in trade or business" as "property used in trade or business, of a character which is subject to allowance for depreciation . . . , held for more than six months and *real property* used in trade or business, held for more than six months, which is not . . . property held by the taxpayer *primarily* for sale to customers in the ordinary course of his trade or business."

It seems fairly clear that growing fruit is not property of a character which is subject to the allowance for depreciation. If, however, it could be established that growing fruit is a part of the real estate on which it is grown, and while still on the tree is not property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, it would appear that we could bring the sale of growing fruit within the purview of the section.

The Internal Revenue Code in no place defines the term real property. Because of this fact, the ordinary meaning of the term as developed under the general law should prevail.⁵

It is fairly well established that fruit unless actually or constructively severed from the tree on which it grows is a part of the realty and passes to the purchaser upon a sale of the grove.

The Supreme Court of Florida adopted this rule in the case of *Adams v. Adams*.⁶ This case involved an action by a decedent's widow for a declaratory decree to determine whether the proceeds of citrus crops went to the widow as part of the homestead or to the personal representative as personal property. The Supreme Court of Florida in holding that fruit on the trees of the homestead land went to the widow as part of the realty said:

Appellants contend that the citrus fruit or the proceeds of it was personal property and passed to the executors to be distributed under the will. To support this contention they rely on *Gentile Bros., Inc. v. Bryan*, 101 Fla.

5. *Crane v. Comm'r*, 331 U.S. 1 (1946).

6. *Adams v. Adams*, 158 Fla. 173, 28 So. 2254 (1946).

233, 133 So. 630. It is true that language in the latter case, if read in the abstract, may be so construed, but, if read in its environment, we do not think it permits this interpretation. The Court was confronted with a mortgage lien given to secure supplies furnished and services rendered to the grove exclusive of the land; the mortgage in other words related only to the crop of citrus fruit. Under such circumstances the Court did say that the 'Fruit when produced from such annual cultivation and attention may in law be classed as fructus industriales and not fructus naturales when the mortgage gives no lien upon or interest in the land or the trees.'

(1) We do not think this case rules the case at bar. In *Simmons v. Williford*, 60 Fla. 359, 53 So. 452, 453, Ann. Cas. 1912C, 735, this court approved the rule that 'Crops of fruit growing on trees, whether regarded as fructus naturales or fructus industriales, are in general parts of the realty, and, unless reserved, go with the realty in its transfer. But by the acts and intention of an owner of land containing bearing fruit trees the growing fruit may be converted into personalty for purposes of sale.' *Summerlin v. Orange Shores, Inc.*, 97 Fla. 996, 122 So. 508; *E. C. Fritz & Co. v. Eldridge*, 129 Fla. 647, 176 So. 539; *Griffith v. Hulion*, 90 Fla. 582, 107 So. 354; *Miller v. Carr*, 137 Fla. 114, 188 So. 103, and other cases support this view.

This conclusion is supported by the Crop Lien Act, Chapter 10279, Acts of 1925, and other acts which show conclusively the rule in this State to be that crops unseparated from the trees or vine are a part of the real estate till separated and follow the latter unless in terms reserved by the seller. We find some exception to this rule, but it is the one generally approved throughout the country. We do not overlook the contention of appellants that growing citrus fruits are never fructus naturales but must at all times be fructus industriales, because they require cultivation by hand. Much learned discussion has been given to this distinction but it has been tempered in this country by crop lien acts and by judicial interpretation. In Florida the fruit follows the realty unless in terms reserved.

(2) It is accordingly our view that the citrus crops in question were a part of the real estate and passed to the widow with the homestead, so the judgment of the chancellor must be and is hereby affirmed.

This same rule represents the great weight of authority.⁷

The only state case on the subject making any reference to income taxation is *Young v. Bond of California*.⁸ There a broker introduced Di Napoli, a tax-conscious prospective purchaser, to Moores, an officer of the bank which owned an orange grove. According to the statement of facts in the opinion:

When Di Napoli met Moores he said he was interested but that he would insist on purchasing the property separately—\$57,500 for the crop and \$67,500 for the land, in order to comply with the federal regulations covering the payment of income taxes on capital gains as distinguished from income.

7. 25 C.J.S. 7; 15 Am. Jur. 200.

8. *Young v. Bank of California*, 88 Cal. App. 2184 (1948).

The sale was consummated but the bank refused to pay the broker a commission and he had no memorandum in writing. The broker sued for his commission and was nonsuited. The judgment of nonsuit was affirmed. He had contended that the oranges were personal property so that his agreement for a commission for the sale of oranges was not required to be in writing by the statute of frauds. In this connection, the court said:

Appellant contends that he should at least be compensated for the sale of the growing crops. The sale was one transaction. The purchase price was segregated between the land and the growing crops merely to meet the federal regulations regarding income taxes—to show whether the purchase price of the crops should be treated as capital gains or income. But growing crops under our decisions are a part of the realty until severed just as growing timber is part of the land. *Sears v. Ackerman*, 138 Cal. 583 (72 P. 171), *List v. Sandell*, 42 Cal. App. 2d, 505,507 (109 P. 2d 376). It is undisputed that throughout all the dealings the parties herein treated the sale of the land and crops as one transaction and there is nothing in the record indicating that any one of them would have considered the sale of one without the other. There is no basis upon which appellant can make a segregation of the sale of the crops from the sale of the land and his case must stand or fall upon the basis of a single transaction covering the entire property.

The Board of Tax Appeals also adopted this rule at an early date. In *Parker v. Comm'r.*,⁹ acquiesced in by the Commissioner,¹⁰ the Board stated,

The respondent claims that inasmuch as growing crops are realty and belong to the land to which they are attached, their value is included in the appraised value of the real estate. There can be no question as to the general proposition of law that growing crops belong to the freehold and in case of sale of the same pass to the purchaser, provided the seller owns both the land and the crops. A different rule obtains where the interests of tenants intervene.

In the event the taxpayer succeeds in proving that fruit neither actually nor constructively served is a part of the real estate on which it is growing, for purposes of the Code, he must then show by a preponderance of the evidence that fruit on the trees was not held by him primarily for sale in the ordinary course of trade or business to fully meet the fifth requirement of section 117(j) outlined above.

The Bureau of Internal Revenue in I.T. 3815 stated:

The production of fruit from orchards or groves constitutes a business, and Section 117(j) of the Code, *supra*, is applicable to the sale of an orchard or grove. The crops are produced with the primary purpose of selling the fruit to customers in the ordinary course of the business. Therefore, regardless of their stage of development, any gain realized from the sale of growing crops is ordinary income.

9. *Parker v. Comm'r.*, 13 B.T.A. 1289 (1928).

10. VIII-1 CUM. BULL. 35.

Attention is directed to the fact that the Bureau says it is of that character regardless of its stage of development. Since the sale of immature fruit is prohibited by state and federal law, we must assume that the Bureau means that a citrus grove owner holds immature fruit for sale at some future time when its maturity will permit it to be sold. If the fruit is a part of the realty it may well be argued that fruit on the trees was not held for sale to customers because the grove owner was not a dealer in citrus groves, but a producer of fruit which he sold to customers, when the fruit became ripe and when it became personal property upon severance from the tree.

There have been a series of recent income tax cases which by direct analogy have a bearing on the question of when property is held "primarily for sale to customers in the ordinary course of trade or business" within the meaning of section 117(j) of the Code.¹¹

These cases arose because of the Bureau of Internal Revenue's ruling I.T. 3666¹² and I.T. 3712¹³ which severely limit the extent to which livestock breeders could sell breeding animals under section 117(j) of the Code and thus receive the preferred capital gains treatment on any profit so made. There is no question that breeding animals are depreciable property used in trade or business and any gain from the sale of such property is treated as if it were capital gain if the sale meets the five requirements for the application of section 117(j). The Bureau of Internal Revenue has taken the position that where a livestock man as a regular practice sells off each year a part of his breeding stock, and does not materially reduce the size of his normal breeding herd, such sales are in the regular course of business and hence section 117(j) is inapplicable. The United States Court of Appeals for the 8th Circuit and the Tax Court of the United States in the cases cited above¹⁴ refused to follow the Bureau's position.

These cases are germane to the instant discussion in that they clearly indicate that one should look at the particular purpose for which section 117(j) property is held at the time of sale, against the background of what the regular or normal business of the taxpayer is in order to determine whether or not specific property is held primarily for sale to customers in the ordinary course of trade or business.

For example, a dairy farmer who from time to time sells off a part of his stock makes such sales as an incident to his main business of producing

11. See *Albright v. U.S.* 173 F.2d 339 (8th Cir. 1949), 49-1 USTC Par. 9215, 1949 P-H Vol. 5, Par. 72,381; *Emerson v. Comm'r*, 12 T.C. No. 115 (May 27, 1949), CCH Dec. 16, 989; *Fawn Lake Ranch Company v. Comm'r*, 12 T.C. No. 153 (June 27, 1949), CCH Dec. 17,061; *Oberg v. Comm'r* T.C. Memo Dec. CCH Dec. 17,016(M); Par. 49,134 P-H T.C. MEMO.

12. I.T. 3666, 1944 CUM. BULL. 270

13. I.T. 3715, 1945 CUM. BULL. 176.

14. See notes 12, 13 *supra*.

dairy products. He does not hold these animals primarily for sale to customers in the ordinary course of his business.

The Bureau of Internal Revenue is quite concerned over the fact that a grove operator who sells his grove for a lump sum on December 31st could, under the rule prior to I.T. 3815 and after the Revenue Act of 1942, succeed in selling the grove at capital gain rates, and at the same time write off all the expense of growing the crop against the net gain. But it is apparent that this is precisely what Congress has seen fit to allow any taxpayer who sells 117 (j) property at a gain. For example, a calendar year taxpayer who, on December 31st, sells at a gain a truck used in his trade purchased on January 1st of the same year is permitted to write off against such gain all allowable depreciation and all ordinary repairs made on the equipment for the year.

If this seems to be an overly generous tax advantage to business men, then the Congress should be approached to have 117(j) amended so as to eliminate this preference.

The Bureau of Internal Revenue has argued that because the purchaser of a grove must make an allocation of the price he paid between the grove and the fruit then on the trees in order to determine his profits when he sells the fruit, that it follows that the seller of the grove should also make such an allocation.

But that argument will not support the Bureau's position. If the owner of a vacant tract of land, a capital asset, sells it to a real estate dealer who subdivided it for resale to his customers, the sale of the tract may be a capital gain or loss to the seller though his purchaser, the dealer, will receive ordinary income from the sale of the lots, and he must allocate a part of his cost to each lot sold. It does not follow that because the dealer must make an allocation of his cost of the realty, that the man from whom he bought must do likewise, nor does it follow that because the dealer's income is ordinary income, the gain to the man from whom he bought was not capital gain.

If a grove owner expects to sell his grove with fruit on the trees he should consider the advisability of making such a sale by using the method normally followed for converting ordinary income to capital gains.

This might be accomplished by conveying the grove to a wholly owned corporation in return for its stock. Such a conveyance is a non-taxable transfer.¹⁵ He may then sell the stock of the corporation to the proposed purchaser, and be entitled to treat the gain as long term capital gain, if he had owned the grove for more than six months. By following this plan the grove owner who plans to sell his grove at a profit should be able to obtain the preferential treatment afforded capital gains even if the courts approve the Bureau's ruling in I.T. 3815.

Several cases are now pending in court in which the validity of I.T. 3815

15. Int. Rev. Code 112(b)(5).

has been challenged. One of these filed some time ago in the Tax Court of the United States has been set for trial at an early date, and the decision of the court on the question involved will probably be forthcoming soon. If the decision of that court goes against the taxpayer, an appeal will almost certainly be taken. If the decision is against the Bureau, the Commissioner of Internal Revenue may take an appeal or he may issue a notice of non-acquiescence. Thus forcing all taxpayers to litigate in order to obtain the benefits of capital gains treatment in this type of case.

A great many citrus growers who have sold their groves at a profit have already paid income taxes in accordance with the Bureau's ruling set forth in I.T. 3815.

It is not the intent of this article to say that the government *is* wrong in its treatment of grove sales but rather that it *may* be wrong. One thing is certain. It will be some time before anyone will know whether the government is right or wrong. Those taxpayers, who have paid such a tax either at the time of filing their returns or as a result of an audit of such return after it was filed, *may still file claims for refund of such tax if the refund is not barred by the statute of limitations.* This is not true, however, if the taxpayer made a compromise of the disputed tax liability with the commissioner, which had the approval of the Secretary of the Treasury or an assistant secretary or an undersecretary.

Claims for refund of federal taxes must be filed within three years of the time the return is filed or within two years of the time the tax is paid, whichever expires last.

The Treasury Department has prescribed a form on which to file such claims. The filing of such a claim is a condition precedent to any action at law for the recovery of such taxes. Such an action can be maintained only on the grounds set forth in the claim for refund. The government has successfully defended many cases which it would have lost had the claim for refund been properly prepared.

In view of the doubt and uncertainty as to the proper tax to be paid on profits from sale of groves, those taxpayers who have claimed I.T. 3815 should not waive their rights to refunds by failing to file claims, until some authoritative decision approves the Bureau's interpretation of the law on this subject.