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TAXATION—DISPOSITION OF GAIN REALIZED FROM SALE OF LAND WITH GROWING CROP

Section 117 (a) (1) of the Internal Revenue Code, defines capital assets and sets up four excluded categories of property.1 Although property used in trade or business (subject to the allowance for depreciation) and real property used in trade or business are within the excluded categories, section 117 (j) of the Code reinstates them to capital gain treatment on two conditions, viz, that such property is not properly includible in inventory and, secondly, is not property held by the taxpayer "primarily for sale to customers in the ordinary course of his trade or business."2 The problem of this comment is to apply these provisions to the gain realized from the sale of land with a growing crop.

Real estate used to produce products of the soil is real property used in trade or business and therefore excluded from capital gain

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1 INT. REV. CODE SEC. 117. CAPITAL GAINS AND LOSSES.
(a) Definitions.—As used in this chapter—
(I) Capital Assets.—The term “capital assets” means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), or real property used in his trade or business; (subsection (C) excluding copyrights, and subsection (D) excluding obligations of the United States and political subdivisions thereof are not relevant to the matter under discussion.)

2 INT. REV. CODE SEC. 117. (j) “Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business.
(1) Definition of property used in the trade or business. For the purpose of this subsection, the term ‘property used in the trade or business’ means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) General rule. If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purpose of this paragraph...
treatment under section 117 (a) and re-included under section 117 (j) on the two conditions. What is the status of the growing crop attached to the real property? Although there is some dispute as to when matured crops become personal property, the majority of the courts agree that an unmatured growing crop is a part of the realty. With the premise that growing crops are a part of the realty, is the gain realized from their sale along with the sale of the land entitled to capital gain treatment under section 117 (j)? The first condition relating to inventory is satisfied by an early ruling which treats growing crops as non-inventory items. The second condition of section 117 (j) (1)(B) excludes from capital gain treatment property "held primarily for sale to customers in the ordinary course of trade or business." If the crops, although real property, are held primarily for sale in the ordinary course of trade or business, the gain is not entitled to section 117 (j) treatment and therefore falls under section 117 (a) (1)(A) which excludes from capital gain treatment property held primarily for sale in the ordinary course of trade or business. If the growing crops as realty are not held primarily for sale, it would appear that section 117 (j) is applicable and the gain realized from sale or exchange of property used in trade or business should be given capital gain treatment. Hence, the issue narrows to the question: When is a growing crop held primarily for sale to customers in the ordinary course of trade or business.

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3 Supra, Note 1.
4 Supra, Note 2.
5 See 172 A.L.R. 815, where the matter is discussed in detail.
6 T.F. 1368 (1923). "Farmers are not permitted to inventory growing crops for the reason that the amount and value of such crops on hand at the beginning and end of the taxable year cannot be accurately determined."
7 Supra, Note 2.
8 Supra, Note 1.
9 The pertinent provision of section 117 (a); "held primarily for sale to customers in the ordinary course of trade or business," had its origin in the Revenue Act of 1924. Section 206 (a) (6) of the 1921 Act, defining capital assets, excluded from that term, "property held for the personal use or consumption of the taxpayer or his family and stock in trade or business of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year." The 1924 Act in section 208 (a) (8) added to the exclusion, "property held by the taxpayer primarily for sale in the course of his trade or business." The Report of the House Ways and Means Committee (68th Congres, 1st session, House Report 179) stated, "the last part of the definition of capital assets is added to remove any doubt as to whether property which is held primarily for sale constitutes a capital asset, whether or not it is the type of property which under good accounting practice would be included in the inventory." In 1934, the pertinent provision under discussion, then section 117 (b) was amended to its present form. Report 558 of the Senate Finance Committee (73rd Congress, 2nd Session) stated the purpose of this amendment; "to prevent tax avoidance by excluding from the category of a capital asset property held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business instead of merely property held by taxpayer primarily for sale..."
Matured, unsevered crops are by some courts considered as parts of the realty and by other courts are considered to be personal property. In those states where the matured unsevered crop is considered to be part of the realty, the gain from the sale or exchange of the same along with the sale of the land to which it is attached raises the same problem as that considered in the case of the sale of land with an unmatured crop. However, in those states in which the matured, unsevered crop is considered to be personalty, it appears that section 117 (j) does not apply insofar as it is not realty and is not property used in trade or business of a character which is subject to the allowance for depreciation provided in section 23(1). Being without 117 (j) treatment, gain from the sale of matured, unsevered crops treated as personalty falls back under section 117 (a) and determination must be made as to whether or not this particular personal property comes within the excluded categories of section 117 (a)(1)(A). It would appear that such property is not of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year. With this determination, it appears that the problem again resolves to whether such crops are property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Thus, it appears that the tax consequences of gain realized from the sale of land with an unsevered matured or unmatured crop, depends upon the same basic statutory problem, i.e., whether the crop is held primarily for sale to customers in the ordinary course of trade or business.

A recent decision by a Federal District Court of Florida held that where a citrus grove with an unmatured, unsevered crop of fruit was sold for a lump sum consideration, the entire gain from

in the course of his trade or business. It appears from the legislative history of section 117 (a)(1) that Congress was primarily concerned with including within the section, property other than that properly included in the taxpayer's inventory.

10 Supra, Note 5. In Wisconsin for purposes of taxation, growing crops are considered to be personal property. Section 70.111 Wis. Stats., describes personal property exempted from general property taxes. In subsection (4) of section 70.111, growing crops and medicinal plants are spelled out as personal property exempted from general property taxes. See Kuehn v. City of Antigo, 139 Wis. 132, 120 N.W. 823 (1909), where ginseng was considered as part of the reality. In this case a distinction was drawn between annual growing crops and crops such as ginseng which takes years to develop.

11 INT. REV. CODE sec. 23 Deductions from gross income, subsection (1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) —(1) of property used in trade or business, or (2) of property held for production of income.

12 Supra, Note 1.

13 Supra, Note 6.
the sale of the citrus grove and fruit was gain from a sale of a capital asset held for more than six months and must be taxed accordingly.14 The court considered the growing fruit to be a part of the realty used for a business purpose and entitled to capital gain treatment under section 117 (j). This decision was reached despite the fact that the Commissioner in I. T. 381515 ruled that where citrus groves were sold with fruit on the trees, a portion of the selling price had to be allocated to the fruit and the balance to the land and trees. The ruling considers the allocated gain from the sale of fruit to be ordinary income insofar as fruit is produced with a primary purpose of selling the fruit to customers in the ordinary course of the business. The ruling apparently applies to the sale of a growing crop in any stage of development.

Two recent Tax Court decisions appear to have followed the Commissioner's ruling in I. T. 3815. In a California case,16 factually similar to the Florida case, the Tax Court held that a growing crop of oranges was not real property used in the taxpayers trade or business within the meaning of that term as used in section 117 (j), and further that the crop constituted property held by the petitioner primarily for sale to customers in the ordinary course of trade or business and consequently not entitled to capital gain treatment. In a Kansas case17 it was held that income realized by a wheat farmer on the sale of a farm with a growing crop of wheat was ordinary income and not capital gain, to the extent that the purchase price could be allocated to the growing crop.

The resolution of the problem must lie in this question: At what point of time and under what circumstances is a growing crop held primarily for sale to customers in the ordinary course of trade or business? It is true in the case of the annual money crop that it is being held primarily for sale eventually. It is generally sold at that time when it has ripened, been severed from the realty and become marketable. Does section 117 (a) (1) (A)18 say that a growing crop is held primarily for sale at a point of time prior to the customary time for selling? The statutory provision must be considered in its entire context. The provision reads “held for sale,” not “held to be sold.” Not only must property be held primarily for sale, but it must be held primarily for sale “in the ordinary course of trade or business.” Where a farmer sells his farm, consisting of buildings, incidentals, and a growing crop, even though

15 I. T. 3815 (1946).
18 Supra, Note 1.
a portion of the selling price is attributable to the growing crop, is the sale of the crop made at a time when it is normally sold to customers in the ordinary course of trade or business? That the crop is being cultivated for ultimate sale is not to be disputed, but in the absence of evidence establishing that a taxpayer consistently enters into contracts for the sale of unmatured crops, it would appear illogical to say that the growing crop is at that time held primarily for sale to customers in the ordinary course of trade or business. Conceding that growing crops can be held primarily for sale in the ordinary course of trade or business, where a taxpayer consistently sells his agricultural products in the severed, ripened state, it would appear that when the crops are sold in their growing state along with the sale of land, they are not sold in the ordinary course of trade or business and hence under present statutory provisions should be entitled to the tax treatment of a capital asset.

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19 Am. Jur. 228, §37. "It is the general rule that the sale of a crop which is the product of the annual planting and cultivation of the earth is valid, if at the time of the sale the crop is planted and growing."