

INVOLUNTARY AND VOLUNTARY SALE OF FARM LAND

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Tax considerations have become a major factor in the sale of farm land. This article cannot begin to present a complete picture of the many tax problems encountered in such sales. Here the purpose is to discuss Federal income tax problems in three specific and limited situations:

- (1) Treatment of condemnation awards on condemnations of farm land;
- (2) Allocation problems in sales of farms with residences thereon;
- (3) Treatment of net loss on sale of farm lands as "net operating loss."

FEDERAL INCOME TAX TREATMENT OF CONDEMNATION AWARDS ON CONDEMNATIONS OF FARM LANDS

The Federal income tax treatment of condemnation awards on condemnations of farm land is a small part of the larger subject of involuntary conversions dealt with by INT. REV. CODE OF 1954, SECTION 1033. The cause of the conversion may be "destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof."¹ Thus, the destruction of a barn by fire or wind, the destruction of livestock by disease or sale or exchange of livestock on account of disease,² and sale or exchange of property to conform to acreage limitations of Federal reclamation laws³ are some examples of conversions of property to which section 1033 may apply.

Losses incurred in involuntary conversions are always recognized. The question here to be considered is when and how is nonrecognition of gain achieved on condemnations taking place since the enactment of the Internal Revenue Code of 1954. If property similar or related in service or use is received directly to replace the converted property, and the value of such property received exceeds the tax basis of the converted property, section 1033(a)(1) provides that gain is not recognized. However, if money or other property not similar or related in service or use is received, any gain is recognized unless the property received is applied to the acquisition of similar property in the manner prescribed in section 1033 and the taxpayer elects not to recognize the gain.

For example, if farm land held by a taxpayer for more than six months has an adjusted basis of \$1,000 and a fair market value of \$2,500 and it is condemned for public use and an award of \$2,500 is received, there is a gain of \$1,500 which is recognized for tax purposes unless the taxpayer elects not to recognize the gain and acquires (usually by

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¹ INT. REV. CODE OF 1954, §1033(a).

² INT. REV. CODE OF 1954, §1033(e).

³ INT. REV. CODE OF 1954, §1033(d).

direct purchase) other farm land similar or related in use to the condemned property.

Recognition of Gain under Int. Rev. Code of 1954, Section 1231.

If similar property is not acquired with the condemnation award, the gain recognized will usually be subject to the special treatment provided by INT. REV. CODE OF 1954, SECTION 1231. Section 1231 provides capital gains treatment for the net gain in the taxable year from sales or exchanges of property used in the trade or business and recognized gains from the compulsory or involuntary conversion of property used in the trade or business and capital assets held for more than six months. Except in the situation of a dealer in realty, farm land held for more than six months will usually qualify as property used in the trade or business or as a capital asset, so that recognized gains on condemnation of such land will be subject to section 1231 and result in capital gains treatment to the extent that all section 1231 gains exceed all section 1231 losses during the taxable year. If section 1231 losses exceed section 1231 gains, then the net loss is deductible in full. The mechanics of reporting on the tax return losses and recognized gains from involuntary conversions of property used in the trade or business and capital assets is the same as encountered by a farmer in reporting gains and losses from sales of farm equipment and breeding livestock qualifying for section 1231 treatment.

To illustrate a possible tax result of the \$2,500 condemnation award in the example used above, if such award is the only section 1231 transaction in the taxable year, the \$1,500 gain is treated as a capital gain. However, still assuming no other section 1231 transactions, if the adjusted basis of the property had been \$3,000 the resulting \$500 loss on the condemnation would be deductible as an ordinary loss.

Unharvested Crops. Condemned farm land often will have on it an unharvested crop. If a crop is included in the condemnation of the land on which it is growing and if the land is a section 1231 asset, then any part of the award attributable to the crop will also be subject to section 1231. Such treatment results from section 1231(b)(4) which provides as follows:

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

Where an unharvested crop is included in the condemnation, serious tax problems are created by INT. REV. CODE OF 1954, SECTION 268 which provides as follows:

Where an unharvested crop sold by the taxpayer is considered under the provisions of section 1231 as 'property used in the trade or business', in computing taxable 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.

Deductions disallowed under section 268 are added to basis by section 1016(a)(11).

In comparing the language of section 1231(b)(4) and section 268 as set forth above, it should be noted that section 1231(b)(4) says "sold or exchanged (or compulsorily or involuntarily converted)" while section 268 says only "sold." One might therefore argue that section 268 does not apply to an involuntary conversion of a crop even though the transaction qualifies under section 1231(b)(4). If that is true, then expenses attributable to the condemned crop would not be disallowed as deductions and capitalized. However, the Treasury does not look upon the difference in language of sections 268 and 1231(b)(4) as excluding exchanges and involuntary conversions from the scope of section 268. U. S. Treas. Reg. 118 §39.24(f)-1 (pertaining to INT. REV. CODE OF 1939, SECTION 24(f), which section is substantially identical to INT. REV. CODE OF 1954, SECTION 268) specifically includes crops "sold, exchanged, or involuntarily converted with the land." If the Treasury's position is sustained, taxpayers must remove all deductions pertaining to a crop condemned with the land from tax returns of the year of condemnation and prior years, at least in the situation where the gain on condemnation is recognized and is subject to section 1231.⁴

If the right to the crop is retained by the taxpayer in the condemnation proceedings, section 1231 will not apply to the crop and therefore section 268 also does not apply. In many instances a complex analysis of the taxpayer's overall tax picture will be necessary during or prior to the condemnation proceedings to determine whether for tax purposes an attempt should be made to separate the condemnation of the land from the disposition of the crop. Frequently, practical considerations will require an inclusion of the crop in the condemnation. But if the crop can be retained or sold at a different time or to a different party without economic loss in excess of possible tax savings, then an analysis should be made of benefits to be derived from capital gains treatment under section 1231 and detriments from loss of ordinary deductions under section 268.

A further question as to the scope of section 268 concerns whether it applies to involuntary conversions of crops with the land when the gain is not recognized under section 1033 by reason of reinvesting in similar property. Even if it is assumed that the word "sold" in section 268 includes those involuntary conversions to which section 1231 applies, does section 268 disallow deductions where section 1231 would apply

⁴ Some disadvantages of qualifying dispositions of growing crops for section 1231 treatment and methods of preventing it are discussed in Chapter V of *TAXATION OF FARMERS* by Harry M. Halstead to be published shortly by the Committee on Continuing Legal Education, American Law Institute.

but for the taxpayer's choosing to reinvest a condemnation award in similar property thereby causing nonrecognition of the gain on condemnation? INT. REV. CODE OF 1939, SECTION 24(f) (now INT. REV. CODE OF 1954, SECTION 268) was enacted for the purpose of reducing capital gains and ordinary expense deductions on the sale of growing crops by denying the deduction of ordinary expenses in the production of such crops where they are sold with the land so as to qualify for capital gains treatment under INT. REV. CODE OF 1939, SECTION 117(j) (now INT. REV. CODE OF 1954, SECTION 1231). Therefore, it seems the better view that section 268 applies only to crops as to which gains and losses are recognized under section 1231. If this view is sustained, then no disallowance of deductions will result under section 268 where the taxpayer reinvests the proceeds of a condemnation of crops with the land in a manner causing nonrecognition of the gain under section 1033. Unfortunately, there are no regulations or cases interpreting section 268 on this particular question.

Acquisitions of Property Similar or Related in Service or Use to the Property Condemned. It has been pointed out above that gains on condemnation of land and other involuntary conversions are taxable unless there is a conversion into property similar or related in service or use to the property converted. To the extent there is gain on the condemnation, it will be recognized up to the amount of the award not used to acquire similar property. For purposes of this discussion the property intended to replace the converted property will be called the "acquired property." In beginning this discussion of acquired property, it is obvious that the term "similar or related in service or use" in section 1033 is a much more limited term than "property of like kind," as the latter term is used in connection with tax-free exchanges of property. Under section 1033 it is not enough that business realty is exchanged for business realty. The acquired property must be property very closely related in service or use to the converted property. This means that property acquired with proceeds of condemned farm land must be farm land. Where a barn is converted, the acquired property must be a barn or other property to be used in a manner similar to the converted barn.

There usually is no investment in similar property where improved real estate is acquired to replace unimproved real estate.⁵ However, where land was condemned before taxpayer could construct a building on it, he was permitted to defer recognition of gain by acquiring improved property where most of the acquired improvement had to be removed to make way for the new building.⁶ Converted farm land used for crops can be replaced with land to be used for orchards or for raising livestock.⁷

Where a taxpayer sells a dairy farm containing a rental residence

⁵ U. S. Treas. Reg. 118, §39.112(f)-1(c)(9).

⁶ Gaynor News Co., 22 T.C. 1172 (1954).

⁷ S. FIN. COM. REP. NO. 1052, 82nd Cong. 1st Sess (1951).

to the State under threat of condemnation, he can defer recognition of gain by replacing the converted property with another farm containing two residences, one of which he can use as his home.⁸ Where a farm, including a residence, is condemned as a single parcel, the taxpayer cannot defer recognition of any part of the gain by acquiring a new residence with part of the proceeds where a farm is not acquired.⁹

The Treasury has ruled that a condemned leasehold in a building can be replaced by a new building, the ownership of which is acquired by the taxpayer.¹⁰ In that situation the Treasury also ruled that gain would be recognized for any part of the award invested in machinery or equipment.¹¹ But where an award on condemnation is made in a single sum for real and personal property, the Tax Court has permitted a disproportionate application of the award as between realty and personalty on acquisition of similar property.¹²

Replacement of converted property may be made by acquisition of control of a corporation owning property of a character which would qualify under section 1033 if such property was acquired directly.¹³ The acquisition of a partnership interest in a partnership owning similar property does not qualify the conversion for nonrecognition of gain.¹⁴

Timing the Conversion and the Acquisition of Similar Property. In order to achieve nonrecognition of gain on a condemnation of land where a cash award is received, property similar or related in service or use must be acquired within

the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earliest, and ending—

- (i) one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or
- (ii) subject to such terms and conditions as may be specified by the Secretary or his delegate, at the close of such later date as the Secretary or his delegate may designate on application by the taxpayer . . .¹⁵

Since under the statutory language just quoted a taxpayer has from the date of the first threat of condemnation to one year from the close of the taxable year in which any gain is realized (or such further time as the Treasury may grant) within which to acquire similar property, there is considerable leeway for tax planning both as to the date of realization of gain and as to the date of acquiring similar property.

⁸ Rev. Rul. 54-569, 1954-2 CUM. BULL. 144.

⁹ O. N. Bymaster, 20 T.C. 649 (1953).

¹⁰ I.T. 3793, 1946-1 CUM. BULL. 96.

¹¹ *Ibid.*

¹² Massillon-Cleveland-Akron Sign Company, 15 T.C. 79 (1950).

¹³ INT. REV. CODE OF 1954, §1033(a)(3)(A).

¹⁴ Rev. Rul. 55-222, 1955 INT. REV. BULL. No. 16, at 10.

¹⁵ INT. REV. CODE OF 1954, §1033(a)(3)(B).

Immediately upon a threat of condemnation of land, the taxpayer should begin to consider the possibility of acquiring similar property. If he is sure that the condemnation will be carried out, he need not wait for the completion of the proceedings to purchase similar property for the purpose of causing a nonrecognition of the gain from the condemnation. If difficulty is encountered in finding similar property, it may be desirable to delay the condemnation proceedings, or the incident of realization of gain from the condemnation, as a means of extending the time within which similar property must be acquired.

If property is acquired after threat of condemnation but prior to the completion of the condemnation, the acquired property must be held by the taxpayer on the date the condemnation is completed in order for the acquired property to qualify the transaction for nonrecognition of gain.¹⁶

Basis and Holding Period of Acquired Property. The basis of similar property acquired with a condemnation award is its cost decreased in the amount of the gain not recognized on the conversion. If more than one piece of property is acquired, the basis determined in accordance with the preceding sentence is allocated to the acquired properties in proportion to their respective costs.¹⁷ The holding period of such acquired property does not seem to include the period for which the taxpayer held the condemned property since the basis of the acquired property is defined in part as "cost" and not as a carryover basis.¹⁸ While this result may be due to an error in drafting section 1223 and section 1033(c), it would be unwise to rely on other than a literal interpretation of the statute prior to regulations or rulings on the question.

Reporting Conversions and Making Elections as to Nonrecognition of Gain. Section 1033(a)(3)(A) authorizes the Secretary of the Treasury to prescribe by regulations the time and manner of a taxpayer's reporting his election not to recognize gain on a condemnation by acquiring similar property. Regulations under the Internal Revenue Code of 1954 on this subject have not been issued. Under the Internal Revenue Code of 1939, Treasury Regulations required that

all the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized.¹⁹

Those Regulations further provide that:

(1) The election not to recognize gain is made merely by the reporting of the transactions and including in gross income

¹⁶ INT. REV. CODE OF 1954, §1033(a)(3)(A)(i).

¹⁷ INT. REV. CODE OF 1954, §1033(c).

¹⁸ INT. REV. CODE OF 1954, §1223.

¹⁹ U. S. Treas. Reg. 118, §39.112(f)-1(c)(2).

only such part of the gain as must be recognized by reason of not applying part of the award to the acquisition of similar property.

(2) A failure to report the gain, whether or not the details of the conversion are reported, is deemed to be an election by the taxpayer not to recognize the gain.

(3) Having made the election not to recognize the gain, if the converted property is not replaced within the required period of time, or if the replacement is made at a cost less than the proceeds of the conversion, the tax liability for the years in which the election was made is recomputed and reported on amended returns.

(4) A decision to realize the gain can be changed at any time before the expiration of the period within which converted property must be replaced by filing a claim for credit or refund.

Assessment of Deficiencies. When the taxpayer elects not to recognize gain on a conversion qualifying under section 1033(a)(3)(C), the statutory period for the assessment of any deficiency will not expire prior to the latest of the following events:

(1) The expiration of three years from the date the Treasury is notified by the taxpayer of the replacement of the converted property or an intention not to replace it (which notice is required by U. S. Treas. Regs. 118, § 39.112(f)-1(c)(5) to be filed with the District Director of Internal Revenue with whom the return was filed); and

(2) The expiration of the period within which a deficiency may otherwise be assessed for the last taxable year in which gain from the conversion is realized.

Because of the special provisions extending the statute of limitations just described, it is important for taxpayers to file the required notice of acquisition of similar property, or notice of intention to recognize the gain, as soon as possible.

ALLOCATION PROBLEMS IN SALES OF FARMS WITH RESIDENCES THEREON

When farm property is sold, it is necessary for the seller to allocate the sales price among various classes of assets in order to properly report the transaction for income tax purposes.²⁰ For example, a farmer selling his farm might allocate the sales price among the following groups of

²⁰ *Watson v. Commissioner*, 345 U. S. 544, 43 A.F.T.R. 621, 53-1 U.S.T.C. ¶9391 (1953); *Williams v. McGowan*, 152 F. 2d 570, 34 A.F.T.R. 615, 46-1 U.S.T.C. ¶9120 (2nd Cir. 1946). Expenses of Sale: While limiting the text to a discussion of allocations of sales price, it should be noted that allocation problems may also arise concerning expenses of sale. Where identifiable, expenses should be allocated to the class of property to which they pertain. General expenses should be allocated among the assets sold in the proportion that the portion of the total selling price allocable to each bears to the total selling price. *Ernest A. Watson*, 15 T.C. 800 (1950).

assets: (1) crops and livestock producing ordinary income, (2) farm land and equipment producing capital gains under section 1231, and (3) non-business assets, such as a personal residence as to which losses are not recognized²¹ or as to which the realization of gain may be postponed.²² The buyer will usually make further allocations within the categories just described so that each item purchased will have a tax basis for computing gain or loss on future sale or for computing depreciation as to those assets subject to the deduction for depreciation.

For the purpose of this discussion let us assume that the seller is selling farm land with growing crops,²³ feeder livestock, and his personal residence which is on the farm. The seller intends to acquire a new residence within the period prescribed by INT. REV. CODE OF 1954, SECTION 1034 so that no gain will be realized on the sale of the old residence. The buyer will operate the farm and live in the residence.

In the above situation, it will be necessary for the seller to make an allocation of the sales price among (1) the residence,²⁴ (2) feeder livestock, and (3) land and crops attached, since the gain or loss in each of these categories will be treated differently for tax purposes. Gain or loss will be measured in each of these categories by the difference between the basis of the assets in each category and the part of the sales price allocated to such assets. The residence falls into a separate category for computing gain or loss on its sale because (1) the loss is not deductible for tax purposes since it is not incurred in a trade or business or in a transaction entered into for profit within the scope of INT. REV. CODE OF 1954 SECTION 165(c), and (2) any gain on the sale of the residence will be recognized as capital gain, except that such gain as is allocable to the residence may be postponed by the acquisition of another residence in the manner prescribed by section 1034, in which event the basis of

²¹ If property used for personal and income purposes is sold, only the loss allocable to the income-producing part is deductible. The seller must compute his tax as though two separate pieces of property were sold in separate transactions. Rev. Rul. 286, 1953-2 CUM. BULL. 20.

²² This article will not discuss sales of partnership interests or corporate stock, which are exceptions to the general rule requiring allocation of the sales price of a going business among the different kinds of property included in the sale.

²³ See the article in this issue entitled *Special Capital Gains Treatment for Farmers*.

²⁴ See proposed Regulation under INT. REV. CODE OF 1954, §1034; U. S. Treas. Reg. §1.1034-1(c)(3)(ii). "Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this section and only an amount allocable to the selling price of such portion need be reinvested in the new residence in order to have the gain allocable to such portion not recognized under this section. If the new residence is used only partially for residential purposes only so much of its cost as is allocable to the residential portion may be counted as the cost of purchasing the new residence."

the old residence enters into the computation of the basis of the new residence. The land with crops attached fall into a separate category because they are both entitled to the special treatment under section 1231 resulting in capital gains treatment of the net gain or ordinary deduction of the net loss from section 1231 transactions in the taxable year. The gain allocable to the feeder livestock falls into a separate category since it is ordinary income.

Because of the above pattern of taxation of gains as ordinary income, capital gains, or a postponement of the recognition of gain, a seller, to the extent that he can exercise control over the allocation of the purchase price among the various assets being sold, may minimize his taxes by carefully planning and negotiating his sale to achieve a favorable allocation. However, it must be kept in mind that the tax objectives of a buyer often are contrary to those of the seller. For example, in the above situation the seller and the buyer may have opposing objectives in each of the three categories of assets sold:

(1) *Residence*: Since the seller is acquiring another residence so as to postpone the recognition of gain on the sale of the old residence, the seller usually will want to allocate as much of the sales price as possible to the old residence. Of course, the seller must keep in mind that he must invest the entire amount attributable to the old residence in a new residence in order to postpone recognition of gain, which fact may limit the amount he will want to allocate to the sale of the old residence. Any gain the seller does recognize on the sale of the old residence will be capital gain. The buyer, on the other hand, usually will want to allocate a minimum amount to the residence for the reason that he will get no tax benefit from the part of his cost allocable to it since he cannot take a deduction for depreciation on the residence or otherwise recover his cost for tax purposes until such time as he ultimately sells the property or converts it to business purposes. However, the buyer may be acquiring the residence as a replacement of his prior residence, and he may desire to postpone the gain on his sale of the prior residence, in which case he may want to allocate a sufficient amount to the residence being acquired to eliminate any tax on the sale of his prior residence.

(2) *Feeder Livestock*: The seller will want to allocate as little as possible of the total selling price to the feeder livestock so as to keep the amount of ordinary income on the transaction at a minimum. The buyer will usually want to allocate as much of the total purchase price as possible to such animals since their cost will be his basis for computing ordinary income on their subsequent sale.

(3) *Land and Crops Attached*: The seller will prefer to allocate any gain which he cannot attribute to the sale of the residence to the land and attached crops on which he will realize capital gains under section 1231. The buyer in this situation will want a low amount allocated to the land, but he may be more cooperative with the seller if he

can negotiate the allocation of a substantial amount to the growing crops so as to reduce his ultimate ordinary income on sale of the crops at maturity. In this particular situation where the crops qualify as section 1231 assets, it should be noted that as between land and crops the allocation of the sales price by the seller makes no difference to him. But the allocation does make a substantial difference to the buyer. The amount properly allocable to the crops by the buyer will be his cost basis for computing gain on the future sale of the crops when harvested, thus limiting the ordinary income to be realized by the buyer on such future sale. On the other hand, such part of the purchase price as the buyer must allocate to the land will be his cost basis for the land deductible only upon a future sale of the land.

Keeping in mind the tax benefits or detriments arising out of favorable or unfavorable allocations of sales prices, the crux of this discussion is how can the buyer or seller establish a proper allocation for tax purposes. First of all, it should be pointed out that allocations which are mere shams cannot be expected to work for tax purposes. Second, it should be realized that in the area of allocation of values opinion evidence often controls so as to result in a substantial leeway in determining what is a fair allocation. Third, the Treasury can be just as extreme in setting up allocations producing more taxes as taxpayers can be in alleging allocations minimizing taxes. Therefore, taxpayers should preserve evidence in their support regardless of how reasonable their allocations may seem to them.

When a sale of a farm and residence is contemplated, there are many things which the buyer and seller can do to support their tax treatment of the transaction. In a bona fide arm's-length transaction between buyer and seller, their agreed allocation of the purchase price as set forth in their contract of sale will be substantial proof of the fair values to be allocated to the various assets sold. To the extent possible the parties should negotiate and agree upon the price to be paid for various classes of property.

Usually, the buyer and seller cannot agree upon an allocation.²⁵ In those situations it will often be desirable for each party to have competent appraisers appraise the property being sold or acquired and make allocations of the sales price in a written report to the respective tax-

²⁵ The parties frequently refuse to discuss allocation, having concluded before beginning the negotiations that the conflict in interest is such that there is no possibility of agreement on an allocation. This is particularly true where the seller desires a high allocation to good will to realize capital gain while the buyer desires a high value on inventory and depreciable assets. See *Grace Bros., Inc. v. Commissioner*, 173 F. 2d 170, 37 A.F.T.R. 1006, 49-1 U.S.T.C. ¶9181 (9th Cir. 1949); *Estate of John C. Burns, Deceased*, 6 T.C.M. 973, P-H Memo. T.C. ¶47,242 (1947); *Constantine H. Kavalaris*, 5 T.C.M. 18, P-H Memo. T.C. ¶46,005 (1946); *Vester Keeter*, 13 T.C.M. 572, P-H Memo. T.C. ¶54,183 (1954); *Violet Newton*, 12 T.C. 204 (1949).

payers. Such appraisals should explain the method used in determining the value of each item. Other evidence which may be preserved to assist the taxpayer on audit of his tax returns are such things as the sales prices of similar property in the community, which would include, for example, sales of similar residences and sales of similar farm land. Photographic evidence of the condition of the property at the time of sales is often useful.

There is no fixed pattern or approach to this problem of proving allocations of sales prices for tax purposes. Much will depend on the size and complexity of the sale, the location of the property, the willingness of each party to negotiate on details, the availability of good appraisers, other sales of like property in the community, the knowledge of the parties concerning values,²⁶ and many other factors. It is true here, as in all areas of the tax law requiring valuations, that opinion evidence and oral testimony is given little weight unless it is supported by records. Taxpayers usually do not have difficulty in their tax audits where they can produce a detailed inventory and cost record of the property sold, a written contract of sale allocating the sales price, written appraisals made for the purpose of determining the sales price and its allocation, and records of similar sales in the community.

TREATMENT OF NET LOSS ON SALE OF FARM LANDS AS NET OPERATING LOSS

Fortunately, there is little to be said on the subject of the inclusion of the net loss on sales of farm lands in the net operating loss of an individual. The Revenue Act of 1954 took care of this matter by specifically providing for the inclusion of such losses in the net operating loss of individuals.²⁷ Corporations were allowed to treat all losses as business losses under the Internal Revenue Code of 1939, as well as under the Internal Revenue Code of 1954, so that the problem was one pertaining only to taxpayers operating as sole proprietors or in partnership.

Prior to the enactment of the Internal Revenue Code of 1954, the courts had held that a farmer who sold his farm at a loss could not include such loss in his net operating loss.²⁸ The reasoning of the courts was that the loss was a non-business loss where the taxpayer was not in the

²⁶ Ernest A. Watson v. Commissioner, 345 U. S. 544, 43 A.F.T.R. 621, 53-1 U.S.T.C. ¶9391 (1953), *affirming* 197 F. 2d 56, 41 A.F.T.R. 1373, 52-1 U.S.T.C. ¶9350 (9th Cir. 1952), *affirming* 15 T.C. 800 (1950). The Tax Court considered at length the intentions of buyer and seller, as to the amount of the sales price allocable to a growing crop, evidenced by the long experience of both parties in the citrus business, estimates of the parties during the negotiations as to the size of the crop on maturity, and production costs.

²⁷ INT. REV. CODE OF 1954, §172.

²⁸ Joseph Sic v. Commissioner, 177 F. 2d 649, 38 A.F.T.R. 804, 49-2 U.S.T.C. ¶9544 (8th Cir. 1949), *affirming* 10 T.C. 1096 (1948), *cert. denied* 339 U. S. 913 (1950). For discussions of the case law prior to the Internal Revenue Code of 1954 see Boehm, *Melody in G's*, 28 TAXES 163 (1950) and Boehm, *Corporation Liquidation Loss Carrybacks*, 28 TAXES 845 (1950).

business of selling farms. The effect of such court decisions was to prohibit individuals from carrying over to other taxable years a net loss from sales of assets such as farm land used in the business of farming. This meant that where there was insufficient income in the year of the loss to offset the loss, there would never be any tax benefit from the loss.

The statutory language solving the above problem is contained in INT. REV. CODE OF 1954, SECTION 172(d)(4)(A), which provides as follows:

- (A) any gain or loss from the sale or other disposition of
 - (i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or
 - (ii) real property used in the trade or business, shall be treated as attributable to the trade or business.

By reason of the above statutory language, the net loss on sales during the taxable year of such things used by the taxpayer in the business of farming as farm land, machinery and equipment, and breeding live-stock is includible in the computation of the taxpayer's net operating loss. Also, under section 172, net operating losses are carried back two years and forward five years. This means that over a period of eight years the taxpayer has an opportunity to have losses on sales of farm land and other assets used in farming reduce taxable income from other sources. The net operating loss is first carried back to the second year preceding the year of the loss. Then, to the extent not used up, the remainder of the net operating loss is carried to the first preceding year and then, successively, to the first, second, third, fourth, and fifth years succeeding the year of loss. There are many modifications to be made in computing the net operating loss and the income for the years to which the net operating loss is carried. Those modifications are specified in section 172. Since they are common to all taxpayers and discussed in all standard texts, they require no comment here.