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## One Aspect of Section 117 J. Relief

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face waters by requiring that all the waters of the state be governed, as nearly as practicable, by the same laws. On the basis of this premise, the State should make an initial survey of the underground waters of the State so as to determine the safe point of yield in a given area.<sup>19</sup> This the State Engineer may now do. Permits should be granted to prevent users in the area on the basis of priority of appropriation and beneficiality of use, under our present underground water statute.<sup>20</sup> Subsequent appropriators, however, should be required to obtain a permit before drilling for water, and the granting of such permit should be predicated upon the findings of the State Engineer in regard to the safe yield of the area and as to reasonableness of the proposed depth and pumping capacity.<sup>21</sup> The courts should not hold that a prior user gains a vested right in his method of diversion; these rights should be held tentative and flexible so that they can be adapted to future contingencies which may arise.<sup>22</sup> Such policies are in complete accord with the purpose of conservation; they provide for the complete use of underground water without fear of dissipating the resources of the State.

M. L. van BENSCHOTEN.

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#### ONE ASPECT OF SECTION 117 J RELIEF

This paper is an evaluation of the Commissioners attempt to have livestock excluded from the benefits of Section 117 J of the Internal Revenue Code relief.

Farmer Jones is in the dairy and hog raising business. He maintains his dairy herd at a constant amount by adding calves the herd produces and selling old cows that are no longer useful as well as the excess young calves. The hog breeding herd is replaced annually (as is the custom in the industry) with the farmer's own young sows and a purchased boar

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19. Wyo. Comp. Stat. 1945, Supp. 1949, sec. 71-416, "The State Engineer is hereby authorized and directed to proceed with the determination of the capacity of the various underground pits, geological structures of formations in the State to yield such waters. After the boundaries and capacities of any such pit or formation or other geological structure containing underground water have been fixed by such determination, the State Engineer shall give notice of such determination to the State Board of Control, which Board shall then proceed with the adjudication of said water within the area supplied from this particular underground pit . . . Interested parties must show . . . proof of beneficial application of the water derived therefrom . . ."
  20. Wyo. Comp. Stat. 1945, Supp. 1949, sec. 71-412, "In order that all parties may be protected in their lawful rights to the use of underground water for beneficial purposes, every person . . . shall . . . file . . . a statement of claim . . . which . . . shall contain . . . the nature of the use on which the claim is based . . . , the location of the well or wells by legal subdivisions, depth to the water table, size of well, type of well, . . . type and method of pumping, horsepower of pump, amount of water pumped each year, the amount of water claimed and a log of the foundations encountered in drilling or digging of the well; . . ."
  21. National Resources Planning Board, *State Water Law in the Development of the West*, United States Government Printing Office, 1943, p. 84.
  22. Hutchins, *Selected Problems in the Law of Water Rights in the West*, (1942) p. 178.

In selling these animals, Farmer Jones realizes a profit of a thousand dollars. On his income tax return Farmer Jones claims this sum is a capital gain under the provisions of Sec. 117 J and that the tax cannot exceed two-hundred and fifty dollars (25%). The Commissioner, however, claims that this is ordinary income under his rulings (IT 3666 and IT 3712)<sup>1</sup> and that the tax can run as high as seven-hundred seventy dollars (77%).

Sec. 117 J is a relief provision under which certain gains of businessmen can be treated as capital gains. The gains to which this relief is applicable are those arising from (1) the sale or exchange or depreciable business property and real property used in the business (inventory property and property held for sale to customers is excluded), which have been held by the taxpayer for more than six months or (2) involuntary conversion (such as condemnation, seizure, destruction, theft) of property in (1) above or of other capital assets, which have been held for more than six months. All of such transactions are lumped together and if a net gain results it may be treated as a long term capital gain but if a net loss results it is deductible in full. Farmer Jones contends that his gains come under this provision and that the gains should thus be capital gains.

IT 3666 and IT 372 were issued to "explain" this section of the Internal Revenue Code to farmers. In these rulings the Commissioner stated that if the stock sold are "culled from the breeding herd" as feeder or slaughter animals in the REGULAR course of farm business, the gains and losses are includible with ordinary farm sales. "Culled from the breeding herd" was defined as the normal selection for sale of those animals that the livestock raiser no longer wants for breeding purposes. These animals are usually sold because of age, disease, injury or merely to maintain the herd at regular size. The Commissioner contends that Farmer Jones's animals were "culled" in the regular course of farm business and hence the regulations apply and the gain is ordinary income.

The cases in which this point has been litigated are all in favor of Farmer Jones however.

The first case was *Albright v. United States*.<sup>2</sup> The facts and contentions of the parties were the same as those of the Commissioner and Farmer Jones. The District Court agreed with the Commissioner<sup>3</sup> but the Court of Appeals reversed in a two to one decision. The court said that the taxpayer must prove five elements before he is entitled to Sec. 117 J relief: (1) that the animals sold were used in his business, (2) that the animals were subject to an allowance for depreciation, (3) that the animals had been held for more than six months, (4) that the animals were not property of the kind includible in the inventory, and (5) that the animals were not held primarily for sale in the ordinary course of the trade or business. The Commissioner admitted that the first four elements were proven below but contested the proof of the fifth element.

On the issue of the cows, the Court pointed out that the rulings (IT 3666 and IT 3712) only referred to "culls" from breeding herds not from draft or

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1. IT 3666, Cum. Bul. 1944 p. 270; IT 3712, Cum. Bul. 1945 p. 176.

2. 173 F. (2d) 339 (C.A. 8th. 1949).

3. 76 F. Supp. 532 (D. C. Minn. 1948).

dairy herds such as the taxpayer in the case and Farmer Jones have, hence, the rulings do not cover the situation and the theory of the rulings could not be followed as Congress intended Sec. 117 J to be a relief measure applicable alike to all taxpayers. As noted above this section permits use of capital gain rates for profits arising from certain property. These types of property are generally held for long periods of time and depreciate in value over the entire period (if they do appreciate) and when the taxpayer disposes of the property he must usually replace it to continue in business, and the cost of replacement is most often more than the sum received for the old asset. Hence, Congress has given relief in the form of lower rates to enable the businessmen to replace their old uneconomical assets more readily.

The court then held that the rulings could not be applied to the sale of the hog herd, even though it was a breeding herd and thus squarely within the terms of the rulings, as the annual sale of the breeding herd was the usual custom of the industry and so presumably necessary for efficient and economical operation of the business and therefore the regulations were, as to this taxpayer, unreasonable and “. . . contrary to the plain language of Sec. 117 J and to the intent of Congress expressed in it.”<sup>4</sup>

The case of *Commissioner v. Issac Emerson*<sup>5</sup> was decided about a month after the *Albright* case, and on practically the same facts the Tax Court agreed with the Court of Appeals of the Eighth Circuit that the sale of hogs and cows from a breeding and dairy herd respectively could be treated as capital gains. The court expressly approved of the *Albright* case. In this case it was pointed out that the taxpayer was on the cash basis and that he would obtain but one litter per hog before he would condition them for sale, but the majority held that the hogs were “property used in the trade or business” and not “property held primarily for sale to customers.”

*Commissioner v. Fawn Lake Ranch*<sup>6</sup> is the third case of this series and it involved the sale of cattle from a breeding herd. The taxpayer was on the accrual basis of accounting and maintained separate accounts for its breeding and ordinary cattle. The taxpayer selected its best cows at the age of two years and transferred them from the ordinary herd to the breeding herd. The inventory value of the cows transferred was then deducted from the ordinary cattle account and added to the breeding herd account. Under the method of valuing cattle used by the taxpayer (unit livestock price method),<sup>7</sup> all of the taxpayers livestock must be included in the inventory. The Commissioner argued that as the cattle were inventoried the gain should be considered ordinary income as Sec. 117 J expressly excludes inventoried property from its benefits, and although the dissent adopted this view, the majority of the Tax Court again followed the reasoning of the *Albright* case and held that the gain could be treated as a capital gain. The majority pointed out that the Commissioner had ruled that inventoring such animals under the unit livestock price method was

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4. 173 F. (2d) 339 at p. 345

5. 12 TC 875.

6. 12 TC 1139.

merely accounting convenience and that such cattle were still capital assets in the very ruling the Commissioner seeks to sustain here (IT 3666). It should be pointed out that while the Commissioner has the power to prescribe the method of accounting which a taxpayer must use, even though it is contra to widespread practice in the industry,<sup>8</sup> this power should not be construed to deprive the taxpayer of any relief provisions of the Code such as Sec. 117 J.

Thus it would appear from the facts, statute, cases and principles that Farmer Jones is correct in his contention that his gain should be treated as a capital gain.

The Commissioner apparently bases his contention upon the fact that these animals are generally removed from the breeding or dairy herd and conditioned before being sold. This, he feels, makes them property "primarily held for sale to customers" as such property is often what the farmer raises for sale in another branch of his business. This same reasoning would apply to a large number of factual situations in which the taxpayer using the property in his business also sells or manufactures the same type of property. One example would be the sale of an old towing truck by an automobile dealer. If this theory is adopted it will greatly limit the relief offered by Sec. 117 J.

However, the fury of the Commissioner seems to be even greater than that of a woman scorned as the Commissioner succeeded in getting the House of Representatives to pass a limitation on Sec. 117 J essentially the same as his rulings (IT 3666 and IT 3712) in 1948 as was pointed out in the *Albright* case.<sup>9</sup> And again this year Secretary of the Treasury Snyder recommended that Congress adopt this restriction upon Sec. 117 J.<sup>10</sup> The Commissioner has also announced he will appeal all adverse decisions arising outside of the eighth circuit.<sup>11</sup> This factor should be considered before litigating the point with the Commissioner as, apparently, sooner or later he will choose the case that he wants to take to the Supreme Court for a final determination of the matter.

W. K. WOODSON.

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7. Reg. 111, Sec. 29.22 (c) 6 as amended, PH Fed. Tax Service 1950 Sec. 9736.

8. *Riverside Mfg. Co. v. United States*, 67 Ct. Cls. 117.

9. 173 F. (2d) 339 at p. 343.

10. PH Weekly Letter of Taxation and Government Regulation, February 13, 1950.

11. PH Fed. Tax Service 1949, Sec. 70, 469 (Apparently the Commissioner will have plenty of cases to appeal. Several memo decisions have recently been handed down in favor of the taxpayer including *Bennett v. United States*, US D. C. West. Div. Tex. PH Fed. Tax Service 1950, Sec. 72,418; *Fitz*, PH Memo TC Sec. 50,029; and *Oberb*, PH Memo TC Sec. 49,134. The government does not publish Tax Court memo decisions).