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Comment

SECTION 117(j): THE TAXPAYER'S FRIEND

Section 117(j) of the Internal Revenue Code originated in the Revenue Act of 1942 from dual motivations; to clear up confusion created by the Revenue Act of 1938 and to alleviate tax hardships from wartime disposal of depreciable business property.

The Revenue Act of 1938 had excluded depreciable property used in the trade or business from the category of capital assets, in order to allow businessmen and corporations the advantage of fully deductible losses on transfers of such business property.¹ Controversy and uncertainty arose with attempts to allocate gains and losses from sales of improved business realty between the depreciable improvements and the land itself.² Wartime conditions prompted many transfers and conversions of business assets resulting in extraordinary gains and losses.³

The congressional solution was the enactment of section 117(j),⁴ re-

¹ H. R. REP. NO. 1860, 75th Cong., 3d Sess. (1938); 1939-1 CUM. BULL. 728, 732, 752.

² H. R. REP. NO. 2333, 77th Cong., 1st Sess. (1942); 1942-2 CUM. BULL. 372, 415.

³ SEN. REP. NO. 1631, 77th Cong., 2d Sess. (1942); H. R. REP. NO. 7378, 77th Cong., 2d Sess. (1942); 1942-2 CUM. BULL. 504, 545.

⁴ INT. REV. CODE § 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 purposes 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 six months, and real property used in the trade or business, held for more than six 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)

sulting in a more favorable treatment of the property and transactions to which it applies.

Ordinarily, upon the *sale or exchange* of a "capital asset" held for more than six months,⁵ the tax on gain is limited to 25% of the net gains,⁶ and the deduction of net losses regardless of the time held is sharply limited.⁷ A "capital asset," as defined by section 117(a), consists of *all* property held by the taxpayer *excluding* (1) inventorable stock in trade or property held primarily for sale to customers in the ordinary course of business, (2) real property and depreciable property used in the trade or business, (3) certain literary, musical, or artistic compositions, copyrights or similar property, and (4) certain government obligations issued on or after March 1, 1941.⁸

Section 117(j) complements this capital asset picture. It applies to sales or exchanges of "property used in the trade or business"⁹ (only if held for more than six months), and the compulsory or "involuntary conversion"¹⁰

property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). 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 as 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 purposes of this paragraph:

"(A) In determining under this paragraph whether gains exceed the losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

"(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than six months shall be considered losses from a compulsory or involuntary conversion."

The Revenue Act of 1943 included within the term "property used in the trade or business" timber with respect to which subsections (k)(1) or (2) of section 117 is applicable. The Revenue Act of 1950 also amended section 117(j)(1) by adding clause (C) to the end of the first sentence, effective with respect to taxable years beginning after September 23, 1950.

The amendments of the Revenue Act of 1951 are discussed later in the text.

⁵ INT. REV. CODE § 117(h). The property must be held for more than six months and calculation of the holding period is determined by months and fractions of months, not by days, as to which see I.T. 3985, 1949-2 CUM. BULL. 51. The importance of carefully planning the time of sale or exchange is readily apparent.

⁶ INT. REV. CODE § 117(b), (c).

The Revenue Act of 1951, § 123 increased the maximum tax on long-term capital gains of corporations to 26% for any taxable year beginning after March 31, 1951 and before April 1, 1954.

The Revenue Act of 1951, § 322(b) increased the alternative (maximum) tax on taxpayers (other than corporations) to 26% for any taxable year beginning after October 31, 1951 and before November 1, 1953.

⁷ INT. REV. CODE § 117(d), (e).

⁸ INT. REV. CODE § 117(a). Note that the exclusions of § 117(j)(1)(A), (B) and (C) are identical to the exclusions of § 117(a)(1)(A) and (C).

⁹ INT. REV. CODE § 117(j)(1), *supra* note 4.

¹⁰ INT. REV. CODE § 117(j)(2)(B), *supra* note 4. Compare the identical definition of an "involuntary conversion" in section 112(f) of the Code.

of "property used in the trade or business" and "capital assets" held for more than six months. Like 117(a), it expressly excludes property described in (1) and (3) of the paragraph above. Thus, broadly speaking, a line is drawn between stock in trade or goods held primarily for sale, the disposition of which continues to result in ordinary gain or loss, and property used in the production of income or operation of the trade or business, the disposition of which receives the more favorable treatment of 117(j).

Section 117(j) provides that if the recognized gains from the specified transactions involving the above described property exceed the losses, the net gains shall be taxed as if from the sale or exchange of *capital assets*. On the other hand, if the losses exceed the gains, the net losses are treated as *ordinary losses* and are deductible in full.

It should be kept in mind that in dealing with "capital assets" and "117(j) assets," gains must initially qualify as income under section 22(a), and losses must similarly be allowable under section 23. Also, in the computation of taxable income, the amount of these gains and losses must be determined as provided in section 111, and in the case of a sale or exchange gains and losses must be recognized under section 112 of the Internal Revenue Code.

Despite the limited circumstances of its origin, section 117(j) is phrased in general terms and is susceptible to broad interpretation. The reactions of the principal participants in the taxpayer-taxgatherer contest have been typical. The Bureau policy, by ruling and litigation, has been to confine the application of this section within as narrow limits as possible. The broad phraseology used has in turn set into motion the ingenuity of tax advisers in the constant struggle to minimize tax liability. Such interaction of contrary interests has left the exact limits of section 117(j)'s beneficial treatment in doubt. It has been suggested that its scope is a broad and expanding one.¹¹ Developments to date seem to bear out that suggestion.

A survey at this time of judicial, administrative, and legislative activities with regard to section 117(j) may be of some help to the occasional tax adviser and his client in the search for relief in the face of increasing tax rates and inflation. The certainty of taxation is not questioned, but at least we may seek to mitigate its rigors. At the outset it is fair to assume that the statutory language covers most ordinary depreciable property and land employed in a business, when these assets are not a part of the inventory or not held primarily for sale. To facilitate analysis, consideration will be given first to the types of property^{11a} to which the section has been applied, and then to the types of transactions included within its scope.

¹¹ Brookes, *The Expanding and Potential Scope of Section 117(j)*, 2 UNIV. OF SO. CALIF. TAX INST. 299 (1950).

^{11a} The Revenue Act of 1943 included within the term "property used in the trade or business," timber with respect to which subsection k(1) and (2) of section 117 is applicable. This specialized aspect of section 117(j) will not be discussed, other than to note that "gain or loss upon the cutting of timber" is entitled to the benefits and subject to the limitations of the section. See Stoel, *Timber Cutting and Timber Sales Under Sec. 117(k) of Internal Revenue Code*, 30 ORE. L. REV. 306 (1951).

TYPES OF PROPERTY TO WHICH SECTION 117(j) APPLIES

Idle Business Property

(1) *Real Property*. Whether idle business realty was included within the phrase "property used in trade or business" was a question arising early in the constructional history of section 117(j). In *Carter-Colton Cigar Co.*,¹² the taxpayer acquired unimproved realty with the intention of erecting a building for use in its business. The original purpose was later abandoned and the property sold. In applying section 117(j) to the resulting loss, the Tax Court held that the character of property used in the trade or business continues even after the *planned* use becomes impossible.¹³ Conversely, where *past* use became impossible, the taxpayer's rental dwelling having been destroyed by a hurricane, loss on the sale of the land received 117(j) treatment. The Tax Court refused the Bureau's argument that the land was not being used in the taxpayer's business at the time of sale.¹⁴

More recently, the Fifth Circuit Court of Appeals applied the section to a lumber company's infrequent sales of unimproved lots after expected city and utility developments failed to materialize.¹⁵ The infrequency of the sales and the absence of any sustained real estate activities were factors influencing the holding that the lots were not "held primarily for sale to customers in the ordinary course of business."

(2) *Personal Property*. Uncertainty with regard to idle depreciable personalty has been resolved in favor of the taxpayer. Section 117(j) was applied to the profit received on the sale of salvaged parts of a dismantled marine railway which had been stored for future use.¹⁶ In *Alamo Broadcasting Co.*, foreign governmental prohibition of transportation of radio equipment from Mexico prevented the American taxpayer's planned use of the equipment.¹⁷ The Tax Court held that the loss upon sale was covered by section 117(j), saying that "... 'used in the trade or business' means 'devoted to the trade or business' and includes property purchased with a view to its future use in the business even though this purpose is later thwarted by circumstances beyond the taxpayer's control." The benefit of the section was also allowed by a district court where a mining company sold its tippie, machinery parts, motors, armatures and railroad rails at a gain, after depletion of the coal in one of its mines.¹⁸

¹² 9 T.C. 219 (1947), *acq'd.*, 1947-2 CUM. BULL. 1.

¹³ Cf. R. H. Hutchinson, CCH 8 T.C.M. 597 (1949). Taxpayer acquired first one eight-acre tract with intent to use four acres for a factory site. Forced to abandon this plan he acquired a second eight-acre property, built a factory on about four acres of it and sold the balance for industrial sites. The first property was subdivided into lots, several homes built, and sold for residential property. *Held*, that the gain on sale of the first property was ordinary income and that gain on sale of the four acres off the second property was long-term capital gain.

¹⁴ Solomon Wright, Jr., 9 T.C. 173 (1947), *acq'd.*, 1947-2 CUM. BULL. 5 (sale was accomplished after four years of effort).

¹⁵ Dunlap v. Oldham Lumber Co., 178 F.2d 781 (5th Cir. 1950).

¹⁶ Wilson Line, Inc., 8 T.C. 394 (1947), *acq'd.*, 1947-1 CUM. BULL. 4.

¹⁷ 15 T.C. 534 (1950), *acq'd.*, 1951-10 INT. REV. BULL. 1.

¹⁸ Providence Coal Mining Co. v. Glenn, 88 F. Supp. 975 (W. D. Ky. 1950).

Non-business Property Converted to Business Use

Thus far the problem with non-business property converted to business use has arisen when residential property is converted to rental use and later sold at a loss. In *Leland Hazard*, the house had been converted to rental property after its use as a residence by the taxpayer.¹⁹ The Tax Court held that the house was used in the trade or business and the loss was therefore deductible in full under section 117(j).

Recently, the application of the section was broadened to include the sale of residence property where there had been no actual rental, but only unsuccessful attempts to rent.²⁰ There is no apparent reason why these precedents dealing with residential property might not be applied in the future to other types of property.

Rental Property: Similar Property Held for Sale

(1) *Real Property*. The line between property used in business and property held primarily for sale has been particularly difficult to draw where the taxpayer holds assets primarily for sale which are similar to other assets used in the trade or business. *Nelson A. Farry* dealt squarely with this problem where realty is involved.²¹ The petitioner developed subdivisions and constructed and sold houses, reporting the profit as ordinary income. He also acquired similar properties for investment purposes, collecting rentals from them. When he sold forty-six of the latter units over a two-year period, the Tax Court held that the sale was covered by section 117(j). The fact that the taxpayer also held properties of a similar nature primarily for sale to customers in the ordinary course of business was held to be irrelevant.

Furthermore, options to purchase under rental agreements have not precluded the operation of section 117(j) upon sales under the options.²² Options are held to be insufficient proof that properties are held primarily for sale.

Delsing v. United States recently applied section 117(j) to a sale of rental units built for wartime housing, although the taxpayer built other houses and held them primarily for sale.²³ However, in several cases involving wartime housing, the taxpayer has been unable to establish that the units sold were not held primarily for sale at the time the sales were made.²⁴

¹⁹ 7 T.C. 372 (1946), *acq'd.*, 1946-2 CUM. BULL. 3.

²⁰ Mary E. Crawford, 16 T.C. 678 (1951), *acq'd.*, 1951-18 INT. REV. BULL. 1.

²¹ 13 T.C. 8 (1949). The case is interesting for the reliance placed upon *E. Everett Van Tuyl*, 12 T.C. 900 (1949), and *Carl Marks & Co.*, 12 T.C. 1196 (1949), both dealing with the interpretation of section 117(a), despite Bureau resistance to application of 117(a) precedents to interpretation of identical phrases in section 117(j).

²² CCH 8 T.C.M. 114 (1949).

²³ 186 F.2d 59 (5th Cir. 1951) (sale of rental dwelling units built for wartime housing, although other houses were built and held primarily for sale); *cf.* *South Texas Properties Co.*, 16 T.C. 1003 (1951), *acq'd.*, 1951-19 INT. REV. BULL. 1, where authorization for "subdividing" in the taxpayer's articles of incorporation was held to be no indication that the taxpayer was engaged in the business of developing and selling real estate.

²⁴ *Lucile McGah*, 15 T.C. 69 (1950), where wartime housing was found to be held primarily for sale during the taxable year in question and application of section 117(j) was denied;

(2) *Personal Property*. Personal property held for rental may also qualify for 117(j) treatment. Options to purchase in leases have been held not to prevent the application of section 117(j) to sales of machinery to lessees.²⁵ The recurring issue, as where realty is involved, is whether the property is used in business or held "primarily for sale."

In *A. Benetti Novelty Co.* the taxpayer prevailed over the Bureau by obtaining the benefit of the section on gains from the sale of used slot machines and phonographs held for rental, although the taxpayer engaged in retail selling of similar properties.²⁶

Property, Other Than Rental Property, Used in the Production of Income

(1) *Real Property*. As assumed at the outset, application of section 117(j) to real property actively used in production of income, for example, factory sites or farm lands, has not been seriously questioned. In *Kirby Lumber Corp. v. Scofield* the section was applied to timber land sold along with standing timber, tenant houses, and equipment used in taxpayer's timber growing and lumber business.²⁷ It is not expected that taxpayers will be troubled in the future in similar situations.

(2) *Growing Crops*. The Bureau has conceded the applicability of section 117(j) to the *land* involved in sales of land with growing crops. However, these sales have resulted in an apportionment problem similar to the one the section was enacted to avoid. The problem arose with the ruling in *I.T. 3815*²⁸ that upon sale of a citrus grove with fruit on the trees, the selling price and resulting gain or loss must be apportioned between the land and trees (to both of which 117(j) concededly applies) and the fruit. This approach was adopted over two dissents²⁹ in *Ernest A. Watson*,³⁰ dealing with the sale of an orange grove, on the basis that the fruit crop constituted property held primarily for sale to customers in the ordinary course of business.³¹

On a sale of land with a growing crop of wheat, the Tax Court has also held that the part of the sale price representing consideration for the crop of wheat was taxable as ordinary income.³²

However, in *Irrgang v. Fahs*,³³ and in *Cole v. Smith*,³⁴ two district courts have applied section 117(j) to the *total* sales price of citrus groves, the first case relying upon Florida law that growing crops are a part of realty and the latter case emphasizing the immaturity of the fruit, hazards of frost or

also *King v. Commissioner*, 5 CCH 1951 FED. TAX REP. ¶ 9304 (5th Cir. 1951) (sale of wartime housing); *Larson v. Korth*, 92 F. Supp. 704 (D. Utah 1950) (housing temporarily rented).

²⁵ *Ruth Dawson v. Kate R. Thomas*, 5 CCH 1951 FED. TAX REP. ¶ 9351 (N. D. Tex. 1948); *Mary Alice Browning*, CCH 9 T.C.M. 1061 (1951).

²⁶ 13 T.C. 1072 (1949).

²⁷ 89 F. Supp. 102 (W. D. Tex. 1950).

²⁸ 1946-2 CUM. BULL. 30.

²⁹ Black and Harron, dissenting, thought the taxpayer was not in the business of selling unmaturing oranges to customers in the ordinary course of business.

³⁰ 15 T.C. 800 (1950), *acq'd.*, 1951-1 CUM. BULL. 3.

³¹ *Louise Owen*, CCH 9 T.C.M. 1112 (1950), following *Ernest A. Watson*, *supra* note 30.

³² *Thomas J. McCoy*, 15 T.C. 828 (1950).

³³ 94 F. Supp. 206 (S. D. Fla. 1950).

³⁴ 96 F. Supp. 745 (N. D. Calif. 1951).

crop failure and the necessity for further cultivation at the time of sale. The result in some areas, then, may well depend upon the taxpayer's choice of court.

For taxable years beginning after December 31, 1950, Congress has resolved the problem in favor of the taxpayer by amending section 117(j) to provide expressly that sales or other dispositions of land together with growing crops or fruit are covered by the section.³⁵

(3) *Livestock*. The most frequently litigated situations under section 117(j) have involved livestock. In I.T. 3666³⁶ the Bureau ruled that livestock raised by the owner and used for breeding or draft purposes were depreciable property used in the trade or business within the meaning of section 117(j). The case of *Albright v. United States*³⁷ and the cases which followed were precipitated by I.T. 3712³⁸ in which the Bureau ruled that normal sales (sales balanced by additions to the herd) of breeding stock from a herd were to be denied the benefit of section 117(j). That is, such stock were to be considered as held primarily for sale to customers in the ordinary course of business, since it was contemplated that eventually all such animals held by a farmer would be sold. The emphasis was placed on the ultimate rather than the primary purpose for which the stock were held.

In the *Albright* case, the taxpayer, a dairy farmer, regularly sold non-producers from his milk herd and all the breeding stock from his swine herd after one litter was produced, the herd being replaced from the litters or by purchase. This was shown to be the local practice in the business. The Eighth Circuit Court of Appeals, reversing the district court, held that the Bureau's interpretation and argument was contrary to the plain meaning of the section, and that the breeding and dairy stock were held primarily for use in the taxpayer's business, not primarily for sale to customers.³⁹

The *Albright* case has been followed by the Tax Court in cases involving dairy cattle and swine,⁴⁰ breeding stock from beef herds,⁴¹ and breeding stock from a herd of registered beef cattle.⁴² The Court of Appeals for the Fifth Circuit and several district courts have followed the Eighth Circuit Court of Appeals, adding to the number of Bureau defeats.⁴³ By Mimeo

³⁵ Revenue Act of 1951, § 323, H. R. REP. 4473, 82d Cong., 1st Sess. (1951).

³⁶ 1944 CUM. BULL. 270.

³⁷ 173 F.2d 339 (8th Cir. 1949).

³⁸ 1945 CUM. BULL. 176.

³⁹ But cf. *Leonard C. Kline*, 15 T.C. 998 (1950). Taxpayer regularly purchased old beef cows that were already bred, held them for a spring crop of calves, then conditioned them and sold them on the beef market. *Held*, that the cows were held primarily for sale and not primarily for breeding. Emphasis was placed upon contrary customary practice of "feeders" in the locality as contrasted with the customary practice in hog breeding relied on in the *Albright* case.

⁴⁰ *Isaac Emerson*, 12 T.C. 875 (1949); *Leslie S. Oberg*, CCH 8 T.C.M. 544 (1949).

⁴¹ *Fawn Lake Ranch Co.*, 12 T.C. 1139 (1949), *non-acq'd.*, 1949-2 CUM. BULL. 4; *Franklin Flato*, 14 T.C. 1241 (1950).

⁴² *Walter S. Fox*, 16 T.C. 854 (1951).

⁴³ *United States v. Bennett*, 186 F.2d 407 (5th Cir. 1951); *Mitchell v. United States*, 96 F. Supp. 473 (N.D. Calif. 1951); *Joy G. Miller v. United States*, 5 CCH 1951 FED. TAX REP. ¶ 9297 (D. Neb. 1951); *Lyle E. Retz v. Birmingham*, 5 CCH 1951 FED. TAX REP. ¶ 9298 (N.D. Iowa 1951). For an earlier District Court case, see *Stutzman v. United States*, 72 F. Supp. 879 (N.D. Ind. 1947), applying section 117(j) to a public sale of dairy cattle, breeding hogs and farm machinery.

6660,⁴⁴ on June 27, 1951, the Bureau conceded at least partial defeat by revoking I.T. 3666 and I.T. 3712, and ruling that gains derived from the sale of dairy, draft or breeding animals may be treated as capital gains under section 117(j) if the taxpayer establishes that the particular animals sold were actually used for dairy, draft or breeding purposes for substantially their full period of usefulness.

Here again Congress has stepped in to support the taxpayer. In the Revenue Act of 1951, the section 117(j) definition of "property used in the trade or business" was amended to include "... livestock, regardless of age, held by the taxpayer for draft, breeding or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry."⁴⁵

The holding period will start with the date of acquisition, not with the date the animal is put to such use. This amendment is sweeping in effect since it applies to taxable years beginning after December 31, 1941. However, the holding period change and the poultry exclusion from "livestock" will be applicable only to taxable years beginning after December 31, 1950.

The line drawn between "livestock" and "poultry" is curious. Whether the *Albright* line of cases remain pertinent with regard to poultry for the taxable years beginning between December 31, 1941 and December 31, 1950 remains to be seen. The necessity of distinguishing livestock and poultry opens up a new area for litigation: what is "poultry," and what is "livestock"?^{45a}

(4) *Other Personal Property.* A recent acquiescence in the decision of *Differential Steel Car Company* may indicate that the Bureau no longer places such great emphasis upon the similarity between property used in the trade or business and property held for sale.⁴⁶ One of the taxpayer's customers had contracted to purchase three locomotives, but due to delays in completion refused to accept them. For about ten months one of the unsold locomotives was used to supplement the switch engine ordinarily used by the taxpayer and was finally sold at a profit. The Tax Court held that the sale was of property used in the trade or business, although the locomotive was of the same general class of equipment normally manufactured and sold by the taxpayer.

In other instances, easily within the plain meaning of the statute, section 117(j) was applied by the Court of Claims to a sale of two oceangoing vessels⁴⁷ and by a district court to a sale of logging equipment, although the sale was pursuant to an option in a logging contract.⁴⁸

In 1944 the Bureau approved the application of the section to sales of

⁴⁴ 1951-15 INT. REV. BULL. 3.

⁴⁵ Revenue Act of 1951, § 324, H. R. REP. 4473, 82d Cong., 1st Sess. (1951).

^{45a} Is "poultry" intended to include all manner of domesticated fowl? For instance, the Senate amendment to the House bill, which added the poultry exclusion, excepted turkeys from that exclusion. This turkey exception was struck by the House after committee conference. Any Bureau or judicial interpretation will be of the utmost importance to the breeders of turkeys, ducks, geese, game-birds, or other more unusual kinds of birds.

⁴⁶ 16 T.C. 413 (1951), *acq'd.*, 1951-14 INT. REV. BULL. 1.

⁴⁷ *Dockendorff v. United States*, 84 F. Supp. 372 (U. S. Ct. Cl. 1949).

⁴⁸ *Ford M. Converse v. Earle*, 5 CCH 1951 FED. TAX REP. ¶ 9430 (D. Ore. 1951).

amortizable war facilities covered by a certificate of necessity under Internal Revenue Code Section 124.⁴⁹ Tax treatment of such facilities is again of current interest but the Revenue Act of 1950 added section 117(g)(3), applicable to taxable years ending after December 31, 1949, which limits the application of section 117(j) to sales of exchanges of emergency facilities subject to section 124 A amortization.⁵⁰

Limited Interests in Realty

All the transactions in realty discussed above have involved absolute ownership interests. Section 117(j) has also been applied to property interests other than a fee simple. I.T. 3975⁵¹ ruled that an inherited life estate in a farm was covered by the section. In *Isadore Golonsky*,⁵² the amount paid a lessee for cancellation of a lease with an unexpired term of only three months was held to be taxable at capital gain rates.⁵³ Both the Bureau, in I.T. 3693,⁵⁴ and the Tax Court⁵⁵ have held section 117(j) applicable to sales of leasehold interests in oil and gas. There seems to be no reason why any legally recognized property interests should not qualify, when the other requirements of section 117(j) are satisfied.

TYPES OF TRANSACTIONS TO WHICH SECTION 117(j) APPLIES

The taxpayer's problems do not end with the determination that his property is within the purview of section 117(j). He must also be able to establish that his particular transaction is comprehended by the section. The scope of section 117(j) includes (1) sales or exchanges and (2) involuntary conversions. No other type of transaction qualifies.

Sales or Exchanges

In the usual situation there will be little doubt whether a "sale or exchange" has occurred. The cases discussed above are illustrative since they involved a "sale or exchange." It is only in the more unusual situations that doubt may arise as to the definitive limits of a "sale or exchange." For example, a district court has recently held that foreclosure of a mortgage on a rental building was a "sale or exchange" within the meaning of section 117(j).⁵⁶

⁴⁹ I.T. 3652, 1944 CUM. BULL. 118.

⁵⁰ INT. REV. CODE § 117(g)(3): "[G]ain from the sale or exchange of property, to the extent that the adjusted basis of such property is less than its adjusted basis determined without regard to section 124 A (relating to amortization deduction), shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in subsection (j)."

⁵¹ 1949-2 CUM. BULL. 48.

⁵² 16 T.C. No. 177 (1951).

⁵³ *Id.* The court failed to discuss which subsection of section 117 applied in the case, though it appeared to be a lease used in business. A lease may be depreciable, T.D. 3760, IV-2 CUM. BULL. 154 (1925); *Robert Treat Hotel Co.*, 20 B. T. A. 968 (1930), *acq'd.*, X-1 CUM. BULL. 55.

⁵⁴ 1944 CUM. BULL. 272.

⁵⁵ *Petroleum Exploration*, 16 T.C. 277 (1951).

⁵⁶ *Rothschild v. Berliner*, F. Supp. (N.D. Calif. 1950), CCH 50-2 U.S.T.C. ¶ 9521.

In view of the same requirement of a "sale or exchange" in the older section 117(a), most of the pertinent litigation has been concerned with that section. Those precedents should be applicable in interpreting the identical phrase in section 117(j).

Under section 117(a) it has been held that "sale or exchange" includes a foreclosure sale by the vendor,⁵⁷ a conveyance pursuant to condemnation proceedings,⁵⁸ a conveyance in satisfaction of a debt,⁵⁹ a conveyance to a mortgagee if the mortgagor is personally liable on the mortgage,⁶⁰ and a conveyance to a mortgagee where some consideration is received by the mortgagor.⁶¹ Where the mortgagee is not personally liable, however, it has been held that an abandonment or conveyance to the mortgagee is not a sale or exchange.⁶² The basic requirement is that the taxpayer must receive something or the promise of something in exchange for that which he sells or relinquishes.

(1) "*Sales*" of leases. Upon disposal at a profit of a lease used in trade or business, the taxpayer must arrange a sale or assignment of the lease to obtain the tax rate benefits of section 117(j). A sublease would not fulfill the requirement of a sale or exchange, since the taxpayer retains his lease. But, if the property is subleased or assigned at a loss, the loss would be fully deductible in either event except for the requirement of section 117(j) that the losses and gains be "netted."

(2) "*Netting*" of gains and losses. The requirement of section 117(j) that gains and losses be netted may prevent the taxpayer from obtaining maximum benefits from the section, since a loss, in absence of offsetting gain, is fully deductible and a gain, in absence of an offsetting loss, is taxable at the reduced capital gain rate.

Faced with both a gain and a loss in the same taxable year, this "netting" aspect of the section will prompt the taxpayer to urge that either the gain or the loss is not covered by section 117(j). For instance, if the taxpayer can persuade the Bureau or the court that section 117(a) applies to the gain, he still obtains a capital gain rate on the gain and is free to deduct the loss in full under 117(j). Or if he can establish that the loss is covered by neither 117(a) nor 117(j), he may be able to deduct the loss in full from ordinary income and retain the full benefit of 117(j) on the gain.

By properly timing his transactions, the taxpayer can, in another way, readily avoid this limitation. Suppose that it is planned to sell two business properties, one at a loss and one at a gain; a sale of each in a different taxable year will permit full deduction of the loss in one year and reduced taxation of the gain in the other year, all within section 117(j).

(3) "*Sale and Lease-Back.*" Some taxpayers have been tempted into selling business properties, often to a tax-exempt organization,⁶³ while re-

⁵⁷ *Helvering v. Hammel*, 311 U. S. 504 (1941).

⁵⁸ *Hawaiian Gas Products v. Commissioner*, 126 F.2d 4 (9th Cir. 1942).

⁵⁹ *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940).

⁶⁰ *Commissioner v. Green*, 126 F.2d 70 (3d Cir. 1942).

⁶¹ *Blum v. Commissioner*, 133 F.2d 447 (2d Cir. 1943).

⁶² *Polin v. Commissioner*, 114 F.2d 174 (3d Cir. 1940).

⁶³ INT. REV. CODE § 101 (tax exempt organizations).

taining the use of the property by a lease-back from the vendee.⁶⁴ A loss currently deductible in full may be thus engineered, or a present gain at favorable rates obtained at a cost of future rentals deductible in full from income. This "sale and lease-back" arrangement suggested by section 117(j) raises the question whether a "sale" has taken place, especially where the deductibility of a loss is in issue.⁶⁵

In *Standard Envelope Manufacturing Co.*, an exchange of property with a retention of the right to lease back for 25 years was held to be a sale entitling the taxpayer to deduct the loss.⁶⁶ Later, a conveyance of real estate for cash, a mortgage and a bond to insure payment of the deferred purchase price, accompanied by a lease-back for 20 years, was held to be a bona fide sale.⁶⁷

However, in *Century Electric Co.*, an exchange of a fee simple was made for cash and a 95 year lease.⁶⁸ The Tax Court held that the transaction was an exchange for property of a like kind and no loss was recognizable under section 112(e).⁶⁹ A sale of tippie tracks by a coal mining company for one dollar and a license to use the tracks was held insufficient to entitle the taxpayer to deduct the loss under section 23(f).⁷⁰ These cases evince a desire of the Bureau and Tax Court for proof of the business realities of the transaction if the taxpayer is to prevail.

Involuntary Conversions

As defined in section 117(j), a compulsory or involuntary conversion results only from the "destruction in whole or in part, theft, seizure, or requisition or condemnation" of property used in the trade or business or of capital assets held for more than six months. As one would imagine, fire insurance proceeds have been accepted as being within the section under that definition.

The application of the section to insurance proceeds extends to a recovery by a lessor for improvements made by a lessee but owned by the lessor.⁷¹ In *Lehman Company of America*, insurance proceeds were allocated between inventory and the taxpayer's factory, machinery and equipment, an ordinary loss being recognized on the inventory and a gain being recognized at capital gains rate on the business property.⁷²

⁶⁴ INT. REV. CODE § 423, added by the Revenue Act of 1950 and applicable to taxable years beginning after December 31, 1950, imposes tax liability upon income from leases of certain "tax exempt" lessor organizations if the purchase is made with borrowed funds and the lease is for more than five years and is unrelated to the organization's tax exempt functions. It does not affect the tax consequences of such arrangements as to the vendors and lessees.

⁶⁵ Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1 (1948).

⁶⁶ 15 T.C. 41 (1950), *acq'd.*, 1950-2 CUM. BULL. 4.

⁶⁷ May Dept. Stores Co., 16 T.C. 547 (1951), *acq'd.*, 1951-18 INT. REV. BULL. 1.

⁶⁸ 15 T.C. 581 (1950).

⁶⁹ INT. REV. CODE § 112(e) applied, because except for the receipt of cash, the exchange was otherwise within section 112(b) (1) of the code and regulations 111, § 29:112(b) (1)-1. Under those regulations the Bureau regards the exchange of a fee simple for a thirty year lease as an exchange for property of a "like kind."

⁷⁰ Harmon Coal Corp., 16 T.C. 787 (1951).

⁷¹ Owen Meredith, 12 T.C. 344 (1949), *acq'd.*, 1949-2 CUM. BULL. 3.

⁷² 17 T.C. No. 47 (1951).

The involuntary conversion feature of section 117(j) applies not only to "property used in the trade or business" but in addition covers all capital assets, as they are defined under 117(a), if held for more than six months. Fire loss from destroyed residential property, a 117(a) capital asset, has been utilized to offset a gain on sale of business property.⁷³ Of course, it should be remembered that recognition of gains resulting from involuntary conversions may be postponed by following the procedure set out in section 112(f) and related regulations.⁷⁴

Guy L. Waggoner held that payments received by a lessor for the lessee's destruction of property was a receipt for property involuntarily converted.⁷⁵ The sum was paid by the War Department in lieu of the performance of an obligation to restore damaged property.

Taxpayers recently received a setback in the attempt to develop the scope of the involuntary conversion concept. *Nehi Beverage Company* involved a novel transaction perhaps not originally contemplated by either Congress or the Bureau.⁷⁶ The petitioner released bottles and cases bearing the company name upon payment of deposits, refunding deposits on return of the items by retailers.⁷⁷ The petitioner determined that its liability account for unrefunded deposits was overstated. As the sum represented fully depreciated containers⁷⁸ an equivalent sum was transferred to an income account entitled "miscellaneous non-operating income." The Tax Court found that breakage, use of the containers for other purposes and the indifference of the consumers were among the causes of the failure to return the containers and redeem the deposits.⁷⁹

The taxpayer argued that an involuntary conversion had taken place, claiming non-recognition under section 112(f), and, as an alternative, claimed capital gains treatment under section 117(j). The Bureau characteristically argued that the entire sum was recognized income taxable at ordinary rates.

Although the Tax Court held that the petitioner was not entitled to 112(f) protection, it did so on the ground that the company had failed to comply with the strict Bureau procedures required under that section.⁸⁰

⁷³ J. H. Anderson, CCH 7 T.C.M. 811 (1948).

⁷⁴ INT. REV. CODE § 112(f), U. S. TREAS. REGS. 111, § 29:112(f)-1, 2 (1941).

⁷⁵ 15 T.C. 496 (1950), *acq'd.*, 1951-1 CUM. BULL. 3.

⁷⁶ 16 T.C. 1114 (1951).

⁷⁷ Taxpayers have accounted for sales price of returnable containers in various ways; e.g., as sales and subsequent repurchases, *LaSalle Cement Co. v. Commissioner*, 59 F.2d 361 (7th Cir. 1932), *cert. denied*, 287 U.S. 624 (1932) (cement sacks); *Beadelston & Woerz, Inc.*, 5 B.T.A. 165 (1926) (bottles and cases); and as deposits recorded as liabilities, *Farmers Creamery Co.*, 14 T.C. 879 (1950) (deposits were not income in the year received).

⁷⁸ Pursuant to Bureau directions, the cost of the bottles was recovered through depreciation allowances on the basis of a four year useful life.

The relationship between depreciation allowances pursuant to section 23(1) and section 117(j) gains should be noted. Excessive depreciation, offsetting ordinary income, reduces the basis of the asset under section 113(b) and results in a larger gain on sale, which is highly favorable to the taxpayer if the transaction is covered by section 117(a) or section 117(j).

⁷⁹ The Bureau accepted petitioner's method of determining how many containers would not be returned.

⁸⁰ U. S. TREAS. REGS. 111, § 29:112(f)-1, 2 (1941). INT. REV. CODE § 112(f) states that such money received as a result of an involuntary conversion must be "forthwith in good faith,

It expressly did not decide whether an involuntary conversion had taken place within the meaning of section 112(f).

The court also rejected petitioner's claim that a "sale or exchange" had taken place, holding that too many elements of a sale were lacking.⁸¹ As to an exchange, the court said that "whatever property right the customer had in the deposit was shattered with the bottle,"⁸² and there could be no exchange of property as contemplated by section 117(j), for, as there used, the word "exchange" means "reciprocal transfers of capital assets."⁸³

Wichita Coca Cola Bottling Co. v. United States was cited for the proposition that closing out part of the deposit liability account and "putting the money to free surplus funds" is a financial act which "creates" income in the year in which it is done.⁸⁴ As there was no undepreciated cost to be recovered from the containers represented by the forfeited deposits, the Tax Court held that upon the authority of the *Wichita* case the petitioner realized income in the full amount of the forfeited deposits.

In direct answer to the petitioner's contention for an involuntary conversion within the meaning of section 117(j), the Tax Court said only that, "There was certainly nothing involuntary about such transfers."⁸⁵

In focusing its attention on the transfer of the sum from the deposit liability account to the income account, the Tax Court appears to have missed the real point in issue, which was whether the property itself had been involuntarily converted as defined by section 117(j). Of course, there was nothing involuntary about the actual accounting transfer. Nor was there anything involuntary about the payment in lieu of the Government's restoration obligation in *Guy L. Waggoner*,⁸⁶ or for that matter, the payment of fire insurance proceeds in other cases discussed. The involuntary occurrence in those cases and in this one must have been the actual destruc-

under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, . . . or in the establishment of a replacement fund . . ." The necessity for strict compliance with the regulations issued thereunder is firmly established. *Kennebec Box and Lumber Co. v. Commissioner*, 168 F.2d 646 (1st Cir. 1948); *Massillon-Cleveland-Akron Sign Co.*, 15 T.C. 79 (1950); see Arditto, *How to Effect Non-Recognition of Income on Involuntary Conversions*, 3 UNIV. OF SO. CALIF. TAX INST. 335 (1951).

⁸¹ *Williamson v. Berry*, 49 U.S. 495 (1850), cited by the Tax Court, designated a sale as "a contract between parties to give and to pass rights of property for money, . . . which the buyer pays or promises to pay to the seller for the thing bought and sold."

Would a contract drawn up covering container deposits, providing procedures for return of containers and providing the obligation to refund the deposits thereon, but giving the bottler a right or option to regard the retailer as a purchaser of the container for a price equal to the amount of deposit upon failure of the retailer to return or account for all containers, satisfy the requirement of a sale?

⁸² *Supra* note 76 at 1123.

⁸³ *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941).

⁸⁴ 152 F.2d 6 (5th Cir. 1945), *cert. denied*, 327 U.S. 806 (1946), involved accumulated deposits on bottles transferred to surplus in 1940. The taxpayer contended for the first time that the sums were the result of sales in prior years beyond the statute of limitations period. The opinion indicates that the decision was put primarily upon the ground of an estoppel based upon the rule requiring consistency in accounting methods for income tax reporting. The question there was one of determining the correct taxable year for what was conceded to be income. Neither section 112(f) nor section 117(j) were involved.

⁸⁵ *Supra* note 76 at 1124.

⁸⁶ *Supra* note 75.