



Appeal of James A. and Carol A. Collins

Two issues were originally presented by this appeal: (1) whether the Franchise Tax Board (FTB) correctly computed appellants' capital gains preference item for 1978, and (2) whether the FTB properly included the capital loss from the sale of land used for farming in computing appellants' farm net loss preference item for 1979. The first issue has been conceded by the FTB, resulting in a \$413 reduction of appellants' liability for 1978.

On January 15, 1979, appellants sold a **100-acre** citrus farm at a loss of \$242,140. They did not include this loss in computing their farm net loss preference item for 1979. The FTB added the full amount of the long-term capital loss to appellants' reported farm net loss, resulting in the assessment at issue.

Section 17062 imposes a tax on the amount by which items of tax preference exceed net business loss. One item of tax preference is "farm net loss," defined in section 17064.7 as **"the** amount by which the deductions allowed by this **part which** are directly connected with the carrying on of the trade or business of farming. exceed the gross income derived from such trade or business."

The parties appear to **agree that the land in question** was used in the trade or business of farming before appellants sold it. However, appellants argue that the loss is not **includible** in determining farm net loss because the loss itself was not directly connected with the carrying on of the trade or business of farming and because Treasury Regulation **§ 1.1251-3(b)(2)** specifically excludes such losses from the farm net loss computation. The FTB contends that Treasury Regulation **§ 1.1251-3(b)(2)** is not applicable to farm net loss calculations for California preference tax purposes and that **the Appeal of Russell Q. and Thyra N. Fellows, decided by this board on August 1, 1984, set forth the rule that capital gains from the sale of farm land are properly included in computing farm net loss. As we will explain below, we conclude that both appellants' argument regarding Treasury Regulation § 1.1251-3(b)(2) and the FTB's argument regarding Fellows are erroneous. However, we also conclude that appellants are correct in their assertion that the capital loss must be excluded from farm net loss because it was not directly connected with the carrying on of the trade or business of farming.**

Appellants argue that Treasury Regulation **§ 1.1251-3(b)(2)** directs that gain or loss on the sale of

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farm property is to be disregarded in computing farm net loss. Appellants are correct in the interpretation of this regulation, but not in the application. We have held that the regulations under Internal Revenue Code (IRC) section 1251 "are applicable for purposes of interpreting the term 'farm net loss' as it appears in Section 17064.7." (Appeal of James A. and Sheila L. Ortloff, Cal. St. Bd. of Equal., Feb. 1, 1982.) However, the federal regulations are only applicable insofar as the IRC section conforms to section 17064.7. Treasury Regulation § 1.1251-3(b)(2) is not applicable to determine farm net loss under section 17064.7 because that regulation refers to a part of ~~IRC~~ section 1251 which is not found in section 17064.7. <sup>2/</sup>

The **FTB's** contention that Fellows, supra, set forth the rule that capital gains from the sale of farm land are to be included in determining farm net loss is erroneous. The only question which we decided in that appeal was whether or not certain land was used in the **trade or** business of farming. The statement to which the FTB apparently refers merely restates an assumption made by the parties, the correctness of which was not an issue before us in that appeal.

It is apparent, on the basis of the foregoing, that the question before us is one of first impression. To answer it, we must look to see if the loss in question comes within the language of section 17064.7, that is, **whether** it was directly connected with the carrying on of the trade or business of farming.

We believe that this loss does not come within the language of section 17064.7 because it arose from the sale of appellants' farm, not from the carrying on of the trade or business of farming. The term "trade or business" itself does not encompass all activities which may produce a profit, but is used "in the sense of a going trade or business." (Wilbor, Jr. v. Commissioner,

<sup>2/</sup> **IRC section** 1251(e)(2) defines "farm net loss" using **language which** is essentially identical to that used in section 17064.7. However, it goes on to say: "**Gains** and losses on the disposition of farm recapture property referred to in section 1231(a) (determined without regard to this section **or** section 1245(a)) shall not be taken into account." It is to this latter sentence, which is not found in section 17064.7, that Treasury Regulation § 1.1251-3(b)(2) refers.

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¶ 58,045 T.C.M. (P-H) (1958).) Here, the loss does not arise from the carrying on of a going trade or business, but from the cessation of that business. In previous appeals where we have had to decide the compass of the trade or business of farming, we have looked to the definition found in Treasury Regulation § 1.175-3. (See, e.g., appeal of Dorr P. L. Currier, Cal. St. Bd. of Equal., May 8, 1984; Appeal of Walter O. and Barbara S. Hansen, Cal. St. Bd. of Equal., Jan. 31, 1984.) That regulation states that "A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant." The sale of a farm is not the same as the cultivation, operation, or management of a farm. We must conclude that the sale of a farm is not directly connected with the carrying on of the trade or business of farming. 3/

Respondent's action, therefore, must be reversed.

3/ Cf. Sic v. Commissioner, 10 T.C. 1096 (1948), affd., 177 F.2d 469 (8th Cir. 1949), cert. den. 339 U.S. 913 (1950) (loss on sale of part of farm held not to be **includible** in net operating loss under § 122(d)(5) of the IRC of 1939, which required that the loss be "attributable to the operation of a trade or business regularly carried on by the taxpayer," because selling farmland was not part of trade or business of farming; specific statutory language in IRC of 1954 changed this result for purposes of net operating loss provisions (see Ford v. Commissioner, 31 T.C. 119, 123 (1958)); Appeal of Andre and Suzanne Andresian, Cal. St. Bd. of Equal., Feb. 4, 1986 (bad debts incurred on the sale of appellants' business were not connected with trade or business of appellants; appellants were not in the business of buying and selling retail shops).

