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## Capital Gains Treatment Denied to Proceeds from Sale of Water

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## CAPITAL GAINS TREATMENT DENIED TO PROCEEDS FROM SALE OF WATER

WATER LAW; FEDERAL TAXATION: Tax Court holds that sale of contractual water is denied capital gains treatment where taxpayer regularly engages in the selling or leasing of such rights. 68 T.C. \_\_\_\_ (1977).

In conjunction with the California Aqueduct project, the State of California sought to cure an anticipated problem of severe settling by pre-soaking the soil. To do so, in 1964, the State of California Department of Water Resources purchased a supply of water from Buena Vista Farms, Inc., a corporation engaged in leasing farmland, in exchange for a cash payment and a supply of water to be delivered to Buena Vista Farms, Inc. after completion of the California Aqueduct. In 1971, Buena Vista Farms, Inc. sold ten percent of its right to receive water from the State of California to an individual. It is the sale of the right to receive water that is the subject of this action.

Since the Revenue Act of 1921, Congress has seen fit to tax certain gains on the sale of investment property at preferential rates. There have been a variety of explanations for this treatment, ranging from relief from the harsh effect of taxing income earned over an extended period in the year of realization to the encouragement of investments and capital formation in the private sector.<sup>1</sup> The taxation of capital gains at a reduced rate represents a compromise between the view that such a tax is unacceptable as a capital levy and the view that such increments to wealth are just as spendable as other forms of income.<sup>2</sup>

Buena Vista Farms, Inc. sought the preferential capital gains treatment for its gain on the sale of the contractual water right and reported the \$105,279 received as a long-term capital gain on its 1971 Federal income tax return. The Commissioner of the Internal Revenue Service determined a deficiency in Buena Vista Farms, Inc.'s tax return after concluding that the gain on the sale was not a capital gain, but rather, ordinary income. By electing not to pay the deficiency, this action was brought on Buena Vista Farms, Inc.'s petition to the United States Tax Court for redetermination of the

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1. CHOMMIE, *THE LAW OF FEDERAL INCOME TAXATION* 324-24 (2d ed. 1973).  
2. J. STANLEY & R. KILCULLEN, *FEDERAL TAX LAW* 364-65 (6th ed. 1974).

proposed deficiency. Judge Fay of the Tax Court found that the sole issue to be resolved was whether the gain by Buena Vista Farms, Inc. was a capital gain or ordinary income.

The Tax Court held in favor of the Commissioner and ruled that the \$105,279 was reportable as ordinary income. In reaching this decision, Judge Fay found that the gain did not qualify for capital gain treatment because the contractual right sold by Buena Vista Farms, Inc. was not a capital asset.

Long-term capital gains are defined as the gain from the sale or exchange of a capital asset held for more than six months (nine months for taxable years beginning in 1977, one year for taxable years beginning after December 31, 1977).<sup>3</sup> The Internal Revenue Code defines the term capital asset to mean all property held by the taxpayers for personal or business use except for five categories.<sup>4</sup> One of those five categories is important to Judge Fay's holding. It is inventory and other property held for sale to customers in the ordinary course of business.<sup>5</sup>

Relying heavily on *Commissioner v. P. G. Lake, Inc.*,<sup>6</sup> Judge Fay held that the sale of a contract right does not establish the sale of a capital asset. The underlying sale of water must be examined to determine whether the contract right represented a capital investment or a right to income.

Judge Fay's finding that the contract water right is not a capital asset was based on a number of considerations. The court found that as part of a leasing operation, the corporation sold water to its lessees and that the sales were both continuous and substantial. Other considerations were the facts that Buena Vista Farms, Inc. maintained an elaborate system of ditches and pipelines for the transport of water and listed water as an inventory item on its financial statements. Perhaps the most critical factor in determining that water was held for sale in the ordinary course of business and that the transaction in question could not be differentiated was that Buena Vista Farms, Inc. had reported cash payments for the sale of water as ordinary income while deducting the expenses incurred from ordinary income as a normal business expense.

The effect of finding that what was sold to the State of California was not a capital asset was that the subsequent sale of the contract right to receive water was not entitled to the preferential capital gains treatment. In *Commissioner v. P. G. Lake, Inc.*<sup>7</sup> it was held

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3. I.R.C. § 1222(3).

4. I.R.C. § 1221.

5. I.R.C. § 1221(1).

6. *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958).

7. *Id.*

that consideration paid a taxpayer for the right to receive future income from the taxpayer's property, rather than for an increase in the value of the property, is taxable as ordinary income and not as a capital gain. As stated in *Helvering v. Horst*, "[t]he taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them."<sup>8</sup>

The holding in this case appears at first glance to deny capital gains treatment to the sale of contractual water rights. It should, however, be limited to those cases in which the taxpayer regularly sells its water rights and not be extended to other holders of contract water rights.

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8. *Helvering v. Horst*, 311 U.S. 112, 117 (1940).