***Armendaris Corp. v. Commissioner, 72 T. C. 52 (1979)***

When a taxpayer's tax is computed under the alternative tax method of section 1201(a), farm net losses do not reduce the taxpayer's tax, and thus do not result in a balance in the excess deductions account (EDA) for section 1251 recapture purposes.

**Summary**

The Armendaris Corporation argued that gains from selling farm recapture property should be treated as ordinary income under section 1251 because it had a farm net loss, which should have increased its EDA. However, the Tax Court ruled that since the corporation's tax was computed under the alternative tax method of section 1201(a), the farm net loss did not reduce its tax liability. Therefore, there was no balance in the EDA, and no part of the gains from the sale of farm recapture property could be treated as ordinary income under section 1251. The court also clarified that breeding cattle sold during the liquidation of a herd are not considered held primarily for sale to customers in the ordinary course of business, thus retaining their capital asset status.

**Facts**

The Armendaris Corporation, formed in 1969, acquired various assets including breeding cattle and rural land through a tax-free exchange under section 351. It planned to liquidate its breeding herd over a few years and lease its rural properties. During its fiscal year ending April 30, 1971, the corporation reported a farm net loss of $566,575 and claimed that gains from selling breeding cattle and a ranch (Hachita Ranch) should be treated as ordinary income under section 1251. The corporation's tax for 1971 was computed under the alternative tax method of section 1201(a), resulting in a tax solely based on its net long-term capital gains.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in the corporation's federal income tax for its fiscal year 1971. The corporation filed a petition with the United States Tax Court challenging this determination. The Tax Court heard the case and issued its opinion on April 4, 1979.

**Issue(s)**

1. Whether the provisions of section 1251 apply to dispositions of farm property by the petitioner during its fiscal year ending April 30, 1971, so as to cause the gain from such dispositions to be treated as ordinary income rather than capital gain.
2. If section 1251 does not apply, whether the gain from the sales of breeding cattle held by the petitioner for more than 24 months is ordinary income from the sale of property held primarily for sale to customers in the ordinary course of the petitioner's trade or business.

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## Holding

1. No, because the petitioner's tax was computed under the alternative tax method of section 1201(a), its farm net loss did not result in a reduction of its tax, and thus there was no balance in its EDA at the close of its fiscal year 1971. Therefore, no part of the gains realized on the disposition of farm recapture property is treated as ordinary income under section 1251.
2. No, because the petitioner was not in the trade or business of selling breeding cattle; it was liquidating a breeding herd without an intent to replace the cattle or continue selling breeding cattle.

## Court's Reasoning

The court applied section 1251, which requires a balance in the EDA for ordinary income treatment upon the disposition of farm recapture property. The EDA is increased by farm net losses but reduced by amounts necessary to adjust for deductions that did not result in a tax benefit. The court interpreted the regulations under section 1251 to mean that when a taxpayer's tax is computed under the alternative tax method of section 1201(a), any farm net loss does not result in a tax reduction and thus does not increase the EDA. The court rejected the petitioner's argument that section 1251 should apply because it had a farm net loss, stating that the section requires a balance in the EDA to apply, which was zero in this case. The court also analyzed the petitioner's alternative argument that the breeding cattle were held for sale in the ordinary course of business, concluding that the liquidation of a breeding herd does not constitute such a business. The court cited regulations and case law to support its finding that the breeding cattle remained capital assets.

## Practical Implications

This decision impacts how taxpayers must analyze farm net losses and section 1251 recapture when their tax is computed under the alternative tax method of section 1201(a). It clarifies that in such cases, farm net losses do not increase the EDA because they do not reduce the taxpayer's tax liability. Tax practitioners must be aware that when a taxpayer's income is primarily from capital gains and is taxed under section 1201(a), any farm net losses will not trigger section 1251 recapture. This ruling also affects the classification of assets during the liquidation of a business, reinforcing that the liquidation of breeding cattle does not convert them into ordinary income assets unless the taxpayer is engaged in the ongoing business of selling such cattle. Later cases that have considered this ruling include those dealing with the classification of assets and the application of section 1251, such as in situations where taxpayers attempt to use farm losses to offset nonfarm income.

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