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T. C. Fitzgerald Jr.

CAPITAL GAINS TREATMENT OF LIVESTOCK SALES

T. C. FITZGERALD, JR.*

The tax savings opportunities which exist for livestock producers have been clouded with disputes for over a decade. Many of the issues which have been productive of litigation and uncertainty have been laid to rest by the amendments contained in the Revenue Act of 1951 and the implementing regulations promulgated in January, 1953, by the Commissioner.

This article embodies a review of the more important litigation involving application of Code Section 117(j) to the peculiar tax problems of livestock operations, and attempts to synthesize whatever guideposts are available from the decisions for evaluating the issues not settled by the 1951 Amendment and the regulations issued January 6, 1953, in T. D. 5970.

Since the Revenue Act of 1942[1] taxable income has been divided into three classifications: ordinary income, capital gain, and Section 117(j) income. The largest part of the average farmer's income is from the sale of crops held primarily for sale to customers in the ordinary course of farming operations. Such income is ordinary income,[2] which must be included in full on his income tax return. When he engages in securities transactions, speculates in commodities, makes a sale of realty not used in his trade or business, or disposes of his personal automobile, he produces a capital gain or loss. Where the assets have been held for more than six months, he reports only one-half of such gain[3] or loss. Deduction of a net capital loss is limited to one thousand dollars for a return by an individual.[4] Income which falls into the third category, or Section 117(j) income, is accorded peculiarly favorable treatment. If the aggregate of 117(j) transac-

*Member of North Carolina and South Carolina Bars. C.P.A., North Carolina.

1. Section 117(j) was added to the Internal Revenue Code by Section 151(b) of the Revenue Act of 1942.

2. IRC 117(a).

3. IRC 117(b). In addition, the maximum tax on capital gains is limited to 26% of the gain. IRC 117(c).

4. Note that if a taxpayer other than a corporation has a net capital loss for a year, his deduction is limited to $1,000.00, IRC 117(d)(2), while a corporation is allowed no deduction for a net capital loss. IRC 117(d)(1). Both of these limitations are somewhat alleviated by the five year capital loss carryover provided at IRC 117(e). No loss is allowable upon sale of assets held for personal use on the theory that it constitutes personal living expenses. IRC 24(a).

tions[5] for any year represents a gain, treatment as a long-term capital gain is permitted, but if in the aggregate a loss is suffered, it is treated as an ordinary loss and is deductible in full against income from other sources. Included in the definition of 117(j) income is that arising from the sale of property used in a trade or business, which has been held for six months or more, and is of a character which is subject to the allowance for depreciation.

BEFORE ALBRIGHT v. UNITED STATES

When Section 117(j) first became law in 1942,[6] the Bureau denied all capital gains treatment on sales of breeding stock, contending that:

5. Also encompassed in Section 117(j) are such transactions as the sale, exchange, or involuntary conversion of farm land (and growing crops thereon, if any), depreciable property used on the farm such as tractors, combines, etc., as well as depreciable livestock and the cutting of timber under certain conditions (IRC 117(k)). Frequently all or a portion of the proceeds of a condemnation award are a return of capital and not regarded as income subject to taxation.

6. Code Sec. 117(j), before the Revenue Act of 1951, provided as follows: (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(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 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) 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 an 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 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 6 months shall be considered losses from a compulsory or involuntary conversion.

(1) the cost of raising livestock was not capitalized and depreciated,
(2) livestock are included in inventory, and
(3) breeding livestock are held for a dual purpose, *viz.*, to produce offspring for a period of time and thereafter to be sold like other products.[7]

The Bureau of Internal Revenue reversed this position in rulings issued in 1944[8] and 1945,[9] conceding points (1) and (2) above, and compromising on point (3). The net effect of these rulings was to allow treatment under 117(j) of income from the sale of breeder cattle only where the sale was abnormal, as, for example, to effect a change in the breed or quality of the herd, or to decrease the overall size of the herd.[10] Where animals were culled from a herd because of injury, age, or disease in accordance with annual practice, the profit was ruled ordinary income.[11] A rule of thumb was thus adopted by the Bureau providing that the number of animals sold from the breeding herd in excess of those added to the herd during the taxable year would qualify as animals abnormally removed from the herd and hence subject to Code Section 117(j). Conversely, sales which did not reduce the breeding herd were treated as productive of ordinary income.

ALBRIGHT V. UNITED STATES[12]

The Bureau position was repudiated in the *Albright* case, where a farmer's treatment of income from sale of dairy cows and hogs was upheld as properly within Section 117(j), without regard as to whether the animals were culls. The taxpayer maintained a herd of thirty-six dairy cattle of which an average of eighteen to twenty head were milk producers. He sold the cows which were unproductive or by reason of injury or disease were unfit for dairy use and replaced them with younger stock. Calves not needed to maintain the size of the herd were sold. All animals sold had been held for more than six months. The court pointed out that the cows had not been held *primarily* for sale in the ordinary course of business, and their sale was merely *incidental* to dairy operations. The court went further and agreed with Albright that income from sale of his

7. Hart and Embree, *Sale of Breeding Livestock*, 27 TAXES 829 (1949).
8. I. T. 3666, 1944 Cum. Bull. 270.
9. I. T. 3712, 1945 Cum. Bull. 176.
10. I. T. 3712, 1945 Cum. Bull. 176.
11. I. T. 3666, 1944 Cum. Bull. 270.
12. 173 F. 2d 339 (8th Cir. 1949).

hogs was Section 117(j) income even though his breeding herd regularly was used for only one breeding season, then sold and replaced with an equal number of young sows. The annual sale of a breeding herd and its replacement by a new one is normal practice in the hog-raising industry, and the court assumed it was necessary to efficient operation.

AFTER ALBRIGHT V. UNITED STATES

Emerson[13] maintained a hog herd for breeding purposes and a herd of Holsteins for milk production. His policy of eliminating unprofitable animals from his dairy herd was analagous to that of Albright, and the court upheld the taxpayer. The taxpayer prevailed also in a remarkable number of decisions[14] while the Commissioner refused to acquiesce. In the *Kline*[15] case, which appears to be the only decision against the taxpayer during this period, there seems to have been an attempted abuse of the provisions of 117(j). Taxpayer bought old cows, bred one set of calves, fattened the cows and sold them. The court pointed out that production of one set of offspring was usual in the hog industry but exceptional as to cattle.

Despite this impressive array of cases to the contrary, the Bureau adhered to its position of non-acquiescence in the hope of getting a split between circuits which might result in a conclusive ruling by the Supreme Court. However, after the decision in *United States v. Bennett,*[16] there was a reluctant shift in the government's position. Mimeograph 6660, issued June 27, 1951,[17] provided that capital gains treatment could be applied to culls, but not in the case of animals "not used for substantially their full period of usefulness." Also animals used for the production of only one offspring or used only temporarily as breeders or producers, including ordinarily hogs, chickens, turkeys, *etc.*, would not be regarded as qualifying for such treatment.

The Commissioner failed in efforts to obtain a clear expression of

13. 12 T. C. 875 (1949).
14. Oberg, 8 T. C. M. 544 (1949); Fritz, et al., 9 T. C. M. 81 (1950); Brouwer, et al., 10 T. C. M. 109 (1951); Becker, 10 T. C. M. 530 (May 1951); Faun Lake Ranch Co., 12 T. C. 1139 (1949); Flato, 14 T. C. 1241 (1950); Mitchell v. United States, 96 F. Supp. 473 (N. D. Cal. 1951); Davis v. United States, 96 F. Supp. 785 (N. D. Iowa 1951); Retz, et al. v. Birmingham, 98 F. Supp. 322 (N. D. Iowa 1951); Fox, 16 T. C. 854 (1951); Schmidt, 10 T. C. M. 623 (1951); Miller v. United States, 98 F. Supp. 948 (D. C. Neb. 1951).
15. 15 T. C. 998 (1950).
16. 186 F. 2d 407 (5th Cir. 1951).
17. 1951-2 Cum. Bull. 60. For a vigorous attack on this mimeo, see Bryon v. Ploeg, 37 IOWA L. REV. 57 (1951).

Congressional intent to determine the applicability of Section 117(j) to livestock when the Revenue Revision Act of 1948[18] failed of passage in the Senate, and again in 1950 when his new proposal[19] was rejected. However in 1951 the Congress did act definitively.

REVENUE ACT OF 1951

In an attempt to clear up the uncertainties which existed despite the issuance of Mimeograph 6660,[20] the Congress provided in Section 324 of the Revenue Act of 1951 as follows:

> Section 117(j)(1) is hereby amended by adding at the end thereof the following new sentences: "Such term also included 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." The first sentence added to Section 117(j)(1) by the amendment made by this section shall be applicable with respect to taxable years beginning after December 31, 1941, except that the extension of the holding period from 6 to 12 months shall be applicable only with respect to taxable years beginning after December 31, 1950. The second sentence added to Section 117(j)(1) by the amendment made by this section shall be applicable only with respect to taxable years beginning after December 31, 1950.

Soon after the law was so changed retroactively, Mim. 6676 of March 6, 1952, was issued, revoking Mim. 6660, June 25, 1951, which had revoked I. T. 3666 and I. T. 3712. None of these revoked rulings are applicable to either the current or prior years.

NEW REGULATIONS

The Commissioner has restated the Bureau's position as to when animals will be considered to be held for draft, breeding, or dairy pur-

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18. This proposed act would have enacted into law substantially the position outlined by the Commissioner in I. T. 3666 and I. T. 3712. Section 134 of H. R. 6712, 80th Cong., 2d Sess., provided:
"Section 117(j)(1) [relating to definition of property used in trade or business] is hereby amended by inserting after the first sentence thereof the following new sentence: 'Such term includes animals used in the trade or business of the taxpayer except those animals which customarily would be selected during the taxable year for sale or exchange in the ordinary course of business.' "
19. The Treasury proposed legislation to eliminate "breeding and dairy animals regularly culled for sale each year" from Code Section 117(j).
20. 1951-2 Cum. Bull. 60.

poses in amendments to Regulations 111, Sec. 29.117-7,[21] which now provides, in part, as follows:

> (c) Livestock held for draft, breeding, or dairy purposes. For the purpose of this section, the term "livestock" shall be given a broad rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals and other mammals. It does not include chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.
>
> The determination whether or not livestock is held by the taxpayer for a draft, breeding, or dairy purpose depends upon all of the facts and circumstances in each particular case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, or dairy purpose may be present in a case where the animal is disposed of within a reasonable time after its intended use for such purpose is prevented by accident, disease, or other circumstance. An animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may, depending upon the circumstances, be considered held for a draft, breeding, or dairy purpose. An animal is not held by the taxpayer for a draft, breeding, or dairy purpose merely because it is suitable for such purpose or because it is held by the taxpayer for sale to other persons for use by them for such purpose. Furthermore, an animal held by the taxpayer for other purposes is not considered to be held for a draft, breeding, or dairy purpose merely because of a negligible use of the animal for such purpose or because of the use of the animal for such purpose as an ordinary or necessary incident to the purpose for which the animal is held.
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> These principles may be illustrated by the following examples:
>
> Example 1. An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile, and is disposed of within a reasonable time thereafter. This animal was held for breeding purposes.
>
> Example 2. The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which would have been used by him for breeding or dairy purposes if he had remained in business. These young animals were held for breeding or dairy purposes.

21. T. D. 5970, Jan. 6, 1953.

Example 3. A taxpayer in the business of raising hogs for slaughter customarily breeds sows to obtain a single litter to be raised by him for sale, and sells these brood sows after obtaining the litter. Even though these brood sows are held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business, they are considered to be held for breeding purposes.

Example 4. A taxpayer in the business of raising horses for sale to others for use by them as draft horses uses such horses for draft purposes on his own farm in order to train them. This use is an ordinary or necessary incident to the purpose of selling such animals, and, accordingly, these horses are not held for draft purposes.

Example 5. The taxpayer is in the business of raising registered cattle for sale to others for use by them as breeding cattle. It is the business practice for the cattle to be bred, prior to sale, in order to establish their fitness for sale as registered breeding cattle. In such case, those cattle used by the taxpayer to produce calves which calves are added to the taxpayer's herd (whether or not the breeding herd) are considered to be held for breeding purposes; the breeding of other cattle is an ordinary or necessary incident to the holding of such other cattle for the purpose of selling them as registered breeding cattle, and the breeding of such cattle does not demonstrate that the taxpayer is holding the cattle for breeding purposes.

Example 6. A taxpayer, engaged in the business of buying cattle and fattening them for slaughter, purchased cows with calf. The calves were born while the cows were held by the taxpayer. These cows were not held for breeding purposes.

It is feared by many in the industry that the rather narrow language used in portions of the new regulations may lead to a restricted application of Section 117(j).[22] The criticisms reflect a feeling that it ought to be clearly stated in the regulations that the reason for disposing of an animal is significant only in the sense that it is some evidence of the fact that the animal was or was not held

22. A criticism of the language of the regulations appears in Halstead, Capital Gains Treatment on Livestock Sales, Nov. 1952, Taxes, 885, p. 889, wherein he makes use of the statement of objections to proposed regulations made pursuant to the Administrative Procedures Act by Mr. Stephen H. Hart, attorney of Denver, Colorado, representing the National Live Stock Committee.

by the taxpayer for draft, breeding, or dairy purposes. The criterion set forth in the law is that the reason for *holding,* not the reason for *disposing* of livestock, is determinative of Section 117(j) applicability. Livestock producers fear that misplaced emphasis will lead to unduly restrictive enforcement in the field.

WHEN LIVESTOCK IS HELD FOR BREEDING PURPOSES

Undoubtedly the Revenue Act of 1951 clarified many controversial points in the taxation of livestock producers. The "full period of usefulness" contention of the Bureau was answered[23] by the requirement for only a twelve month holding period. This holding period runs from the date of acquisition by birth, purchase, gift, *etc.,* and not from the date the animal is dedicated in use for the prescribed purpose. The Bureau's attempt to deny capital gain treatment for temporary breeders was brushed aside; only poultry are excluded from the benefits of 117(j).[24]

It is clear that an area of conflict still remains. Whether an animal is held for breeding purposes is an issue which in all probability will continue to be litigated.[25] It would seem that animals which have produced offspring on several occasions would present no problem. Conversely, livestock incapable of producing because of alteration are clearly excluded. But what have the cases decided in those instances which fall between these extremes?

In *Miller v. United States,*[26] taxpayer raised his own replacement heifers and regularly introduced them into the herd when they were around fourteen months old. Each fall he culled the herd and included some heifers approximately eighteen to nineteen months old. The court accorded capital gains treatment to these sales, noting that the animals spent several months in the breeding herd and hence upon sale were made subject to dock for pregnancy and for

23. Sen. Rep. No. 781, 82d Cong., 1st Sess. 42 (1951).

24. The original Senate version of the 1951 Revenue Act included turkeys held for breeding purposes but excluded other poultry. The Conference Committee removed this provision including turkeys and the final bill excluded all poultry. H. R. Rep. No. 1213, 82d Cong., 1st Sess. 12 (1951).

See *Glenn E. Magee,* 17 T. C. 1583 (No. 195) where gain on sale of breeding turkeys in 1945 was treated as capital gain. Note that the new provision excluding poultry applies only for taxable years which begin after December 31, 1950.

25. The point is discussed in the record of the Senate Finance Committee hearings. Cong. Rec. Sept. 28, 1951, p. 12587.

26. 98 F. Supp. 948 (D. C. Neb. 1951).

removal from the higher market classification of "open heifers."[27]

In two cases decided by the Tax Court prior to the retroactive amendments of the Revenue Act of 1951 it was held that cattle raised by the owner of a breeding herd and not sold until they were two years old were part of the herd and accorded capital gains treatment, while those sold at an earlier age were ordinary assets, *i. e.*, held primarily for sale to customers in the ordinary course of business.[28]

In the *Fox*[29] case the Tax Court applied the same type of rule to cows twenty-six months and over and to bulls thirty-four months and over. The Court of Appeals for the Fourth Circuit indicated this rule survived the 1951 Revenue Act, saying:

> We are of the opinion that these conclusions of the Tax Court should not be disturbed. The opinion of that court was handed down prior to the enactment of the 1951 amendment to Sec. 117(j)(1) heretofore referred to but it does not appear that the amendment affects in any way either the reasoning or the conclusions reached by the court.
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> The taxpayers do not agree with this and now urge that the amendment of 1951 renders the holding of the Tax Court untenable and makes clear that the gains here in issue are taxable [capital] gains. In this argument the petitioners stress the fact that the amendment refers to livestock, regardless of age; and from this they argue that a breeding herd may be made up of animals none of which have as yet been bred or which may even be too young for breeding. This argument ignores the real point of the matter. The important thing is not the age of the animals but the purpose for which they are held.

The Court went on to distinguish the *Albright* case on its facts pointing out that in that case the

> . . . taxpayer did not claim as a capital asset any animals except those which had actually been part of his producing herd. This is a far different situation than that in the instant case, where

27. Compare Laflin v. United States, 100 F. Supp. 353 (D. C. Neb. 1951) where the same court held the sale of a group of heifers to be ordinary income even though some were with calf. In that case the taxpayer raised registered cattle for sale to other breeders. Hence the incidence of pregnancy tended to improve the value of heifers rather than subject them to dock. See also G. E. Nance .... T. C. M. ...., 52, P-H257 T. C. Mem. Dec.

28. James M. McDonald, 17 T. C. 210; A. Harold Schmidt, 10 T. C. M. 523 (1951).

29. Walter S. Fox, 16 T. C. 854 (1951), affirmed (4 Cir., 1952), ... F. 2d ...., 72571 P-H Fed. 1952.

> there was no showing that any of the animals sold were part of the producing unit and where most of them were sold at an age before they could possibly have become so.

It should be noted that in this case the actual use of the animals was considered determinative, the average age factor was developed merely as a measure of convenience.

In *Pfister v. United States,*[30] gain on sales of heifers held for breeding purposes from birth until more than a year old was treated as a capital gain.

THE ACCOUNTING PROBLEM

Many of the most technical tax problems of farmers are those involving tax accounting. Basically there are three methods of accounting permitted for farmers, namely: the cash receipts and disbursements method, the accrual method,[31] and the crop method.[32] Although over half of the high-income farmers have adopted the accrual basis of accounting, over ninety per cent of all farmers make income tax returns on the cash basis.

A cattleman on the cash basis of accounting for income tax purposes is entitled to deduct as ordinary expense all costs of operation, including labor, feed, and other supplies used in raising livestock. Animals purchased for draft, dairy, or breeding purposes may be depreciated.[33] Hence, many livestock sold by a cash basis farmer have a very low or a zero tax basis and most or all of the proceeds are taxable at capital gains rates under Section 117(j). Thus, even in a period of falling prices such as the present, a cash basis taxpayer will in all probability obtain a benefit through the operation of this Code section.

The accrual basis livestock producer does not receive as much benefit from Section 117(j). He loses its benefit to the extent of the inventory value of raised livestock sold, as the inventory value represents costs which would have been deductible in full from or-

30. 102 F. Supp. 640 (D. C. S. D. 1952).
31. Under this method, inventories of farmers may be valued at (1) cost, (2) cost or market, (3) farm price method, (4) unit livestock method.
32. Applies only to farmers engaged in producing crops which take more than one year from the time of planting to the time of gathering and disposition. This method of accounting permits the deduction of the entire cost of producing the crop from gross income realized in the year when the crop is marketed.
33. See depreciation rates set out in Bulletin "F" issued by the Commissioner of Internal Revenue. A farmer on the cash basis must claim depreciation each year or lose the benefit thereof, as his tax basis of an animal is reduced where depreciation is allowed or *allowable*. I. R. C. 113(b)(1)(B).

dinary income were he on the cash basis. The Commissioner has not granted permission to accrual basis cattlemen to change to the cash basis.

The Commissioner was successful in stopping an analagous tax benefit by getting Congress to enact the new Code Sections 24(f) and 113(b)(1), requiring farmers to capitalize the cost of producing growing crops sold subject to Section 117(j). The Bureau has asked Congress[34] to pass similar legislation requiring cash basis cattlemen to capitalize the costs of raising livestock.

CONCLUSION

Under the present state of the law, investment in livestock has the outstanding advantage of offering an opportunity to build up a herd and realize income at the minimum tax cost. A cash basis taxpayer can largely control the year in which income is recognized. If operating expenses are paid out of ordinary income, an immediate tax advantage is available, while the herd can be maintained more or less intact for future realization of capital gain benefits. The mechanics of Section 117(j) make it peculiarly advantageous to lump losses (which are fully deductible) in one year and to realize gains (returnable only to the extent of fifty per cent) in a different year, rather than to offset them in a single taxable year.

It appears that any attempt to secure capital gains treatment by running feeder cattle through a breeding herd for a short period is foredoomed to failure. Where facts, however, show a sincere intention on the part of the taxpayer to hold animals as breeders, the decided cases indicate such benefits will not be denied. Indeed, many corporation executives have established such herds with a degree of success. If such a taxpayer intends to realize a profit[35] from such operations rather than to maintain a country home[36] or establish losses,[37] he will find from the tax standpoint that he has the possibility of a very satisfactory investment indeed.

34. Letter of Secretary of the Treasury Snyder to Sen. Walter F. George, Chairman of the Senate Finance Committee, and Repr. Robert L. Doughton, Chairman of the House Ways and Means Committee, June 27, 1952.
35. Israel O. Blake, 38 B. T. A. 1457 (1938).
36. Morton v. Commissioner, 174 F. 2d 302 (5th Cir. 1949).
37. Estate of Mortimer B. Fuller, 9 T. C. 1069 (1947); Deering v. Blair, 23 F. 2d 975 (D. C. Cir. 1928).