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CAPITAL GAIN TREATMENT FOR LIVESTOCK

— by Neil E. Harl*

Sales of livestock held for draft, dairy, breeding or dairy purposes, and held for the requisite holding period, are eligible for long-term capital gain treatment.¹ This provision was of substantial importance to farmers and ranchers before repeal of the 60 percent exclusion for net long term capital gains effective in 1987.² Enactment of the 28 percent maximum rate tax on net long term capital gains income in 1990 effective in 1991³ and the imposition of additional tax brackets for individuals at the 36 percent and 39.6 percent levels in 1993⁴ on ordinary income have focused increased attention on eligibility for capital gains treatment for higher income individual taxpayers. Corporations, by contrast, pay income tax on long term capital gains at a maximum rate of 35 percent,⁵ the same rate applicable to corporate taxable income in excess of \$10,000,000.⁶

The sale of livestock held primarily for sale to customers "in the ordinary course of business" produces ordinary income.⁷ Such animals are excepted from the provision applicable to "property used in the trade or business."⁸

Meaning of term "livestock"

The term "livestock" is given a broad definition in the regulations and includes "cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals and other mammals."⁹ The term does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs or reptiles.¹⁰ Bees are not considered to be livestock.¹¹ Apparently, other insects are likewise not considered to be livestock.

Furbearing animals which come within the definition include chinchilla, mink and fox.¹² Chinchilla are livestock only if held for breeding purposes.¹³ The sale of pelts of mink culled from a breeding herd is eligible for capital gain treatment.¹⁴

Holding period

To be eligible for long-term capital treatment, animals held for draft, dairy, breeding or sporting purposes must be held for the minimum applicable holding period.¹⁵ The holding period for cattle and horses is 24 months or more.¹⁶ For all other livestock, the necessary holding period for long term capital gains treatment is 12 months or more.¹⁷

The holding period is calculated by excluding the day on which the assets were acquired and including the day on which the assets were sold.¹⁸ The holding period for an animal born while the dam (the mother) was in the taxpayer's possession is the date of birth, not the date of conception.¹⁹

The necessary "use" of the animals

Merely owning draft, dairy, breeding or sporting animals for the requisite holding period is not alone sufficient to obtain net long term capital gain treatment; the animals must be held for the specified purposes.²⁰ In determining whether animals have been held for the required purposes, "all of the facts and circumstances" are taken into account.²¹

The purpose for which an animal is held is generally shown by the taxpayer's use of the animal. The regulations acknowledge that an animal held for ultimate sale to customers in the ordinary course of business may nevertheless be held for draft, dairy, breeding or sporting purposes.²²

If a farmer, in maintaining a breeding herd, regularly culls unfit animals, the ones culled and sold should be eligible for Section 1231 treatment.²³ The motive to cull is controlling, not when the culling occurred or how many animals were culled.²⁴ To be successful in obtaining Section 1231 treatment, the taxpayer should be able to demonstrate that the animals culled were either inferior or at least different from livestock kept for breeding purposes.

In *A. Duda & Sons, Inc. v. United States*,²⁵ additional factors were taken into account in determining whether animals were eligible for Section 1231 treatment including the substantiality and frequency of sales, any solicitation and advertising efforts and the method by which the taxpayer differentiated the animals sold and those retained for the necessary purpose.²⁶ The *Duda* case suggests that if the facts indicate that the taxpayer was in the business of selling purchased breeding stock, for example, courts may deny Section 1231 treatment for culls. At least, a taxpayer counting on Section 1231 treatment should avoid a visible and zealous campaign to market the culls.

If an entire herd is sold when the taxpayer retires from business, even young animals which would ultimately have been actually used for the necessary purposes are accorded Section 1231 treatment.²⁷ Section 1231 treatment has been accorded sales of animals where the taxpayer had to abandon temporarily plans to increase the breeding herd and

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who disposed of the animals segregated for breeding purposes.²⁸ Section 1231 treatment has been available where heifers were purchased to start a breeding herd and several months later the taxpayer sold the animals because weather conditions made feeding difficult.²⁹ Likewise, Section 1231 treatment has been approved where the taxpayer abandoned plans for leasing cattle for dairy and breeding purposes.³⁰

Facts suggesting that a livestock operation is a tax shelter are not helpful in proving use for the necessary purpose. Thus, in such a case in which the taxpayer bred gilts at 11 months of age and sold bred gilts at 13 months of age, the Tax Court disregarded the taxpayer's arguments and held the gilts had not been used for breeding purposes.³¹

FOOTNOTES

- ¹ I.R.C. § 1231(b). See generally 4 Harl, **Agricultural Law** § 27.04[3] (1994); Harl, **Agricultural Law Manual** § 4.02[10][d] (1994).
- ² Tax Reform Act of 1986, Sec. 301(a), repealing I.R.C. § 1202.
- ³ Revenue Reconciliation Act of 1990, Sec. 11101(c), amending I.R.C. § 1(j).
- ⁴ Revenue Reconciliation Act of 1993, Sec. 13201(a), 13202(a), amending I.R.C. § 1.
- ⁵ I.R.C. § 11(b)(1)(C).
- ⁶ *Id.*
- ⁷ See Treas. Reg. § 1.61-4(a)(1), (2). See also Gettings v. Comm'r, T.C. Memo. 1988-328 (sale of cattle not eligible for capital gain treatment where no proof that cattle were not held for sale to customers in ordinary course of business or that cattle were depreciable assets.)
- ⁸ I.R.C. § 1231(b).
- ⁹ Treas. Reg. § 1.1231-2(a)(3).
- ¹⁰ *Id.*
- ¹¹ Sykes v. Comm'r, 57 T.C. 618 (1972).
- ¹² Rev. Rul. 57-588, 1957-2 C.B. 305.
- ¹³ Greer v. Comm'r, 17 T.C. 965 (1953), *acq.*, 1953-1 C.B. 4.
- ¹⁴ E.g., United States v. Cook, 270 F.2d 725 (8th Cir. 1959).
- ¹⁵ I.R.C. § 1231(b)(3).
- ¹⁶ I.R.C. § 1231(b)(3)(A).
- ¹⁷ I.R.C. § 1231(b)(3)(B).
- ¹⁸ Rev. Rul. 66-7, 1966-1 C.B. 188. See Caspe v. U.S., 694 F.2d 1116 (8th Cir. 1982).
- ¹⁹ Greer v. U.S., 269 F. Supp. 801 (E.D. Tenn. 1967), *aff'd*, 408 F.2d 631 (6th Cir. 1969). See Gamble v. Comm'r, 68 T.C. 800 (1977) (Section 1231 treatment for sale of 16-month old colt acquired as an unborn foal; pre-1970 holding period of "12 months or more" applied).
- ²⁰ Treas. Reg. § 1.1231-2(b)(1). See, e.g., Messmer v. Comm'r, T.C. Memo. 1989-231 (raised heifers culled from herd held for dairy purposes).
- ²¹ Treas. Reg. § 1.1231-2(b)(1).
- ²² *Id.*
- ²³ Albright v. U.S., 76 F. Supp. 532 (D. Minn. 1948), *rev'd and rem'd*, 173 F.2d 339 (8th Cir. 1949).
- ²⁴ McDonald v. Comm'r, 214 F.2d 341 (2d Cir. 1954), *rev'g and rem'g*, 17 T.C. 210 (1951), *on remand*, 23 T.C. 1052 (1955), *acq.*, 1956-1 C.B. 4.
- ²⁵ 383 F. Supp. 1303 (M.D. Fla. 1974), *rev'd*, 560 F. 2d 669 (5th Cir. 1977).
- ²⁶ *Id.*
- ²⁷ Treas. Reg. § 1.1231-2(b)(2), Ex. 2.
- ²⁸ Coldwater Cattle Co. v. U.S., 61-1 U.S. Tax Cas. (CCH) ¶ 9203 (N.D. Tex. 1961).
- ²⁹ Carter v. Comm'r, 257 F.2d 595 (5th Cir. 1958), *rev'g*, T.C. Memo. 1957-65.
- ³⁰ Clingman v. U.S., 77-1 U.S. Tax Cas. (CCH) ¶ 9306 (E.D. Calif. 1977).
- ³¹ Bades v. Comm'r, T.C. Memo. 1982-355.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

FENCE. The disputed property was located on the defendant's side of a creek between a fence and the creek. The defendant's title stated that the bank of the creek was the boundary; however, after a dam was built, the creek expanded and the new bank was closer to the fence. The plaintiff argued that the title was insufficient to describe the boundary because the creek bank changed from time to time. The court held that the title description was sufficient because the original bank was somewhere beyond the current bank and enclosed the disputed property. The plaintiff also argued that the fence was the boundary line. The court upheld the jury verdict for the defendant as supported by sufficient evidence that the fence was not "designedly enclosed," that the plaintiff's grazing of cattle on the land was not hostile possession, and that the fence was a casual fence used to keep cattle from the creek. **Dellana v. Walker, 866 S.W.2d 355 (Tex. Ct. App. 1993).**

BANKRUPTCY

GENERAL-ALM § 13.03.*

AVOIDABLE TRANSFERS. The debtor was a farmer and feed dealer who borrowed operating funds from a bank which had an unperfected security interest in the debtor's accounts receivable. On the 91st day before the bankruptcy petition, the debtor gave the bank a check in partial payment of the loan, but the check was dated for the next day and was not recorded by the bank until the next day. The court held that the funds were considered received by the bank when it recorded the payment; therefore, the transfer was within 90 days of the petition and avoidable by the trustee. The bank also collected on several of the accounts receivable pre-petition by loaning funds to the debtor's customers who paid the proceeds back to the bank which applied the payments on the debtor's loan. The bank argued that it was allowed to do this under the "earmarking