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TAXATION-FEDERAL INCOME TAX-GAIN ON SALE OF LIVESTOCK

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TAXATION—FEDERAL INCOME TAX—GAIN ON SALE OF LIVESTOCK—Taxpayer was engaged in the business of raising and breeding beef cattle. Each year he would add to the breeding herd the young females raised the previous year and would cull from the herd those older cows who had outlived their most productive years and such young heifers as had proved unproductive. These culls were sold on the market, and taxpayer returned the amounts received from these sales as capital asset gain. The Commissioner assessed a deficiency claiming the sales resulted in ordinary income. *Held,* the sale of culls from a breeding herd is treated as a sale of capital assets under section 117(j) of the Internal Revenue Code. *Miller v. United States,* (D.C. Neb. 1951) 98 F. Supp. 948.

Ordinarily the sale of livestock is not regarded as a sale of a capital asset under section 117(a)(1) of the Code because livestock is subject to an allowance for depreciation[1] and therefore does not meet one of the requirements of the definition of a capital asset.[2] However, since 1942 section 117(j) has allowed capital gains treatment for certain kinds of property not otherwise treated as capital assets. In order to come within the provisions of section 117(j), the taxpayer must show that the property sold: (1) was used in his trade or business, (2) was subject to an allowance for depreciation, (3) was held for more than six months, (4) was not the kind of property properly includible in inventory if on hand at the close of the taxable year, and (5) that the property was not held by the taxpayer primarily for sale to customers in the ordinary course of business.[3] Although some question might have been raised about the sec-

[1] Treas. Reg. 111, §29.23(1)-10. The farmer may elect to put the cattle in inventory rather than depreciate them. Treas. Reg. 111, §29.22(a)-7.

[2] I.R.C., §23(1). This section excludes property for which depreciation may be allowed and also property properly included in inventory.

[3] I.R.C., §117(j). The court divided the section into these five requirements in Albright v. United States, (8th Cir. 1949) 173 F. (2d) 339.

ond[4] and fourth[5] requirements, the fifth requirement has occasioned most of the litigation on the question of whether livestock may be treated as capital assets under section 117(j). The Commissioner has ruled that culls from a breeding or dairy herd may not be so treated.[6] The Commissioner's viewpoint is that the yearly culling of the overage breeders and those young animals not wanted to be retained in the breeding or dairy herd is a normal and regular business practice of stockraising and therefore such stock is kept primarily for sale to customers. The sale of the cattle is the ultimate disposition of them and is as primary a purpose of the raiser as any other.[7] In rejecting this contention the court in the principal case is following the weight of judicial opinion. The position of the courts has been that the primary business of the farmer is maintaining his dairy or breeding herd, and the sale of culls is merely an incident thereto required for economical and successful management of the primary business.[8] It would seem that the question is a close one, and the Commissioner's argument is especially strong where the stockraiser keeps a breeding herd and sells and replaces the whole herd every year,[9] or where the stock sold are those kept with the breeder herd only a short time.[10] The argument loses much of its force where the sale is of breeder or dairy stock which have passed their productive usefulness. Clearly in such case, although it is known when the cattle are acquired or raised that they will be ultimately sold, that is not the primary purpose in keeping them. Also, since section 117(j) was intended as a relief provision,[11] the inclusion of the words "primarily for sale to customers in the ordinary course of business" should limit the exclusionary provision to the obvious cases where the whole purpose of the business is to sell the property to

[4] Because most cattle raisers do not capitalize and depreciate their stock the Commissioner might argue that §117(j) should not be made available to them. See Hart and Embree, "Sale of Breeding Livestock," 27 TAXES 829 (1949).

[5] Treas. Reg. 111, §29.22(a)-7 allows the inclusion of stock in inventory. However, the Commissioner has ruled that this is for accounting convenience only and livestock is not inherently a kind of property properly includible in inventory. I.T. 3666, 1944 Cum. Bul. 270.

[6] I.T. 3666, supra note 5. I.T. 3712, 1945 Cum. Bul. 176 defines culls as "the normal selection for sale of those animals which, due to injury, age, disease, or for any other reason (other than that of changing the breed or quality of the offspring) are no longer desired by the livestock raiser for breeding purposes, also the normal selection for sale of animals for the purpose of maintaining the herd at a regular size." Although neither I.T. 3666 nor I.T. 3712 refers to dairy cattle, Commissioner's Letter dated Aug. 4, 1947, CCH FED. TAX REP. ¶6091 (1948), includes dairy cattle in the same category as breeding herds.

[7] See dissent in Albright v. United States, supra note 3. Cf. United States v. Bennett, (5th Cir. 1951) 186 F. (2d) 407, where the court contends that it is ridiculous to say that ultimate disposal of the stock is the primary purpose.

[8] Albright v. United States, supra note 3; Isaac Emmerson, 12 T.C. 875 (1949); Fawn Lake Ranch Co., 12 T.C. 1139 (1949); United States v. Bennett, supra note 7; Franklin Flato, 14 T.C. 1241 (1950).

[9] See Albright v. United States, supra note 3.

[10] See principal case at 956.

[11] H. Rep. No. 2333, 77th Cong., 2d sess., pp. 53-54 (1942), 1942-2 Cum. Bul. 372 at 415; S. Rep. No. 1631, 77th Cong., 2d sess., p. 50 (1942), 1942-2 Cum. Bul. 504 at 545; Leland Hazard, 7 T.C. 372 at 376 (1946).

customers.[12] Therefore, even in the case of a yearly sale of a breeding herd, if this is the normal course of that business and necessary to the economical management of it, the sale should be considered only a secondary purpose of raising the animals and they should be treated as capital assets under section 117(j).[13]

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[12] It would seem that the use of the word "customers" might imply a regular stock in trade transaction rather than an incidental sale of culls.

[13] See Hart and Embree, "Sale of Breeding Livestock," 27 TAXES 829 (1949), as to what positions the Commissioner might take if he is consistently defeated in his present contention that culls are held primarily for sale to customers in the regular course of business.