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TAX ASPECTS OF LIVESTOCK OPERATIONS

JAMES D. KEAST*

I. INTRODUCTION

Livestock has become an increasingly popular investment for tax shelter—rivaling oil and gas. The primary reason lies in the *Internal Revenue Code* which permits a “farmer” to utilize the cash receipts and disbursements method of accounting even though inventories are involved.¹

The principal advantage of the cash basis of accounting for a breeding herd is that it permits maintenance and raising costs to be deducted in the year of payment in lieu of being capitalized. When the breeding animals are culled from the herd, the gain qualifies for capital gain treatment. The parlaying of ordinary deductions into a capital gain has a particular lure for the sophisticated investor.² Cattle breeding is considered a speculative venture in many quarters, yet the personal prestige, glamour, tax benefits, and profit potential in owning a breeding herd continue to attract the city executive.³ One author has even gone so far as to compare certain aspects of the cattle business with jet plane leasing, purchasing uncirculated silver certificates, and rare coin speculation.⁴

The importance taxation plays in the cattle industry is reflected in Col. H. L. Oppenheimer's book *Cowboy Arithmetic*. Col. Oppenheimer devotes an entire chapter to the tax aspects of the cattle industry.⁵ The Corn Belt farmer and western rancher is also highly concerned with the taxation of livestock. Doane Agricultural Service, Inc. has recognized this interest

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1. Treas. Reg. § 1.61-4 (1957); Treas. Reg. § 1.471-6(a) (1958) states: A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used. . . .

2. Lowe, J. TAXATION, Oct. 1966, p. 236. “Cattle operations probably have the greatest lure, not only in glamour but as an ideal tax shelter. Any sophisticated investor can imagine maintaining a breeding herd, using the cash basis of accounting to deduct current maintenance costs, and selling the herd at capital gain rates. . . .”

3. *Executive Farms: Profit or Pleasure*, DUN'S REVIEW AND MODERN INDUSTRY, June 1965.

4. *Business Week*, Sept. 23, 1967, p. 155.

5. OPPENHEIMER, *COWBOY ARITHMETIC*, Chapter X (2d ed. 1964).

in its publication *Practical Tax Management For Farmers* which devotes a chapter to taxation of livestock.⁶

Another opportunity for the investor hoping to turn a quick profit is purchasing heifer and steer cattle and fattening them for market. Money is committed for a relatively short time, as the average feeding cycle is six months. Coupled with the profit opportunity are certain tax advantages to be discussed later.

However, the reader should keep in mind that most cattle feeders and owners of breeding herds are also motivated toward making a profit. Cattle prices are cyclical and volatile. A rapid rise or drop in prices can result in corresponding profits and losses. The opportunity for a profit is quite real.

This discussion will be limited to important areas of tax management concerning:

1. Cattle feeders who purchase cattle from the rancher or farmer and fatten the cattle for market; and
2. ranchers and farmers who raise breeding, draft, and dairy livestock, and the tax affect on sales, exchanges, and culling animals from the herd.

II. CATTLE PURCHASED FOR FEEDING AND RESALE

A. Farming and Farmer

A cattle feeding operation must, for tax purposes, be classified as a "farming" enterprise to utilize the cash receipts and disbursements method of accounting.⁷ A "farm" includes stock, dairy, poultry, fruit, and truck farms as well as plantations, ranches and all land used for farming operations.⁸ The regulations define farmer as an individual, partnership or corporation that cultivates, operates or manages farms for gain or profit, either as an owner or tenant.⁹

6. O'BYRNE & KEAST, PRACTICAL TAX MANAGEMENT FOR FARMERS, chapter 2 (1966); O'BYRNE & KEAST, DOANE'S TAX MANAGEMENT GUIDE, § 1.9 *et seq.* points out the practical and after tax savings of cattle operations.

7. Treas. Reg. § 1.61-4 (1957). This code section sets out the items a farmer is to include in gross income; Treas. Reg. § 1.471-6(a), see note 1 *supra*.

8. Treas. Reg. § 1.61-4(d) (1957) defines a farm. ". . . The term 'farm' embraces the farm in the ordinarily accepted sense, and includes stock, dairy . . . ranches, and all land used for farming operations"; Treas. Reg. § 1.175-3 (1963) defines "farm" for soil and water conservation purposes, and is cross referenced to Treas. Reg. § 1.61-4(d) (1957). The definition of "farm" is essentially the same except for the requirement that it must be operated for profit rather than for recreation or pleasure.

9. Treas. Reg. § 1.61-4(d) (1957).

Typically, the cattle feeder purchases calves or unfattened cattle. Depending on their size and condition, he will either graze them until of sufficient size for feedlot feeding, or commence feeding them when purchased. The length and intensity of feeding is dependent on the size, condition and quality when placed in the lot and the desired end product of market weight and grade. For example, a Holstein steer's physical conformation may render it incapable of grading USDA Prime. Therefore, a long feeding period would not necessarily result in a higher quality. The feeding period typically extends from 60 to 180 days. For reasons of availability of feeders and feed, the feeding period often commences in the fall. This places the purchase in one tax year and the sale in another tax year.

B. Figuring Profit

The cash method taxpayer deducts the cost of feeding and caring for the animal as an ordinary expense in the year of payment.¹⁰ The regulations specifically prohibit deduction of the purchase price as an expense. Rather, in the year of sale, purchase price (cost) must be deducted from the sales price to determine profit.¹¹ Thus, if the purchase is in one tax year and the sale in the next tax year, the cost has no tax effect in the year of purchase, and only determines the extent of gain in the year of sale.

Where the sale of the animal occurs in a year other than the year of purchase, the profit on the sale for an accrual method taxpayer may be different from that of a cash basis taxpayer. This will depend upon the method of inventory valuation used by the accrual method taxpayer.

An accrual method taxpayer must include the cost of purchased animals in inventory in the year of purchase.¹²

C. Kind of Income

Feeder cattle purchased for fattening are considered as being held for resale in the ordinary course of business. Consequently, any profit must be treated as ordinary income.¹³ However, under certain conditions, raised

10. Treas. Reg. § 1.461-1(a)(1) (1967) reads in part. "Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year when paid."

11. Treas. Reg. § 1.61-4(a)(5) (1957) provides "... the profit from the sale of livestock . . . which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs. . . ."

12. Treas. Reg. § 1.61-4(b)(7) (1957).

13. Treas. Reg. § 1.61-4(a)(2) (1957) includes "the profits from the sale of any livestock . . . which were purchased" in gross income.

cattle run through a feedlot could produce a section 1231 gain.¹⁴ Such section 1231 treatment is appropriate where animals held for breeding or dairy purposes are culled from the herd (because inappropriate for that use) and fattened in the feedlot before marketing.¹⁵

The other side of the coin is purchasing pregnant cows and permitting them to calve before fattening and resale. Since they are considered to be held for sale in the ordinary course of business, rather than for breeding purposes, section 1231 does not apply. Any profit is treated as ordinary income.¹⁶

D. Cash Method Advantages

Cattle feeding ventures can be classified as farming. Thus, the cash receipts and disbursements method of accounting may be elected.¹⁷ The cash basis taxpayer can deduct the expenses of feeding and maintaining the animals in the year of payment.¹⁸ If cattle feeding is the only or major farm enterprise, the deduction of feed and care in one year could result in a farm loss for tax purposes in the year of deduction. This farm loss, assuming the business is operated for profit, can then offset other income.¹⁹

The cash method taxpayer has an opportunity to further increase year-end deductions by making advance purchases of feed. The cases approving year-end purchases of feed to be consumed in the next tax year have collectively laid down some guidelines:²⁰

14. INT. REV. CODE OF 1954, § 1231.

15. *Cluck v. Comm'r.*, 29 T.C. 7 (1957) *aff'd*, 261 F.2d 267 (5th Cir. 1958). The taxpayer culled breeding cows from the herd and placed them in the feedlot for fattening before selling them on the beef market. The feeding of the culled breeding animals was a step in the marketing process. It did not convert them from breeding animals (capital) to "held for sale" animals (inventory).

16. *Leonard C. Kline*, 15 T.C. 989 (1957); *Treas. Reg. § 1.1231-2(c)* (1957) example 6 reads, "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 are not considered as held for breeding purposes."

17. See notes 1 and 8 *supra*.

18. *Treas. Reg. § 1.167-12* (1958) in referring to allowable expenses of farmers states in part, ". . . the purchase of feed and other costs connected with raising livestock may be treated as an expense deduction insofar as such costs represent actual outlay. . . ."

19. *Treas. Reg. § 1.165-6(a)(2)* (1960) states that "if the taxpayer owns and operates a farm for profit in addition to being engaged in another trade or business, but sustains a loss from the operation of the farming business, then the amount of loss sustained in the operation of the farm may be deducted from gross income, if any, from all other sources." The converse paragraph 3 of the same section reads, "Loss incurred in the operation of a farm for recreation or pleasure shall not be allowed as a deduction from gross income."

20. The Court, in *Cravens v. Comm'r.*, 272 F.2d 895 (10th Cir. 1960) and *Ernst v. Comm'r.*, 32 T.C. 181 (1959) held for the taxpayer, and permitted the

1. The purchase must be final, without any provision or possibility of a refund if not all consumed. If the agreement provides for a settlement if all the feed is not needed, the transaction may be considered a deposit (not a final purchase) and this may be used to disapprove the deduction.
2. The feed must be delivered on site or at least set aside for use by the cattle owner/feeder.
3. A need must exist for the advance purchase, such as guarantee of availability, hedge against a price rise, or discount for quantity purchase.
4. Labor costs must not be included in the advance payment for feed.

The year-end deductions provide the framework for a year-end tax "rollover" offsetting nonfarm income in the year of the deduction. However, the profit in the year of sale is determined without regard to these feed and maintenance costs. Thus it is possible to have considerable unsheltered ordinary income in the year of sale.

Trading of live animal futures has become possible within the last few years. The astute cattle feeder may engage in a true hedging transaction to protect against price fluctuations. Profit or loss on a true hedge is ordinary gain or loss.²¹ To create a hedge there must be a deliverable commodity at the termination of the contract. There should also be a direct relationship between the commodity traded and the business of the taxpayer.²²

III. RAISED LIVESTOCK FOR DRAFT, BREEDING, AND DAIRY PURPOSES

A. *Sales and Exchanges*

Livestock held for draft, dairy, or breeding purposes and held for 12 months or more are section 1231 assets.²³ Livestock is given a broad interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals.²⁴ As a section 1231 asset, the net gain is treated as a long-term capital gain and the net loss is treated as an ordinary loss.²⁵

deduction of advance feed purchases. The cogent point was the business necessity of purchasing in advance. *But see* Lillie, 45 T.C. 54 (1965) and Shippey v. U.S., 308 F.2d 743 (8th Cir. 1962) holding for the government on the facts.

21. Treas. Reg. § 1.1233-1(b) (1960).

22. *Corn Products Refining Co. v. Comm'r.*, 350 U.S. 46 (1955).

23. INT. REV. CODE OF 1954, § 1231(b)(3). In defining § 1231 assets, livestock is included by the regulations. "Such term includes 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," Treas. Reg. § 1.1231-2(a) (1957).

24. Treas. Reg. § 1.1231-2(a) (1957).

25. INT. REV. CODE OF 1954, § 1231(a).

The tax basis of raised animals for the cash method taxpayer is "zero" because the cost of raising the animal has been deducted as an ordinary business expense.²⁶

The accrual method taxpayer has a gain computed as the difference between the last inventory value and the sales price.²⁷ However, cost of raising the animal during the year must be added to the inventory value. This has the effect of increasing ordinary income and reducing capital gain.²⁸

Breeding, draft, and dairy animals valued on the farm price method (cost or market, whichever is the lower), can be removed from inventory at maturity, transferred to a capital account, and depreciated. On the other hand, valuation by the unit-livestock-price method requires raised animals to be inventoried.²⁹

Compared to the cash method, the accrual method has less section 1231 potential. The cash method taxpayer has all animals on a "zero" basis. Thus, the entire proceeds are a section 1231 gain.

In addition to the requirement that livestock be held for draft, dairy, or breeding purposes to be a section 1231 asset, they must be held for 12 months or more.³⁰ For a raised animal, this means it must be 12 months of age or older. Livestock held for breeding, draft, or dairy purposes need not be mature when sold to qualify as a section 1231 asset if they meet the age requirement.³¹ The regulations provide some exceptionally good guidelines as to when sales of or from a herd qualify for section 1231 treatment. An entire herd will qualify if the taxpayer retires from business.³² A taxpayer

26. See note 18 *supra*.

27. Treas. Reg. § 1.61-4(b) (1957).

28. Rev. Rul. 55-188; 1955-1 CUM. BULL. 167.

29. Until *U.S. v. Catto*, 384 U.S. 102 (1966) case was decided by the U.S. Supreme Court, ranchers on the unit-livestock-price method of valuing inventories attempted to remove breeding cows from closing inventory in the year they reached maturity. They were placed in the breeding herd and then assigned a "zero" tax basis. The purpose was to give them the same treatment as under the cash basis of accounting. Such procedure is contrary to the Treasury regulations. Depending on the U.S. Circuit in which the case arose, the taxpayer was sometimes successful. *Catto* held the regulations valid, and that to undertake such procedure was a change of accounting methods requiring the Commissioner's prior approval.

30. See note 23 *supra*.

31. Treas. Reg. § 1.1231-2(a) (1957) reads in part, "section 1231 applies to the sale, exchange or involuntary conversion of livestock, regardless of age. . . ."

32. Treas. Reg. § 1.1231-2(c) example (2) (1957) reads, "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 are considered as held for breeding . . . purposes."

who breeds cattle to establish fitness before sale is not considered as holding them for breeding purposes.³³

B. *Involuntary Conversion*

Livestock meeting section 1231 requirements sold due to drouth have been involuntarily converted.³⁴ With raised animals the entire sales proceeds can be used to purchase replacement animals without present recognition of gain. Rev. Rul. 66-191 approved involuntary conversion treatment for cows fattened in a feedlot for two months before the sale.³⁵

It is also an involuntary conversion when breeding, dairy, and draft livestock are sold or destroyed on account of disease.³⁶

C. *Tax-Free Exchange*

Trading of livestock under the tax-free exchange provisions of section 1031 has not come before the courts. The basic requirement is that property held for productive use in trade or business or for investment is exchanged solely for property of a like kind and similar use.³⁷ "Like kind" is defined in terms of "nature or grade of property."³⁸ Within the definition the taxpayer clearly can trade cows for cows, bulls for bulls, and ewes for ewes. Furthermore, since reference is to "nature or character of property," bulls should be exchangable for cows as both sexes are used for breeding purposes.

The regulations on involuntary conversion refer to "similar or related in service or use." This is a more restrictive definition. In this instance the regulations read in terms of cows for cows.³⁹

33. Treas. Reg. § 1.1231-2(c) (1957), example (5) states, "the taxpayer is in the business of raising registered cattle for sale to others or for use by them as breeding cattle. It is the business practice of the particular taxpayer to breed the offspring of his herd which he is holding for sale to others prior to sale in order to establish their fitness for sale as registered breeding cattle. In such case, the taxpayer's breeding of such offspring is an ordinary and necessary incident to his holding them for the purpose of selling them as bred heifers or proven bulls and does not demonstrate that the taxpayer is holding them for breeding purposes."

34. INT. REV. CODE OF 1954, § 1033(f); Treas. Reg. § 1.1033(f)-1 (1958).

35. Rev. Rul. 66-191, IRB 1966-27, 17.

36. INT. REV. CODE OF 1954, § 1033(e).

37. INT. REV. CODE OF 1954, § 1031(a).

38. Treas. Reg. § 1.1031(a)-1(b) (1956).

39. Treas. Reg. § 1.1033(f)-1(d) (1958) refers to replacements, "The replacement requirements of Section 1033 will be satisfied only if the livestock sold or exchanged is replaced within the prescribed period with livestock which is similar or related in service or use to the livestock sold or exchanged because of drouth, that is, the new livestock must be functionally the same as the livestock involuntarily converted. This means that the new livestock must be held for the same

The exchange of heifer calves for bull calves probably qualifies for a tax-free exchange if the bull calves are actually held for productive use rather than sale. In most exchanges of this nature a tax-free exchange is impossible because the bull calves are "steered" and sold. The better approach is to make a taxable exchange at a young age. The animals at this time might be valued as low as \$20 per head. This would be the extent of recognizable income per animal.

D. Animals Culled from the Herd

Section 1231 requires that the livestock be 12 months of age or older. At one time the Internal Revenue Service also wanted to require that the animals be mature when sold, to be eligible for section 1231 treatment. However, the current regulations clearly state "regardless of age."⁴⁰

Once the animal is 12 months of age or older, the important criteria is that it be "held" and "intended" to be used for draft, dairy, or breeding purposes when sold. In an example in the regulations, the animal was 12 months of age and held for the breeding herd. Before it was actually used for breeding it was discovered to be sterile or unfit for the herd. The animal is still considered to be held for breeding purposes. Consequently the sales proceeds are eligible for capital gain treatment.⁴¹

According to the regulations and various cases,⁴² replacement animals can be set aside at weaning and designated for the breeding herd. As the animals mature, the unfits, nonbreeders, diseased, and those not meeting herd standards can be culled and still retain the section 1231 classification. Only a reasonable number can be placed in the herd replacement category.

useful purpose as the old was held. Thus, although dairy cows could be replaced by dairy cows, a taxpayer could not replace draft animals with breeding or dairy animals."

40. Treas. Reg. § 1.1231-2(a) (1957), see note 31 *supra*.

41. Treas. Reg. § 1.1231-2(c) (1957), example (1) states, "an animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile or unfit for the breeding purposes which it was being held, and is disposed of within a reasonable time thereafter. This animal is considered as held for breeding purposes."

42. *Moore v. U.S.*, 246 F. Supp. 19 (ND Miss. 1965), is one of the latest in a line of cases holding that immature animals "held" for breeding purposes are eligible for § 1231 treatment when culled from the herd. *Moore* followed *McDonald v. Comm'r.*, 214 F.2d 341 (2d Cir. 1954). This is one of the early cases considering the § 1231 classification of immature breeding animals. In the *Moore* case the taxpayer established a sale herd, replacement herd, and a breeding herd. Heifers intended for the breeding herd were kept in the replacement herd until maturity. Bulls over 12 months of age from the replacement herd were eligible for § 1231 treatment.

The taxpayer's own practice should dictate the number. For example, if the practice on a 100 cow herd was to replace 20 old cows per year, it could be good herd management to start out with 30 heifers in the replacement herd. Assuming 10 head were culled before actually placed in the breeding herd, those 10 would be section 1231 animals even though never actually a part of the herd.

Culls from the mature breeding herd normally present no problem as long as the number of culls is within good herd management practices. One range management expert recommends culling of up to 25 percent of the cow herd per year. In his opinion the culling rate would require up to 50 percent of the heifer calves produced just to maintain the herd with such a culling percentage.⁴³

43. KYD, BEEF CATTLE SCIENCE HANDBOOK, 96 (1961).