Capitalizing Raising Costs for All Section 1231 Animals: United States v. Catto

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Section 1231 of the Internal Revenue Code treats livestock held for draft, breeding, and dairy purposes as property used in business or trade. Upon sale, any profit is treated very favorably for tax purposes. Recently, however, there has been much controversy over the differing computation of this gain under two of the accounting methods available to farmers, the cash method and the accrual method. This note will examine this problem in the light of recent litigation and against the background of legislative intent and administrative interpretation. A change is proposed which will bring farm taxation nearer to the general tax treatment applied to other businesses and which will provide for more equal treatment among farmers.

The Problem

Draft, breeding, and dairy livestock are included in section 1231 because the nature of their use characterizes them as “property used in trade or business.” For example, a dairy cow or a breeder bull is used to produce the farmer’s product just as a punch press is used to produce the auto maker’s product. Section 1231 provides that when these assets are sold the net capital gain for the year is taxed at the favorable long-term capital gains rate provided certain conditions are met. Controversy has arisen over the advantage cash-method taxpayers have over accrual-method taxpayers on capital gains treatment of breeding livestock. This advantage is best illustrated by examples.

1 INT. REV. CODE OF 1954, § 1231(b)(3).
2 A third accounting method, the crop method, is also available to farmers. Treas. Reg. § 1.61-4(c) (1957). It is not widely used, however, because it only applies to computing income for the few crops which require more than a year from the time of planting to mature. A fourth accounting method is in use and apparently allowed without protest from the Commissioner even though no provision in the Code or regulations and no reported rulings have given authority for its use. Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 850 (1963) (dissenting opinion); H. Halstead, Federal Income Taxation of Farmers 27 (1961).
3 INT. REV. CODE OF 1954, § 1231.
4 Much litigation has concerned classification of these animals as section 1231 assets. This note is not concerned with such identification. For the reader who is interested in classification of breeding livestock for capital gain treatment, see Annot., 46 A.L.R.2d 723 (1956); 3B J. Mertens, The Law of Federal Income Taxation § 22.130 [hereinafter cited as Mertens].
5 These conditions as given in the Code are: (a) Asset must be of a character subject to allowance for depreciation (this includes livestock). (b) Asset must be held for more than 6 months (more than 12 months for draft, breeding, and dairy livestock). (c) Asset must not be of a type includable in inventory (except certain livestock) or held for sale in the ordinary course of business. (d) Asset must have been involuntarily converted and held for the proper period. See INT. REV. CODE OF 1954, §§ 1221, 1231; J. Stanley & R. Kilcullen, The Federal Income Tax 340-46 (4th ed. 1961).
6 The same problems also apply to dairy and draft animals. However,
Examples Under Accrual and Cash Methods

Farmer A and Farmer B are neighbors whose farms are similar in size and nature of operations. Both farmers raise cattle for sale in addition to their crops. Each maintains a breeding herd to which young calves are frequently added and culls removed to maintain the size and quality of the herd. These breeding herds are used to produce the rancher's business product and qualify under section 1231 as property used in trade or business.

Farmer A elects to use the accrual method of accounting because it most clearly reflects his income and its accuracies appeal to him. Farmer A must use inventories and for accounting simplicity he elects to include his breeding animals in the same inventory as his animals held for sale. He is allowed deductions for the costs of raising all his animals, but each year as his animals increase in for simplicity, and since most of the litigation has been over breeding livestock, references to breeding livestock hereafter will include draft and dairy animals.

7 Under the accrual method both income and deductions are reported in the year they accrue even though they have not been received or paid: income is reported in the year in which the right to receive it is fixed and certain; deductions are reported in the year the liability to pay becomes fixed and certain. See 2 MERTENS §§ 12.60-.94.

8 INT. REV. CODE or 1954, §§ 446, 471. Most businesses are required to use the accrual method because normally inventories most clearly reflect business income. For a general discussion of both cash and accrual methods as applied to farm accounting, see H. HALSTEAD, FEDERAL INCOME TAXATION OF FARMERS 19-47 (1961); Boehm, Tax Accounting for Agriculture, 17 Ohio St. L.J. 1 (1956).

9 "The sacrifice in accounting accuracy under the cash method represents an historical concession by the Secretary and the Commissioner to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure." United States v. Catto, 384 U.S. 102, 116 (1966) (emphasis added).

10 Treas. Reg. § 1.61-4(b) (1957). The inventory system is synonymous with the accrual method. 2 MERTENS § 16.03, n.22.2; Diamond A Cattle Co. v. Commissioner, 233 F.2d 739, 741 (10th Cir. 1956).

11 Treas. Reg. § 1.61-4(b) (1957). Section 1231 animals need not be included in inventory. By an election available to both cash and accrual farmers, they may be capitalized and depreciated in the same manner as machinery used in manufacturing. Treas. Reg. § 1.167(a)-6(b) (1956); Lee Wilson & Co., P-H 1942 B.T.A. Mem. ¶ 42,437; Fawn Lake Ranch Co., 12 T.C. 1139 (1949), acquiesced in, 1953-1 CUM. BULL. 4; Elsie SoRelle, 22 T.C. 459 (1954), acquiesced in, 1955-1 CUM. BULL. 6.

12 He is allowed to do this even though no other business using the accrual method may inventory section 1231 assets along with items held for sale in the ordinary course of business. INT. REV. CODE or 1954, § 1231(b) (1). Normally, section 1231 does not apply upon sale of items included in inventory. Id. Farmers are allowed to include their section 1231 animals in inventory along with animals held for sale to simplify recordkeeping. These assets still qualify for capital gains treatment because they are of a character subject to depreciation. I.T. 3666, 1944 CUM. BULL. 270; Elsie SoRelle, 22 T.C. 459 (1954), acquiesced in, 1955-1 CUM. BULL. 6; Diamond A Cattle Co., 21 T.C. 1, aff'd, 233 F.2d 739 (10th Cir. 1956); Fawn Lake Ranch Co., 12 T.C. 1139 (1949), acquiesced in, 1953-1 CUM. BULL. 4.

size and value his inventory value for each animal will increase by approximately the same amount as the deductions for raising costs.\(^{14}\) This inventory increase is ordinary income but it is offset by deducting raising expenses from ordinary income. In other words, even though deductions are formally allowed, Farmer A's expenses for raising the breeding cow are accumulated in inventory, with the effect that deductions are deferred until the time of sale. He decides to sell a cow which he has raised to maturity and held for breeding purposes, meeting in all respects the qualifications for section 1231 property.\(^{15}\) Suppose it has cost Farmer A $100 to produce and raise this cow. This $100 in costs is the inventory value at the time of sale. Farmer A sells the cow for $200. His capital gain\(^{16}\) is the difference between the inventory value and the sale price, or $100.\(^{17}\) Since individuals are allowed a deduction of 50 percent on net long-term capital gain,\(^{18}\) Farmer A deducts $50 from his capital gain. The remaining $50 is his taxable income on the raising and sale of his cow.

Farmer B elects to use the cash receipts and disbursements method of accounting\(^{19}\) because he does not keep formal records\(^{20}\) and recognizes that inventories prevent him from reaping the full benefits from section 1231. He, too, is allowed to deduct the costs of raising his animals;\(^{21}\) however, since he is not required to keep inventories, these costs are not accumulated in any manner to reflect the income from the increase in value of each animal as it grows to

\(^{14}\) The methods of approximating or establishing these raising costs for increase in inventory value depend on the choice of inventory valuation method selected. The mechanics of each method are beyond the scope of this note. They are outlined and discussed in H. Halstead, Federal Income Taxation of Farmers 27-36 (1961). Most farmers who use the accrual method employ the simplest inventory variant available, even though the tax consequences are unfavorable. See Treas. Reg. § 1.471-6(d) (1958). The users of this method are in all likelihood the small farmers with simple records for whom the cash method was originally designed. Larger operators with sophisticated records and expert tax advice use the more favorable variants and these are the few who profit most from the cash-method advantages.

\(^{15}\) See notes 4-5 supra.

\(^{16}\) "Gain" is defined as the excess of the sales proceeds over the accumulated cost or other basis of the property sold. Int. Rev. Code of 1954, §§ 1001, 1011-13.


\(^{19}\) Under the cash method, income and deductions are reported in the year the transactions are actually made. It is essentially an in-and-out of pocket method of accounting in which income is reported in the year it is received and deductions in the year paid. See 2 Mertens §§ 12.38-.59.


\(^{21}\) Treas. Reg. § 1.162-12 (1958). See also note 40 infra.
maturity. If it has also cost Farmer B $100 to produce and raise his cow, he has had $100 in deductions during the raising period without any income from inventory increases. On the same day at the same market place where Farmer A sold his cow, Farmer B sells a similar breeding cow which also brings $200. When a cash-method farmer sells a breeding cow, the full sale price is treated as capital gains since there is no inventory value to subtract. Farmer B is also allowed a 50 percent deduction on the long-term capital gain, or $100 in his case since his basis is zero. In that year, Farmer B would report $100 of taxable income on the transaction. However, in previous years, he has had $100 in deductions from ordinary income for costs incurred in raising the breeding cow. Assuming Farmer B's tax bracket has remained constant, his resulting total tax liability on the raising and sale of the breeding cow is zero.

Farmer B's advantage results from being able to deduct current expenses incurred in raising his cow from ordinary income instead of offsetting increased inventory value. Farmer A follows the practice required by the Internal Revenue Code in all other businesses. Under the Code, a taxpayer must capitalize costs of producing any property used in businesses with a useful life beyond the taxable year. These costs are capitalized by adding them to the cost basis of the property, then deducting them upon sale when computing the gain or loss. When Farmer A increased his inventory value each year for his cow as it grew, he was accumulating these costs of production to later offset any gain on the sale. Farmer B, on the other hand, did not accumulate any costs of production but immediately deducted these expenses from ordinary income. In effect, Farmer A deducted not from ordinary income but from capital gains.

Simplified Accounting for Farmers

Farmer B reaps a capital gains windfall because cash-method accounting is still allowed to farmers as an historical hangover from the earliest days of federal taxation. Farm accounting has been considered sui generis. Farmers have been looked upon as simple folk unable to cope with modern and sophisticated business accounting and so isolated from urban centers that expert help was unavailable. Congress has furthered this gentle treatment for tax accounting by allowing current deductions for land clearing expenses, soil and water conservation expenses, and fertilizer expenses. Accounting simplicity was also the reason for Congress' 22 As will be shown later, these costs are only fixed for the sake of an example. They cannot be fixed with certainty because of the difficulty of allocating various costs among several farm operations. See text accompanying notes 113-19 infra.

23 INT. REV. CODE OF 1954, § 1202.
26 See INT. REV. CODE OF 1954, §§ 1001(a), 1011-1013, 1016.
28 INT. REV. CODE OF 1954, § 182.
29 INT. REV. CODE OF 1954, § 175.
excluding livestock from the depreciation recapture under section 1245.\[31\] Courts have also perpetuated the hangover by regarding general accounting principles applied to other businesses as not applicable to farming operations.\[32\] However, these early ideas requiring special accounting treatment for farmers may be ending. In a recent case, \textit{United States v. Catto},\[33\] the Supreme Court based its decision on the general principles of business accounting and suggested that the cash method should be curtailed in farm accounting use wherever distortions would result.

The Catto Case

In the \textit{Catto} case, ranchers\[34\] using the accrual method challenged the validity of regulations requiring breeding animals to be included in inventory along with animals held for sale.\[35\] They claimed that the advantages of special accounting treatment afforded cash-method ranchers for breeding animals should also be allowed to accrual-method ranchers. The ranchers followed the regulations, but filed for a refund of the tax paid in excess of what they would have paid using the cash method for breeding animals. In effect, they were asking for the cash-method windfall for their breeding animals while keeping the accrual method for the cattle held for sale. As long as farming businesses were to be treated as an exception to general accounting principles, they wanted this advantage to be given to all farmers. The Court refused their refund, rejected their claim of discrimination,\[36\] and issued some broad statements reflecting its attitude toward present farm accounting.

\[31\] \textit{Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means}, 88th Cong., 1st Sess. 1552 (1963). Livestock is excluded from the operations of sections 1245 and 1250 which have largely emasculated section 1231 benefits for other businesses by requiring depreciation recapture on section 1231 property which is capitalized and depreciated. \textit{Int. Rev. Code of 1954}, §§ 1245, 1250. Again, the reason given for excluding ranchers has been accounting difficulties. This is only a problem of identification which may be solved by adequate recordkeeping and by tagging, clipping, branding or otherwise identifying animals as section 1231 property. This is already necessary for proper classification and imposes no additional burden on the cash-method farmer claiming the benefits under section 1231. See text accompanying note 112 infra.


\[33\] 384 U.S. 102 (1966). This case has been frequently discussed. See, \textit{e.g.}, \textit{O'Byrne, Supreme Court Restricts Capital Gain on Breeding Animals under Unit-Livestock Method}, 24 \textit{J. Taxation} 376 (1966); 18 \textit{S.C.L. Rev.} 873 (1966); 2 \textit{Land & Water L. Rev.} 245 (1967); 52 \textit{A.B.A.J.} 678 (1966).

\[34\] The terms “ranchers” and “farmers” are used interchangeably throughout this note. The term “farmers” includes individuals, partnerships, and corporations engaged in raising livestock and the same rules apply as to other “farmers.” Almost all farms have a few draft, breeding, or dairy animals. \textit{Treas. Reg. § 1.61-4(d) (1957)}; \textit{Treas. Reg. § 1.175-3 (1957)}.

\[35\] \textit{Treas. Reg. § 1.471-6(f) (1958)}: “A taxpayer who elects to use the ‘unit-livestock-price method’ must apply it to all livestock raised . . . for . . . breeding . . . purposes.”

\[36\] 384 U.S. at 115-16.
The Court found nothing wrong with requiring accumulation and deferral of expenses under the accrual method, even after acknowledging that "the contention of the [ranchers] is not without force . . ." 37 This general business practice, the Court said, was consistent with accounting logic and the legislative and administrative history of the statute: 38

The general and long-standing rule for all taxpayers, whether they use the cash or accrual method of accounting, is that costs incurred in the acquisition, production, or development of capital assets, inventory, and other property used in the trade or business may not be currently deducted, but must be deferred until the year of sale, when the accumulated costs may be set off against the proceeds of the sale. 39

General Accounting Principles and Farmers

Thus, the Court bases capitalization of the costs of acquiring a business asset on general business accounting practices and applies these principles to a farm problem. This was the Court's answer to the contention of the ranchers in Catto that these principles do not apply because the regulations allow all costs of feeding and raising cattle to be deducted currently without reference to the method of accounting used. 40 It was the argument of these accrual-method ranchers that they should be allowed to exclude raising costs from accumulation in inventory. 41 Instead, the Court placed accrual-method farmers on the same footing with other businesses by requiring an accounting procedure which capitalizes the acquisition of section 1231 assets. 42 The Court went on to examine cash-method accounting in terms of general accounting practice: "Under general principles of accounting, therefore, it would be expected that expenses incurred by ranchers in raising breeding livestock should be charged to capital account, even though the ranchers employed the cash method of accounting." 43 The Court then pointed out an "historical concession" 44 by the Commissioner to farmers—current deductions for expenses incurred in raising livestock. 45 This was to simplify rec-

37 Id. at 109.
38 Id.
39 Id.
40 Treas. Reg. 45, § 110 (1919): "The costs of feeding and raising live stock may be treated as an expense deduction . . . ." The present regulation is substantially the same: "The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay . . . ." Treas. Reg. § 1.162-12 (1958).
43 384 U.S. at 109-10 (emphasis added).
44 Id. at 116. See note 9 supra.
45 See note 40 supra.
ords in an era of small farms not likely to keep records sufficient to defer costs of raising livestock.

This simplification had no effect on tax liability before favorable capital gains treatment for profit on sale of property used in trade or business was allowed in the Revenue Act of 1942. Until then, neither the cash nor accrual methods had any advantage. The Revenue Act of 1951 settled a long court battle between the service and the taxpayers by specifying draft, breeding, and dairy animals as property used in trade or business and eligible for long-term capital gains treatment on the sales proceeds. Now that the rancher had won by codification what had been available since 1942 only through litigation, the tax advantages under the cash method became evident to owners of large herds. The Commissioner's office was flooded with requests for change of accounting method from accrual to cash. Since 1942 when the advantage became possible, changes from the accrual to the cash method have generally been denied livestock raisers unless particularly persuasive non-tax reasons are given for the change.

When changes of accounting method were denied accrual-method ranchers, they attempted to fashion a hybrid system incorporating the advantages of both methods. They justified this attempt by arguing discrimination under the regulations. The taxpayers were successful in some circuits. In Catto, however, the Supreme Court rejected this claim of discrimination and the attempt to use a hybrid accounting method as an effort to defeat the "Commissioner's goal of providing a unitary accounting method for all taxpayers." In reaching this conclusion, the Court said,

46 Ch. 619, § 151, 56 Stat. 946 (now INT. REV. CODE OF 1954, § 1231).
47 Ch. 183, § 324, 65 Stat. 501 (now INT. REV. CODE OF 1954, § 1231(b) (3)).
48 The taxpayers were highly successful in these suits. Cases are collected in United States v. Catto, 384 U.S. 102, 112 n.18 (1966); Annot., 46 A.L.R.2d 723 (1956).
49 Revenue Act of 1951, ch. 183, § 324, 65 Stat. 501 (now INT. REV. CODE OF 1954, § 1231(b) (3)).
50 Special Letter from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, June 27, 1952, S. Rep. 8307 (1952), CCH 1952 STAND. FED. TAX REP. ¶ 6239 [hereinafter cited as Special Letter]. Change of accounting method requires the permission of the Commissioner. INT. REV. CODE OF 1954, § 446(e); Robert S. DeHaven, 36 T.C. 935, 939 (1961). These changes have been denied even though in 1953 the Service announced it would no longer refuse livestock raisers such a change to allow them to take full advantage of section 1231. Bureau Release, May 12, 1953, CCH 1953 STAND. FED. TAX REP. ¶ 6191; cf. Carter v. Commissioner, 257 F.2d 595 (5th Cir. 1958); Jack Frost, 28 T.C. 1118 (1957).
51 Special Letter.
52 Under certain conditions hybrid systems have been approved for farming and other businesses. INT. REV. CODE OF 1954, § 446(c) (4).
53 E.g., United States v. Wardlaw, 344 F.2d 225 (5th Cir. 1965); Carter v. Commissioner, 257 F.2d 555, 600 (5th Cir. 1958); Scofield v. Lewis, 251 F.2d 128, 130 (5th Cir. 1958); Contra, United States v. Ekberg, 291 F.2d 913 (8th Cir. 1961); Little v. Commissioner, 294 F.2d 661 (9th Cir. 1961).
54 384 U.S. at 117. In a more recent case, this denial in Catto was extended to another inventory variant, the farm-price method. Wilson v. United States, 67-1 U.S. Tax Cas. ¶ 9378 (Ct. Cl. 1967).
The issue in the present case, however, is complicated by the substantial tax differential worked by the Treasury Regulations in favor of cash-method ranchers and against accrual-method ranchers when breeding livestock are sold. It is the position of the Commissioner that the Treasury Department is unable by administrative action to require cash-method ranchers to capitalize the expenses incurred in raising their breeding livestock.  

### Legislative Intent

In arguing its case, the Government maintained that the Commissioner was precluded from changing these regulations favoring the cash-method rancher by Congressional intent found in the 1951 amendment expressly providing capital gains treatment for draft, breeding, and dairy livestock. This intent, the Government believed, is found in a passage from both committee reports on the bill and quoted by the Court in a footnote: "[G]ains from sales of livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and presently recognized by the Bureau of Internal Revenue." (Emphasis added by the Court.)

Probably in no other area of law is legislative intent more important or closely examined than in federal taxation. The Secretary and the Commissioner must determine such intent before issuing regulations and the courts will use expressions of intent found in the legislative history of a statute. In 1952, the Commissioner and the Secretary of the Treasury made a detailed study of the legislative history of the 1951 amendment pursuant to changing the regulations to require cash-method farmers to capitalize costs of raising breeding animals. At that time, less than a year after the amendment, they felt the language expressed in the committee reports demonstrated an awareness by Congress of the windfall to cash-method ranchers and that the word "presently" precluded them from acting. Consequently, they asked Congress to change the Code to require cash-method farmers to capitalize these costs in much the same manner as accrual farmers. However, Congress rejected both this request and a bill introduced by the livestock interests which would have allowed accrual ranchers the same advantage as cash-method ranchers.

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55 384 U.S. at 114-15 (emphasis added).
57 Note 49 supra.
59 384 U.S. at 115 n.23.
60 Commissioner v. Aluminum Co. of America, 142 F.2d 663, 667 (3d Cir. 1944); Rodney Milling Co. v. United States, 75 F. Supp. 707, 715 (Ct. Cl. 1948); Hanley v. United States, 63 F. Supp. 73, 81 (Ct. Cl. 1945). See INT. REV. CODE OF 1954, § 7805.
62 Special Letter.
63 Id. See also committee reports cited note 58 supra.
64 Id.
65 H.R. 3896, 83d Cong., 1st Sess. (1953). This act, if passed, would have
While it may be arguable that the word "presently" was intended by Congress to freeze the accounting practices as they were in 1951 for a year or two, it is hardly tenable that these practices were intended to last indefinitely. Catto was decided some 15 years later during which time many changes had taken place in the character of farming businesses.

It may be argued with equal force that by speaking of the accounting methods "presently recognized" the committees were not concerned at all with the mechanics or results under the different methods. This is the province of the Commissioner. Instead, the reports show the committees were concerned mainly with the classification of draft, breeding, and dairy animals as properly within section 1231. The Senate report recites the victories of farmers and ranchers in the courts and the stubborn position of the Commissioner in refusing to allow these animals to be classified as property used in trade or business. Only a single sentence in each report mentions accounting methods. Although the Government felt Congress was aware of the disparity in treatment between the methods, there is nothing in the legislative history of the amendment to demonstrate this.

Statutory Reenactment Rule

The Government further argued that by the request of the Service for legislation in 1952, Congress was apprised of the advantage to the cash-method rancher worked by the regulations. It was contended that because of the statutory reenactment of the provisions for capital gains treatment for breeding animals in the 1954 Code some problem might be encountered with the "reenactment rule." Under this rule, whenever Congress reenacts a statute substantially unchanged, a rebuttable presumption is created that Congress has allowed accrual ranchers to deduct feeding and raising costs of breeding cattle against ordinary income without accumulating them in inventory.

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approved administrative construction of the statute.\textsuperscript{77} This rule, however, has been characterized as an anachronism.\textsuperscript{78} Considering the complexity of the modern tax law, it would be expecting too much to assume Congress was aware of all the workings of the regulations under the Code sections.

Limitations to this “rule” further restrict its use.\textsuperscript{79} For example, it is required that the administrative construction be consistent\textsuperscript{80} and longstanding.\textsuperscript{81} The Court has held that a 3-year period does not make a statute longstanding.\textsuperscript{82} Nor has the Commissioner’s construction been consistent in favoring the cash-method ranchers. To the contrary, he has consistently opposed favor to either method.\textsuperscript{83} Seven years before the 1951 amendment the Commissioner stated the policy that favorable capital gains treatment was not to depend upon the accounting method, cash or accrual.\textsuperscript{84} It was clear that cash-method farmers were allowed to deduct expenses against current income only because of accounting difficulties in allocating various costs.\textsuperscript{85} The Commissioner has opposed this special treatment during each step of its history.\textsuperscript{86}

Congress passed no corrective legislation as requested in 1952.\textsuperscript{87} However, there are dangers in assuming that Congress by its inaction approved administrative construction of a statute. The Supreme Court has said, “[W]e walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.”\textsuperscript{88} In \textit{Catto} the Court knew that Congress was supposedly aware of the inequities, but this failed to prevent observations by the Court that the regulations “favored” cash-method ranchers.\textsuperscript{89} The Court did not need to rule on legislative intent since the \textit{Catto} case did not directly involve cash-method ranchers. However, the Court in demonstrating its awareness of the favored treatment afforded cash-method ranchers seems to invite action from the Commissioner: “We need not here determine the correctness of the Secretary’s interpretation of the

\textsuperscript{77} E.g., Helvering v. Winmill, 305 U.S. 79, 83 (1938), where the Court said, “Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.” Additional cases are collected in 1 \textit{Mertens} § 3.22 n.95.

\textsuperscript{78} 1 \textit{Mertens} § 3.24.

\textsuperscript{79} E.g., Janney v. Commissioner, 108 F.2d 564 (3d Cir. 1939), aff’d, 311 U.S. 189 (1940). \textit{See generally} 1 \textit{Mertens} §§ 3.23–24.

\textsuperscript{80} E.g., Helvering v. Clifford, 309 U.S. 331 (1940).

\textsuperscript{81} E.g., Augustus v. Commissioner, 118 F.2d 38 (6th Cir.), cert. denied, 313 U.S. 585 (1941).

\textsuperscript{82} United States v. Calamaro, 354 U.S. 351, 359–60 (1957).


\textsuperscript{84} Id.

\textsuperscript{85} \textit{See} Moen, \textit{Special Capital Gains Treatment for Farmers}, 17 \textit{Ohio St. L.J.} 32, 40 (1956).

\textsuperscript{86} \textit{Special Letter}.

\textsuperscript{87} Id.

\textsuperscript{88} Helvering v. Hallock, 309 U.S. 106, 120 (1940) (emphasis added). \textit{See} Helvering v. Clifford, 309 U.S. 331, 337 (1940), where the Court considered it irrelevant that the Treasury had recommended legislation which Congress failed to adopt.

\textsuperscript{89} 384 U.S. at 114–15.
legislative history, since no question is presented in this case concerning the vulnerability of the position of cash-method ranchers to action by the Secretary.  By inviting the Commissioner to reexamine his interpretation of the legislative intent, the Court may have removed the only obstacle to changing the regulations so that cash-method ranchers and farmers could also be required to capitalize the costs of raising section 1231 livestock.

Vulnerability of Cash Farmers to Administrative Action

The possible "action" which would render the cash-method rancher "vulnerable" would be a requirement that the costs of raising section 1231 livestock be capitalized in some manner which would bring the tax treatment of the cash and accrual ranchers closer to being equal. The Court feels it is the Commissioner who has the authority and should make the change rather than Congress: "Congress has granted the Commissioner broad discretion in shepherding the accounting methods used by taxpayers . . . ." Nor is the Court to rule for the change: "It is not the province of the Court to weigh and determine the relative merits of systems of accounting." The Code directs the Commissioner to require the accounting method which most clearly reflects income. There are no statutes which directly authorize special forms of accounting for farmers. This places the responsibility squarely on the shoulders of the Commissioner to issue regulations to remedy the situation.

Reasons for Change: Character of Farming

There are compelling reasons for such a change. When the original accounting system for tax purposes was set up, rural taxpayers were possessors of small, family-owned and operated farms. At best, most farmers kept informal records. Requirements for allocating costs—a difficult task on farms even with the most sophisticated records—were discarded as impossible. However, since the early days of Federal income taxation when farmers were truly sui generis, changes have taken place other than capital gains treatment for property used in business or trade. The character of farming and ranching operations has changed from simple family farms to giant businesses, frequently corporate-run. Few farmers before 1942 reached an income level high enough to pay income taxes.

90 Id. at 115 n.23 (emphasis added).
91 Id. at 114.
93 See INT. REV. CODE OF 1954, § 446(b), (c).
94 See notes 96-100 infra and accompanying text.
During the period since capital gains treatment was first allowed for property used in trade or business, capital per farm and assets per farm worker have increased at constant dollars nearly 11 times. To-day, a great investment of capital is required to make a farming or ranching operation profitable. Wherever large amounts of capital go, good recordkeeping follows. This historical concession for farmers has become largely antiquated. The courts have said the regulations should have no more force than the reasons sustaining them. If the simplified system under the cash method is to continue, then some way should be found to require cash-method ranchers to capitalize the costs of raising livestock as any businessman would be required to do in acquiring property to be used in business or trade. All of the other tax benefits on livestock are available to the farmer, including depreciation. A Proposed Regulation

For nearly 3 decades the Commissioner has wanted to require cash-method farmers to capitalize their costs of raising breeding livestock. Urged by the Supreme Court, clothed with authority by the Code, armed with statistics of change, and unfettered by

U.S. DEPT OF AGRICULTURE, ECONOMIC RESEARCH SERVICE, AGRICULTURE INFORMATION BULL. NO. 314, THE BALANCE SHEET OF AGRICULTURE 17 (1966). Farm size has more than doubled since 1940. U.S. DEPT OF COMMERCE, BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 605 (1967) [hereinafter cited as STATISTICAL ABSTRACT]. With approximately the same number of total acres available, average farm size increased from 167 acres per farm to 359. Id. Today, the number of farms over 500 acres is the only category of farms increasing in number. Id. at 607. They account for about 15% of all farms. Id. at 607.

The largest category of farms and ranches enumerated by the Bureau of Census consists of those producing over $40,000 yearly of agricultural commodities and livestock. STATISTICAL ABSTRACT 610. This category represents 42.6% of the total production. Id. Those producing over $20,000 yearly represent 62.7% of the total yield. Id. These large operations are the only farms which justify the capital outlay for mechanization so necessary to profitable farming today.

Hopkins, Tax and Economic Aspects of Raising Beef Cattle, 42 TAXES 411 (1963), reports a study to furnish financial guides for establishing a medium-sized ranching operation in northern California. The initial investment required in 1963 was about $180,000. Id.


Treas. Reg. § 1.167(a)-6(b) (1956). Depreciation is another method which would result in capitalizing raising costs. It is presently available under both cash and accrual methods as an option. Costs of raising or purchasing animals held for draft, breeding and dairy purposes may be capitalized and depreciated as with any other capital asset. However, since salvage value today for livestock upon sale to canners is invariably greater than the value under any method of original valuation, there would be no capital gain, but only ordinary income. For this reason, capitalization and depreciation of section 1231 animals is not generally desirable or used.

E.g., Albright v. United States, 173 F.2d 339 (8th Cir. 1949).

See text accompanying notes 89-90 supra.

See INT. REV. CODE OF 1954, §§ 446, 7805.

See notes 96-100 supra and accompanying text.
legislative intent\textsuperscript{107} and the "statutory reenactment rule,"\textsuperscript{108} the Commissioner should now propose a regulation which would require capitalization of these costs. Even the simplest farming operation could account for its breeding cows by number and age. The small farmer for whom simple recordkeeping is ostensibly maintained in the regulations would have very little trouble identifying these animals and accounting for them.\textsuperscript{108} By using a system similar to the unit-livestock-price-method of inventory valuation,\textsuperscript{110} commonly used in the accrual method, cash-method farmers could be required to assign a value to each animal held for draft, breeding, or dairy purposes by age. This value would be an approximation of the costs incurred in raising the animal and could vary according to the costs of the region with approval of the Commissioner. For example, if Farmer B had estimated that it cost $55 to produce a calf and $15 to raise it each year to maturity (say, 3 years) he would assign the following values: as a calf, $55; as a yearling, $70; as a 2-year-old, $85; as a mature cow, $100. These increases in value would be reported each year as ordinary income to offset the deductions taken for the raising costs. When Farmer B sells this cow, the $100 of acquisition, production, and development costs would be deducted from his entire sale receipts. In other words, he would compute his capital gain in the same manner as Farmer A, deducting from capital gains instead of ordinary income, and pay the same amount of tax.\textsuperscript{111}

This simple method would involve very little additional recordkeeping, if any. It may be argued that such a regulation would require inventories for cash-method farmers. Animals held for sale and not for draft, breeding, or dairy purposes would not be included in these records. Separate records showing date of acquisition, age, type, and use are necessary to be able to prove satisfactorily to the Service that any animals sold as section 1231 assets qualify as such. The courts have held that this is a question of fact which is best established by adequate records.\textsuperscript{112} Such records are kept now on any well-managed farm. It would not be good tax policy to allow a group of taxpayers as large as farmers to benefit from careless recordkeeping.

\textsuperscript{107} See text accompanying notes 56-72 supra.
\textsuperscript{108} See text accompanying notes 73-90 supra.
\textsuperscript{109} See note 31 supra.
\textsuperscript{110} Treas. Reg. § 1.471-6 (1958). See Internal Revenue Service, U.S. Treasury, Pub. No. 225, Farmer's Tax Guide 1967 Edition 33 (1966): "Under this method, livestock is grouped or classified according to kind and age, and a standard unit price is used for each animal within a class or group. This method recognizes the difficulty of establishing the exact costs of producing and raising each animal, but the unit prices assigned should reasonably approximate the normal costs incurred. Unit prices and classifications are subject to the approval of the Internal Revenue Service upon examination of your return. Once you have established your unit prices and classifications, they may not be changed except with the consent of the Service."
\textsuperscript{111} See text accompanying notes 14-18 supra.
\textsuperscript{112} See, e.g., McDonald v. Commissioner, 214 F.2d 341, 342-43 (2d Cir. 1954); United States v. O'Neill, 211 F.2d 701 (9th Cir. 1954); Fox v. Commissioner, 198 F.2d 719 (4th Cir. 1952); Albright v. United States, 173 F.2d 339 (8th Cir. 1949).
Practicality of Estimating Raising Costs

Requirements that cash-method taxpayers capitalize costs of raising section 1231 animals have been attacked as "utterly impractical." The basis of this attack is the difficulty of allocating costs among several farm operations and within each operation, even if the farm produces livestock exclusively. Although actual costs could not be determined, reasonable estimates could be made. The Supreme Court on several occasions in recognizing the difficulties of precise determination in tax matters has ruled that a rough approximation is better than ignoring tax consequences altogether. A method of approximation of raising costs is presently recognized by the regulations for accrual farmers and has been approved by the courts as being based wholly on estimated costs and allowed because of the difficulty of ascertaining actual costs. This method, as the Court says in Catto, "was introduced as a special concession to accrual-method ranchers, who were thereby enabled to avoid the difficulties of establishing the actual costs of raising their livestock." Such a method, if required of cash-method farmers, would present little difficulty even with the simplest records using only rudimentary bookkeeping skills.

Conclusion

The philosophy of taxation is based upon equality of application. True, the base has been eroded by favoritism to many groups by Congress. With the problem of capitalization for section 1231 animals, however, the Commissioner has the authority to issue regulations requiring equal treatment among livestock raisers. Such a regulation could be designed which would provide equal treatment among ranchers notwithstanding accounting method. The regulation would also bring farm tax liability under section 1231 closer to the liability of other businesses. Farms have grown up. For fairness to all taxpayers and accounting accuracy, farms require and should have accounting procedures which more accurately reflect income. The Secretary and the Commissioner should exercise their authority to issue regulations requiring all farmers to capitalize the raising costs for all section 1231 animals.

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118 Little v. Commissioner, 294 F.2d 661 (9th Cir. 1961). See generally 3B MERTENS § 22.130.
119 334 U.S. at 116.
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