12 T.C. 875 (1949)

Livestock culled from a breeding herd and sold after being used for breeding purposes can qualify for capital gains treatment under Section 117(j) of the Internal Revenue Code, even if the farmer conditions the animals for market before sale.

Summary

Isaac Emerson, a farmer, sold livestock from his dairy and hog-breeding herds in 1945 and 1946. He sought to treat the profits as capital gains under Section 117(j) of the Internal Revenue Code. The Commissioner argued that the sales constituted ordinary income. The Tax Court, relying on *Albright v. United States*, held that the livestock (excluding two sows held for less than six months) qualified as capital assets, and the profits were taxable as capital gains. The court rejected the Commissioner's interpretation that culling animals for sale in the regular course of business automatically disqualifies them from capital gains treatment.

Facts

Isaac Emerson operated a 320-acre farm, deriving income from hogs, cattle, milk, grain, eggs, and poultry. He maintained a Holstein dairy herd, selling unprofitable cows for slaughter and replacing them with young stock. He also maintained a hog herd, selecting gilts for breeding each year. After the sows' litters were born, they were turned out with feeder hogs, conditioned for market, and sold. In 1945, Emerson sold two bulls, one boar, ten sows, and eleven cows; in 1946, he sold twelve cows and seven sows. All animals except two sows in 1945 were held for longer than six months. The livestock was held primarily for dairy or breeding purposes.

Procedural History

The Commissioner determined deficiencies in Emerson's income tax for 1945 and 1946, arguing that the profits from livestock sales were ordinary income, not capital gains. Emerson petitioned the Tax Court for a redetermination of the deficiencies.

Issue(s)

1. Whether the profit realized by the petitioner from the sale of animals from his dairy and hog-breeding herds constitutes ordinary income or capital gain under the provisions of Section 117(j)(1) of the Internal Revenue Code.

Holding

1. Yes, because the livestock (excluding the two sows held less than six months) was used in the petitioner's trade or business, subject to depreciation, held for more than six months, not includible in inventory, and not held primarily for sale to customers in the ordinary course of business.

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Court’s Reasoning

The court relied heavily on *Albright v. United States*, which addressed nearly identical facts. The court emphasized that the animals were used in Emerson’s trade or business of farming and were subject to depreciation. The court found that the livestock was not property of the kind includible in the taxpayer’s inventory. The critical question was whether the animals were held primarily for sale to customers in the ordinary course of his trade or business. The court rejected the Commissioner’s reliance on I.T. 3666 and I.T. 3712, which stated that sales of culled animals in the regular course of business were not sales of capital assets. The court quoted *Albright*, stating that the Commissioner’s interpretations were “contrary to the plain language of section 117 (j) and to the intent of the Congress expressed in it.” The court also stated, “Nothing in the language of the section justifies the inference that a farmer should be denied the right to treat the profits received from the sales of such livestock when they are no longer profitable or fit for use in the farmer’s business as productive of capital gains and not of ordinary income.” Judge Disney dissented, arguing that sows sold after only one litter were held primarily for sale, not for breeding.

Practical Implications

This case, along with *Albright*, clarifies that farmers can treat gains from the sale of culled breeding livestock as capital gains, even if the animals are conditioned for market before sale. It rejects a strict interpretation that any sale of culled animals in the ordinary course of business automatically disqualifies them from capital gains treatment. The key is whether the animals were initially held for breeding or dairy purposes. This ruling allows farmers to benefit from the lower tax rates applicable to capital gains, incentivizing investment in breeding stock. Subsequent cases applying this ruling would need to focus on demonstrating that the primary purpose for holding the livestock was breeding or dairy, rather than sale.

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