12 T.C. 1139 (1949)

Gains from the sale of breeding cattle can be treated as long-term capital gains under Section 117(j) of the Internal Revenue Code, even if the number of raised cattle added to the breeding herd exceeds the number sold during the taxable year.

Summary

Fawn Lake Ranch Co. challenged the Commissioner’s determination that profits from the sale of breeding cattle were ordinary income, not capital gains. The Tax Court ruled in favor of the ranch, holding that the gains qualified for long-term capital gains treatment under Section 117(j) of the Internal Revenue Code. The court invalidated I.T. 3666 and I.T. 3712, which the Commissioner relied upon, as applied to the facts, finding them inconsistent with the statute’s intent. The court followed the Eighth Circuit’s decision in *Albright v. United States*, emphasizing that Section 117(j) was intended as a relief measure applicable to all taxpayers within its provisions.

Facts

Fawn Lake Ranch Co. operated a large cattle ranch. It maintained two separate accounts: one for breeding cattle (cows and bulls) and another for ordinary cattle (steers and heifers until age two). Heifers intended for breeding were transferred to the breeding cattle account at age two. The company produced and raised almost all its livestock, selling animals from both accounts. In 1943, the number of heifers added to the breeding herd exceeded the number of cows sold from it. The company initially reported proceeds from all cattle sales as ordinary income but later filed amended returns claiming capital gains treatment for the breeding cattle sales.

Procedural History

The Commissioner determined that the profits from the breeding cattle sales constituted ordinary income, subjecting them to income and excess profits taxes. The Tax Court reversed the Commissioner’s determination, holding that the gains qualified for long-term capital gains treatment.

Issue(s)

1. Whether the gains realized from the sale of cattle from the breeding herd should be treated as ordinary income or long-term capital gains under Section 117(j) of the Internal Revenue Code when the number of raised cattle added to the herd exceeds the number sold.

Holding

1. Yes, the gains should be treated as long-term capital gains because the cattle were used in the taxpayer’s trade or business and were not held primarily for

sale to customers in the ordinary course of business, thus qualifying under Section 117(j).

Court's Reasoning

The Tax Court found the Commissioner's reliance on I.T. 3666 and I.T. 3712 to be misplaced. These rulings stated that if the number of raised animals added to the breeding herd exceeded the number sold, none of the animals sold would be considered capital assets. The court cited *Albright v. United States*, which held that these departmental rulings were "contrary to the plain language of section 117 (j) and to the intent of the Congress expressed in it." The court emphasized that Section 117(j) was enacted as a relief measure for taxpayers and that livestock held for breeding purposes are depreciable assets not primarily held for sale. The court reasoned that the cattle in the breeding herd were "being held for breeding purposes and are to be considered capital assets under the pertinent statute; that, having become part of the breeding herd, they are not held primarily for sale to customers in the ordinary course of business." The court also addressed the argument that because the taxpayer used the inventory method of accounting, it was precluded from the benefits of Section 117(j). The court noted that I.T. 3666 specifically provided that the fact that livestock may be inventoried "does not render such live stock 'property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year' so as to deprive the farmer of the benefits of section 117 (a) or <span normalizedcite="26 U.S.C. 117 (j) of the Internal Revenue Code." Judge Turner dissented, arguing that the breeding herd should be considered property includible in inventory and thus excluded from Section 117(j)'s benefits.

Practical Implications

This case clarifies that the sale of breeding livestock can qualify for capital gains treatment under Section 117(j), even if the herd size increases during the year. Taxpayers can rely on the actual use of the livestock (breeding) rather than solely on a formulaic comparison of sales and additions to the herd. This decision provides ranchers and farmers with a valuable tax benefit, allowing them to treat gains from the sale of breeding animals as capital gains rather than ordinary income, potentially reducing their tax liability. Subsequent cases and IRS guidance must consider the specific facts and circumstances to determine whether livestock is held for breeding purposes, but *Fawn Lake Ranch* remains a key precedent.

