Strong v. Commissioner, 91 T. C. 627 (1988)

Livestock received as rent under a lease agreement must be recognized as income when transferred to a breeding herd, as it constitutes a 'money equivalent'.

Summary

The case involved the Strongs and Karkoshes, who leased breeding animals to their closely held farm corporations and received livestock as rent. The issue was whether the livestock received as replacements for their breeding herds should be recognized as rental income. The Tax Court held that the taxpayers must recognize rental income when they transferred the livestock to their breeding herds, as this action represented a 'money equivalent' under the crop-share recognition rule. The court determined the income amount based on the value of the livestock at the time of income realization, which was when the animals reached their breeding weight or when legal title was transferred for calves.

Facts

The Strongs and Karkoshes leased their breeding sows and cows to their respective farm corporations, Four Strong, Ltd. and K & O Farms, Inc. In exchange, they received gilts and calves as rent. The Strongs received one gilt per leased sow annually, and one calf per eight leased cows. The Karkoshes received one gilt per leased sow annually. The farm corporations were responsible for raising the gilts to a breeding weight of 270 pounds before transferring them to the taxpayers. The Strongs and Karkoshes did not report rental income from the livestock used as replacements in their breeding herds, only reporting income when these animals were sold after being culled from the herds.

Procedural History

The IRS issued notices of deficiency to the Strongs and Karkoshes, asserting that they should have recognized rental income from the livestock they received as rent and added to their breeding herds. The cases were consolidated in the U. S. Tax Court, where the taxpayers argued they should not recognize income until the livestock was sold. The Tax Court ruled against the taxpayers, holding that they must recognize rental income upon transferring the livestock to their breeding herds.

Issue(s)

1. Whether the taxpayers must recognize rental income from livestock received as rent under their lease agreements when they transfer the livestock to their breeding herds?
2. When does the taxpayers' receipt of livestock as rent constitute a realization of income?
3. When must the realized rental income be recognized for tax purposes?

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4. What is the proper amount of rental income that the taxpayers must recognize?

Holding

1. Yes, because the transfer of livestock to the breeding herds represents a 'money equivalent' under the crop-share recognition rule.
2. Yes, because the taxpayers realized income when they acquired sufficient incidents of beneficial ownership in the livestock, which was when the gilts reached breeding weight or when legal title to the calves was transferred.
3. Yes, because the taxpayers must recognize the realized rental income when the livestock is transferred to their breeding herds, as this constitutes a reduction to a 'money equivalent'.
4. The amount of rental income recognized should be based on the value of the livestock at the time of income realization, which is when the gilts reached breeding weight or when legal title to the calves was transferred.

Court's Reasoning

The court applied the crop-share recognition rule under section 1. 61-4(a) of the Income Tax Regulations, which allows for the postponement of income recognition on crop shares until they are reduced to money or a 'money equivalent'. The court found that transferring the livestock to the breeding herds constituted a 'money equivalent' because it allowed the taxpayers to avoid the cost of purchasing replacement animals. The court distinguished this case from Vaughan v. Commissioner, where the agreement was found to be a management contract rather than a lease, and the taxpayers did not have to recognize income from the increase in the cattle herd. The court also considered the factors listed in Grodt & McKay Realty, Inc. v. Commissioner to determine when the taxpayers acquired sufficient incidents of beneficial ownership in the livestock. The court held that the taxpayers realized income when the gilts reached breeding weight or when legal title to the calves was transferred, and they must recognize this income when the livestock was transferred to their breeding herds. The court valued the livestock at the time of income realization, taking into account the additional value added by the farm corporations in raising the gilts to breeding weight.

Practical Implications

This decision impacts how taxpayers who receive livestock as rent under lease agreements must report their income. Taxpayers must recognize rental income when they transfer livestock received as rent to their breeding herds, as this constitutes a 'money equivalent' under the crop-share recognition rule. This rule applies even if the livestock is not sold, and the taxpayers do not receive cash. The decision also clarifies that the value of the livestock at the time of income realization, which may include the costs incurred by the lessee in raising the livestock, should be used to determine the amount of rental income recognized. Tax practitioners advising clients in similar situations should ensure that rental income

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is properly reported when livestock is transferred to a breeding herd, and that the value of the livestock is accurately determined. This case has been cited in later decisions, such as Estate of Davison v. United States, which further developed the concept of ‘money equivalent’ in the context of crop-share rentals.

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