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NOTE

TAXATION—Income Tax—Change of Accounting Methods—Accrual Basis To Cash Basis For Raised Breeding Livestock—United States v. Catto, 86 Sup. Ct. 1311 (1966).

The taxpayers were ranchers engaged in the business of raising livestock for sale, and maintained herds of livestock for breeding purposes. During the taxable years in question both breeding animals and animals raised for sale were included in the business operation. In addition to sales of animals raised specifically for sale, some sales were made from the breeding herd which respondent had raised. The respondent had elected the "unit-livestock-price" variant of the accrual method of accounting for his overall ranching operation¹ and during the years in dispute reported gains in accord with this election. After paying taxes on such gains, claims for partial refunds were filed with the Commissioner of Internal Revenue on the basis that they (the taxpayers) were entitled to use the cash method of accounting² in calculating the gain from sales of their breeding livestock.³ The Commissioner rejected the claims and a suit was brought in order to obtain the refunds. Both the District Court⁴ and the Court of Appeals for the Fifth Circuit⁵ allowed recovery on the claims and the Supreme Court granted certiorari.⁶ In reversing, the Court *held* that taxpayers engaged in the livestock business, who use an accrual method of accounting for animals raised for sale, may not employ a cash method of accounting for animals raised for breeding purposes in order to take advantage of a tax benefit available to cash method taxpayers when breeding animals are sold.

When a new operation is started by a rancher, he has a choice as to the accounting method (cash or accrual) he feels is best suited for his needs and will provide him the best tax advantages.⁷ In addition to a choice of methods of accounting, a rancher selecting the accrual method has a

1. Treas. Reg. § 1.471-6(e) (1958).

2. This would afford more capital gain treatment for the income from the sales of the breeding animals.

3. The taxpayer wanted to remain on the accrual basis for all other phases of his operation.

4. *Catto v. United States*, 223 F. Supp. 663 (W.D. Tex. 1963).

5. *United States v. Catto*, 344 F.2d 227 (5th Cir. 1965).

6. *United States v. Catto*, 86 Sup. Ct. 314 (1965).

7. INT. REV. CODE OF 1954, § 446(b),(c). Unlike other industries employing inventories, a rancher may choose the cash method even though inventories are an important income producing factor. Treas. Reg. § 1.471-6(a) (1958).

choice as to methods of valuing his inventory.⁸ He may select the cost method,⁹ the lower of cost or market,¹⁰ or the unit-livestock-price method.¹¹

The cash method of accounting is less complicated than the accrual method, income being recognized when received and expenses being deducted when they are paid. The following formula will illustrate the mechanics of cash method accounting: total sales minus purchases equals *gross* income and *gross* income minus expenses equals *taxable* income (before the allowable personal deductions). Thus, if a rancher has sales of \$48,000, purchase of \$12,000 and \$8,000 of expenses, his taxable income will be \$28,000. This method allows a taxpayer to regulate his sales and purchases to fall within the tax year of his choice, thereby enabling him to control his taxes to a certain extent.¹²

The accrual method of accounting requires that inventories be used in computing taxable income. In the accrual method, income is recognized when it is realized and expenses are recognized when they are incurred, without regard to the time of receipt or payment. The following formula illustrates the mechanics of the accrual method of accounting: (sales plus closing inventory) minus (purchases plus opening inventory) equals *gross* income and *gross* income minus expenses equals *taxable* income (before allowable personal deductions). This method of accounting spreads the taxable income more evenly over the years and reflects the taxpayer's income more accurately.¹³ It should be noted that expenses are currently deducted from gross income under both accounting methods.

Perhaps the most significant section of the Internal Revenue Code which should be considered when electing an accounting method is section 1231.¹⁴ This section, as amended by section 1231(b)(3),¹⁵ provides capital gain treatment for

8. INT. REV. CODE OF 1954, § 471.

9. Treas. Reg. § 1.471-3 (1958).

10. Treas. Reg. § 1.471-4 (1958).

11. Treas. Reg. § 1.471-6 (1958).

12. INT. REV. CODE OF 1954, §§ 61(a), 62, 162(a); Treas. Reg. § 1.162-12 (1958).

13. Treas. Reg. § 1.446-1(c)(1)(ii) (1957).

14. INT. REV. CODE OF 1954, § 1231.

15. Revenue Act of 1951, ch. 521, § 325, 65 Stat. 501, codified as Int. Rev. Code of 1939, ch. 1, § 117(j)(1), 53 Stat. 50 (now INT. REV. CODE OF 1954, § 1231(b)(3)).

the sale of all livestock used for breeding purposes and held for twelve months or more. A comparison of the two accounting methods with focus on section 1231 will indicate the importance of considering this section when selecting accounting methods.

Under the cash basis of accounting, the deductions allowable under section 162(a)¹⁶ are taken against ordinary income in the year the expenses are actually paid, thereby giving a zero basis for raised breeding animals. As a result of this zero basis the entire proceeds are treated as capital gains when the animals are sold.

As stated above, a rancher selecting the accrual method also has a choice of valuing his inventory. Because of the difficulty of computing the actual cost of livestock raised, the unit-livestock-price method is most frequently employed.¹⁷ Under this method the annual increments in the unit inventory values are taken into income annually, being included in the closing inventory value which results in an increase in income.¹⁸ In addition, as mentioned previously, the expenses are deducted currently. As a result of this procedure, the annual inventory increments offset the deductions for the estimated expenses of raising the livestock, and thereby give an adjusted basis to the animals equal to the unit inventory values.¹⁹ When the animals are subsequently sold only the proceeds in excess of the adjusted basis are accorded capital gain treatment, whereas the entire proceeds of sale are accorded such treatment under the cash method since the basis is zero. The result of this process is the portion of the sales proceeds which represents the recovery of expenses is taxed as ordinary income to accrual method ranchers and as capital gains to those employing the cash method.²⁰

The Regulations provide that once a rancher elects the unit-livestock-price method of inventory valuation he must apply it to *all* livestock, whether the livestock is held for

16. INT. REV. CODE OF 1954, § 162(a).

17. Treas. Reg. § 1.471-6(c), (e) (1958).

18. See formula in text *supra* p. 246.

19. Treas. Reg. § 1.61-4(b) (1957).

20. See generally Jamison, *Tax Planning with Livestock and Farming Operations*, 1961 So. CAL. TAX INST. 583.

sale or for breeding purposes.²¹ They further provide that a change of accounting methods may be accomplished only with the consent of the Commissioner²² and no changes have been approved since 1949²³ As a result to this refusal to consent to changes in accounting methods, several taxpayers have chosen to test the validity of the Regulations in the courts. The taxpayers involved in these cases have challenged the validity of the Regulations only to the extent they require a taxpayer to include *all* livestock in their inventories, contending that raised breeding livestock is property used in the business of ranching. None of the taxpayers involved have sought to make a complete change of accounting methods for their entire ranching operation.

The Court of Appeals for the Fifth Circuit was the first to render a decision on the question and it held that the Regulations were invalid and allowed an accrual method taxpayer to remove his raised breeding stock from inventory.²⁴ The Eighth Circuit was next to decide the question and it decided in favor of the Government, disallowing the removal.²⁵ A like result was reached by the Ninth Circuit in the same year.²⁶ The question was recently before the Fifth Circuit again and it followed its earlier decision which held that the taxpayer was not required to use the accrual method of accounting for his breeding livestock.²⁷ Although the Supreme Court had denied certiorari in an earlier case concerning the same matter,²⁸ it was granted in this case in order to resolve the conflict among the circuits.²⁹

The Supreme Court reversed the Court of Appeals of the Fifth Circuit in the principal case, and held that an accrual method taxpayer cannot remove his raised breeding livestock from the inventory.³⁰ The taxpayers proposed to

21. Treas. Reg. § 1.471-6(f) (1958).

22. *Ibid.*

23. Bowen, *Circuits Conflict on Changing Method of Accounting for 1231 Livestock*, 15 J. TAXATION 227 (1961); Catto v. United States, *supra* note 4.

24. Scofield v. Lewis, 251 F.2d 128 (5th Cir. 1958).

25. United States v. Ekberg, 291 F.2d 913 (8th Cir. 1961), *cert. denied*, 368 U.S. 920 (1961).

26. Little v. Commissioner, 294 F.2d 661 (9th Cir. 1961).

27. United States v. Catto, *supra* note 5.

28. United States v. Ekberg, *supra* note 25.

29. United States v. Catto, *supra* note 6.

30. United States v. Catto, 86 Sup. Ct. 1311 (1966).

accomplish the removal of their raised breeding livestock from inventory in two steps: first, by deducting the opening inventory value of the animals actually sold from ordinary income and treating the entire proceeds as capital gains; and second, by removing the livestock retained from the closing inventory and deducting the opening inventory value from ordinary income, thereby achieving a zero basis for these animals.³¹ With a zero basis, the entire proceeds from subsequent sales could be accorded capital gain treatment. Under the government's theory the opening inventory value of the animals sold would be used as a basis for determining gain under section 1231 and not, therefore, deducted from ordinary income.

The taxpayers' principal contention was that breeding livestock was not the type of property that was properly included in inventory and they drew a parallel between the capital equipment of manufacturers and breeding livestock. However, the case ultimately centered on the question presented in the previous cases, *i.e.*, the validity of the Regulations which require a taxpayer to apply the unit-livestock-price method to all livestock raised.³² The court held that this Regulation was valid and that the unit-livestock-price method was soundly grounded in accepted accounting principals, thereby providing ranchers who employed this method with a true reflection of their income. The court reaffirmed the principle that the Commissioner has broad discretion in regulating the accounting methods employed by taxpayers and as long as income is properly reflected, he is not obligated to permit taxpayers to alter their accounting techniques to accommodate every fluctuation of the revenue laws. Application of the cash method of accounting to sales of breeding livestock only, the court stated, would "substantially distort the economic picture of the respondents' ranching operations."³³ The court concluded by resolving that the taxpayers in the present case desired to selectively combine "attributes of both methods [thereby fashioning] a hybrid system that

31. *United States v. Catto*, *supra* note 5.

32. See notes 21-22 *supra* and accompanying text.

33. *United States v. Catto*, *supra* note 30, at 1319.

would defeat the Commissioner's goal of providing a unitary accounting method for all taxpayers."³⁴

The decision in the *Catto* case definitely clarifies the current situation. It is now certain that a rancher employing the accrual method of accounting can not remove raised breeding stock from his inventory. A distinct inequity, which had previously existed in some circuits, was now universally created between the rancher employing the cash method of accounting and those employing the accrual method.

The Internal Revenue Service has admitted that the cash method rancher is receiving a capital gain windfall but contends it is foreclosed from amending the present situation.³⁵ To add insult to injury, the Commissioner has refused to allow any accrual basis rancher to change to a cash basis since the enactment of section 1231(b)(3),³⁶ steadily maintaining, in the applications for change which he has acted upon, that "a change from the accrual method to the cash receipts and disbursements method of accounting will result in a distortion of income."³⁷ This reasoning seems to be based on the theory that cash method accounting does not reflect income accurately; however, this method of accounting has been accepted for years.³⁸ At the present time the only way to avoid this perplexing situation seems to be to change taxable entities, e.g., proprietorship to corporation or partnership to corporation, and, after changing entities make a new election as to accounting methods.

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34. *Ibid.*

35. *Id.* at 1318, n.23.

36. Bowen, *supra* note 23.

37. *Irvine v. United States*, 212 F. Supp. 937 (1963).

38. Bowen, *supra* note 23, at 229.