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subject: Breeder Animals

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LEGEND

Taxpayer =

ISSUES

1. What is the ‘‘cost” of a self-produced animal to be used in the trade or business of farming for purposes of computing its depreciation deduction?

2. What is the proper placed in service date relating to self-produced breeding animals used in the trade or business of farming?

CONCLUSIONS

1. For purposes of computing the depreciation deduction of a self-produced animal to be used in the trade or business of farming, the “cost” of the animal is the costs required to be capitalized with respect to the animal under § 263A or other applicable provision of the Code.

2. The Internal Revenue Service will not challenge a taxpayer’s position that for depreciation purposes, the placed-in-service date of an animal raised or purchased for breeding purposes is when such animal reaches the age of maturity (that is, when such animal reaches the age it can be bred).

FACTS

Taxpayer is a large farm operation required to use the accrual method of accounting. Taxpayer is also subject to the animal capitalization rules of § 1.263A-4 of the Income Tax Regulations. Taxpayer’s are born approximately days after the breeder is inseminated. For depreciation purposes, Taxpayer places its breeder animals in service when they are ready for insemination. Where insemination is successful, that breeder animal is placed in service for depreciation purposes generally at mid-year.

Taxpayer indicates that are born on a daily basis and that are impregnated on a daily basis. As a result, Taxpayer assumed a constant flow of animal birth and impregnation and selected the mid-point of the taxable year as the proper placed-in-service date for the taxable years ended and . Because of the unavailability of the additional first year depreciation deduction under § 168(k) for animals placed in service on or after January 1, 2005, Taxpayer assumed that the placed-in-service dates occurred in thirds during the taxable year ended .

LAW AND ANALYSIS

ISSUE 1: WHAT IS THE ‘‘COST” OF A SELF-PRODUCED ANIMAL TO BE USED IN THE TRADE OR BUSINESS OF FARMING FOR PURPOSES OF COMPUTING ITS DEPRECIATION DEDUCTION?

Section 167(c) provides the basis for depreciation. Pursuant to IRC § 167(c)(1), the basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in IRC § 1011, for purpose of determining the gain on the sale or other disposition of such property.

Section 1011 provides that the adjusted basis for determining gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under § 1012 or other applicable sections).

Section 1012 provides that except as otherwise provided in the Code, the basis of property shall be the cost of such property.

Section 263A(b)(1) provides that, except as otherwise provided, § 263A shall apply to real or tangible personal property produced by the taxpayer.

Section 263A(g)(1) provides that, for purposes of § 263A, the term “produce” includes construct, build, install, manufacture, develop or improve. Section 1.263A-2(a)(1) provides that, for purposes of § 263A, “produce” includes the following: construct, build, install, manufacture, develop, improve, create, raise or grow.

Section 263A(a)(1) provides that in the case of any property to which § 263A applies, the direct costs of the property and the indirect costs properly allocable to the property shall be included in inventory costs (in the case of property that is inventory in the hands of the taxpayer) or shall be capitalized (in the case of other property).

Section 1.263A-1(e)(2)(i) provides generally that direct material costs of producers include the costs of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. Direct labor costs of producers include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced.

Section 1.263A-1(e)(3)(i) provides that “indirect costs” are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to section 263A. Taxpayers subject to section 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

Section 263A(d)(1) provides that § 263A does not apply to the production of any animal or any plant with a preproductive period of 2 years or less if the taxpayer is not required to use an accrual method of accounting under § 447 or § 448(a)(3). See also § 1.263A-4(a)(2). For purposes of determining whether a plant has a preproductive period in excess of 2 years, the preproductive period of plants grown in commercial quantities in the United States is based on the nationwide weighted average preproductive period for such plant. § 1.263A-4(b)(2)(i)(A). See also Notice 2000-45, 2000-2 C.B. 256.

Section 1.263A-4(b)(1) provides that unless otherwise provided, § 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of any property in a farming business (including animals and plants without regard to the length of their preproductive period). The types of direct and indirect costs that generally must be capitalized by taxpayers under § 263A are described in section 1.263A-1(e), and specific examples of the types of costs typically incurred in the trade or business of farming are provided in § 1.263A-4(b)(1)(i) and (ii).

Section 1.263A-4(b)(1)(ii) provides that the costs of producing an animal typically required to be capitalized under section 263A include the costs incurred so that the animal's raising process may begin (preparatory costs), such as the acquisition costs of the animal, and the costs of raising or caring for such animal during the preproductive period (preproductive period costs). Preproductive period costs include, but are not limited to, management, feed (such as grain, silage, concentrates, supplements, haylage, hay, pasture and other forages), maintaining pasture or pen areas (including costs that the taxpayer has elected to deduct under sections 175 or 180), breeding, artificial insemination, veterinary services and medicine, livestock hauling, bedding, fuel, electricity, hired labor, tax depreciation and repairs on buildings and equipment used in raising the animals (for example, barns, trucks, and trailers), farm overhead, taxes (except state and Federal income taxes), and interest required to be capitalized under section 263A(f).

Section 1.263A-4(b)(2)(ii) provides that an animal's actual preproductive period is used to determine the period that the taxpayer must capitalize preproductive period costs with respect to a particular animal.

Section 1.263A-4(b)(2)(ii)(A) provides that the preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation.

Section 1.263A-4(b)(2)(ii)(B) provides that in the case of an animal that will be used in the trade or business of farming (for example, a dairy cow), the preproductive period generally ends when the animal is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention). However, in the case of an animal that will have more than one yield (for example, a breeding cow), the preproductive period ends when the animal produces (for example, gives birth to) its first yield. In the case of any other animal, the preproductive period ends when the animal is sold or otherwise disposed of.

Section 1.263A-4(b)(2)(ii)(C) provides that in the case of an animal that will have more than one yield, the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield using any reasonable method. Any depreciation allowance on the animal may be allocated entirely to the yield. Costs incurred after the beginning of the preproductive period of the second yield, but before the first yield is weaned from the animal must be allocated between the first and second yield using any reasonable method. However, a taxpayer may elect to allocate these costs entirely to the second yield. An allocation method used by a taxpayer is a method of accounting that must be used consistently and is subject to the rules of section 446 and the regulations thereunder.

The raising of animals constitutes the production of tangible personal property for purposes of § 263A. §§ 263A(g), 1.263A-2(a)(1). Accordingly, the production of animals is subject to the cost capitalization requirements of § 263A(a) unless the exemption in § 263A(d)(1) is applicable.

Section 263A generally requires that both the direct costs and the properly allocable indirect costs of producing an animal shall be included in inventory costs (if the animal is inventory in the hands of the taxpayer) or shall be capitalized to the animal (if the animal is not inventory in the hands of the taxpayer, such as animals held for dairy, draft or breeding purposes). More specifically, the capitalized costs of producing an animal typically include (i) the costs incurred so that the animal's raising process may begin (preparatory costs), such as the acquisition costs of the animal, and (ii) and the costs of raising or caring for such animal during the preproductive period (preproductive period costs), examples of which are given in § 1.263A-4(b)(1)(ii).

Preproductive period costs are capitalized into a produced animal during its preproductive period, which commences at the time of acquisition, breeding or embryo implantation. In the case of breeder animals (animals that will have more than one yield), the preproductive period begins at the time of acquisition, breeding or embryo implantation, and ends when the animal produces (for example, gives birth to) its first yield. § 1.263A-4(b)(2)(ii).

A special cost allocation rule applies when a breeder animal gives birth to its first yield. Preproductive period costs that are incurred after the breeder animal is first bred or implanted (the beginning of the preproductive period of the yield) but before the breeder animal gives birth to its first yield (the end of the preproductive period of the breeder animal) must be allocated between the breeder animal and the first yield. Any depreciation allowance accruing on the breeder animal during this period is a preproductive period cost that is allocable between the breeder animal and the first yield; however, a taxpayer may choose to allocate such depreciation entirely to the first yield. § 1.263A-4(b)(2)(ii)(C).

An additional special cost allocation rule applies to weaning of the first yield of a breeder animal. Preproductive period costs incurred after a breeder animal is bred or implanted with its second yield (the beginning of the preproductive period of the second yield) but before the first yield is weaned from the breeder animal must be allocated between the first yield and the second yield using any reasonable method. However, a taxpayer may elect to allocate these costs entirely to the second yield. § 1.263A-4(b)(2)(ii)(C).

Under these rules, the capitalized costs of a self-produced breeder animal under § 263A would generally consist of:

(i) the acquisition costs of the breeder animal;

(ii-a) if the breeder animal is not the first yield of its parent, the preproductive period costs incurred from the acquisition of the breeder animal or the breeding or implantation of its parent until the breeder animal is born;

(ii-b) if the breeder animal is the first yield of its parent, a reasonably allocable portion of the preproductive costs incurred from the acquisition of the breeder animal or the breeding or implantation of its parent until the breeder animal is born (the remainder of the costs being allocated and capitalized to the parent); at taxpayer election, the breeder animal (as the first yield of its parent) can bear all of the depreciation allowance accruing on the parent during this period;

(iii) preproductive period costs of the breeder animal from its birth until it is first bred or implanted; if the breeder animal is the first yield of its parent, some portion of these costs may be allocable to the second yield of the parent during the weaning of the breeder animal; and

(iv) a reasonably allocable portion of the preproductive period costs incurred from first breeding or implantation until the breeder animal gives birth to its first yield (the remainder of the costs being allocated and capitalized to the first yield); at taxpayer election, the first yield can bear all of the depreciation allowance accruing during this period.

Under these rules, the capitalized costs of a self-produced non-breeder animal under § 263A would generally consist of:

(i) the acquisition costs of the non-breeder animal;

(ii-a) if the non-breeder animal is not the first yield of its parent, the preproductive period costs incurred from the acquisition of the non-breeder animal or the breeding or implantation of its parent until the non-breeder animal is born;

(ii-b) if the non-breeder animal is the first yield of its parent, a reasonably allocable portion of the preproductive costs incurred from the acquisition of the non-breeder animal or the breeding or implantation of its parent until the non-breeder animal is born (the remainder of the costs being allocated and capitalized to the parent); at taxpayer election, the non-breeder animal (as the first yield of its parent) can bear all of the depreciation allowance accruing on the parent during this period; and

(iii) preproductive period costs of the non-breeder animal from its birth until it is placed in service; if the non-breeder animal is the first yield of its parent, some portion of these costs may be allocable to the second yield of the parent during the weaning of the breeder animal.

ISSUE 2: WHAT IS THE PROPER PLACED IN SERVICE DATE RELATING TO SELF-PRODUCED BREEDING ANIMALS USED IN THE TRADE OR BUSINESS OF FARMING?

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a taxpayer's trade or business.

Section 1.167(a)-2 provides that the depreciation allowance in the case of tangible property does not apply to inventories or stock in trade.

Section 1.167(a)-10(b) provides that the period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service.

Section 1.167(a)-11(e)(1) provides that an asset is placed in service when the asset is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. Accord § 1.46-3(d)(1)(ii). See also § 1.168-2(l)(2) of the proposed Income Tax Regulations.

For animals purchased for breeding purposes, there is considerable evidence that the placed-in-service date begins when such animal is capable of being bred. In Rudolph Investment Corp. v. Commissioner, T.C. Memo 1972-129, the Service disallowed a depreciation deduction for yearling heifers purchased for breeding purposes by the taxpayer. The Tax Court allowed a depreciation deduction based on the testimony that the taxpayer's cows became part of the breeding herd at the taxpayer's ranch when they were yearlings. Thus, this case illustrates that the Tax Court envisions that cows purchased for breeding purposes are depreciable beginning when they are capable of being bred. See also chapter 7, page 7-10, of the Service's MSSP "Swine Farm Industry" ("Immature livestock acquired for breeding purposes is eligible for depreciation when it reaches maturity. This means depreciation begins when it reaches the age when it can be bred."); IRS Pub. 225, Farmer's Tax Guide, page 37 (2006) ("Depreciation for livestock begins when the livestock reaches the age of maturity. If you acquire immature livestock for draft, dairy, or breeding purposes, your depreciation begins when the livestock reach the age when they can be worked, milked, or bred").

Thus, an animal purchased for breeding purposes is placed in service when the animal reaches the age when it can be bred. This same conclusion should apply to an animal raised for breeding purposes. When an animal is raised for breeding purposes, the animal is ready and available for its assigned function (that is, breeding) when the animal reaches the age it can be bred.

Section 1.263A-4 provides guidance with respect to the application of § 263A to property produced in a farming business. Section 1.263A-4(b)(1)(ii) provides that the costs of producing an animal typically required to be capitalized under § 263A include the costs incurred so that the animal's raising process may begin (preparatory costs) and the costs of raising or caring for such animal during the preproductive period (preproductive period costs). Preproductive period costs include, among other things, breeding and artificial insemination.

Section 1.263A-4(b)(2)(ii) provides the preproductive period for an animal. An animal's actual preproductive period is used to determine the period that the taxpayer must capitalize preproductive period costs with respect to a particular animal. Pursuant to § 1.263A-4(b)(2)(ii)(A), the preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation. In the case of an animal that will used in the trade or business of farming (for example, a dairy cow), § 1.263A-4(b)(2)(ii)(B) provides that the preproductive period generally ends when the animal is placed in service for purposes of § 168. However, in the case of an animal that will have more than one yield (for example, a breeding cow), § 1.263A-4(b)(2)(ii)(B) provides that the preproductive period ends when the animal produces (for example, gives birth to) its first yield.

In the case of an animal that will have more than one yield, § 1.263A-4(b)(2)(ii)(C) provides that the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield using any reasonable method, and any depreciation allowance on the animal may be allocated entirely to the yield. This provision anticipates that depreciation can begin before the end of the preproductive period of the breeder animal. Because the preproductive periods of the breeder animal and the first yield overlap, § 1.263A-4(b)(2)(ii)(C) clearly envisions that depreciation can begin before the end of the preproductive period for a breeder animal that will have more than one yield.

The rules under § 1.471-6 for the unit-livestock-price method have been amended several times to conform with § 263A and § 1.263A-4. However, the rule under § 1.471-6(f) regarding the election of a livestock raiser to include the inventoriable costs of animals raised for draft, breeding, or dairy purposes in inventory or to treat such costs as property used in a trade or business subject to depreciation after maturity, was not amended. Similarly, the rule under § 1.471-6(g) requiring a livestock raiser that uses the "unit-livestock-price method" to include in inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as property used in a trade or business subject to depreciation after maturity, was not amended. See also Rev. Rul. 60-60, 1960-1 C.B. 190, 191 (reference to § 1.471-6(g)).

The above discussion provides persuasive authority that the placed-in-service date of an animal raised or purchased for breeding purposes is when the animal reaches maturity (that is, when such animal reaches the age when it can be bred). When an animal is raised or purchased for breeding purposes, the animal is ready and available for its assigned function (that is, breeding) when the animal can be bred. Thus, the

Service will not challenge a taxpayer's position that for depreciation purposes, the placed-in-service date of an animal raised or purchased for breeding purposes is when the animal reaches the age when it can be bred.

As discussed above in connection with the first issue, depreciation incurred on a breeder animal during the period from breeding or implantation [the beginning of the preproductive period of the yield] until the birth of the yield is a preproductive period cost of the yield that is capitalized to the yield. If the yield is the first yield of the breeder animal, such depreciation is a preproductive cost of both the first yield and of the breeder animal itself (whose preproductive period does not end until it gives birth to the first yield). Accordingly, such depreciation must generally be allocated between the breeder animal and the first yield using any reasonable method; the taxpayer may choose, however, to allocate all of the depreciation to the first yield. § 1.263A-4(b)(2)(ii)(C).

The placed-in-service date for an animal that is raised or purchased for breeding purposes and that will have more than one yield is before such animal gives birth to its first yield, which is when the preproductive period ends for the animal pursuant to § 1.263A-4(b). As a result, the costs capitalized under § 263A for taxable years after the placed-in-service year and under § 263A before the end of the preproductive period of this breeder animal will result in a redetermination of basis for depreciation purposes. In such a case, for the taxable year in which the basis is redetermined and subsequent taxable years, depreciation is determined by recovering the redetermined adjusted basis over the recovery period remaining as of the beginning of the particular taxable year (taking into account the applicable convention), using the same depreciation method applicable to the animal for the taxable year in which the increase in basis occurs. The redetermined adjusted basis is the unadjusted basis reduced by the depreciation previously allowed or allowable (whichever is greater) with respect to the property and increased to reflect the costs capitalized under § 263A for taxable years after the placed-in-service year and under § 263A before the end of the current taxable year. Thus, the increase in basis is accounted for over the remaining recovery period beginning with the taxable year in which the basis is redetermined.

Because of the redetermination of basis, we note that a taxpayer that is currently using the optional tables provided in section 8 of Rev. Proc. 87-57, 1987-2 C.B. 687, to compute the annual depreciation allowance under § 168 for the animal can not continue to use the table beginning in the taxable year in which the animal's basis is redetermined. See section 8.02 of Rev. Proc. 87-57. Further, pursuant to § 1.168(k)-1(f)(2), any increase in the basis of an animal that is raised or purchased for breeding purposes and is qualified property or 50-percent bonus depreciation property is subject to the additional first year depreciation deduction provided by § 168(k), provided the increase in basis occurs before January 1, 2005.

EXAMPLE

A simplified example may help to illustrate the foregoing principles. Assume that a taxpayer places a breeder animal into service in Year 1 and this breeder animal is 50-percent bonus depreciation property. The depreciation for the breeder animal is determined under § 168 by using a 3-year recovery period, the 150% declining balance method, and a half-year convention. All preproductive costs incurred between the breeding of the breeder animal and the birth of the yield are allocated entirely to the breeder animal. The taxpayer incurs $1000 of preparatory costs and preproductive period costs with respect to the breeder animal in Year 1.

The taxpayer incurs $250 of preproductive period costs with respect to the breeder animal in year 2. The breeder animal gives birth to its first yield in Year 2.

The tax consequences are as follows: In Year 1, $1,000 of preparatory and preproductive period costs are incurred and are capitalized into the basis of the breeder animal. Beginning with its placed in service date, the breeder animal is subject to an allowance for depreciation under § 168. $500 of additional first year (bonus) depreciation and $125 of regular depreciation are accrued on the breeder animal. The $625 of depreciation is capitalized into the breeder animal in Year 1 as a preproductive cost of the breeder animal and becomes part of the depreciable basis of the breeder animal for Year 2.

Because of the depreciation that accrued in Year 1 but is capitalized into the breeder animal as a preproductive period cost, depreciation in Year 2 must be calculated from a depreciable basis that is restated to reflect the capitalized depreciation accrued in Year 1. The basis of the breeder animal in Year 2 is restated to include (i) its adjusted basis at the end of Year 1 ($375); (ii) the regular and bonus depreciation ($125 and $500) that was accrued and capitalized into the basis of the breeder animal in Year 1; and (iii) the preproductive period costs ($250) incurred in year 2 and capitalized into the breeder animal.

		Depreciation Expense				
1st year cost analysis		Year 1	Year 2	Year 3	Year 4	
PPE incurred in year 1	$1,000.00					
Bonus depreciation allowable	($500.00)	$500				
Adjusted basis less bonus for regular depreciation	$500.00					
Depreciation rate @ 3 yrs 150% DB HY convention	25.00%					
1st year regular depreciation allowable	$125.00	$125				
2nd year cost analysis & restated basis						
Yr 1 adjusted basis @ EOY	$375.00					
Yr 1 bonus depreciation capitalized under § 263A	$500.00					
Yr 1 regular depreciation capitalized under § 263A	$125.00					
PPE incurred in year 2	$250.00					
Restated basis in 2nd year	$1,250.00					
Yr 2 depreciation allowable	$750.00		$750.00			
3rd year cost analysis						
Yr 2 adjusted basis @ EOY	$500.00					
Yr 3 depreciation allowable	$333.35			$333.35		
4th year cost analysis						
Yr 3 adjusted basis @EOY	$166.65					
Yr 4 depreciation allowable	$166.65				$166.65	
Depreciation allowable on breeder		$625.00	$750.00	$333.35	$166.65	
Depreciation capitalized into breeder under § 263A		($625.00)				
Total depreciation expense allowed per year [capitalizable into yields of breeder]		$0.00	$750.00	$333.35	$166.65	$1,250.00
IRC 168(b)(2) optional table rates for 3 yr recovery period 150% DB HYC ((rate x (original cost – bonus depreciation))		25.00%	37.50%	25.00%	12.50%	
IRC 168(b)(2) rates for 2.5 yr remaining recovery period 150% DB HYC switching to SL in year 3 (rate x adjusted basis at beginning of year 2, 3, or 4, as applicable)			60.00%	66.67%	100.0%	

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

With respect to the additional first year depreciation deduction, there are two critical dates--the acquisition date and the placed-in-service date. Generally, depreciable property is qualified property and therefore subject to the 30-percent additional first year depreciation if the property is acquired after September 10, 2001, and before January 1, 2005, and placed in service before January 1, 2005 (assuming all other requirements of §§ 168(k) and 1.168(k)-1 are met). Generally, depreciable property is 50-percent bonus depreciation property and therefore subject to the 50-percent additional first year depreciation if the property is acquired after May 5, 2003, and before January 1, 2005, and placed in service before January 1, 2005 (assuming all other requirements of §§ 168(k) and 1.168(k)-1 are met). Thus, the critical dates for determining if the property is eligible for the additional first year depreciation deduction are the property's acquisition date (for example, the property must be acquired after September 10, 2001, for the 30-percent additional first year depreciation deduction) and the property's placed-in-service date (that is, the property must be placed in service before January 1, 2005). This placed-in-service date is determined without taking into account any applicable convention.

[redacted]

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Please call if you have any further questions.