When is Grain a Capital Asset?

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WHEN IS GRAIN A CAPITAL ASSET?

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Grain that is raised by a farmer and held for sale or for feeding to livestock is inventory in the hands of the farmer. If and when such grain is sold, the proceeds from the sale are treated as ordinary income for income tax purposes.[1] This article explores the opportunities for a farmer to convert the character of the grain to a capital asset and thereby get the benefit of treating the proceeds from the sale as a capital gain.

I.R.C. section 1221 defines a capital asset as any property held by a taxpayer with some specific exceptions.[2] The exceptions are: (1) inventory[3]; (2) depreciable or real property[4]; (3) copyrights, letters, literary compositions, musical compositions or artistic compositions in the hands of the creator, the original owner or someone who has a basis in the property that is carried over from the creator or the original owners[5]; and (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or inventory sold.[6] From the above definition, it is clear that grain is not a capital asset while it is being held as inventory. Therefore, as long as it is held to be sold in the ordinary course of business or to be used in the ordinary course of business by feeding it to livestock, it cannot be a capital asset. If the grain is not held in inventory, then it does not fall within any of the exceptions to I.R.C. section 1221 and is therefore a capital asset. Consequently, if the purpose for holding the grain is not to sell or feed it in the ordinary course of business, it may be a capital asset.

Whether a taxpayer holds property as a capital asset or for use in the ordinary course of business is a question of fact.[7] The factors to be considered in determining whether particular property is a capital asset are set out in *United States v. Winthrop*,[8] as follows: (1) the nature and purpose of the acquisition of the property and the duration of ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

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1. 26 U.S.C. §§ 61(a)(2), 62(1) and 63(b) (1982).
2. *Id.* at § 1221.
3. *Id.* at § 1221(1).
4. *Id.* at § 1221(2).
5. *Id.* at § 1221(3).
6. *Id.* at § 1221(4).
7. Bauschard v. Comm'r, 279 F.2d 115, 117 (6th Cir. 1960).
8. 417 F.2d 905 (5th Cir. 1969).

(7) the time and effort the taxpayer habitually devoted to the sales.[9]

As the Taxpayer's purpose for holding the property is the determinative factor,[10] a farmer may be able to change the characterization of the proceeds from the sale of the grain. For example, if a farmer gives the grain to someone who is neither a farmer nor a dealer in grain, the grain may be a capital asset in the hands of the donee.[11] If grain is distributed by a partnership or a corporation to the partners or shareholders as part of a liquidation and the partners do not use the grain in a farm or grain dealing business, the grain may be a capital asset in the hands of the partner or shareholder.[12] If the purpose for which a farmer holds grain changes from a business purpose to an investment purpose, the grain may become a capital asset in the hands of the farmer.[13] The tax advantages of the above examples and some suggestions for structuring transactions to get those advantages are discussed below.

GIFTS OF GRAIN

Shifting Income to a Lower Bracket

A farmer can realize several income tax advantages by giving grain to someone in a lower income tax bracket. The first advantage is that the income realized from the sale of grain will be shifted to the donee and therefore taxed at a lower rate. The shift in income tax liability comes about because the donor is neither required to recognize income when the grain is given away nor when the grain is sold.[14] The amount of income the donee must recognize on the sale is the difference between the amount the donee receives for the grain and the donee's basis in the grain.[15] Since the donee acquired the grain by gift, the donee's basis is the basis in the hands of the donor prior to the gift, plus the gift taxes paid that are attributable to the appreciation in the value of the property while it was in the hands of the donor.[16]

The basis of the grain in the hands of the donor will depend upon the donor's method of accounting and the timing of the gift. If the donor uses the cash method of accounting and gives the grain away in a year after the expenses of raising the grain are deducted, the donor's basis is zero.[17] If the

9. *Id.* at 910.

10. In Glisson v. Comm'r, 50 T.C.M. (P-H) 1376 (1981), the court stated, "Since intent is subject to change, the crucial factor is the purpose for which the property is held during the period in question." *Id.* at 1382. *See also* Eline Realty Company v. Comm'r, 35 T.C. 1, 5 (1960); Carl Marks and Co. v. Comm'r, 12 T.C. 1196, 1202 (1949).

11. *See* Reynolds v. Comm'r, 155 F.2d 620 (1st Cir. 1946); Scott v. McCrory, 52 A.F.T.R. (P-H) 1745, 162 F. Supp. 535 (D. Neb. 1957).

12. *See* Greenspon v. Comm'r, 229 F.2d 947 (8th Cir. 1956).

13. *See* Stefka v. United States, 2 A.F.T.R.2d (P-H) 5538 (W.D. Tex. 1958); Williamson v. Bowers, 120 F. Supp. 704 (E.D.S.C. 1950).

14. Elsie SoRelle v. Comm'r, 22 T.C. 459 (1954); Estate of Farrier v. Comm'r, 15 T.C. 277 (1950).

15. 26 U.S.C. § 1001(a) (1982).

16. *Id.* at § 1015(a), (d).

17. Rev. Rul. 531, 1955-2 C.B. 520. The donor's basis in the grain will be the cost of producing the grain unless those costs are deducted by the donor. *Id.* Revenue Ruling 55-531 also says that if the donor uses the cash method of accounting, the cost of producing the grain cannot be deducted in the year the grain is given away or in a subsequent year. *Id.* The ruling also requires a donor who

donor uses the cash method of accounting but gives the grain away in the same year the expenses of raising the grain are incurred or if the donor uses the accrual method of accounting, the donor will not be allowed to deduct the costs of raising the grain but will be allowed to treat such costs as the donor's basis in the grain.[18]

Most farmers use the cash method of accounting and will therefore be able to shift the income tax liability on the full value of the grain to the donee if the grain is given away in a year after the expenses of raising the grain are deducted. If the grain is given away in the same year the expenses of raising it are incurred, the farmer will shift the income tax burden on only the difference between the cost of raising the grain and the sale price of the grain, because the farmer will not be allowed to deduct the cost of raising the grain.

It should be noted that landowners who rent their land under a cropshare lease will not be able to shift the income tax liability on the proceeds from the sale of grain unless they are considered farmers for income tax purposes as a result of material participation in the farm business. Grain that is received as rent by non-materially participating landlords is income to the landlord at the time it is received.[19] The income does not have to be recognized at the time it is received,[20] but any disposition of the grain will trigger recognition of the grain.[21]

Reducing Earned Income

A second advantage of the gift of grain is that the proceeds from the sale of the grain will not be treated as earned income of the farmer.[22] If the farmer's income is below the social security wage base,[23] the farmer's self-employment tax will be reduced as a result of reducing earned income.[24] If the farmer is collecting social security benefits and has earned income, the reduction in earned income may increase the amount of benefits the donor receives.[25]

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uses the accrual method of accounting to adjust beginning inventory for the year of the gift to remove the cost or other basis of the donated grain. *Id.* The ruling does not prohibit deducting the expense of producing the grain in a year prior to the gift. *Id.* Similarly, the court in Parkhill v. United States, 385 F. Supp. 204 (D.C. Tex. 1974) did not allow the taxpayer to deduct the cost of producing grain that was given away in the year the costs were incurred. The question of deductibility in a year prior to the gift was not at issue.

18. *Id.* 26 U.S.C. § 1012 (1982) says that the basis of property is its cost.

19. Tatum v. Comm'r, 400 F.2d 242 (5th Cir. 1968).

20. *Id.*

21. Rev. Rul. 11, 1975-1 C.B. 27.

22. 26 U.S.C. § 1402(a) (1982) defines "net earnings from self-employment" as gross income from a trade or business. By giving the grain away, the donor removes the proceeds from gross income and therefore removes it from earned income.

23. The wage base for 1985 is $39,600. 1 FED. TAXES (P-H) ¶ 3145 (1985).

24. In 1985, the combination of the old age, survivors and disability insurance (11.40%), hospital insurance (2.70%) and the credit against those taxes (2.3%) yields a net rate of 11.8%. The net rate is scheduled to increase over the next five years to a rate of 15.3% in 1990. *Id.*

25. The amount of social security benefits received is decreased by 50 cents for each dollar of earned income over a base amount. For 1985, the base amount for a person who is 65 years old or older is $7,320. If earned income is high enough, no social security benefits will be received. For example, if a person who is 65 or older qualifies for $7,000 of benefits based on the amount that

Shifting Character of the Gain on Sale

A third advantage to the gift of grain is the opportunity to shift the character of the grain to a capital asset if the donees do not hold the grain as inventory. The character of the gain is determined by the purpose for which the donees held the grain.[26] In several cases, taxpayers inherited real estate that was held as inventory by the decedent. If the taxpayer treated the real estate as an investment, the gain that was realized when the taxpayer sold the property was characterized as capital gain.[27] If the taxpayer did more with the real estate than merely liquidate the investment, the taxpayer was treated as a dealer in real estate and the gain realized on the sale of the real estate was taxed as ordinary income.[28] In *Schumacher v. United States*[29] the taxpayers received real property by gift.[30] The court concluded that their purpose for holding the property was for investment and consequently treated the sale as the sale of a capital asset.[31] Therefore, if the donees of grain do nothing more than liquidate their investment in the grain, the gain on the sale of the grain should be treated as capital gain.[32]

If the grain is a capital asset in the hands of the donee and if the donee satisfies the long-term capital gains holding period requirements,[33] the donee will qualify for the long-term capital gains exclusion.[34] In some cases, the

person earned before retirement, $21,320 ($7,320 + (2 x $7,000)) of earned income will reduce social security benefits to zero. If that person has less than $7,320 of earned income from the sale of grain and other sources or more than $21,320 of earned income from sources other than the sale of grain, giving away the grain will have no effect on the amount of social security benefits received. If earned income is between those two amounts, each dollar of income shifted to a donee will result in an additional 50 cents of social security benefits to the donor. *Id.*

26. *See supra* note 10 and accompanying text.

27. McConkey v. United States, 130 F. Supp. 621 (Ct. Cl. 1955); Riedel v. Comm'r, 261 F.2d 371 (5th Cir. 1958); Yunker v. Comm'r, 256 F.2d 130 (6th Cir. 1958); Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955).

28. Huxford v. United States, 441 F.2d 1371 (5th Cir. 1971); Bistline v. United States, 260 F.2d 77 (9th Cir. 1958); Brown v. Comm'r, 143 F.2d 468 (5th Cir. 1944); Comm'r v. Boeing, 106 F.2d 305 (9th Cir. 1939).

29. 1 A.F.T.R.2d (P-H) 1329 (S.D. Tex. 1958).

30. *Id.* at 1330.

31. *Id.* at 1331.

32. The author submitted a ruling request to the I.R.S. on behalf of clients who received grain from a farmer as a gift. The request asked the following two questions: (1) Is the grain a capital asset in the hands of the donees? and (2) Can the donees tack the holding period of the donor to their holding period for purposes of meeting the long-term capital gains holding period? On December 20, 1984, the I.R.S. responded saying it would not issue an advance ruling because the question of whether or not the grain is held by the donees for sale to customers in the ordinary course of business is primarily a question of fact. By so ruling, the I.R.S. has tacitly agreed that as a matter of law, the fact that the donor held the grain as inventory does not require the donee to treat the sale of the grain as the sale of inventory.

33. 26 U.S.C. § 1222 (1982). Property acquired after June 22, 1984 and before January 1, 1988, or before 1977 must be held for more than six months to qualify for the long-term capital gains treatment. Treas. Reg. § 1.1222-1(a) (as amended). Property acquired after December 31, 1977 and before June 23, 1984 must be held more than one year to qualify for long-term capital gains treatment. *Id.* Property acquired during 1977 must be held more than nine months to qualify for long-term capital gains treatment. *Id.*

34. 26 U.S.C. § 1202 (1982). For taxable years beginning after November 1, 1979, the exclusion is 60% of the amount by which the net long-term capital gain exceeds the net short-term capital loss for the year. *Id.* at § 1202(a). For taxable years ending before November 1, 1978, the exclusion was 50% of the amount by which the long-term capital gain exceeded the short-term capital loss for the

donee may hold the grain for the required period after the gift and before the sale.

If the time between the gift and the sale by the donee does not satisfy the long-term holding period requirement, the donor's holding period apparently can be tacked to the donee's holding period to meet the requirement where the basis in the hands of the donee is determined in whole or in part by the basis in the hands of the donor.[35] Since the donor's basis in the grain is carried over to the donee, the requirements of I.R.C. section 1223(2) are satisfied.

It apparently does not matter that the donor held the grain as inventory. In *Commissioner v. Tri-S Corporation*[36] the character of property held by the taxpayer changed from inventory to a capital asset on April 7, 1961.[37] The property was sold on October 6, 1961—two days short of the six month holding period that was in effect for long-term capital gains.[38] The court implicitly tacked the period the property was held as inventory to the period it was held as a capital asset by allowing the taxpayer to treat the gain realized on the sale of the property as long-term capital gain.[39] Similarly, in *Estate of Eileen M. Knudsen*[40] the taxpayer's purpose for holding property changed from "for sale to customers" to "for investment" after February 16, 1972.[41] The property was sold on April 7, 1972—well short of the period required for long-term capital gains treatment.[42] Again the court implicitly allowed the taxpayer to tack the period the property was held in inventory to the period it was held as a capital asset by treating the gains realized on the sale of the property as capital gains.[43]

If the donee has net long-term capital losses,[44] those losses will offset capital gains (whether it is long or short-term) from the grain on a dollar for dollar basis.[45] By contrast, each dollar of long-term capital loss will off-set

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year. For taxable years ending after October 31, 1978, and before November 1, 1979, there is a transition rule that allows the 60% rate to be applied only to the lesser of the net capital gain for the year or the net capital gain for the period after October 31, 1978. *Id.* at § 1202(c).

35. *Id.* at § 1223(2).

36. 400 F.2d 862 (10th Cir. 1968). In Daugherty v. Comm'r, 78 T.C. 623 (1982), the court stated that it will no longer follow *Tri-S* with respect to the per se rule that a condemnation notice changes raw land from inventory into a capital asset. That statement in *Daugherty* should have no effect on the issue of tacking the holding periods.

37. *Id.* at 863-66. The Fifth Circuit court did not clearly uphold or reject the tax court's finding that the property was inventory before the conversions. The Fifth Circuit did clearly find the property was not inventory after April 7, 1961. By not clearly addressing the issue of its character before that date, the Fifth Circuit implies that the periods can be tacked regardless of the character of the property before the conversion.

38. *Id.* at 863.

39. *Id.* at 864.

40. 49 T.C.M. (P-H) 966 (1980).

41. *Id.* at 971.

42. *Id.* at 969.

43. *Id.* at 971. *But see* Ridgewood Land Co. v. Comm'r, 41 T.C.M. (P-H) 40 (1972), *aff'd*, 477 F.2d 135 (5th Cir. 1973), in which the court stated that the holding period began on the day the property was converted from being held as inventory to being held for investment. *Id.* at 47. That statement was *obiter dictum* since the date of conversion was early enough to make the holding period after the date of conversion meet the long-term holding period.

44. 26 U.S.C. § 1222(8) (1982).

45. *Id.* at § 1211.

only fifty cents of ordinary income from the sale of grain and the offset is limited to $3,000 per year.[46]

> **Example:** Assume a donee of grain has a net long-term capital loss of $10,000 in the year the grain is sold for $8,000. If the $8,000 from the sale of grain is treated as ordinary income, $6,000 of the long-term capital loss can offset $3,000 of the income and the remaining $4,000 of long-term capital loss is carried to another year.[47]
>
> If the $8,000 from the sale of grain is treated as a short-term capital gain, the whole gain is offset by the long-term capital loss[48] and the remaining $2,000 of long-term capital loss can be used to offset $1,000 of ordinary income.[49]

If the donee has net short-term capital losses[50] from sources other than the sale of the grain, such losses will offset capital gains from the grain up to the amount of the net short-term capital losses.[51] The net short-term capital losses from other sources will offset ordinary income from the grain only to the limit of $3,000 per year.[52]

> **Example:** Assume a donee has a net short-term capital loss of $10,000 in the year the grain is sold for $8,000. If the $8,000 from the sale of grain is treated as ordinary income, the short-term capital loss can offset only $3,000 of the income. The remaining $7,000 of short-term capital loss is carried to another year.
>
> If the $8,000 from the sale of grain is treated as a short-term capital gain, the whole gain is offset by the short-term capital loss from other sources[53] and the remaining $2,000 of short-term capital loss can be used to offset $2,000 of ordinary income.

Taking Advantage of the Gift Tax Annual Exclusion

Another advantage of the gift of grain is the reduction in the size of the donor's estate for federal estate tax purposes.[54] Since the donees have a present interest in the grain, the gift qualifies for the annual exclusion.[55] Therefore, the donor can give up to $10,000 of grain to each donee each year without using up any of the unified credit.[56] If the donor's spouse agrees, the

46. *Id.*

47. *Id.* at §§ 1211(b)(1)(C)(ii), 1212(b).

48. 26 U.S.C. § 1211(b)(1) allows capital losses to be deducted to the extent of capital gains without reference to the long or short-term character of the gains and losses.

49. 26 U.S.C. § 1211(b)(1)(C)(ii) allows one-half of long-term capital losses in excess of net short-term capital gains to offset ordinary income up to a $3,000 limit.

50. *Id.* at § 1222(6).

51. *Id.* at § 1211. The net short-term capital losses from other sources will offset either long-term (26 U.S.C. § 1222(11)) or short-term (26 U.S.C. § 1222(5)) capital losses from the sale of the grain.

52. *Id.* at § 1211(b).

53. *Id.* at § 1222(5).

54. *Id.* at § 2031(a). The benefit of removing the value of the grain from the estate will be reduced by any gift taxes that have to be paid.

55. *Id.* at § 2503(b).

56. 26 U.S.C. §§ 2010 and 2503 allow a unified credit against the estate and gift taxes respectively. To the extent the credit is used to offset gift taxes, it is not available to offset estate taxes since

donor can use his or her spouse's annual exclusion as well[57] and give up to $20,000 of grain to each donee each year without using up any of the unified credit.[58] If the donor gives more than the amount of grain that qualifies for the annual exclusion, the excess will not create a gift tax liability until the donor's unified credit is used up.[59]

PRACTICAL SUGGESTIONS

Shifting Income

A transaction that is designed to take advantage of the shift of income from the donor to the donee must be carefully structured to make sure the donees have dominion and control of the grain before any arrangements are made for the sale of the grain.[60] For adult donees, the grain can be given directly. There should be sufficient time between the date of the gift and the date of the sale to show the I.R.S. that they are not one transaction.[61] If the grain is in an elevator, the warehouse receipt can be issued in the name of the donees. If the grain is stored on the farm, the grain should at minimum be segregated from the rest of the donor's grain.[62] If possible, the grain should be locked in a bin for which the donees have the key.

It is more difficult to give donees who are under the age of majority dominion and control of the grain because they are not competent to act for themselves.[63] One possibility is to invoke the provisions of the Uniform Gifts to Minors Act.[64] In most states, this option will not be available because only gifts of securities, money, life insurance policies or annuity contracts are covered by the act.[65] A warehouse receipt is apparently not a security[66] and therefore cannot be issued in the name of a custodian for a minor under the Uniform Gifts to Minors Act. A number of states have broadened the cover-

the credit against the estate tax for gift taxes paid does not include the gift taxes that are offset by the unified credit. *Id.* at § 2012(a).

57. *Id.* at § 2513.

58. *Id.* at §§ 2010, 2503.

59. *Id.* The unified credit for 1985 is $121,800 which will offset the taxes on $400,000 of gifts or transfers at death. The credit is scheduled to increase to $155,800 for gifts or transfers at death in 1986 and to $192,800 for gifts or transfers at death in 1987 and thereafter. Those amounts of credit will offset the gift or estate taxes due on $500,000 and $600,000 respectively. *Id.* at §§ 2010, 2505.

60. In Parkhill v. United States, 385 F. Supp. 204 (N.D. Tex. 1974), a gift of crops just before they were sold was treated as a sale by the donor and a gift of the proceeds rather than a gift of the crops and a sale by the donees. *Id.* at 207-08. In Urbanovsky v. Comm'r, 34 T.C.M. (P-H) 1665 (1965), the court taxed the sale of cattle to the donor because the cattle and the proceeds from the sale of the cattle were not segregated from the donee's cattle and proceeds. *Id.* at 1669.

61. In Alexander v. Comm'r, 194 F.2d 921 (5th Cir. 1952), the donee held cattle about one year between the time of the gift and the time they were sold.

62. *But see* Campbell v. Prothro, 209 F.2d 331 (5th Cir.1954) (sale of calves taxed to donee even though the donor's calves were not segregated from the donor's calves); Visintainer v. Comm'r, 187 F.2d 519 (10th Cir. 1951) (proceeds from sale of sheep branded but not segregated were included in donees' income).

63. Grain elevators may not want to deal directly with a minor since the minor can disaffirm a contract. RESTATEMENT (SECOND) OF CONTRACTS § 14 (1981). Some elevators may be willing to deal directly with the children of valued customers.

64. UNIFORM GIFTS TO MINORS ACT, 8A U.L.A. 317 (1983).

65. *See, e.g.*, WIS. STAT. ANN. § 880.62(1) (West 1981).

66. Brown v. Cummins Distilleries Corp., 53 F. Supp. 659, 664 (D.C. Ky. 1944).

age of the Uniform Gifts to Minors Act to include tangible personal property as custodial property.[67] For those states, a warehouse receipt or the grain itself is within the scope of the Uniform Gifts to Minors Act.[68]

Another possibility is to put the grain into a trust for the benefit of the donees. The problem with this method of transferring grain to the donees is that if the trust sells the grain within two years of the gift, I.R.C. section 644 will impose a tax on the trust equal to the tax the donor would have paid if the donor had sold the grain.[69] Therefore, if the grain is to be sold within two years of the gift, I.R.C. section 644 removes all the tax advantages of the gift. As it is costly to store grain for an extended period of time, the two year waiting period effectively eliminates the trust as a vehicle for the gift of grain.

A third possibility for giving the grain to minor donees is to create a partnership or an S corporation.[70] The donor could contribute the grain to the partnership or S corporation in exchange for an interest in the partnership or shares of the corporation.[71] The donor could then give the partnership interest or shares in the corporation to the donees before the grain is sold. At the time of the sale by the partnership or corporation, the donees would be the shareholders and would therefore be required to include the income from the sales on their tax return.[72]

A fourth possibility for giving the grain to minor donees is to make the gift through a custodian but not under the Uniform Gifts to Minors Act.[73] If this method is used, the custodian should be someone other than the donor to make it easier to show that dominion and control shifted from the donor to the donee. The gift should be completed before any arrangements for the sale of the grain are made[74] and the custodian should be given control of the grain by a warehouse receipt or by locking the grain in a bin that has none of the donor's own grain in it.[75] The proceeds from the sale of the grain should be

67. *See* CAL. CIV. CODE § 1155(e) (West 1982); COLO. REV. STAT. § 11-50-102(6) (Supp. 1984); CONN. GEN. STAT. ANN. § 45-101(e) (West 1981); DEL. CODE ANN. tit. 12 § 4501(5) (1979); ILL. ANN. STAT. ch. 110½ § 201(g)(1) (Smith-Hurd Supp. 1985); MD. EST. & TRUSTS CODE ANN. § 13-301(4) (1974); 20 PA. CONS. STAT. ANN. § 5302 (Purdon Supp. 1985); S.C. CODE ANN. § 20-7-150(5)(a) (La. Co-op. Supp. 1983); and TEX. PROP. CODE ANN. § 141.002(5) (Vernon 1984).

68. The Uniform Gifts to Minors Act was reissued as the Uniform Transfers to Minors Act in 1983. UNIFORM TRANSFERS TO MINORS ACT, 8A U.L.A. 63 (Supp. 1984). It has not yet been enacted by any state. The Uniform Transfers to Minors Act is much broader than the Uniform Gifts to Minors Act. It includes as custodial property any interest in property, real or personal, tangible or intangible which eliminates the concept of a security altogether. *Id.* at § 1(6), 8A U.L.A. 64 (Supp. 1984). Under the Uniform Transfers to Minors Act, either a gift of grain or a warehouse receipt would qualify as custodial property.

69. 26 U.S.C. § 644(a) (1982).

70. *Id.* at § 1361(a)(1).

71. The property can be contributed to the partnership or corporation without causing the donor to recognize gain. *Id.* at §§ 351(a), 721. The donor's basis in the contributed grain will be carried over to the partnership or corporation. *Id.* at §§ 362(a), 723.

72. A contribution of the grain to a partnership or corporation owned by the intended donees may be treated as a future interest and would therefore not qualify for the gift tax annual exclusion. Rev. Rul. 443, 1971-2 C.B. 338.

73. The Uniform Gifts to Minors Act does not preclude other means of making a gift to a minor through a custodian.

74. *See supra* note 60.

75. *See supra* note 62.

held by a custodian for the benefit of the minor donee.[76]

Getting Capital Gain Treatment

To get the advantages of capital gain treatment of the proceeds from the sale of the grain,[77] the donees must avoid the appearance of being farmers or dealers in grain.[78] Although it can be argued that selling the grain in several transactions is consistent with the donee's intent to hold the grain as an investment, the I.R.S. is less likely to treat the donees as dealers in grain if they sell all of the grain they received in one transaction. If the donor wants to follow the same pattern of marketing the grain that would have been used if there were no gift, the donor should buy and sell on the commodities futures exchange to re-create that pattern.[79] If the donor re-creates the same pattern of sales on the commodities exchange, the donor and donee(s) as a group will enjoy the same gains and losses that would have occurred if there had been no gift and the donor followed his or her usual marketing pattern.[80]

> **Example:** Mary gave 10,000 bushels of soybeans to her grandchildren on January 1, 1985. If Mary had kept the beans, she would have sold them in 1,000 bushel lots during 1985. To get the same pattern of sales after the gift, Mary should sell short 1,000 bushel contracts for December 1985 delivery. She can sell these contracts at the same time she would have sold 1,000 bushel lots of grain if there had been no gift. In December, 1985, Mary can buy back the contracts she has sold and her grandchildren can sell their grain. Any decrease in the price received by the grandchildren will be offset by an increase in the price received by Mary and vice versa. Therefore, the family as a whole will receive the same prices for the soybeans as if Mary had sold them in her usual pattern.

Liquidation of a Partnership or a Corporation

The distribution of grain from a partnership or a corporation upon liqui-

76. The method of holding the proceeds of the sale could be a continuation of the custodianship outside the Uniform Gifts to Minors Act. Another possibility would be to put the proceeds in a Uniform Gifts to Minors Act account. In most states the Uniform Gifts to Minors Act statute does not allow anyone other than the original donor to put the assets into a Uniform Gifts to Minors Act account. *See, e.g.*, WIS. STAT. ANN. § 880.62(1)(a) (West 1981). As a practical matter, no one is likely to challenge the use of a Uniform Gifts to Minors Act account as a vehicle for holding the proceeds from the sale of the grain.

77. The advantages are discussed in the text beginning at footnote 43, *supra*.

78. See *supra*, note 8 for a discussion of the factors that are considered in determining whether or not an asset is held for sale in the ordinary course of business or for investment reasons.

79. As long as the donor's activities on the commodities exchange have no connection with the donee's grain, the donor's market activities should not affect the dealer status of the donees.

80. If the donor realizes gain from the commodity exchange activities, the donor will have more income to report which appears to reduce the income shifting advantage of the gift. However, the additional income tax is not very painful compared to the alternatives. One alternative is to sell the donee's grain too early and trigger recognition of all of the proceeds by the donor. The other alternative is for the donor to make no offsetting transaction on the commodities exchange so that the donor has no gain to offset the donee's loss. If the donor suffers a loss on the commodities exchange, the effect of the commodities exchange activity will be to shift even more income to the donees since the donor can deduct the loss and the donees will report the gain.

dation may be an event that converts the grain from inventory to a capital asset.[81] To attain the status of a capital asset in the hands of the partner or shareholder, the partner or shareholder cannot use the grain as inventory in a trade or business.[82] Therefore, the partner or shareholder is most likely to be successful in claiming the character of the grain has changed to a capital asset when the partner or shareholder does not continue in a farming business after the liquidation of the partnership or corporation.

Change in Purpose for Holding the Grain

It is possible for the character of grain to change while it is in the hands of the farmer who raised it. The facts to support such a change in character will not arise very often but it is important to be able to recognize the facts and claim the advantages of capital gain treatment when they do arise.

In order to change the character of the grain, the farmer must be able to show that he or she is holding the grain for an investment purpose rather than as inventory to be sold in the ordinary course of business. Some factors a court may consider in making this determination can be derived from *Slappery Drive Industrial Park v. United States*.[83] Those factors are: (1) the purpose and duration of holding the property; (2) the extent and nature of efforts to sell the property; and (3) the use of ordinary channels to sell the property.[84] In the case of grain, an extraordinary set of facts will be necessary to change the character of the income from the sale of the grain. In *Williamson v. Bowers*[85] such extraordinary facts were present. In that case, a cotton farmer set aside 250 bales of cotton because he knew they would be extremely valuable just after the war.[86] Because his intent was to hold on to the cotton as an investment, he was allowed to treat the cotton as a capital asset upon sale.[87]

To prove an intent to hold the grain as an investment, it is important to segregate the investment grain from grain that is held as inventory.[88] If a farmer can successfully show that the grain is held for investment purposes, there are several potential tax advantages. First, the farmer can enjoy the advantages of capital gain treatment.[89] Second, the proceeds from the sale of the grain will not be subject to the self-employment tax.[90] Finally, if the

81. In Greenspon v. Comm'r, 229 F.2d 947 (8th Cir. 1956), inventory that passed to two 50% shareholders upon liquidation of a corporation was treated as a capital asset in the hands of the shareholders. *Id.* at 953.

82. In Baker v. Comm'r, 248 F.2d 893 (5th Cir. 1957), partners who used inventory from a dissolved partnership in a business similar to the partnership's business were treated as receiving ordinary income upon sale of the inventory. *Id.* at 896.

83. 561 F.2d 572 (5th Cir. 1977).

84. *Id.* at 587.

85. 120 F. Supp. 704 (E.D.S.C. 1950).

86. *Id.* at 705.

87. *Id.* at 707. *See also* United States v. Bondurant, 245 F.2d 265 (6th Cir. 1957) (cotton shipper held cotton as an investment); Hufford v. United States, 254 F. Supp. 272 (E.D. Wash. 1965) (barley jobber held barley seed as an investment); Stefka v. United States, 2 A.F.T.R.2d (P-H) 5538 (W.D. Tex. 1958) (cotton farmer held cotton as an investment).

88. *See* United States v. Bondurant, 245 F.2d 265 (6th Cir. 1957).

89. The advantages are discussed in the text beginning at footnote 43, *supra*.

90. *See supra* note 24 and accompanying text.

farmer is collecting social security benefits, the proceeds from the grain sales will not be treated as earned income and therefore will not reduce the amount of social security benefits the farmer receives.[91]

Other Applications of This Technique

Farmers should be able to shift the income from any product to donees as long as dominion and control of the product is given to the donees before arrangements for the sale of the product are made. Shifting the character of a product such as livestock may be more difficult than shifting the character of grain. Unlike grain, livestock must be cared for after the gift. If the donee or an agent for the donee cares for the livestock, the donee may become a farmer for income tax purposes which would make the livestock inventory in the hands of the donee and therefore create ordinary income upon the sale of the livestock.[92] If the donor cares for the livestock, the donee may not have the necessary dominion and control to shift the income from the donor to the donee.[93]

SUMMARY

The character of grain for income tax purposes may be shifted from inventory to a capital asset in some situations. A farmer may give the grain to someone who is neither a farmer nor a dealer in grain; a partnership or corporation may distribute grain to its partners or shareholders upon liquidation; or the farmer may change his or her purpose for holding the grain to an investment purpose. If such a shift in character is accomplished, the taxpayer will get the advantage of capital gains treatment of the sale of the proceeds and will reduce earned income for purposes of the self-employment tax and the limit on earned income when collecting social security benefits.

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91. *See supra* note 25 and accompanying text.

92. It could be argued that by caring for the livestock the donee is doing nothing more than preserving the value of an investment. If the livestock are sold at the first opportunity to liquidate the investment at a reasonable price, the donee may be successful in treating the proceeds as capital gains.

93. *But see* Alexander v. Comm'r, 194 F.2d 921 (5th Cir. 1952). In that case, the donor continued to care for the cattle that he gave to the donee. The court held that the proceeds from the sale of the cattle should be included in the donee's income.