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TREASURY POSITION ON SECTION 1231 GAINS AND THE EARNED INCOME TAX CREDIT

— by Neil E. Harl*

The following letter has been issued by the U.S. Department of the Treasury regarding Section 1231 gains and the earned income credit—

The Honorable James Jeffords
United States Senate
Washington, D.C. 20510

Dear Senator Jeffords:

The Commissioner asked us to reply to the March 13, 1997 letter from you and several of your colleagues concerning the ability of dairy farmers to claim the earned income tax credit (EIC). Specifically, you have asked whether gain from the sale of cows culled from a herd is properly treated as disqualified income for purposes of determining whether a dairy farmer is eligible to claim the EIC under 32 of the Internal Revenue Code.

Generally, Section 32 of the Code provides a refundable income tax credit for individuals with earned income below a specified amount. Section 32(I)(1) provides that the earned income tax credit shall not be allowed for the taxable year if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $2,200. Under Section 32(i)(2)(D), added by the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (1996 Act), P.L. 104-193, disqualified income includes the capital gain net income (as defined in section 1222) of the taxpayer for such taxable year.

Section 1222(9) of the Code defines "capital asset" as property held by the taxpayer whether or not connected with a trade or business. Section 1221(2), however, excludes property used in a trade or business from the definition of a capital asset.

The treatment of gains and losses from the sale of property used in a trade or business is provided in § 1231 of the Code. Section 1231(a)(1) provides that, if the § 1231 gains for any taxable year exceed the § 1231 losses for such taxable year, such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be. Section 1231(b) defines property used in a trade or business. In general, cattle held by a taxpayer for breeding or dairy purposes, and held for 24 months or more, are considered livestock, and fall within the definition of property used in a trade or business under § 1231(b).

Thus, section 1231 of the Code ordinarily permits gains from the sale or exchange of property used in a taxpayer's trade or business and held for the prescribed period of time to be treated as capital gains, even though this property would be denied capital asset treatment under § 1221(2). Consequently, although § 1221(2) states that property used in a trade or business is not a capital asset, § 1231(a) indicates that gain on the sale of such property, unless excepted under § 1231(b)(1)(A), (B), (C), or (D), may result in capital treatment. We conclude, therefore, that the § 1231(a) gain should be taken into account in computing the § 1221(9) capital gain net income, which is disqualified income for EIC purposes.

Our conclusions are based on the following: First, § 1231(a) was amended by the Tax Reform Act of 1984. Prior to amendment, the section stated that gains and losses from the sales or exchanges of property used in a trade or business "shall be considered as gains and losses from sales or exchanges of capital assets." Beginning with 1984, the language of § 1231 was changed to indicate that gains from the sales or exchanges of property used in a trade or business "shall be treated as long-term capital gains or long-term capital losses." The committee reports do not focus on this language as a significant change and, in fact, refer to the prior law as generally treating § 1231 gains and losses

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as long-term capital gains and losses rather than as gains and losses from the sale of capital assets. S. Rpt. No. 169, Vol. 1, 98th Cong., 2d Sess. 498, April 2, 1984.

Second, § 1231(a) prescribes capital treatment of certain gains for other purposes of the Internal Revenue Code despite the absence of the term "capital asset." For example, § 1221 generally limits the deduction of losses from the sale or exchange of capital assets to the gains from such sales or exchanges. In applying the limitation, however, taxpayers may reduce § 1231(a) gains treated as capital gains by losses from the sale of capital assets. See Form 4797 and Schedule D of Form 1040. See also Rev. Rul. 76-70, 1976-1 C.B. 225.

The difference in language between § 1231(a) and § 1222(9) may cause some confusion. The language contained in § 1231(a) refers to treating the gains and losses as long-term capital gains or long-term capital losses, while the language of § 1222(9) refers to capital gain net income as the excess of gains from the sales or exchanges of capital assets over such losses. We believe, however, that the language difference is of little consequence.

In addition, a question arises whether the purpose of the amendment made to § 32 by the 1996 Act would be fully implemented if gains treated under § 1231(a) as long-term capital gains were not included in the definition of disqualified income. The reason for adding the provision to the definition of "disqualified income" is set forth in the House Report underlying the proposed House bill. The Report states:

> "The committee believes that individuals with substantial assets could use proceeds from the sale of those assets in place of the earned income credit to support consumption in times of low income. . . (I)n order to apply a proxy for an asset-based test, the recently enacted disqualified income test concentrates on the returns generated by those assets. . .. The committee believes that net capital gains and other passive income represent other flows of income from assets that could be liquidated to support current consumption."

Accordingly, based on the above, if a dairy farmer has net gain from any taxable year from the sale of § 1231 assets, including the sale of dairy cows, held for at least 24 months, such gains are treated as long-term capital gains by operation of the legal requirements set forth in § 1231. Thus, such gains properly are taken into account in determining the dairy farmer's capital gain net income under § 1222 for the taxable year. Under § 32, if the farmer's aggregate amount of disqualified income for the taxable year, including capital gain net income, exceeds $2,200, that farmer is not eligible to receive the earned income tax credit under the amendments made to § 32 by the 1996 Act. . . .

Sincerely,

Lewis J. Fernandez
Deputy Assistant Chief Counsel
(Income Tax and Accounting)

Commentary by Neil E. Harl:

I disagree with the Treasury's analysis of the law. In their view, income from Section 1231 gain is included in the calculation because gains from Section 1231 assets are treated as capital gains. That conclusion is reached despite the clear statutory message that Section 1231 assets are not capital assets.

As noted in my article, "Farmers and the Earned Income Credit," 8 *Agricultural Law Digest* 41 (1997), "capital gain net income" was added in 1996 to "disqualified income." The statute states that "capital gain net income" is to have the meaning given the term in Section 1222 of the Internal Revenue Code. Section 1222 defines "capital gain net income" as "the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges." Section 1221 defines "capital assets" as all assets except for five enumerated categories of asset. Section 1221(2) specifically excludes from the definition of capital asset, assets used in the trade or business under I.R.C. § 1231.

I would hope that the Treasury would reconsider its interpretation of the Code section involved and reach what I believe is the correct conclusion, that gains from Section 1231 assets are not included in "disqualified income."

Unless the Treasury reconsiders, the focus will be on a statutory solution to the problem. Although I do not believe that an amendment is necessary, I.R.C. § 32 should be amended to make it absolutely crystal clear that gains from Section 1231 assets are not to be included in "capital gain net income."

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

AUTOMATIC STAY. The debtor had filed for Chapter 7 in September 1993 and in October 1993, the state of Illinois filed a complaint under the state Environmental Protection Act against the debtor as a shareholder in a agricultural chemical corporation which had made alleged violations of the Act. The state court action included requests for civil penalties, an injunction and litigation costs. The state filed claims in the debtor's