Embryo Transplants— The Tax Angle

J.W. Looney, dean of the University of Arkansas School of Law, Fayetteville, addresses a few tax questions concerning embryos, donor cows, recipients and related transplant expenses. A former faculty member at both Virginia Polytechnic Institute and State University and the University of Missouri-Columbia, Looney has taught several courses in agricultural law, taxation and estate planning. The licensed lawyer has a strong interest in agriculture and has been a contributing author for Doane's publications. His background also includes private law practice in the state of Arkansas and an active interest in livestock farming.

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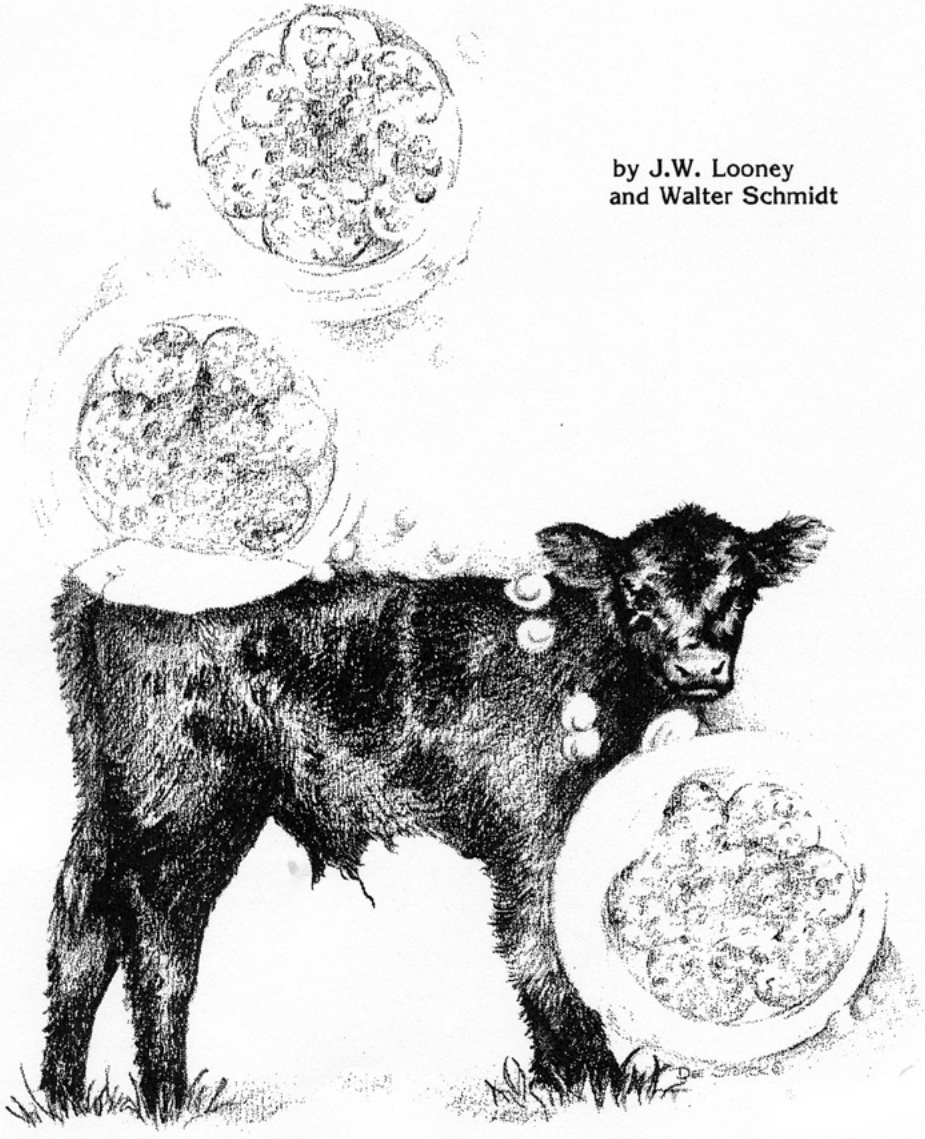
The last decade has seen rapid development of embryo transplant technology as a commercially viable industry. For the taxpayer involved in some aspect of that industry, new technology has created a variety of tax questions: can a farmer deduct all embryo transplant fees? Will the type of guarantee given by a transplant center affect the purchasing farmer's right to deduct these fees? Are both donor and recipient cows "used for breeding" and therefore qualified for long-term capital gain treatment when sold?

This article addresses these and other questions relating to the tax implications of embryo transplants. In some cases answers will be definite; in others, because technology has developed so recently, only tentative answers can be suggested. In any case, before acting, discussion with a professional tax consultant is advisable.

For an excellent and more detailed treatment of the tax ramifications see Paul J. Dostart's "Taxation of Embryo Transplants: The Land of Milk and Money" in volume 36 of The Tax Lawyer, page 61 (1982).



by J.W. Looney
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Guidelines for taxing embryo transplant breeding are an outgrowth of the rules for taxation of traditional breeding methods. Accordingly, there have been very few tax rulings on questions dealing specifically with embryo transplant technology. As a result, much of the following discussion is of a tentative nature. An attempt is made to illustrate the nature of the issues and consider possible solutions.

1. May a farmer deduct costs associated with embryo transplants?

The tax question facing a farmer buying an embryo is basically whether he is purchasing a calf or raising one. The Internal Revenue Code makes a distinction between farm-raised livestock and purchased animals. In both cases a farmer may deduct costs of raising the animals, i.e., feed, veterinary costs, etc. (No deduction is allowed for feed grown on the farm). Price of purchased animals is capitalized and may be recovered by annual deductions under the accelerated cost recovery system (ACRS) formerly depreciation. Investment tax credit based on purchase price may also be claimed.

If the breeding animal was purchased and depreciation or cost recovery deductions were taken, deducted amounts must be "recaptured," upon sale as must any "non-earned" investment tax credits claimed.

Consider the example of a breeding animal originally purchased for $10,000. If, after holding the animal for the required 24 months and claiming cost recovery deductions of $3,700, the farmer sells the animal for $12,000, only the $2,000 in excess of the original basis may be claimed as long-term capital gain. The $3,700 "profit" resulting from cost recovery deductions must be reported as ordinary income, i.e. "recaptured."

Thus, breeding animals which are purchased are treated differently for tax purposes than animals which are farm-raised. Farm-raised breeding animals have no initial purchase cost and if all expenses incurred in raising them have been deducted, such livestock have a basis of zero and are not depreciated. When sold, all proceeds will be taxed as long-term capital gain (or ordinary loss), if the livestock was held for the required 24 months.

If the farmer is considered to be purchasing a calf when acquiring the embryo by transplant, he will have to capitalize the costs and depreciate them over time. If the cost of the embryo and transplant are seen as nothing more than traditional breeding fees, they can be deducted as expenses incurred in farm-raising the animal.

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The IRS, in looking at this question, has determined the answer lies in the nature of the agreement between purchaser and seller of the embryo. Simply put, if the seller guarantees the farmer will receive a live, healthy calf, the farmer has, in effect, purchased a calf, and costs involved must be capitalized. Only those expenses incurred after birth may be deducted.

On the other hand, if the guarantee was limited to assuring the recipient cow would be pregnant, the IRS has concluded the risk of loss stays with the farmer and he has not actually purchased a calf. Embryo and transplant costs, in that case, are treated as breeding costs and may be deducted immediately.

2. Does the taxpayer / breeder owning donor and recipient cows hold both for "breeding purposes?"

A number of factors affect tax treatment, of livestock sales. In general, if the animal was raised primarily for future sale the proceeds of sale will be taxed as ordinary income. If primary use of the livestock was for breeding (or for draft, dairy or sporting purposes) the income may be treated as more favorable long-term capital gain. To qualify for long-term capital gain treatment cattle and horses must have been held for 24 months before sale. (All other animals held for breeding, draft, dairy or sporting purposes need only be held for 12 months.)

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Since only cattle held for breeding purposes (or for draft, dairy or sport) and held for 24 months qualify for long-term capital gain treatment, the question of whether donor and recipient cows are held for breeding purposes is, obviously, of some importance. There have been no direct rulings in this area, and while some conclusions seem evident, certain questions remain.

The tax-paying owner of a donor cow clearly seems to be holding the animal for breeding purposes since in all likelihood that is the cow's primary use. The farmer who owns recipient cows, however, may want to argue that the primary use of those animals is not breeding in the sense that a donor cow is used. Such animals, he may assert, are simply property used in his trade or business (i.e. not animals held for breeding purposes). If such an argument is successful, the property must be held for only 12 months before sale to qualify for long-term capital gain treatment. It is unclear, at present, if the IRS would agree with such a characterization and it has been suggested that the likelihood of success of such an argument is limited. It is more likely the recipient cow will also be treated as being held for breeding purposes and a 24-month holding period required. Certainly, it is clearly undesirable for the recipient cow to be classified as held "primarily for sale." Such a classification would require that any gain be treated as ordinary income when the animal was sold.

3. What are the implications of owning and leasing a recipient cow?

The farmer who leases a recipient cow to increase his herd will treat the costs as a deductible breeding expense. The owner of the leased recipient cow will treat the income as ordinary income earned in the normal course of business.

When the recipient cow is sold, the question arises of how to characterize the animal for tax purposes. Clearly, if the cow was being held primarily for future sale and was only incidentally leased, the appropriate characterization would be that she was "held for sale" and any gain would be treated as ordinary income.

A more difficult question arises when the cow is held primarily to be leased as a recipient. The taxpayer-owner will wish to characterize the animal as held for leasing purposes (as property held in the trade or business of leasing). In such cases the holding period required for capital-gain treatment is only 12 months. If the cow is characterized as held primarily for breeding, a 24-month period is necessary.

The lessor who has raised his own recipient cow will not be faced with the question since the animal will have been held for at least two years. If the cow was purchased and held for, say, 20 months, however, the lessor has a "close call" on his hands. One Tax Court decision held that milk cows leased to dairies were held by the lessor (owner) for dairy purposes—not primarily as property used in the trade or business of leasing. The analogy seems clear, but the issue has not been clearly settled.

4. How is the sale of embryos treated for tax purposes?

If one part of a breeder's normal business is the regular sale of embryos, they are considered part of inventory, and their sale proceeds are taxed as ordinary income. Of course, embryos may not be depreciated and do not qualify for investment tax credit.

When the embryo is sold by a breeder who does not normally make such sales as part of his business, a classification question arises. Such a breeder, if he has held the embryo for 24 months, may argue that his profit be treated as long-term capital gain since literal requirements of the IRS are met: the sale of "cattle . . . regardless of age . . . held for breeding purposes." The IRS may dispute that characterization. In at least one ruling they have implied embryos are not "cattle." However, no direct decision has so stated.

In general, if the animal was raised primarily for future sale, the proceeds of sale will be taxed as ordinary income. If primary use of the livestock was for breeding, the income may be treated as more favorable long-term capital gain.

The breeder who sells an embryo (but not as a regular part of his business) and claims capital gain treatment faces yet another question if the embryo was implanted in a recipient cow before sale. For example, consider a breeder who acquires an embryo, holds it for, say 22 months, then implants it in his own recipient cow. The cow with embryo is then sold three months later. May

the breeder claim that the part of the sale which represents profit made on the embryo qualifies as long-term capital gain? Presumably so, since the breeder is still "holding" the embryo until the sale 25 months after he acquires it. Naturally, that part of the sale price represented by the recipient cow is treated as ordinary income or capital gain depending on characterization of the recipient cow and the purpose for which she is held.

Keep in mind that the possibility of such a characterization will arise only if the embryo is sold by one who does not regularly make such sales part of his business and if the IRS accepts the initial description of an embryo as "cattle . . . regardless of age . . . held for breeding purposes." If not, presumably, cost of the embryo would be a deduction from expenses and price received for the cow would be either ordinary income or capital gain depending on how long the farmer had owned the cow.

5. For the non-farmer, what are the tax implications of investing in embryos?

The non-farmer investor who regularly buys and sells embryos for profit is best characterized as a dealer. As such, his product is held primarily for sale and his gain is taxed as ordinary income. The true investor is acquiring a capital asset when purchasing an embryo and any profit would be taxed as capital gain if the holding period requirement was satisfied.

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The non-farming investor who chooses not to sell his embryos, but to implant them and develop a herd, faces an interesting development. In a recent case the Tax Court ruled against an investor turned farmer who claimed deductions for rent and maintenance costs for leased recipient cows. The court reasoned the taxpayer was not a farmer until the calves were weaned. Up until that time he was not entitled to tax rules applicable to farmers.

Conclusion

As the discussion above indicates, tax law involving embryo transplanting is far from settled. Legal rules have yet to catch up with concepts the new science has developed. Further, what has been discussed is at best a brief and incomplete sketch of several issues this new technology has raised. The embryo transplanting breeder should consult a reliable tax advisor when confronted with a new situation or before reaching definite conclusions based on a given situation.

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