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TAX SHELTERS: FARM OPERATIONS

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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GENERAL

Farm operations generally involve raising animals and plants to provide food and fiber in the United States and abroad. As with other businesses, most taxpayers are engaged in farming operations principally in order to derive economic profits from them. Some taxpayers, however, acquire farms or ownership interests in farm activities because several special tax rules that apply to farm operations can be used to shelter income earned in other economic activities. The major tax advantages are a deferral of tax payments for one or more years, deferral until the taxpayer's taxable income falls to a lower marginal tax bracket, or conversion of the income (and the tax rate) from ordinary income to capital gain.

Tax deferral usually results from the current deduction of costs which are associated with the income which will not be reported until a later taxable year. Examples of costs which can be deducted before the related income is recognized are feed costs for animals which will not be sold until the next taxable year and costs of developing breeding animals, vineyards, and orchards.

Conversion occurs where capital and development costs have been deducted in the year incurred against ordinary income from other sources (instead of being capitalized and depreciated) and then in a later year the fully developed farm operation is sold at a capital gain.

Farm operations vary in size from small family farms to large multi-unit farms. The types of ownership in which taxpayers engage in farming vary from sole proprietorships, family partnerships and family corporations to large corporations and nationally syndicated limited partnerships with passive investors.

Farm operations are governed by special tax rules, many of which confer tax benefits on farming activities and on persons who engage in farming. Some of these special rules reflect an historical intent to simplify recordkeeping for farmers; other rules provide incentives for farmers to engage in land improvements and other activities. Still other farm rules are intended to correct abuses of the special farm tax rules. These corrective rules have been added (particularly in the Tax Reform Act of 1969) because in recent years high-bracket taxpayers such as business executives, doctors, lawyers, entertainers, athletes, and other investors whose principal occupations are outside of farming, have invested in farming operations that generate farm "tax losses" which they use to shelter nonfarm income.[1]

Where individual investors with large nonfarm incomes begin farming on a part-time basis or become passive investors in farm activities, certain deductions, which are currently allowed under the special farm rules, become attractive. These deductions, which are de-

[1] Under present law, the special tax rules available to farmers can be utilized by both full-time farmers and by high-bracket taxpayers who participate in farming as a sideline. Part-time farmers are entitled to use the special farm rules even if they are absentee owners who pay agents to operate their farming activities and regard their own participation (such as being limited partners in a nationwide syndicate) as a completely passive investment.

liberately sought by nonfarmer investors are used to reduce their income from other sources. Furthermore, when the property stops providing tax losses and starts producing taxable income, many investors in farm syndicates dispose of their investments.

Like the outside investor, many "full-time" farmers or ranchers (that is, those individuals whose principal occupations are farming) also have other sources of income (from investments, from nonfarm employment or from nonfarm businesses) and can also utilize farm "tax losses" to shelter their nonfarm income.

PRESENT LAW

Use of the Cash Method Without Inventories

Taxpayers engaged in farming may report their income and expenses from farm operations on the cash method of accounting, without accumulating inventory costs. Farmers may also deduct the cost of seeds and young plants purchased in one year which will be sold as farm products in a later year.[2] This rule contrasts with the tax rules which govern nonfarm taxpayers engaged in the business of selling products, who must report their income using the accrual method of accounting and must accumulate their production costs in inventory until the product is sold.[3]

The special inventory exception for farmers was adopted by administrative regulation more than fifty years ago. The primary justification for this exception was the relative simplicity of the cash method of accounting which, for example, eliminates the need to identify specific costs incurred in raising particular animals.

In cases where inventory costs are deducted in a year earlier than the year in which the related income is received, such accelerated deductions create a "loss" which is used to offset a taxpayer's other income. When the income related to these accelerated deductions is realized in a later year, it will be in a greater amount than if the accelerated deductions had been deferred and matched against the income. The net effect of the acceleration of these deductions is the deferral of taxes on the taxpayer's other income.

Current Deduction for Development Costs of Business Assets

The Treasury has long permitted farmers to deduct currently many of the costs of raising or growing farm assets (such as costs related to breeding animals, orchards and vineyards) which are held for the production of income. In similar nonfarming businesses (such as manufacturing), these costs generally are treated as capital expenditures

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[2] However, a farmer may not deduct the purchase price of livestock, such as cattle, which he intends to fatten for sale as beef.

[3] Under the cash method of accounting, all items which constitute gross income are reported in the taxable year in which actually or constructively received, and expenses are deducted in the taxable year in which they are actually paid. The primary advantage of the cash method is that it generally requires a minimum of recordkeeping; however it does not match income with related expenses.

A primary goal of the accrual method of accounting is a matching of income and expenses. Under this method, income is included for the taxable year when all the events have occurrred which fix the right to receive such income and the amount can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to the expense and the amount can be determined with reasonable accuracy. Also under the accrual method where the manufacture or purchase of items which are to be sold is an income-producing factor, inventories must be kept and the costs of producing the merchandise must be accumulated in inventory (rather than deducted when incurred). These costs may be deducted only in the year the merchandise is sold. Regs. § 1.446–1(a)(4) and (c).

Use of the cash method without inventories gives a taxpayer the opportunity to control the timing of deductions to a much greater extent than does the accrual method.

and are depreciated over their useful lives.[4] Typically, the development costs of certain farm assets can be expensed. These assets are used in a taxpayer's business and may eventually be sold at a gain which is taxed at the lower capital gain tax rate. Since development costs can be deducted before the income is realized from the sale of livestock or corps, the development costs may offset a farm investor's income from other sources such as salaries, interest, professional fees, etc.

Current Deduction of Certain Land Improvement Expenses

Certain provisions of present law allow specific types of capital improvements to farmland to be deducted when the taxpayer pays them. These costs include soil or water conservation expenditures (sec. 175), fertilizer costs (sec. 180), and land clearing expenses (sec. 182). Similar capital expenditures in a nonfarm business would be added to the basis of the property and, since land is nondepreciable, could be recovered only out of the proceeds when the land is sold.

Capital Gain Treatment for Sales of Assets Developed Through Deductible Expenditures

Capital gain treatment is generally available on the sale of depreciable assets used in farming (as well as on the sale of the underlying farmland itself), even though these assets or land may have been developed or improved by expenditures which were deducted against ordinary income.[5] Thus, an investor or farmer can combine deductions from ordinary income for expenses of raising the livestock or developing an orchard or vineyard with capital gain treatment when he sells the breeding animals, orchards, or vineyards. (Capital gain treatment is not available to the extent that various recapture rules of present law are applicable.)[6]

Accelerated Depreciation

After breeding animals, vineyards or orchards reach maturity and are held for the production of annual crops, farmers and farm investors continue to receive tax benefits through deductions for accel-
herd, vineyard or orchard.
erated depreciation. For example, an investor or rancher can deduct his costs of raising breeding animals (but not the purchase price) and, after purchased animals reach maturity, he can use 200 percent declining balance depreciation on the purchase price of the animals which he originally purchased for the herd.[7]

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[4] Thus, if a taxpayer builds a factory to be used in his manufacturing business, he is required to capitalize all the costs attributable to construction of the factory. Such costs will be recovered over the useful life of the building.

There are certain exceptions to the requirement that costs attributable to business assets be capitalized. Thus, under section 174, a taxpayer may elect to deduct currently research and experimental expenditures.

Of course, not all costs relating to development of farm assets are currently deductible. A farmer is required to capitalize costs of water wells, irrigation pipes and ditches, reservoirs, dams, roads, trucks, farm machinery, land and buildings.

[5] Under section 1231, a taxpayer who sells property used in his trade or business obtains special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the gain, if any, is treated as capital gain. The loss, if any, is treated as an ordinary loss. Machinery, equipment, buildings, and land used by a taxpayer in his business are examples of section 1231 property.

[6] This capital gain benefit has been described in the staff's overview pamphlet on tax shelters as a "conversion" of the rate of tax on income offset by the early development deductions from ordinary income to capital gain. In effect, the taxpayer's nonfarm income which is initially sheltered by accelerated farm deductions is transformed into added capital value of the farm asset and taxed as part of that value when the farm capital assets (vineyard, breeding animal, farmland, etc.) are later sold.

[7] If the rancher purchased cattle which had been used for breeding by a previous owner, the cattle can be depreciated on the 150 percent declining balance method. The offspring of purchased animals cannot be depreciated, since the owner is considered to have no cost basis in such animals. However, as indicated earlier, the cost of raising such offspring can be expensed.

Under the Asset Depreciation Range System (ADR), the depreciable lives of farm assets are relatively short. For breeding or dairy cattle, the ADR range is 5.5–8.5 years. For breeding or work horses, the ADR class life is 8–12 years; for breeding hogs, 2.5–3.5 years; for breeding sheep and goats, 4–6 years; and for farm machinery and equipment, 8–12 years.

Accelerated depreciation under a 150-percent declining balance method is also available for new farm buildings and for the costs of purchased vineyards and orchards. The capitalizable costs of vineyards and orchards planted by the taxpayer may be depreciated on a 200-percent declining balance method.[8]

The opportunity to claim accelerated depreciation on breeding animals, orchards and other farm capital assets which have reached maturity means that farmers and farm investors can shelter not only their nonfarm income (by preproductive period cost deductions) but also part of their annual farm income from crop sales after the property reaches its productive period.[9]

Investment Credit

The investment credit is available to farmers and farm investors for personal property used in farming. Livestock (except horses) held for the production of income, orchards and vineyards, and other tangible property such as fences, drain tiles, paved barnyards, water wells and storage facilities may qualify for the investment credit.

Leverage

A taxpayer who invests directly in a herd of feeder cattle, a vineyard, or other farm property (including investments through agency relationships where the taxpayer signs a management contract with another person to operate the business on his behalf) can take advantage of leveraging to increase the amount of his deductions in a farm investment. Thus, if the taxpayer can borrow funds to pay for deductible expenses he may deduct amounts in excess of his equity capital in the farm operation.

Similarly, if an investor becomes a partner in a farming partnership, he may be able to deduct amounts in excess of his equity capital in the partnership if the partnership is financed in part by nonrecourse obligations.[10]

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[8] Under the ADR system, the useful lives of farm buildings range from 20 to 30 years. Although there are no ADR guidelines, taxpayers are currently using useful lives for fruit trees which vary from 15 to 30 years, depending on the type of trees and on different climate conditions.

[9] The latter benefit is especially valuable to farm investors who are primarily interested in the appreciation in value of the underlying ranch land on which they maintain a breeding herd vineyard or orchard.

Many such taxpayers regard cattle as a cash crop which helps them carry the land by providing annual income to pay the underlying mortgage and real estate taxes. Sheltering the cash flow from the property itself is as important to such investors as it is to the owners of a rental apartment house who use accelerated depreciation to shelter their annual rental income.

[10] The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)).

Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner assumes liability for part of the partnership debt, this also increases his basis. However, under the regulations where the partnership incurs a debt, and none of the partners has personal liability (the "nonrecourse" loan), then all the partners are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752–1(e)). For example, if a partner invested $10,000 in a partnership, in return for a 10 percent profits interest, and the partnership borrowed $100,000 in the form of a nonrecourse loan, the partner's basis in the partnership would be $20,000 ($10,000 of contributions to the partnership, plus 10 percent of the $100,000 nonrecourse loan to the partnership).

Expenses of Syndication

Until recently, in the case of a farming partnership, as in the case of tax shelters generally, it has been the common practice for limited partners to deduct the payments made to the general partner for services in connection with the syndication and organization of the limited partnership. However, in Rev. Rul. 75–214 (I.R.B. 1975–23, 9), the Service ruled that such payments to general partners constitute capital expenditures which are not currently deductible. Nevertheless, because of the past practice of taxpayers deducting these payments, it might be appropriate to clarify the law in this area.

TAX REFORM ACT OF 1969

In the Tax Reform Act of 1969, Congress made several changes in the tax law that were designed to reduce the deferral and conversion benefits for farm investors.

Recapture of Certain Farm Losses

Section 1251 requires a limited recapture as ordinary income (rather than capital gain) of previous farm tax losses whenever assets used in a farming business are sold or disposed of. If, in previous years, an individual taxpayer whose nonfarm income exceeded $50,000 in a year used the cash method of accounting and incurred a farm loss larger than $25,000 in the same year, the farm loss in excess of $25,000 must be recorded in an "excess deductions account" (EDA). Any gain that would otherwise be treated as capital gain on the later sale of farm assets must be reported as ordinary income to the extent of the balance in the taxpayer's EDA account at that time."[11]

A farmer who elects to report his farm operations on an accrual method of accounting (and who thus uses inventories) is not subject to the EDA rules.

This provision continues to allow a farm investor who uses the cash method of accounting to defer current taxes on his nonfarm income. It merely places a potential limit on the amount of ordinary nonfarm income which may be converted to capital gain in a future year. Thus, even where an EDA account must be maintained, this provision reduces conversion benefits but does not affect the time value of deferring taxes on nonfarm income or (in the case of depreciation deductions) on annual farm crop income.

Recapture of Improvements to Farm Land

Section 1252 recaptures amounts previously deducted as soil and water conservation and land clearing expenses if farmland is sold within 5 years after acquisition. If the land is held for a longer period, the amount recaptured is reduced by 20 percent for each year over 5 years that the property is held. Thus, if the land is held more than 10 years, there is no recapture.

As in section 1251, this provision prevents (to some extent) farm investors from converting nonfarm income (previously offset by ordi-

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[11] It is immaterial what specific farm deductions produce a net farm loss. The EDA is a running account from year to year and is reduced by the amount of net farm income which the taxpayer may have in later years.

Corporations (other than Subchapter S corporations) and trusts must establish an EDA account for the full amount of their farm losses regardless of size and regardless of the amount of their nonfarm income. A Subchapter S corporation is governed by the same dollar limitations that apply to individuals, except that the corporation must include in its nonfarm income the largest amount of nonfarm income of any of its shareholders.

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nary farm deductions) into capital gain when farmland is sold. This provision does not, however, prevent the initial deferral of taxes on nonfarm income.

Capitalization of Development Costs of Citrus and Almond Groves

Section 278 contains a special rule which requires the capitalization of all amounts attributable to the planting, cultivating, maintaining or developing citrus groves incurred during the first four years after the grove was planted.

This provision was enacted as a result of a concern that tax-shelter syndicates were engaging in citrus grove operations primarily to obtain current deductions for development expenses, and that the influx of these ventures into the citrus growing industry distorted the economics of the industry to the detriment of full-time citrus growers. For example, since a portion of the syndicate's return was in the form of tax benefits, it could accept lower prices for the sale of the crop than full-time farmers.

The Revenue Act of 1971 extended this capitalization rule to almond groves.

Lengthened Holding Periods for Noninventory Livestock

The holding period for long term capital gain treatment of cattle and horses held for draft, breeding, dairy, or sporting purposes (such as horse racing) was lengthened to 24 months (sec. 1231(b)(3)). The minimum holding period for other livestock held for such purposes was lengthened to 12 months.[12]

One effect of this rule is that many sales of "culls" from a breeding herd (animals originally held for breeding purposes but eliminated from the herd) are taxable at ordinary income rates, since many culls are sold within 24 months.

Depreciation Recapture for Livestock

Livestock depreciation after 1969 was made subject to recapture when the animal is sold (sec. 1245). This rule has little adverse effect on the fulltime rancher, who typically raises most of his own livestock and therefore has no depreciable cost basis in most of his animals. This rule adversely affects those farm investors, however, who purchase breeding animals out of a short-term preoccupation with accelerated depreciation deductions.[13]

Tax-Free Exchange of Livestock

The statute was also amended in 1969 to prevent tax-free exchanges of livestock of different sexes (sec. 1031(e)). Such exchanges had previously been used to enable a rancher (or ranch investor) to build up his herd free of current tax by exchanging bull calves, most of which are not used for breeding purposes, for heifer calves which could be used to increase the size of the herd.

[12] Before the 1969 Act, the minimum holding period had been 12 months in the case of livestock held for draft, breeding, or dairy purposes and 6 months for other livestock (including race horses) used in a trade or business.

[13] Investors who purchase breeding animals as a long-term investment may escape much of the burden of depreciation recapture, because as their herd grows larger an increasing proportion will consist of raised offspring which have no depreciable basis. Eventually, most of the herd can be sold at capital gain rates with little depreciation recapture.

Activities Not Engaged in for Profit

This provision limits the current deduction of expenses in an activity which a taxpayer engages in other than "for profit" (sec. 183). Although section 183 is not limited to farm investors, it may adversely affect high-bracket taxpayers who enter farming chiefly as a tax shelter. The rule attempts to separate activities which a taxpayer carries on principally as a hobby or for personal purposes and those which he intends to conduct as a profitmaking business. A taxpayer is presumed to be engaged in an activity for profit if the activity shows a profit in at least two of five consecutive years.[14] If an activity is found not to be engaged in for profit, expenses can be deducted only to the extent that income derived from the activity exceeds deductible interest, taxes and casualty losses.

ADMINISTRATIVE RULINGS

After a period of litigation over its authority to implement its ruling position on prepaid feed, the Internal Revenue Service has recently published a revenue ruling setting forth administrative criteria under which taxpayers on the cash method of accounting can deduct payments for feed not consumed during the taxable year of payment. Revenue Ruling 75–152, I.R.B. 1975–17, 15, states that, in order to be deductible, the payment must not be a deposit; there must be a business purpose for the timing of the feed purchase; and the deduction must not create a material distortion of income. If any one of these tests is not satisfied, the Service will permit the deduction only as the feed is consumed by the livestock.

The Internal Revenue Service has also published various administrative positions (which are also common to other tax shelters) relating to the deductibility of prepaid interest, to the treatment of certain nonrecourse obligations as equity investments rather than debt, and to the classification of certain partnerships as corporations. The administrative positions are summarized in the staff's pamphlet on the *Overview of Tax Shelters*. One of the most important of these rulings for farm operations (as well as tax shelters generally) is in Rev. Proc. 74–17, 1974–1 C.B. 438, where the Service set forth certain guidelines which it will apply for advance ruling purposes in determining whether the formation of a limited partnership is for the principal purpose of reducing Federal taxes.

If the requirements of the Revenue Procedure are not satisfied, no ruling letter will be issued. However, the taxpayer is still free to argue (with an Internal Revenue agent, or before a court) that he is entitled to the deductions claimed in connection with the partnership.

The Service guidelines are as follows:

(1) All of the general partners, in the aggregate, must have at least a one percent interest in each material item of partnership income, gain, loss, deduction or credit.

(2) The aggregate deduction of the limited partners during the first two years of the partnership's existence cannot exceed the amount of the equity investment in the partnership.

(3) No creditor who makes a nonrecourse loan to the partnership may acquire, as a result of making the loan, any direct or indirect

[14] This presumption is liberalized to two of seven consecutive years in the case of the breeding, training, showing or racing of horses.

interest in the profits, capital, or property of the limited partnership, other than as a secured creditor.

PROBLEM

Impact of the 1969 Changes

Despite the restrictions imposed by the Tax Reform Act of 1969, a large increase occurred after 1969 in the use of farm tax rules to shelter nonfarm income. In particular, the number and volume of publicly syndicated investments in almost all areas of agriculture increased substantially. Farm tax benefits have been effectively packaged and sold to high-bracket taxpayers through limited partnerships and management contracts for investments in cattle feeding, cattle breeding, tree crops, vegetable and other field crops, vineyards, dairy cows, fish, chickens and egg production. Sales and leasebacks of existing farmlands by fulltime farmers to outside investors have also been offered. During the five and one-half years between January 1, 1970, and July 1, 1975, the dollar amount of tax shelter offerings in partnership form registered with the National Association of Securities Dealers was $942,424,000 in cattle feeding and breeding ventures and $166,575,625 in vintage and other farming shelters.[16] (There are many more public and private syndications which are not required to be registered.)

From another viewpoint, Table 1 shows the average farm loss reported for tax purposes since 1969 by individual taxpayers in different income brackets. This table shows that farm losses have increased as taxpayers' income levels have increased, and that this trend has remained consistent during the three years covered by the table. The fact that the largest farm losses are concentrated in income levels over $100,000 suggests that high-bracket taxpayers have continued to make use of the special farm tax rules to shelter nonfarm income.

Since deductions from tax shelters (from farming or other investments) reduce a taxpayer's adjusted gross income, Table 1 does not show the full extent to which farm losses are being used by wealthy taxpayers to shelter nonfarm income.

TABLE 1.—NET FARM LOSSES BY SIZE OF ADJUSTED GROSS INCOME

Adjusted gross income	1970		1971		1972	
	Number of returns showing farm loss	Average farm loss	Number of returns showing farm loss	Average farm loss	Number of returns showing farm loss	Average farm loss
All returns—total	1,234,092	($2,350)	1,290,203	($2,540)	1,171,591	($2,758)
Total net farm loss (thousands)		(2,899,513)		(3,277,548)		(3,230,956)
Under $5,000	485,531	(2,659)	475,983	(2,969)	363,492	(3,281)
$5,000 under $10,000	379,947	(1,576)	385,338	(1,664)	325,492	(1,879)
$10,600 under $20,000	284,652	(1,669)	327,808	(1,822)	354,754	(1,852)
$20,000 under $50,000	63,949	(4,202)	78,358	(4,087)	100,840	(3,894)
$50,000 under $100,000	14,697	(9,473)	16,575	(9,527)	19,642	(9,607)
$100,000 under $500,000	5,012	(21,016)	5,787	(20,903)	6,941	(21,784)
$500,000 under $1,000,000	210	(43,143)	252	(52,516)	301	(50,296)
$1,000,000 or more	94	(128,149)	102	(134,069)	129	(170,481)

Source: U.S. Treasury Department, Statistics of Income—Individual Income Tax Returns, 1970, 1971, 1972.

[16] More detail on these figures appears in the staff pamphlet containing an overview of tax shelters.

Table 2 shows the impact of the farm loss recapture rules of section 1251 of present law. In terms of numbers of returns, the returns which show nonfarm income of $50,000 and higher and a net farm loss of $25,000 or more have generally been less than one percent of all returns which report both nonfarm income and farm losses. In terms of the dollar amount of farm losses which are required to be placed in an EDA account, Table 2 also shows that section 1251 affects no more than 8 percent of all farm losses reported on returns which show both nonfarm income and farm losses.

TABLE 2.—IMPACT OF SEC. 1251 OF PRESENT LAW [1]

[Money amounts in thousands of dollars]

	1969		1970		1971	
	Number of returns	Net farm loss	Number of returns	Net farm loss	Number of returns	Net farm loss
Returns showing nonfarm adjusted gross income—total	1,128,413	$2,465,610	1,202,914	$2,776,871	1,288,185	$3,184,109
Farm loss under $25,000	1,119,693	1,993,499	1,913,262	2,281,637	1,277,582	2,602,966
Farm loss $25,000 or higher	8,720	472,111	9,652	495,234	10,603	581,143
Effect of existing farm recapture rule (sec. 1251):						
Returns showing nonfarm income $50,000 and higher and net farm loss of $25,000 or more	5,251	328,833	5,228	319,433	5,810	373,752
Less $25,000 exemption per return		131,275		130,700		145,250
Amount of farm losses subject to potential §1251 recapture		197,558		188,733		228,502
Percentage of total net farm loss subject to recapture		8		6.8		7

[1] Sec. 1251 of present law requires that taxpayers engaged in farming establish an "excess deductions account" containing the portion of any farm loss above $25,000. This account must be established only if the taxpayer's nonfarm adjusted gross income exceeds $50,000 in the same year. The figures above show the effect of these limitations in relation to total net farm losses shown on all returns reporting nonfarm income.

Source: U.S. Treasury Department, Statistics of Income—Business Income Tax Returns, 1969, 1970, and 1971. The figures shown cover individuals receiving farm income and who filed Schedule F (farm income and expenses).

Deferral Shelters Generally

High-bracket taxpayers have continued to use farm tax rules to shelter nonfarm income because, except for citrus and almond groves, the restrictions in present law do not prevent the initial deferral of taxes on nonfarm income by means of accelerated deductions incurred in farm activities. Present law focuses largely on recapturing some deductions which otherwise would be used to convert ordinary income into capital gain, and on denying capital gain treatment by increasing the holding periods for farm assets. However, farm expenses are still deductible as they are paid, under the cash method of accounting. The time value of deferring taxes on nonfarm income remains a strong attraction for "outside investors" to invest in farming and to use as much borrowed money as possible to create farm "tax losses."

The tax benefits of deferral are less attractive to taxpayers in lower marginal tax brackets because each dollar of deductions results in a smaller amount of taxes being deferred. A taxpayer who is in the 50-percent marginal tax bracket because of the maximum tax on earned income provision, in particular, may be reluctant to use a deferral shelter since the income reportable in later years may well be taxed in higher brackets than the income offset by the farm tax losses. Assuming a rate of return of 7 percent tax-free on the deferred taxes, a taxpayer would have to shelter income for 5 years to offset the increased tax due to an amount being taxed in the 70-percent bracket rather than the 50-percent bracket.

From a tax shelter point of view, farm investments offer deferral of taxes on nonfarm income where deductible expenses are incurred in the year or years prior to the years when the revenue associated with them is earned.[17] This type of deferral occurs regardless of whether the proceeds upon the later sale of the underlying farm products are taxed at ordinary income rates or at capital gain rates.

The period of deferral can be relatively short, involving expenses incurred at the end of one calendar year and sales of the farm product during the next year, or relatively long (where trees or vines take 7–10 years to reach a fruit-bearing stage). Where the deferral period is short, the transaction is often referred to as a "rollover" because the taxpayer merely delays (or rolls over) the tax on his nonfarm income from one year to the next.

A. Cattle Feeding

Cattle feeding offers one of the best known and, until recent downturns in the farm economy, most widely used deferral shelters.

Typically, the investment is organized as a limited partnership or as an agency relationship (under a management contract) in which a commercial feedlot or a promoter agrees to act as an agent for the investor in buying, feeding and managing cattle. Cattle usually weighing 400–750 pounds are purchased and then fed special grains and other rations in order to increase their weight gain. After being fed a specialized diet for four to six months so that their weight increases to about 900–1,200 pounds, the cattle are sold at public auction to meat packers or food companies.

A cattle feeding venture is typically formed in November or December, and utilizes leveraging and the cash method of accounting to permit taxpayers with income from other sources to defer taxes otherwise due on such income by deducting expenses for prepaid feed, interest, and management fees in that year. Usually the amount borrowed by the syndicate is sufficient to create tax losses which allow the taxpayer to deduct 100 to 150 percent of his own cash investment.

Income is realized in the following year when the fattened cattle are sold. At that time, the bank loans are repaid and any unpaid fees due the feedlot (or promoter) are deducted. The balance is distributed to the investors. Since feeder cattle are held for sale to customers, sales of the animals produce ordinary income. If the investors were to reinvest their profit from one feeding cycle into another one, they could theoretically defer taxes indefinitely on the nonfarm income which they sheltered originally. (To shelter nonfarm income from subsequent years, an additional investment would be required.)

The following example shows how cattle feeding can benefit a taxpayer in the 70-percent marginal tax bracket even if the program operates at a break-even point economically.[18] Assume that taxpayer T

[17] As indicated earlier, where accelerated depreciation is available on breeding herds and orchards used in producing annual crops, depreciation can also shelter the investor's farm income from sales of the annual crop.

[18] Solely for purposes of illustration, it is assumed that the program operates at a breakeven point. It should be noted, however, that until recent economic conditions, many syndications were structured on the assumption that three of every four breeding cycles would be profitable.

invests in a cattle feeding venture on December 15, 1975, and that the fattened cattle are sold six months later on June 15, 1976. T's share of the deductible expenses incurred in 1975 is as follows:

Initial investment—1975		
Cash investment by taxpayer		$100,000
Borrowings (nonrecourse loans)		250,000
Total funds available to buy and feed cattle		350,000
Purchase price of cattle (750 head at $280 each, not deductible)		210,000
Deductions:[1]		
Prepaid feed for 6 months	$105,000	
Prepaid interest at 12 percent for 6 months	15,000	
Management fee paid to feedlot operator	20,000	
Tax loss—1975		(140,000)
Tax deferred—1975 (70 percent)		98,000
Investor's unrecovered equity[2]		2,000
Sale of the cattle—1976		
Tax results:		
Selling price of cattle[3]		$350,000
Less: basis		210,000
Ordinary gain		140,000
Tax liability (70 percent)		98,000
Cash flow:		
Cattle sales proceeds		350,000
Less:		
Loan repayment		250,000
Tax on sale (due Apr. 15, 1977)		98,000
After-tax cash to investor		2,000

[1] Solely for purposes of illustration, it is assumed that the amounts shown as deductions are deductible under present law in 1975. (To be deductible, each of the items must meet certain administrative tests. Thus, for example, to the extent it represents a prepayment for services to be rendered in 1976, the management fee might not be deductible in 1975.)
[2] $100,000 cash investment less $98,000 tax deferral in 1975.
[3] The selling price per head is assumed to be $466.67.

These figures show that the amount of tax which T owes at the end of the deferral period equals the amount of his previously deferred tax ($98,000), plus a current tax on any profit which he makes on the sale or minus a tax reduction due to any loss which he suffers.[19]

In order to show the time value to T of having deferred $98,000 in taxes on his income for one year, assume that he invests his 1975 tax saving in an industrial development bond paying 7 percent interest tax free. The tax-free interest earned over the one-year period from April 15, 1976 (when T's return for 1975 is due) to April 15, 1977 (when his return for 1976 is due) would be $6,860. Another way to express this benefit is that even though the investment broke even economically, T's average annual rate of return on the cash which he invested has been 20.38 percent.[20]

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[19] Some feedlot operators who promote cattle feeding programs offer to guarantee that they will purchase an investor's equity for a specified percentage of his original investment, or will reimburse him for a percentage (often as high as 80 percent) of any economic loss which the investor may suffer if cattle prices should fall. By such a "stop-loss" guarantee, the investor's risk of a declining cattle market is reduced.

[20] The annual rate of return is computed by dividing $6,860 by the sum of the amounts invested times the periods over which the amounts were invested. T is out-of-pocket $100,000 from December 15, 1975, until April 15, 1976, when his 1975 return is due. From April 15, 1976, until June 15, 1976, T has only $2,000 invested ($100,000 less $98,000 in tax reduction).

Since the EDA account rule of section 1251 of present law only recaptures capital gain on the sale of farm assets, it has no effect on the deferral benefit obtained by the taxpayer in this example. The portion of the tax loss incurred in 1975 which exceeds $25,000 would result in an addition to the EDA of $115,000 but the $140,000 of farm ordinary income reported in 1976 would reduce the EDA to zero with no adverse effect on the taxpayer.

Prepaid feed deductions.—Since many, if not most, investors in cattle feeding shelters buy in at the end of the calendar year, deductions for prepaid feed for the cattle have been central to the creation of tax losses in that year. In recent years, the Internal Revenue Service has questioned deductions for prepaid feed claimed by taxpayers using the cash method of accounting. The Service (in Rev. Rul. 75–152) has prescribed several technical criteria and relied on its general authority to recompute a taxpayer's income if the taxpayer's method materially distorts his income. However, investors in cattle feeding shelters may still circumvent the administrative criteria in order to justify deductions for prepaid feed. (There may be legitimate business reasons for buying feed late in the calendar year).

The tax-saving aspects of a cattle feeding program will make such a program appear to be a relatively better investment, when compared with an investment without similar tax advantages, than the nontax economic considerations would warrant. In addition to the recent recession. artificially induced overcapacity may have been partially responsible for the severe downturn in cattle feeding. The losses resulting from overcapacity in cattle feeding would most affect lower bracket farmers who are in cattle feeding solely as a business and not the tax shelter investor who will have 70 percent of his loss (after guarantees, if any) absorbed by the Treasury.

It has been argued that the livestock industry needs outside capital and that the tax rules should not be changed to make the attraction of new capital more difficult during this depressed period. However, it also has been argued that, in view of present concern over funds for capital formation, this is an appropriate time to require all investment alternatives to compete for investors' funds on the basis of the earnings from the economic activity rather than earnings after special advantages from tax shelters.

B. Shell eggs

Another deferral shelter which gives even greater writeoffs per investment dollar than cattle feeding is the production and sale of eggs. In egg shelters, the entire amount invested and borrowed can be spent on deductible items in the first year. Those items include poultry flocks, prepaid feed, and a management fee to the person who operates the program for the investors (to the extent that it is otherwise deductible). Under present law amounts paid for egg-laying hens which are commonly kept for only one year from the time they start producing are allowable deductions in the year the poultry is purchased.[21]

In one recent syndicated offering of $6 million in limited partnership interests in a shell egg operation, the partnership proposed to

[21] Rev. Rul. 60–191, 1960–61 C.B. 78. The purchase cost of this poultry may be deducted currently if the farmer consistently does so and if the deductions clearly reflect his income).

borrow an additional $6 million (in the form of a nonrecourse loan) and to spend the proceeds in December of the first year as follows:

Purchase of flocks	$5,400,000
Purchase of feed, medication and supplies	6,120,000
Initial management fee to general partner (not to be claimed as a deduction)	480,000
Total	12,000,000

Thus, $11,520,000 of the $12,000,000 would be paid for currently deductible items.

The availability of writeoffs of this magnitude in egg production has attracted numerous outside investors in recent years. Many full-time farmers have objected to this introduction of outside investors into egg production, arguing that shelter-minded investors have distorted the economics of the egg industry and produced instability in egg prices.[22]

C. Winter vegetables and other plant shelters

Shelters involving the growing of winter vegetables operate in essentially the same method as cattle feeding and egg production shelters. Invested capital is leveraged to the greatest extent possible and deductible expenses, consisting of the costs of seeds and young plants, planting and cultivation expenses, interest, rent, and management fees, are incurred in one year, while the related income is realized in margin the following year.

Similar deferral shelters can be found in the raising of horticultural plants where significant expenses are incurred in one year and the related income is realized in the following year. For instance, programs for raising azaleas and rosebushes have also been used as rollovers to defer taxes on nonfarm income from one year to another.

Deferral and Conversion Shelters

A deferral and conversion shelter offers an investor an opportunity not only to defer taxes but also to convert ordinary income into capital gain. The manner in which these benefits are obtained is by deducting development costs of section 1231 property (breeding cattle, orchards, vineyards, etc.) and capital gain property (farmland) from ordinary income and selling the assets developed after holding them long enough to qualify for capital gain tax rates. Since the recapture rules which apply to these deducted development expenses are much more limited in scope than depreciation recapture rules generally, many farm operations can be structured so that there will be little or no recapture of previously deducted development costs.

A. Cattle Breeding

Livestock breeding offers taxpayers the opportunity to defer taxes over a period of two or more years and also to convert ordinary income to capital gain.

In general, breeding operations organized to provide tax shelters rely on current deductions for prepaid expense items; current deductions for expenses of raising young animals to be used for breeding, dairy, draft or racing purposes; the investment credit; accelerated depreciation and additional first year depreciation on purchased animals and

[22] See Tax Reform Hearings, 94th Cong., 1st Sess., 213 (July 15, 1975) (Statement of John Wallace, President, United Egg Producers).

equipment; and capital gain when the mature animals are eventually sold.

Although cattle is the most widely used breeding shelter, there have been investments offered for the purchase, breeding and sale of horses, (discussed below), fur-bearing animals (such as mink, chinchilla and beaver), other types of farm animals (such as dairy cattle and hogs), and some kinds of fish or shellfish.

In the cattle breeding operation, a herd of heifers and cows is maintained by the investors. The cows in the herd are bred each year and a calf crop of 75 to 95 percent is typical. In general, most of the bull calves produced each year are sold (often to a feedlot). The rancher retains most of the heifer calves, which, after about two years are used for breeding. In addition to the bull calves sold, the venture will periodically sell heifer calves not wanted or needed for breeding operations as well as "culls" (animals which for age or other reasons are not needed or suited to the herd.) The operation derives its periodic revenue from the sale of some of these cattle each year.

The cycle of a breeding herd is about 5–7 years. At the end of that period of time, the herd will normally have grown, its quality strains will have been established and most of the costs to raise the animals will have been deducted as the investors paid them. The investor can then sell his raised breeding animals and obtain capital gain with no recapture of either depreciation (since the raised animals had a zero basis) or of previous development costs (if the investor kept his annual farm losses under $25,000). Only the investor's profit on his sale of purchased breeding animals will be subject to recapture of previous depreciation deductions.

Table 3 illustrates the substantial tax benefits which a high-bracket taxpayer can obtain on a break-even cattle breeding operation conducted over a five-year period. Assume that T, a taxpayer in the 60-percent marginal rate bracket, enters into a management contract on November 1, 1975, with a professional rancher for the purchase and maintenance of a herd of cattle to be raised for breeding purposes. The basic costs in 1975 are as follows:

Cash investment by T in 1975	$27,200
Borrowed funds	46,800
Total funds available	74,000
Purchase cost of breeding animals (200 head at $260 each)	52,000
Deductible expenses (1975): Interest, feed and other maintenance expenses, management fees	22,000

T will also have to invest additional amounts in the program as follows: 1976, $9,800; 1977, $11,000; 1978, $11,400; and 1979, $9,700.

The loan bears 9 percent interest with principal payments of $5,200 due in each of 9 years. The breeding herd is assigned a 6-year useful life for purposes of depreciation and the investment credit. First-year additional depreciation of $4,000 is taken in 1975. The herd is depreciated under a 150-percent declining balance method.

The operating results of the herd on an annual basis over five years might typically be as shown in Table 3.

TABLE 3.—CATTLE BREEDING PROGRAM

	1975	1976	1977	1978	1979	1980
Income:						
Steer sales [1]	0	$11,200	$9,400	$8,200	$10,600	$25,000
Sales of breeding cattle [1]	0	4,800	5,000	5,600	6,800	73,100
Less basis of purchased cattle sold	0	(7,820)	(4,830)	(2,838)	(1,901)	(6,652)
Gross income	0	8,180	9,570	10,962	15,499	91,448
Deductible expenses [2] (interest, maintenance expenses and management fees)	22,000	20,600	20,200	20,000	21,900	3,000
Depreciation:						
Additional first year depreciation	4,000					
150 percent declining balance depreciation	2,000	9,545	6,003	4,118	2,293	0
Taxable income (loss)	(28,000)	(21,965)	(16,633)	(13,156)	(8,694)	[4] 88,448
Cumulative taxable income (loss)	(28,000)	(49,965)	(66,598)	(79,754)	(88,448)	0
Investment credit [3]	3,467					
Investment credit recapture		589	485	381	156	728
Tax increase or reduction—60 percent bracket taxpayer:						
Annual effect on taxes	(20,267)	(12,590)	(9,495)	(7,513)	(5,060)	38,430
Cumulative effect	(20,267)	(32,857)	(42,352)	(49,865)	(54,925)	(16,495)

[1] This example assumes that 90 percent of the cattle of breeding age give birth to live calves; all bull calves are sold each year; 10 percent of all heifers are culled each year; 15 percent of all breeding cows are culled each year; and that after 5 years, the entire herd is sold for an amount which enables the operation to break even.

[2] 1 yr interest and maintenance costs are prepaid annually as is 1 yr management fee except in 1980 when the cattle are sold. Maintenance expenses and management fees are based on figures circulated by a promoter. The total amount of these deductions tends to decrease annually because interest costs decrease as the loan is paid off, but this decrease is offset to some degree by the costs of maintaining an increasing number of animals. Solely for purposes of illustration, it is assumed that these expenses are deductible when paid.

[3] Useful life 6 yr. Computation of investment credit: 10 percent of (2/3 of $52,000) equals $3,467.

[4] The income realized in 1980 equals the losses suffered in prior years. Of this income, the amount which is ordinary income is computed as follows:

Income from sale of animals held less than 2 yr	$25,000
Depreciation recapture on purchased animals still in herd	15,952
EDA recapture (balance in EDA account from 1975 addition)	3,000
Less deductible expenses	(3,000)
Ordinary income	40,952

Note: The remainder of the income attributable to the sale of the breeding herd, or $47,496, is capital gain.

Assuming that this investment qualifies as an activity carried on for profit, T would reduce his total tax liability by $16,495 (the sum of the $54,925 in tax reductions in 1975 through 1979 less the $38,430 in taxes due in 1980), on an investment which has neither made nor lost money apart from taxes. In addition, T has deferred taxes on his nonfarm income in the amount of $54,925 (of which $38,430 is only deferred and is repaid in 1980). If the amounts deferred were invested in 7 percent tax-exempt industrial development bonds until the taxes for 1980 became payable, T would have obtained a benefit of $15,589 by the time value of delaying payment of taxes on his nonfarm income. The total benefit from conversion and deferral so computed is $32,084 ($16,495 plus $15,589) on a breakeven project.[29]

This example also shows the limited scope of the farm loss recapture rules of section 1251 of present law. In the first year of this investment only $3,000 (the excess of the farm loss over $25,000) need be added to an EDA account. Although farm tax losses are incurred in four additional loss years, nothing more has to be added to the account because

[29] In computing the tax benefits it is assumed that all deductions from farming in 1975 through 1979 offset nonfarm income which would otherwise be taxed in the 60-percent bracket. In computing the taxes in 1980, it is assumed that the ordinary income is taxed in the 62-percent through 66-percent brackets. The ordinary income is taxed in brackets higher than the 60-percent bracket because it is bunched in one year. It is also assumed that T has no other capital gains during 1980, so that he can use the alternative tax on capital gains (a flat 25-percent rate). Further, it is assumed that investment credit is recaptured because the purchased animals were not held for 60 months.

the annual losses are less than $25,000. On the facts of this example, the EDA rules recapture only $3,000 of the farm deductions; an additional $47,496 of development costs has been converted from ordinary income into a capital gain.

B. Horse Operations

Although there appear to be fewer syndicated tax shelters in horse breeding and racing than in cattle feeding or breeding, two formats can be used by taxpayers seeking tax shelter in horse operations. In one format, an investor or group of investors buys mares (female horses) and conducts a breeding operation. Such an operation can take advantage of accelerated deductions, principally the current deduction of breeding fees (which are paid to another party to breed the mares to a stallion); expenses during the preproductive period of raising the foals; and accelerated depreciation (including first year depreciation) on purchased mares. The foals are in some cases retained for racing purposes or sold to others, usually as yearlings.

Income from such sales is ordinary income, since yearlings are by definition held for less than 24 months. However, the income is not matched with the expenses of raising the foals (since the breeding fees and maintenance expenses were deducted in a prior year). Capital gains can be generated in a breeding operation when brood mares which have been held for more than 24 months are sold. If the mare had been purchased, any gain would be recaptured to the extent of the depreciation taken on it. If the mare sold had been born to another mare in the investor's herd, it would have no basis since all the costs incurred in breeding the mare and raising her would have been deducted previously. Consequently, under present law there would be no depreciation recapture and all the proceeds of sale would be capital gain except to the extent that the EDA rules of section 1251 apply.

In the other format, an individual (or group of individuals) buys a mare and breeds it to a stallion. The breeding fee is deducted when paid (usually upon successful breeding or upon birth of a live foal), and the costs of raising the foal are deducted when they are paid. Alternatively the investors may buy a stallion or undivided interests in a stallion and then claim depreciation deductions.

The horse is not generally ready to race until he becomes at least two years old. The income derived from racing is ordinary income, but, again, it it not matched with the costs of developing the income-producing assets. If the owner sells his race horse after or during its racing career, capital gain may be realized. An exceptionally successful horse may generate substantial breeding fees (which are ordinary income to the owner). Or the owner may syndicate interests in the horse to a group of investors who desire to obtain breeding rights to the horse (such as the syndicate in the case of Secretariat). Amounts received by the owner on such a syndication have been held entitled to capital gain treatment. (*Harry F. Guggenheim*, 46 T.C. 559 (1966).

C. Orchards, Groves and Vineyards

An investment in an orchard, vineyard or grove involves a "tree crop" as distinct from a "field" crop such as vegetables. The list of tree crop partnerships covers virtually anything grown in an orchard or vineyard in the form of trees or vines which produce annual crops of fruits (e.g., apples and avocadoes), nuts (e.g., pecans, pistachios, walnuts), or grapes. As indicated earlier, citrus fruits and almonds are generally no longer suited to tax shelters because of the cost capitalization rule of section 278.

Tree crops offer investors both tax deferral on their nonfarm income and potential conversion to capital gain if and when the underlying vineyard is sold (or the investor sells his interest in a syndicate). During the development period of the trees or vines, the owners obtain deductions from cultivating, spraying, fertilizing and irrigating the tree or vine to its crop-producing stage. They also depreciate farm machinery, irrigation equipment, sprinkler systems, wells and fences which they install on the property. They can also obtain the investment credit; and deductions may also be available for interest, fees and some prepaid items. (In some cases, the investors lease the land on which the vineyard operation is conducted, thereby substituting deductible ground rents for nondeductible purchase price dollars.)

After the trees start producing fruit or nuts, the owners can depreciate the costs of the seedings and their original planting which were capitalized when incurred.[24] Such depreciation can partly shelter the annual crop income. Income from the crop sales is ordinary income. Capital gains is also available when the underlying land and the orchard are sold (except to the extent that various recapture rules come into play).

Table 4 illustrates the shelter available through a limited partnership formed to acquire farm land for planting and developing a grape vineyard. The crop will include wine and variety grapes which will be marketed as table grapes, crushed into wine or dried into raisins. The transaction shown is based on an actual limited partnership offering which is representative of many vineyard syndications.[25] In this offering, limited partnership shares are sold for $10,000 per unit of interest up to a maximum of 225 Units. The limited partners buy in during September of the first year and contribute a total of $2,250,000 equity. The corporate general partner (representing the promoter) contributes his property rights, including options to acquire the land on which the vineyard will be developed.

Annual profits and losses will be allocated entirely to the limited partners during the first seven years; thereafter, the annual allocation will be 10 percent to the general partner and 90 percent to the limited partners.

The partnership will purchase 1500 acres of farm land for $3.5 million, paying $500,000 down and financing the balance by a nonrecourse 9 percent purchase money mortgage. Principal payments will not begin until the fourth year of operations: in that year, principal payments will begin in annual installations of $150,000 for ten years, after which the annual installments increase under a schedule until the unpaid balance is paid in full.

The partnership plans to elect the cash method of accounting and to use maximum allowable depreciation of buildings, sprinkler systems, wells, pumps, stakes and the grape vines. (Vines become eligible

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[24] Trees and vines must be depreciated over their useful lives in the business. The useful life is often determined by average industry experience. In some regions, for example, apple trees are depreciated over 18 years, fig trees over 25 years, walnut trees over 33 years, and grape vines over 20–30 years.

[25] Grape harvests are currently at record high levels, particularly in the case of wine grapes. The result is expected to be a period of price reductions for various domestic wines until demand catches up with the current oversupply. Since grapevines take about 4 years to become productive, some part of the current harvests can probably be traced to plantings by tax shelter syndicates during the early 1970's.

for depreciation and for the investment credit in the year that grapes are first produced in commercial quantities.)

Each limited partner's tax basis for his partnership interest includes his share of the nonrecourse mortgage. Table 4 shows the projected tax losses and positive taxable income during the first seven years of operations. (Grapevines generally bear commercial quantities of fruit in their third year and mature by the seventh year. In this example, since the syndicate will begin at the end of the first year, crop revenues begin in the fourth year.)

TABLE 4.—GRAPE VINEYARD PROJECTIONS

Year	1	2	3	4	5	6	7
Crop revenue				$680,000	$1,020,000	$1,200,000	$1,400,000
Expenses:							
Cultivation costs [1]	$75,000	$260,000	$260,000	265,000	280,000	295,000	305,000
Harvesting [2]				40,000	48,000	56,000	66,000
Administrative costs [3]	8,000	20,000	20,000	20,000	20,000	20,000	20,000
Management fee [4]	42,500	42,500	42,500	42,500	42,500	42,500	42,500
Property taxes [5]	24,000	24,000	24,000	24,000	24,000	24,000	24,000
Interest [6]	337,500	270,000	270,000		256,500	243,000	229,500
Loan origination fee [7]	30,000						
Depreciation [8]	248,000	218,000	125,000	216,000	192,000	170,000	152,000
Total expenses	765,000	834,500	741,500	607,500	863,500	850,500	839,000
Taxable income (loss)—partnership	(765,000)	(834,500)	(741,500)	72,500	157,000	349,000	561,000
Taxable income/(loss) per unit	(3,400)	(3,709)	(3,296)	322	698	1,551	2,493
Tax saving per unit—70 percent bracket	2,380	2,596	2,307				
Add: Investment credit per unit [9]	298	111		356			
Cash flow:							
Crop revenues				680,000	1,020,000	1,200,000	1,400,000
Less:							
Expenses other than depreciation	517,000	616,500	616,500	391,500	671,000	680,500	687,000
Mortgage principal				150,000	150,000	150,000	150,000
Total	517,000	616,500	616,500	138,500	199,000	369,500	563,000
Cash available for distribution—per unit				616	884	1,642	2,502

[1] Includes materials, supplies, and labor used in cultivating and maintaining the vines; e.g., irrigating, fertilizing, inset and pest control, weeding, pruning, tying, and vine training. Does not include cost of the vine seeds and planting the vines.

[2] Covers costs of picking, packing, storing, and selling the yearly grape crop.

[3] Includes utilities, bookkeeping and secretarial salaries.

[4] Payable to an affiliate of the general partner at $38 per acre. Includes arranging for renting tractors and other farm machinery, field supervision and "extraordinary" services such as replacing dead or unhealthy vines.

[5] Estimates used, but no effect is given to the projected value of capital improvements to the property.

[6] 1st year includes interest for ¼ of the year ($67,500) plus prepaid interest for the 2d year ($270,000). Interest shown in later years is based on the unpaid balance of the mortgage at the start of those years.

[7] Payable to the lender under the existing 1st mortgage encumbering the land.

[8] Based on capital improvements included in the purchase price of the land and to be installed by the seller. Includes installing frost control sprinkler systems, wells, tanks, reservoirs, stake, and posts. Wells, etc., are depreciated over years under the 200 percent accelerated method, plus 1st year "bonus" depreciation. Sprinklers and stakes are depreciated over 15 years under the 200 percent method plus bonus depreciation. Vine depreciation begins in year 4 and is spread over 25 years under the 200 percent declining balance method.

[9] Credit claimed on various machinery and equipment and on the vines themselves when they become income-producing in the 4th year.

Table 4 shows how maximum advantage is taken of cash method deductions for cultivation costs as the vineyard matures from planting to full production and, after the productive life begins, of deductions for depreciation and the investment credit (which help shelter part of the annual grape revenues). During the first three years, no revenue is expected from the young vines. Growing costs, depreciation and interest deductions (magnified by leverage) create tax losses which flow through to the limited partners and shelter their income from other sources. Since the investors buy in late in the first year, they pay interest for 3 months of that year and also prepay the interest relating to year two. The projections also assume (solely for purposes of illustration) that the expenses shown are otherwise deductible when paid. During this period, tax losses totalling $10,405 are available for each $10,000 unit.

For an investor in the 70 percent bracket, this means total tax savings of $7,283, which leaves only 27 percent of each original unit unrecovered from tax savings. The investment credit further increases the effective deferral of taxes on each investor's nonfarm income and further reduces his cash left at risk.

As grape revenues begin coming in, the venture "crosses over" to producing positive taxable income and increasing amounts of cash flow from annual sales are distributed to the partners. A further investment goal not reflected in the table is capital appreciation of the underlying land. The value of the property, with maturing vines beginning to produce major amounts of income, is expected to increase. The general partner begins to receive a percentage of net profits and the syndicate begins repaying the mortgage, thereby increasing its equity in the property.

The investors will begin deciding whether to remain in the venture or to sell their interests. If an investor sells his interest in the partnership, or if the partnership sells the entire farm (including the land and the vines), the investor will be entitled to capital gain treatment of any gain he realizes on the land and the vines, except to extent that recapture is required for previous depreciation (sec. 1245), cultivation expenses (sec. 1251), or soil and water conservation or land clearing expenses (sec. 1252).[26]

D. Ranchland Leases

Individual investors and syndicates have often obtained deferral and conversion benefits by investing in ranchland which the owners then lease to a local farmer or cattleman. In this type of transaction, the investors become absentee owners of the underlying farm land but do not conduct their own farm business. Some public offerings have been structured basically as a sale-leaseback under which an existing farmer sells his farm to outside investors who then lease the land back to the farmer at a specified rental. Often, the seller/rancher is given an option to repurchase the property at the end of the lease at a price which will give the investors some profit (and capital gain).

Under this format, the investors usually use a large proportion of borrowed funds to make their initial purchase and to pay many of the deductible expenses which they will incur during the term of the lease. In this way the investors obtain the advantage of leverage: deductions greater than the amount of their own cash investment and deductions for interest prepayments (to the extent these are available under present law). During the lease, the investors typically upgrade the land and obtain special deductions for soil and water conservation expenses, fertilizer and land clearing costs. They also deduct property taxes, maintenance costs and depreciation on barns, silos, corrals, fencing and other improvements. Sometimes, the promoters of syndicates of this kind act as managers of the farm for the investors

[26] The dollar limitations on the EDA rules (sec. 1251) apply separately to each partner in a partnership. Therefore, whether any partner must set up an EDA account depends on whether he has nonfarm income of more than $50,000 and whether he owns enough units so that his share of the partnership's tax losses during years 1–3 exceeds $25,000.

and charge a management fee, which can also be deducted when paid by the investors (provided the payment is for current services).

Under present law, the EDA rules of section 1251 may not apply at all to this transaction, since the investors might be considered to be engaged in real estate rather than in farming. The investment interest limitation in section 163(d) does not apply if the lease is not a net lease, and many ranchland leases are not net leases. (That is, the owners rather than the tenant pay most of the operating expenses.) The farm land recapture rules of section 1252 of present law might reduce the investors' capital gain if and when they sell the land, but this provision would not affect their initial deferral of taxes by means of tax losses.

E. Timber and Christmas trees

Timber has some of the characteristics of annual crops such as vegetables and fruits, and of minerals extracted from the ground (such as gas and oil). It is unlike short-term crops, however, in that timber does not replace itself quickly; it is unlike minerals in that it does replace itself eventually and, being located above ground, it is relatively easy to find. Timber growers are permitted to claim capital gain treatment on the portion of their income which can be attributed to the increase in value of the trees while the trees are growing and before they are cut.[27]

In addition to capital gain, some of the current costs of growing timber are deductible currently as paid. These include interest on financing an investment in timber, expenses for estimating the inventory of uncut trees, for salaries and other costs of managing a tree farm (such as clearing unwanted trees and brush), and property taxes. To the extent that expenses of growing and carrying timber are deducted currently, while the income which the expenses help produce is recognized when the timber is later sold, a mismatching of income and expense occurs. This permits deferral of taxes on a timber owner's income from other sources and eventual conversion of the tax rate on such income by the capital gain rate for the grown trees. In addition, the time value of the deferral is magnified by the long period between the taking of the deductions and the receipt of the income.

The growing and selling of Christmas trees is the most frequent form of timber tax deferral shelter. Capital gain is not available if Christmas trees are not over six years old when they are cut. Under present law, however, costs for shearing, pruning, shaping, weeding and thinning trees being grown as Christmas trees have been held to be deductible as incurred.[28]

ALTERNATIVE APPROACHES

There are a number of alternatives approaches that the committee could consider to deal directly or indirectly with tax shelters in farm operations. If the committee believes that certain incentives are no longer desirable or that the tax benefits are greater than they need be,

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[27] The capital gain preference for timber permits an owner to elect to treat his cutting of standing timber as giving rise to capital gain even though he has not actually sold the timber. The gain is measured by the difference between the cost of the timber cut and its fair market value on the first day of the taxable year in which it is cut (sec. 631(a)). Any amount realized in excess of the fair market value, such as from converting the cut timber to logs, or resulting from increases in value after cutting, is taxed as ordinary income.

[28] See, e.g., Daniel D. Kinley, 51 T.C. 1000 (1969), affirmed 70–2 U.S.T.C. Par. 9462 (2d Cir. 1970); Rev. Rul. 71–228, 1971–1 C.B. 53.

the particular provisions could be eliminated or the preference cut back to some extent. Thus, for example, the committee could require accrual accounting and inventories for all farm operations or for all farm operations over a particular size (measured by assets or receipts) or type. The committee also could require capitalization of development costs, such as reproductive period expenses of orchards, vineyards and animals held for draft, dairy, breeding, or sporting purposes.

Even if full accrual accounting is not required, the committee could require capitalization of the costs of assets used in the trade or business whose useful lives are less than one calendar year if their useful lives overlap two taxable years. Similarly, the committee could require the inventorying of plants and seeds if they are planted in one taxable year and the products are sold in a later year. Where seasonal growing or similar requirements place the operating year in two successive calendar years, the taxpayer could be required to adopt an appropriate fiscal year. Also, the committee could consider disallowing any deduction for feed until it is consumed.

With respect to animals held for draft, dairy, breeding or sporting purposes, the committee could require that the animal actually have been used for such purposes to qualify for capital gains treatment. Alternatively, the holding period for such animals could be lengthened or measured only from the date the animal was first actually used for one of these purposes.

In addition, the committee could reduce accelerated depreciation and repeal the special deduction provisions for soil and water conservation expenses, fertilizer expenses, and land clearing expenses. If these special deductions are not repealed, the recapture provision for soil and water conservation expenses and land clearing expenses could be modified to eliminate the phaseout of recapture.

If the committee believes that incentives should be continued but that the tax benefit involved should not be available to offset income unrelated to that particular activity, then the committee could limit the tax writeoffs to income from that particular activity, thus not allowing any excess deductions to be used to shelter nonfarm income. This is the approach that the administration made in its limitation on artificial loss (LAL) approach which was essentially adopted by the committee (with certain modifications and exceptions) in its 1974 tax reform bill as described below.

Also, if the committee believes that a significant problem is the use of funds borrowed on a nonrecourse basis to generate deductible expenses, it could limit a taxpayer's deductions in a particular activity to the amount at risk in the form of capital contributions and recourse borrowings. This type of a limitation was adopted with respect to livestock operations in the committee's 1974 tax reform bill.

Another approach to deal with farm tax shelter investments could be considered if the committee decided against all of the above approaches; that is, if the committee believes that continuing the tax incentives achieves desirable objectives and that revising the provisions directly or applying an LAL approach or an "at risk" limitation would unduly restrict their purpose, then the committee could consider dealing indirectly with the preferences, such as by broadening the minimum tax.

If the committee feels that deferral should continue to be permissible but that conversion of ordinary income into capital gain should be more closely circumscribed, the EDA provisions could be modified by reducing the amount of nonfarm income allowable before an EDA account must be maintained and the amounts of farm losses which must be added to the EDA could also be increased.

Following is a summary of the committee's decisions with respect to farming operations in its 1974 tax reform bill, Mr. Ullman's proposals, and alternative proposals by other committee members.

Limitation on Artificial Losses

A. 1974 committee bill

Last year the committee's bill would have applied the LAL approach to certain farm deductions in order to limit the extent to which a tax loss produced by certain "accelerated deductions" could offset (and shelter) nonfarm income. Under last year's bill, accelerated deductions in the farm area were:

(1) preproductive period expenses of growing an agricultural crop (not including such expenses in the case of livestock); and

(2) prepaid feed, seed, fertilizer and similar farm supply expenses.

Under the provision, deductions otherwise allowable for these expenses could continue to be deducted against the taxpayer's net related income for the same year from the farm property in which the deductions were incurred, and also from other farm properties in which he may have invested. (Net related income would be the gross income from the farm property less the nonaccelerated deductions incurred in operating the property during the same year.) The accelerated deductions in excess of net related income from the entire "class" of farm properties in which the taxpayer has invested would be required to be suspended in a "deferred deduction account." The deferred deductions would be allowable in a later year when the taxpayer has net related income (in excess of accelerated deductions in that year) from the group of farm properties which he owns at that time. Special rules were provided for releasing deferred expenses from the suspense account when a taxpayer sells or otherwise disposes of the underlying farmland, orchard, or vineyard, etc., and when feed whose cost was prepaid is consumed by the taxpayer's animals.

The LAL limitation would not apply to losses which represent true economic losses not attributable to accelerated deductions; thus these losses could continue to be deducted currently.

The 1974 decisions would not have included under LAL the costs of raising animals (as distinct from agricultural crops), other than prepaid feed costs. The deductible costs of raising livestock would have been subjected to a different limitation under the 1974 bill (that limitation is discussed further below).

The treatment of crop preproductive period expenses as accelerated deductions would not have included taxes, interest, depreciation or expenses incurred on account of a casualty loss or on account of disease or drought.

To a limited extent, the 1974 bill would have allowed a tax loss produced by accelerated deductions from a class of farm properties to be deducted against nonfarm income. An "artificial loss" could shelter up to $20,000 of nonfarm income, but if a taxpayer has nonfarm income over $20,000, the amount of an artificial farm loss which could shelter nonfarm income would be reduced from $20,000, on a dollar-for-dollar basis, for each dollar of nonfarm income in excess of $20,000. This means that no artificial farm losses could be taken as deductions currently by the taxpayers with nonfarm income of $40,000 or more.

The 1974 bill would have applied to individuals, estates and trusts and to corporations which were excepted from the provision in the 1974 bill requiring farm corporations to use the accrual method of accounting for their farm operations.

B. Mr. Ullman's proposal

Mr. Ullman would apply the LAL provision as outlined above, except that he would apply LAL separately to each farm. In addition, Mr. Ullman would apply LAL to:

(1) preproductive period expenses of raising livestock, and to

(2) depreciation of livestock after they have begun to be productive in the taxpayer's business.

C. Mr. Corman

Mr. Corman would provide that farm losses can be deducted against nonfarm income only to the extent of $10,000 a year. Any amount of a farm loss disallowed under this provision would be treated as an expense of farming in the following year. This limitation on the deduction of a farm loss would not apply to a taxpayer whose nonfarm income is less than $20,000.

D. Messrs. Waggonner and Conable

The proposal would apply LAL to the entire group of farm activities which the taxpayer owns or in which he has invested.

E. Mr. Helstoski

The proposal would apply LAL in the case of farm operations on an aggregate basis and, in addition, would calculate the dollar limitation (instead of using the flat nonfarm income limit of $20,000) on the basis of a percentage of total income (such as 20% from nonfarm sources).

F. Mr. Stark and Mrs. Keys

For farmers with nonfarm income of more than $20,000, their proposal would apply LAL but phase out the use of farm losses to shelter nonfarm income so that no farm losses could be applied against nonfarm income in excess of $30,000.

Limitation of Tax Losses Incurred in Livestock Enterprises to the Amount for Which the Taxpayer Is at Risk

A. 1974 committee bill

Last year the committee's bill would have provided that in the case of feeder cattle and livestock used for breeding, draft, dairy, or sporting purposes, deductions for losses would not be allowed in excess of the amount of capital or credit of the individual which is at risk in the venture for the same taxable year. A taxpayer would not be considered "at risk" in the case of a nonrecourse loan or to the extent that he has a right to be reimbursed for any loss on the investment, such as by reason of a "stop loss" or a guaranteed repurchase agreement, insurance, or other similar arrangement.

Unlike the LAL approach, this rule would have applied to a tax loss (arising from a livestock investment) regardless of the kind of current expense deductions which produced the loss. This rule would also have applied to tax losses incurred during the period of raising livestock to maturity and to tax losses incurred while the livestock are being productively used in the taxpayer's business. The latter category would, for example, include depreciation deductions on a breeding herd. The rule would not limit the calculation of the amount of depreciation otherwise allowable for the year, but would limit any tax loss (i.e., excess of deductions over income) from the business from being offset currently against the taxpayer's income from other sources.

Any amount of a tax loss which could not be deducted currently because of this limitation could be carried over and deducted in a later year if the taxpayer's risk investment in the business at that time is large enough to absorb the previously unused loss.

This rule would have applied separately to each livestock business in which a taxpayer has invested.

B. Mr. Ullman

Mr. Ullman's proposal is the same as the rule in the committee's 1974 bill.

C. Mr. Pickle

Mr. Pickle would limit farm losses to the amount of the taxpayer's capital at risk in the business. (Presumably, this is a substitute for the application of LAL.)

Accrual Accounting for Corporations

A. 1974 committee bill

In 1974 the committee proposed to require all corporations (except subchapter S corporations and family corporations), and all partnerships in which a corporation had a 5-percent interest, to use the accrual method for farm operations.

The rationale for this decision was that most corporations are business entities which can keep the records and make the allocations required under the accrual method. However, the committee recognized that many farm operations carried on in corporate form are relatively small operations. Consequently, Subchapter S corporations, which by definition can have no more than 10 shareholders, and certain family-owned corporations were excepted from the requirement of accrual accounting.

A family corporation was defined as a corporation in which 75 percent of the total combined voting power of all classes of stock entitled to vote, and at least 75 percent of the total number of shares of all other classes or stock, are owned by an individual, his brothers, sisters, ancestors and lineal descendants, a spouse of any of them and the estate of any of them. For purposes of the family corporation rules, stock owned by a partnership or trust would be treated as owned proportionately by its partners or beneficiaries.

The "family corporation" exception did not provide for attribution of stock of personal holding companies or discretionary trusts, and did not include cousins as members of the family.

B. Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

Activities Not Engaged in for Profit

Mr. Archer

In giving the taxpayer an opportunity to determine whether the rule of present law limiting deductions incurred in an activity which is not engaged in for profit applies to him (sec. 183) on the basis of his experience in a 5- or 7-year period, the proposal would limit the waiver of the statute of limitations in these cases so that the waiver does not apply to unrelated items on the taxpayer's return.

Repeal of Farm Excess Deductions Account

A. 1974 committee bill

Because farm losses were included in the limitation on artificial losses, the 1974 committee bill would have repealed the provisions relating to farm excess deduction accounts (sec. 1251).

B. Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

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