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DEMOLISHED OR REMODELED--THE IMPACT OF INCOME TAX REFORM ON TAX SHELTERED INVESTMENTS IN LIVESTOCK

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Introduction

The income tax advantages of certain agricultural investments and their use by high income investors have been well publicized.[1] One of the most popular investments, the raising of beef breeding cattle, was an obvious target of recent income tax reform efforts. Descriptions of the Tax Reform Act of 1969 portray its impact as "demolishing tax shelters" in agriculture [5, p. 187]. In September 1970, as if acting on cue, Black Watch Farms, Inc., a popular registered Angus management firm filed for court protection under bankruptcy laws. Hundreds of well-heeled investors suddenly found themselves looking for a place to keep their cows and "cowboys" to care for them.[2] If tax shelter investments in breeding livestock were not demolished, it appeared that they had been dealt a devastating blow. Let's take a look at the tax law changes which contributed to Black Watch Farms' financial problems and see if, in fact, tax shelter aspects of breeding cattle investments have been demolished or merely remodeled.

Tax Reform Provisions

Conversion of ordinary income to capital gains with lower tax rates is the essential feature of a tax-sheltered investment. The Tax Reform Act of 1969 sought to limit income conversion via livestock investments with several provisions.[3] They include: recapture of excess livestock depreciation, an increase from one to two years in the holding period for cattle to qualify for long-term capital gains treatment, a provision stating that exchange of male

for female calves cannot be made without tax consequences,[4] the establishment of an excess deductions account (EDA),[5] tightening of hobby loss rules,[6] and an increase in the maximum tax rate on capital gains.[7]

The impact of these provisions on livestock investments is mixed, depending primarily on the size of the investment, tax losses, and manner of operation. Examination of a budgeted example provides an indication of the impact of the various reform provisions.

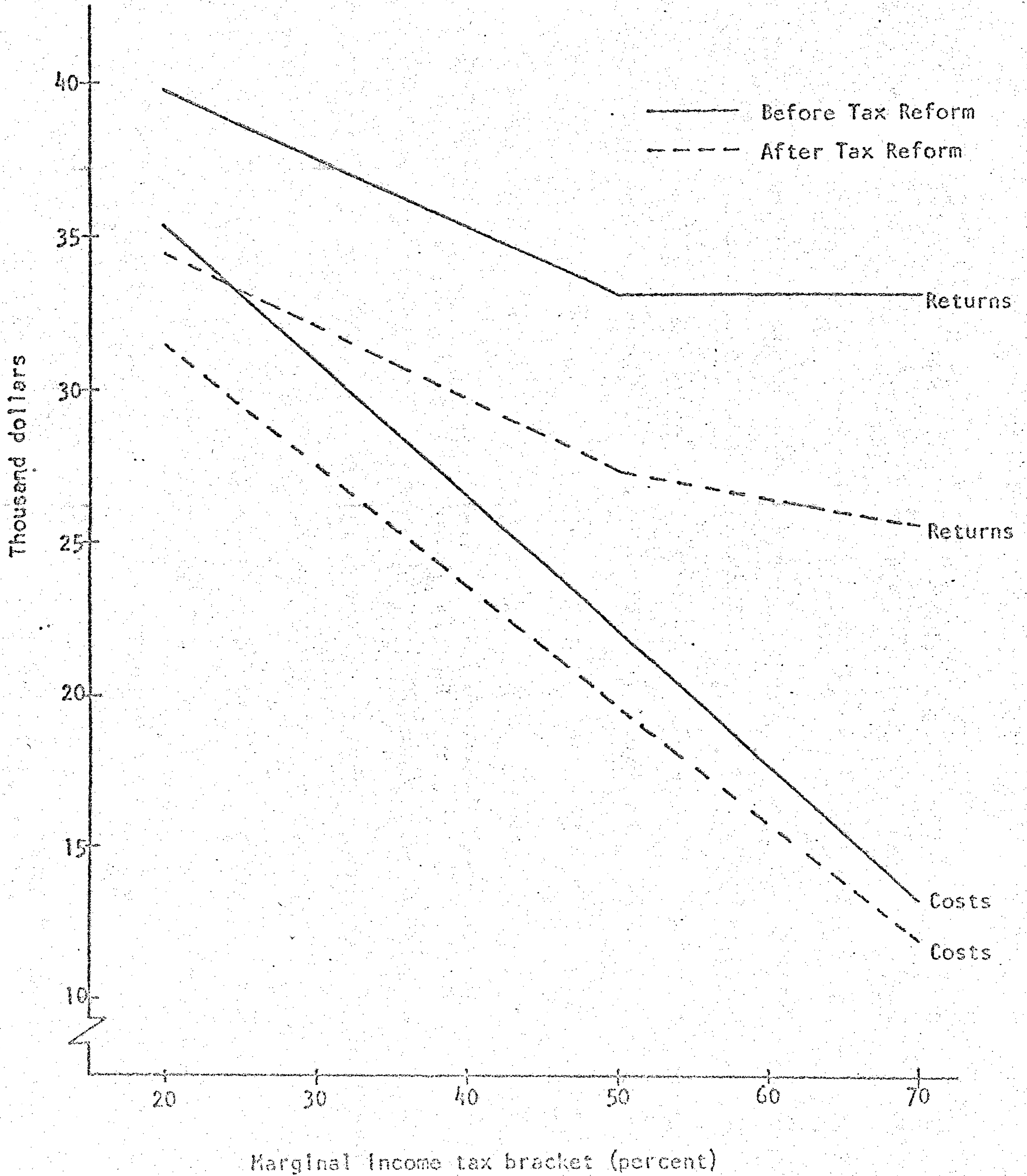
A Budgeted Example

A previous budget for a tax sheltered investment in a 100-cow beef breeding herd is revised to show the impact of tax reform [4]. Recapture of excess depreciation and the one-year increase in holding period to qualify for capital gains are the only provisions which require revision of the budget. These provisions result in a redistribution of income between capital gains and ordinary income categories. Capital gains decrease $13,752 after reform with the recapture provision accounting for $2,829 of the decrease and the increased holding period accounting for the remaining $10,923 (Table 1). The entire $13,752 is treated as ordinary income after reform. Before tax reform all taxable income is capital gains, after reform the taxpayer also has taxable ordinary income of $8,919 in year six of the investment.

The annual tax consequences of the investment for a taxpayer in the 70 percent marginal income tax bracket are shown for the before and after reform situations (Table 1). A comparison of actual gains for this taxpayer reveals a decrease in returns of $6,189 ($19,888 - $13,699) attributable to tax reform. This 31 percent decrease in after-tax returns is applicable to taxpayers in other brackets. Computations for all tax brackets are illustrated by Figure 1. Redistribution of income for tax purposes results in lower after-tax costs, lower after-tax returns and decreased actual returns after tax reform. Annual

FIGURE 1

After-Tax Costs and Returns for Investment In a 100-Cow Breedino Herd by Marginal Income Tax Bracket of the Investor, Before and After the Tax Reform Act of 1969



losses are not large enough to create an EDA and capital gains are not large enough to raise the maximum tax rate above 25 percent. Figure 1 shows that taxpayers in all tax brackets could expect positive returns from the budgeted tax shelter investment. As before reform, the tax advantage is greatest for taxpayers in the highest brackets.

Concluding Remarks

How will tax reform affect the livestock sector? Increasing the holding period to qualify for capital gains treatment decreases the profitability of tax shelter investments in livestock and will also increase rancher's tax liability since the income from some young culls which were formerly treated as capital gains is now ordinary income. Recapture of excess livestock depreciation and prohibition of tax-free exchanges of male for female calves will affect nonfarm investors and a few registered livestock producers rather than commercial cattle operations.[8] The EDA and increases in maximum capital gains tax rates will not affect small- and medium-sized tax sheltered investments but will remove the differential advantage formerly enjoyed by taxpayers above the 50 percent marginal income tax bracket. These two provisions will have little effect on ranchers.

Decreased tax shelter advantages for livestock investments will have several effects but in aggregate they are probably small. A decrease in breeding cattle ownership by nonfarm investors with an accompanying decrease in capital available to ranchers is likely. Oppenheimer Industries, Inc., a large cattle management company, reported a 17 percent decrease in their cattle management business during the year following passage of the Tax Reform Act. Herd numbers declined from 148,000 in 1969 to 122,000 in 1970 [8, p. 1]. Mr. Ronald Jarvis, Jr., President of Oppenheimer Industries, Inc., wrote that his firm normally

channels over $20 million annually into agriculture through its various cattle programs but in 1970 this dropped to a little over $13 million [7]. Mr. Jarvis noted that all of this decrease can't be attributed to tax law changes. Bad publicity surrounding the collapse of Black Watch Farms, an unfavorable stock market, and depressed conditions in the entertainment industry were also factors in the decrease [7].

The preceding discussion reveals that tax shelter aspects of beef breeding cattle investments were not demolished by the Tax Reform Act of 1969 but they were remodeled. Redistribution of income for tax purposes from capital gains to ordinary income decreases returns from cattle investments. New tax provisions will also limit the size of tax shelter investments in cattle. Careful planning and good management, however, can still result in attractive tax advantages for investors in the highest tax brackets.

Footnotes

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[1] Examples for cattle investments are in [2 and 3].

[2] For an interesting description of the trials and tribulations of over 500 investors who found themselves looking for homes for over 15,000 registered Angus see [9 and 10].

[3] These provisions are described in [5 and 12].

[4] This provision is effective for all 1954 Code years and was included to correct an erroneous interpretation of the law permitting a tax-free exchange for like kind property [5, p. 198]. Davenport feels that even fairly reckless tax lawyers probably would not have advised that exchanges of calves were without tax consequences [6, p. 329].

[5] Any farm losses of over $25,000 in a tax year go into the EDA if the taxpayer has other taxable income in excess of $50,000. Any balance in the EDA is recaptured as ordinary income on the disposition of farm recapture property [5, pp. 187-193].

[6] There is diversity of opinion on the effect of new hobby loss provisions. One source refers to them as "fangs for a paper tiger" [5, p. 199]. Davenport, however, contends that they "are a distinct step to the rear" and that the IRS will probably forego further hobby audits since it usually loses these cases in court [6, pp. 330-332, 345]. It appears that some hobby farmers may be able to get around the regulation by qualifying as a Subchapter S Corporation [11, p. 50].

Footnotes (Continued)

[7]The first $50,000 of capital gains continues to be subject to a maximum rate of 25 percent but the maximum rate on gains in excess of $50,000 will be increased to 35 percent in 1972 [5, p. 52].

[8]Recapture of excess depreciation was a strong factor in the collapse of Black Watch Farms. In addition it appears that the cattle were seriously overpriced, a declining stock market cooled investor interest, and loan funds became difficult to obtain [9]. Some investors who were forced to sell their cattle on the open market recovered only 10 cents per dollar invested.

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