NONFARM INVESTORS AND BEEF BREEDING HERDS--INCENTIVES AND CONSEQUENCES

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> Tax dollars the Government deliberately waives should be viewed as a form of expenditure and weighted against the priority of other expenditures. When the preference device provides more social benefit than Government collection and spending, that "incentive" should be expanded; when the preference is inefficient or subject to abuse, it should be ended.
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> Richard M. Nixon
> Message Regarding Tax Reform
> April 21, 1969

Beef breeding cattle investments have become an increasingly popular means of sheltering large non-agriculture income from taxes. The most attractive features of agricultural tax shelters are (1) the ability to postpone the payment of taxes on income and (2) the ability to reduce income taxes by converting ordinary income into capital gains.

The purpose of this report is to examine the income tax aspects of investments in beef breeding cattle; to determine, under various alternative assumptions, whether an economic incentive for beef cattle investment exists in the absence of special tax rules; and to point out some of the consequences for the beef industry, the Federal treasury and society of nonfarm investment in beef breeding herds.

BACKGROUND: THE FEDERAL INCOME TAX STRUCTURE

That the Federal income tax is the major producer of revenue to finance Federal expenditures is generally known. It should also be recognized that taxes, including the Federal income tax, can assist in attaining several objectives other than raising revenue, such as: preservation of natural resources, encouraging the production of certain desired products, and equitable income distribution to the producers, owners, and developers of resources. Ideally, Federal tax policy should neither distort resource allocation nor skew income distribution unless these are consistent with recognized national goals.

The attractiveness of agricultural investments as a tax shelter is due primarily to three developments; (1) a 1915 administrative decision[1] (by the Commissioner of Internal Revenue) permitting "farmers" to report income for tax purposes by either the accrual method of accounting or the cash receipts and disbursements methods, (2) a 1919 Treasury Regulation[2] allowing farmers to write off capital expenditures incurred in the development of orchards and ranches and (3) legislative action in 1951[3] expanding the category of assets used in a trade or business and entitled to capital gains treatment upon sale to include livestock held for draft, breeding, or dairy purposes.

The first two of these developments allow for the deduction of costs before the income is realized. The taxpayer may offset other income by these premature deductions thus delaying the receipt of taxable income. The third development permits the conversion of ordinary income into capital gains subject to tax at a lower rate.

The Federal income tax structure is progressive,

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[1] Treasury Decision 2153 (1915).

[2] Treasury Regulation 45, sec. 110 (1919).

[3] 65 Stat. [now Internal Revenue Code of 1954, sec 1231 (b) (3).]

i.e., marginal tax rates increase coincidentally with income. This type of structure is based on the ability to pay principle. However, at least two major features of our income tax structure provide a substantial preferential advantage to investments of high income taxpayers.

First the graduated or progressive income tax rate provides an incentive to business spending that is not equal among all taxpayers. To illustrate simply, assume that a taxpayer is considering whether to spend $100 as a business expense. If he does not spend it, a portion must be paid as income tax. If the taxpayer is in the 70 percent (highest) tax bracket, $70 of the $100 would be paid in taxes. His real cost of making the business expenditure is only $30. Contrast this situation with that of a 14 percent (lowest) bracket taxpayer. If he does not make the deductible expenditure, he must pay $14 as a tax. His real cost of a $100 business expenditure, then is $86. Thus our graduated income tax system results in what amounts to a tax subsidy for business expenditures where the amount of benefit is directly proportional to the size of the tax bracket. It nonetheless encourages investments, especially for the high bracket taxpayer.

A second area of preference deals with the tax treatment given the gain realized upon sale of capital assets. Not only is capital gain taxed at more favorable rates than ordinary income, but high income taxpayers receive a proportionately greater benefit from this provision. All individuals realizing capital gain have the option of (a) excluding one-half of the capital gain from income with the remainder taxed at ordinary income rates or (b) paying a 25 percent tax on the amount of capital gain.[4] The former option is cheaper for taxpayers whose marginal ordinary tax bracket is less than 50 percent. Given these options a taxpayer in a 22 percent tax bracket pays an 11 percent tax on capital gain. The 70 percent bracket taxpayer pays 25 percent on his capital gain. Clearly the relative saving is greater for the high bracket taxpayer.

Thus, the incentive is for the high income taxpayer to invest relatively cheap dollars in investments which yield additional income, preferably capital gain income. When that income is realized, the incentive is to repeat the process. Consequently, our income tax structure encourages expansion of the economy, fitting a national policy in which economic growth is a major goal.

Regardless of the original intent behind special farm tax rules and regulations, questions of tax equity have been raised and the charge has been made that the special rules foster unfair competition for the genuine farm operator. This charge is based on the fact that the greatest advantage of the special rules goes to the taxpayer who has (1) tax losses that are not economic losses and (2) substantial nonfarm income against which to offset the farm tax loss. The tax benefit is considerably less to the taxpayer who has only the income from farming.

The overall issue has come to be popularly known as "tax-loss farming." Tax-loss farming is perhaps most evident in the beef breeding herd enterprise.

NONFARM INVESTORS IN BEEF CATTLE BREEDING HERDS

"Nonfarm investors" refer to those individuals who derive the major part of their incomes from activities outside agricultural production. They invest in farming activities with funds originating from sources outside agriculture for any variety of reasons. They may or may not have a farm residence.

The type of nonfarm investor receiving a great amount of publicity currently is the one who channels his investment through a farm management company. The management company usually purchases the cattle on behalf of the investor-client; arranges for care, feeding, maintenance, and even marketing of the cattle and performs other management services. Some even handle financial arrangements for the investor.

Any number of variations in management contracts may exist but the following features are generally common to all:

1. Opportunities for income tax savings are generally advertised prominently.
2. The purchase price of the brood cows (or heifers) is usually above the going market price.
3. The management company charges a fee for its services, usually some fixed percentage of gross cash expenditures.
4. Maintenance fees, based on a fixed annual rate depending upon the age of the animals, must be paid.
5. Financial arrangements feature minimum down payments and maximum use is made of allowable deductions for income tax purposes.

[4] When a taxpayer's capital gain exceeds $50,000, the rate on the excess is 35 percent. Thus, this effectively abolishes the option since it is the same as the maximum ordinary rate on one-half of the gain.

While purebred, "exotic" breeds, and crossbred herds make up a large portion of cattle managed, this paper emphasizes "commercial" herds.

SIMULATION OF INVESTMENT IN A BEEF BREEDING HERD

In light of the foregoing considerations a study of the effects of certain Federal income tax provisions on farm and nonfarm investors in beef cattle breeding herd enterprises was made.

A computer program simulating an investment in a commercial beef cow-calf enterprise over a 15-year period was written and provided the basis for the study. Nonfarm investors in the 32, 50, and 70 percent marginal Federal income tax brackets and farm investors with no nonfarm income were simulated. Reported here are some of the results which deal with the nonfarm investor.[5]

Let us assume a "typical" nonfarm investor, allow him to invest in a commercial beef cow-calf herd, and discuss his possible motivations by viewing the results of his investment. Assume he originally makes a 10 percent down-payment on 100 unbred heifers and 5 bulls. He will keep most of the heifer calves to add to his herd, sell all steers at weaning and purchases bulls as needed. His herd is located on a ranch in New Mexico. His calving rate to weaning is 87 percent; cow death loss is 2 percent and bull death loss zero.

For simplicity, assume the investor will realize over the 15-year period the same prices and costs as were experienced in 1970 (which was a more favorable year for prices than the average of recent years).

Assume the investor's off-farm income is $210,000 each year so that his marginal income tax bracket is 70 percent.[6] He arranges for his investment through an investment company which takes care of all arrangements, manages the herd; feeds, breeds, and sells the herd; so that unless he wants to, the absentee investor need never leave his office to manage his investment. He pays a yearly "maintenance" fee to the investment company which covers all fees except the initial purchase price of the animals. Also, assume the investor is able to convince the Internal Revenue Service he is engaged in farming with the intent to make a profit.

After 15 years, the nonfarm investor liquidates his herd, it having grown from 100 to 348 cows. Over this period, his total cash received is $469,000 total cash disbursed is $557,000, leaving a before-tax net of -$88,000 (Table 1). He has paid $26,000 in Federal income taxes on the beef enterprise during the 15-year period, but because of losses during certain years, has been able to offset some of his nonfarm income and save $141,000 in taxes on nonfarm income.

Taking into account his net cash returns of -$88,000, income taxes paid on the beef enterprise of $26,000, and income taxes saved on other income of $141,000, his total "net benefit" over the 15 years from investment in a beef herd is $27,000. His average yearly owned investment was $29,446 and average return to owned capital was 6.21 percent (average net benefit divided by average yearly owned investment).

Had the nonfarm investor been in the 50 percent instead of the 70 percent marginal income tax bracket, Table 1 shows that his net benefit would be $33,000 less or -$5,000. Had he been in the 32 percent marginal bracket his net benefit would have been -$47,000.

Back to the investor in the 70 percent bracket, what is the value to him of the provisions of capital gain, income averaging, and offsetting farm income with farm losses? The results show that if all income were treated as ordinary income (i.e., no capital gain), the investor's net benefit would be -$12,000 instead of $27,000. Without the income averaging provision, net benefit is $21,000. Without the provision to offset nonfarm income with farm losses, net benefit becomes -$114,000. And without any of these three provisions, net benefit to the nonfarm investor is -$148,000.

It is obvious that without the two provisions (capitalgain and offsetting nonfarm income with farm losses) there would be little, if any, capital entering the beef breeding herd enterprise from nonfarm investors. Also, it is obvious that, unless these investors found other tax shelters for their money, Federal revenues would increase by a substantial amount depending on the extent of nonfarm investment in the beef breeding industry.

Two questions immediately follow from these results: (1) what is the extent of nonfarm investment in beef breeding herds in the U.S.? (2) what effect

[5] More complete details on this study and an explanation of additional price and cost alternatives used may be found in [1].

[6] Beginning in 1972, the maximum Federal income tax rate on earned income is reduced to 50 percent. The rate on investment income and income from other sources not fitting the earned income definition remains at 70 percent. One of the purposes of this rate reduction was to reduce the attractiveness of tax sheltered investments.

Table 1. -- NET BENEFITS RECEIVED FROM INVESTING IN A BEEF COW HERD, NONFARM INVESTOR, PRODUCT PRICES CONSTANT AT 1970 LEVELS, LOW MAINTENANCE FEE, LOW INITIAL HEIFER COST, 15 YEARS OF SIMULATED PRODUCTION, SOUTHERN PLAINS

	Current law	Current law except for provisions of:			
		Capital Gain	Income aver'g	Non - farm tax sav'g	All three
	Total over 15 years ($1000)				
Cash received	469	469	469	469	469
Cash disbursed[a]	557	557	557	557	557
Net, pre - tax	- 88	- 88	- 88	- 88	- 88
Net worth change[b]	0	0	0	0	0
Income tax (farm share)					
32% bracket	10	20	24	10	45
50% bracket	12	23	27	12	50
70% bracket	26	38	32	26	60
Non - farm tax saving[c]					
32% bracket	52	43	52	0	0
50% bracket	94	77	94	0	0
70% bracket	141	114	141	0	0
Net benefit[d]					
32% bracket	- 47	- 65	- 61	- 98	- 133
50% bracket	- 5	- 34	- 21	- 100	- 138
70% bracket	27	- 12	21	- 114	- 148
Net benefit (discounted)					
32% bracket	- 20	- 28	- 25	- 53	- 65
50% bracket	7	- 6	1	- 53	- 67
70% bracket	32	14	30	- 58	- 71
Receipts, ordinary income	324	469	324	324	469
Receipts, capital gain	145	0	145	145	0
Net operating loss used	0	0	0	0	0
Return to owned capital[e]			Average yearly percent		
32% bracket	- 3.99	- 5.53	- 5.20	- 6.38	- 8.63
50% bracket	- 0.67	- 3.86	- 2.59	- 6.47	- 8.97
70% bracket	6.21	- 2.16	4.78	-.7.37	- 9.60

[a]Before income tax. Includes all cash expenses including downpayments on livestock, facilities (if farmers - investor), and interest and principle on borrowed funds.

[b]Excludes net cash receipts.

[c]This value represents the taxes that would have been paid by the investor had he not been able to offset other income with losses in the beef breeding herd investment.

[d]Represents the total net monetary returns to the investor, computed as follows: Net benefit = cash received - cash disbursed + net worth change - income tax (farm share) + non-farm tax saving.

[e]Average yearly net benefit divided by average yearly owned investment

does this investment have on the beef industry and society? Though data to answer these questions is inadequate, some information is available from two sources: the Internal Revenue Service and the Securities and Exchange Commission.

EXTENT OF NONFARM INVESTMENT CAPITAL IN BEEF BREEDING HERDS

The 1969 Federal income tax returns showed that 75 percent of some 7,614 individuals with

farming activities (as demonstrated by filing schedule F with their 1969 Federal income tax returns) and who also had adjusted gross incomes over $100,000 reported farm losses totaling $117 million. An additional 13, 187 individuals with adjusted gross incomes between $50,000 and $100,000 reported $124 million in farm losses [2]. The majority of these losses were generated from activities classified as "livestock farms."

The Securities and Exchange Commission (SEC) ruled several years ago that offerings of limited partnership interests and agency services represented securities which had to be registered and cleared with SEC in the same way as the sale of common stock.[7] Prospectuses from 10 different beef cattle investment companies whose offerings appeared in 1970 and 9 whose offerings appeared as of September 1971 were obtained from SEC.

The offerings vary as to what functions the investor and the investment company provide. In some, the investor purchases a limited partnership interest. Others provide "agency services" where the investment company acts as agent for an investor in making a contract between the investor and a rancher or a management company to obtain and manage a herd of cattle. Still another offers common stock in a company which owns and manages cattle and other interests.

Most of the prospectuses indicate the maximum amount of initial capital being sought. Taking the 19 different offerings as a group, if all units were sold, about $114 million of equity capital would be raised. Assuming this could be used as collateral for borrowing at a ratio of 3 to 1, this amount could support a total fund of $456 million, which is no small infusion into the U.S. beef cattle industry.

EFFECTS OF NONFARM INVESTMENT ON THE BEEF INDUSTRY AND SOCIETY

These numbers are upper limits because some of these offerings have not as yet received SEC clearance, all of the units offered may not be sold, and some of the offerings may be withdrawn. Furthermore, the number represented does not imply that there will be an increase of that magnitude in current beef cow numbers. The numbers of beef cows are in large part determined by the amount of available rangeland usable for grazing purposes. Typically, these offerings propose to place animals on ranches and utilize Federal and state grazing permits which have heretofore been utilized by ranchers; the only difference is that nonfarm investors own the animals, rather than the ranchers.

Many ranchers have seen that their profits can be increased by renting out their land and grazing permits to cattle investment companies and hiring out their labor on their own ranch to these companies. In this case, cattle numbers would not be increased unless land and grazing permits were previously not being used to capacity. With a tremendous influx of new capital into the industry, it is conceivable that ranchers who have land which is marginal between grazing and cropping and whose returns could be increased or made more secure, may become involved with cattle investment companies who wish to use their land and labor resources. In this case, it is likely that cattle numbers would be increased, though gradually over time.

Whenever a contract is effected between a nonfarm investor and a beef cattle management or investment company, at least six segments of society are affected in some degree in terms of revenues: (1) the investor, who is assured of neither profits nor loss; (2) the investment company, who is usually assured of profits as long as it stays in business, since its revenues are typically taken off the top, regardless of the returns to the investor; (3) the U.S. Treasury, which is assured of a loss of revenues which would have been received had not investors found a tax shelter for their income; (4) the ranch owner, who by renting out his land and grazing rights, is typically assured a net return higher (or more secure) than he could have received had he owned the animals being placed on his ranch; (5) the cattle raising industry (partly composed of individual ranchers who depend on their ranch income as their main source of livelihood), who may be placed at a competitive disadvantage due to an increased demand for inputs for producing beef animals and a reduced product price due to increased production; and (6) the consumer of beef products, who will pay more or less for beef products depending on whether the quality and quantity of beef animals are affected by the infusion of additional capital into the beef industry.

From society's standpoint, the pluses and minuses of each of the above six segments (and several more) must be added up in determining whether the income tax subsidies and incentives relative to beef breeding herds are in the public interest.

[7] The SEC does not pass upon the merits of individual offerings, but is concerned with the compliance by the issuer with statutory standards of fair and adequate disclosure to the public of provisions of the offerings.

Data are not available to approximate the benefits and costs associated with all sectors of society, but let us use our simulated nonfarm investor described elsewhere in this report as an example to determine the pluses and minuses for two of the above sectors (the nonfarm investor and the Federal treasury). Table 2 indicates the sources of loss to the Federal treasury and the offsetting gain (if any) to the investor, for the current tax law and for various alternatives to the current tax law. In terms of revenues not received, the loss to the Federal treasury as a result of investment in beef breeding herds by the nonfarm investor, far outweighs any benefits to the nonfarm investor from this investment. If other sectors are ignored, this represents a substantial cost to society.

Table 2 LOSS TO THE FEDERAL TREASURY AND GAINS TO THE NONFARM INVESTOR AS A RESULT OF NONFARM INVESTMENT IN BEEF BREEDING HERDS, FOR VARIOUS INCOME TAX BRACKETS AND PROVISIONS OF THE TAX LAW[a]

	Current law	Current law except for provisions of			
		Capital gain	Income averaging	Nonfarm tax saving	All three
	Total over 15 years ($1000)				
Loss to Federal treasury					
From using farm losses to Offset nonfarm income					
32% bracket	52	43	52	0	0
50% bracket	94	77	94	0	0
70% bracket	141	114	141	0	0
From reduced farm taxes[b]					
32% bracket	35	25	21	35	0
50% bracket	38	27	23	38	0
70% bracket	34	22	28	34	0
Total					
32% bracket	87	68	73	35	0
50% bracket	132	104	117	38	0
70% bracket	175	136	169	34	0
Gain to nonfarm investor[c]					
32% bracket	-47	-65	-61	-98	-133
50% bracket	-5	-34	-21	-100	-138
70% bracket	27	-12	21	-114	-148

[a]This case is the same as reported in Table 1. Ignored are the gains and losses associated with other segments of society, including an expected increase in net income (and taxes paid) of ranch owners on whose land the managed cattle are kept and of the management company itself.

[b]Assumed that maximum income taxes (farm share) would have been paid if provisions of capital gain and income averaging had been excluded from the tax law. These figures represent the reduction in those maximum taxes under the current law, under the current law less capital gains provisions, etc.

[c]Net benefit recorded in Table 1.

SUMMARY AND CONCLUSIONS

This paper (1) examines the income tax aspects of investments in beef cow herds; (2) determines, under various assumptions, whether an economic incentive for beef cow herd investment exists in the absence of special tax rules; and (3) points out some of the consequences for the beef industry and society of nonfarm investment in beef breeding herds.

A "background" section establishes the special tax provisions which entice high bracket nonfarm investors to invest in farm enterprises. IRS and SEC data are used to indicate the extent of capital from

nonfarmers entering agriculture with a focus on investment in beef breeding herds.

A computer simulator is used to trace the initial investment in 100 beef cows over a 15-year period by a nonfarm investor. Singled out for their individual and combined effects on "net benefit" of the nonfarm investor and cost to the Federal treasury are provisions of (1) capital gains, (2) offsetting nonfarm income with farm losses, and (3) income averaging.

Results indicate that (1) cost to the Federal treasury far outweighs benefits to nonfarm investors; (2) without provisions of capital gains and offsetting other income with farm losses, the incentive for nonfarm investments in beef cows is destroyed; and (3) investment by a nonfarm investor is not profitable under the current tax shelter provisions unless he is above the 50 percent marginal income tax bracket, even with favorable prices and costs.

REFERENCES

[1] Harrison, Virden L., and W. Fred Woods, "Farm and Nonfarm Investment in Commercial Beef Breeding Herds–Incentives and Consequences of Current Provisions of the Tax Law," forthcoming USDA, ERS Unnumbered Report.

[2] U. S. Treasury Department, Internal Revenue Service, *Statistics of Income Individual Tax Returns, 1969 Preliminary*, Washington: U. S. Gov. Printing Office, 1971, p. 22.