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FARM AND NONFARM INVESTMENT IN COMMERCIAL BEEF BREEDING HERDS: INCENTIVES AND CONSEQUENCES OF THE TAX LAW

U.S. DEPARTMENT OF AGRICULTURE • ECONOMIC RESEARCH SERVICE

ABSTRACT

This report examines the incentives and consequences of investment by farmers and nonfarmers in commercial beef breeding herds. It investigates the profitability of investment in beef cow herds with and without the special tax provisions of capital gains, net operating loss carryover, income averaging, and offsetting nonfarm incomes with farm losses. A computer simulator was used to budget the operations over a 15-year period using several levels of product and input prices. Results indicated that there is no economic incentive for nonfarm investments in commercial beef cow herds through management companies without the special provisions of capital gains and offsetting nonfarm income with farm losses. Even with current provisions of the tax law, nonfarm investment in beef cow herds is not profitable unless the investor is at or above the 50 percent tax bracket. Implications for various sectors of society as a result of nonfarm investment in beef breeding herds are discussed.

Key Words: Nonfarm investment, Tax shelters, Beef cow herds, Farm tax law, Capital gains, Investment incentives, Simulation.

CONTENTS

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SUMMARY

Investments in beef breeding herds, computer simulation studies show, are not profitable for nonfarmer-investors under current tax law provisions except at the 50-percent tax bracket and above, and then only if product prices and input costs are very favorable.

By budgeting operations over a 15-year period using several levels of product and input prices, the computer simulator determined that:

--Without the provision of offsetting farm losses against nonfarm income, nonfarmer-investors would realize a substantial loss even with the most favorable costs and prices. However, the exclusion of this provision has no effect on net benefits to farmer-investors who have no off-farm income.

--Without the capital gains provision, nonfarmer-investors would realize considerable losses except at marginal tax brackets of 50 percent or more, and only under the most favorable price and cost conditions. Even in these cases, the yearly return to owned capital is less than 4 percent. Exclusion of this provision would reduce net benefits to farmer-investors by about 15 percent.

--The net operating loss provision does not benefit nonfarmer-investors and only slightly benefits farmer-investors.

--Exclusion of the income averaging provision would only slightly reduce net benefits to nonfarmer- and farmer-investors.

Given the incentives for nonfarm capital to enter the commercial beef breeding herd industry offered by provisions of the Internal Revenue Code, the loss to the Federal Government, in terms of revenues not received, will continue to far outweigh the monetary benefits to nonfarmer-investors. This implies, all else equal, substantial loss to society.

There is no economic incentive for nonfarm investments in beef breeding herds through management companies without the special rules of capital gains and offsetting nonfarm income with farm losses currently provided by the tax law.

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by

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INTRODUCTION

This report examines the incentives and consequences of investment by farmers and nonfarmers in commercial beef breeding herds under provisions of the current tax law. It attempts to answer the question: "Can nonfarm investors expect to obtain an economic profit by investing in commercial beef breeding herds through a management company without the special tax provisions of capital gains and offsetting nonfarm incomes with farm losses?" This question is of interest to the Government agencies administering the tax provisions and to those segments of society affected by them.

The Internal Revenue Service (IRS) and the Treasury Department must determine whether beef breeding herd investments are legitimate business ventures or activities (hobbies) not engaged in for profit. The Securities and Exchange Commission (SEC) must ascertain whether individual commercial beef breeding herd investment or management companies are accurately describing the facts in their prospectus offerings. 2/ The U.S. Department of Agriculture is concerned that capital flows to agriculture are sufficient to meet the capital needs, but also that individual farmers and ranchers are not placed at a competitive disadvantage by investment capital available from individuals outside the agricultural sector. The investment or management companies acting as managers or brokers for nonfarm investors are sensitive to any changes in the tax laws that might result in a loss of the attractiveness of agricultural investments.

A related question of interest in this report involves the cost to the Federal Government, in terms of tax revenues not received, of current provisions of the tax that make beef cattle investments more favorable for farmers and nonfarmers. Singled out for study of their individual and combined effects on Federal revenues and incentives to investors are provisions of capital gains, offsetting nonfarm income with farm losses, net operating loss carryover, and income averaging.

The findings of this report are based on a computer simulation of investment in a beef cow-calf enterprise over a 15-year period. Nonfarmer-investors in 32, 50, and 70-percent marginal income tax brackets as well as farmer-investors with no off-farm income were simulated. Appendix 1 gives background information on special farm tax rules in the Federal income tax structure, the extent of nonfarm investments in agriculture, and an example of how beef breeding herds may be used as tax shelters.

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2/ 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.

The simulation example assumes that 100 unbred commercial heifers and 5 commercial bulls were purchased in the first year. Thereafter, herd expansion occurred by keeping all heifer calves born during the first 5 years, 75 percent of those born during the second 5 years, and 50 percent of those born in years 11 through 15. By year 15, cow numbers reached 348 head. Bulls were purchased, used for three breeding periods at a ratio of one bull to 20 cows, and sold at 1,800 pounds. Steer and heifer calves not kept for replacement or expansion purposes were sold at weaning at 425 pounds.

The area chosen for study was the Southwest, particularly central New Mexico. Product prices, costs, management techniques, and environmental factors reflect conditions there. Of course, the maintenance charge to nonfarmer-investors resembles like charges anywhere in the United States. Cattle price data are based on New Mexico monthly average prices for appropriate months of purchase or sale, as reported by USDA [2]. Data for input coefficients and management practices were obtained through consultation with experts in Southwest beef cattle systems, notably Wylie D. Goodsell, USDA, and James R. Gray, New Mexico State University. Publications [1, 3] supplemented these data.

Cows were culled at the rate of 17 percent per year. Calf crop to weaning was 87 percent. Death losses were 2 percent for cows and zero for bulls.

The policy on borrowing funds required a 10-percent downpayment on livestock, facilities, and equipment, with the loan to be repaid in five equal yearly payments. All maintenance (operating) costs were paid when incurred. The interest rate on loans was constant at 7 percent.

The depreciation method used was declining balance (with the 20 percent additional first year provision) for all depreciable items except bulls, for which straight-line depreciation was used. The depreciation period was 6 years for purchased cows, 3 for purchased bulls, and 10 years for all facilities and equipment purchased. Salvage values were $180 for cows, $320 for bulls, and zero for facilities and equipment.

The farmer-investor was assumed to own 5,000 acres of land valued at $30 per acre in year 1, increasing in value at 3 percent per year. His beginning debt of $50,000 on land and facilities was assumed to be perpetual in that no principle was paid over the 15-year period. However, both principle and interest were paid on loans made on livestock, facilities, and equipment during the simulation period. The nonfarmer-investor was assumed to own no farm assets except livestock.

Investment in beef breeding animals is highly speculative, with success dependent largely on the future farm price for beef animals. Initial purchase price for breeding stock and operating or maintenance costs are also important factors in the success of the investment. Consequently, for this study three different levels of product prices and two different levels of input prices were used to determine the success of a farmer or nonfarmer-investor. The product price levels are: (1) prices adjusted to begin at 1970 levels, that vary over the 15 years in the same manner as in 1959-70, (2) prices that are constant at 1970 levels, and (3) prices that are constant at 20 percent above 1970 levels.

Input price levels applicable to the nonfarmer-investor represent (1) low constant maintenance fees and low initial heifer cost, and (2) high constant maintenance fees and high initial heifer cost. Input price levels applicable to the farmer-investor are (1) constant input prices at 1970 levels, and (2) increasing input prices beginning at 1970 levels. Appendix tables 2 and 3 indicate the product and input prices used in the simulation.

Arrangement of Tables

Six tables each for the nonfarmer-investor (tables 1-6) and farmer-investor (tables 7-12) represent various combinations of these product and input prices. Tables 1-12 are designed to show the success, in terms of net benefits derived over a 15-year period, for nonfarmer- and farmer-investors purchasing 100 beef cows initially. In addition, each table shows the effect of revoking provisions of the current law regarding capital gains, net operating loss carryover, income averaging, and offsetting nonfarm income with farm losses for various levels of marginal income tax brackets.

Table 3 describes the results of the most favorable case in this report in terms of product and input prices for the nonfarmer-investor; table 9 shows the same for the farmer-investor. There is no real unfavorable case, but table 4 for the nonfarmer-investor and table 10 for the farmer-investor describe results which could occur if prices acted the same as in 1959-70 (adjusted to begin at 1970 levels), and represent the least favorable results. All factors affecting the beef herd investment, other than those listed above, were identical for all cases illustrated in tables 1-12.

Tables 13 and 14, derived from tables 2 and 8 (nonfarmer- and farmer-investor, respectively), give an indication of costs to the Federal Government, in terms of revenues not received, and of the gain by the investors in a beef breeding herd under current and altered provisions of the Internal Revenue Code.

Results of the Simulation Study

Conclusions to be drawn from the foregoing tables are clear. Investment in commercial beef breeding herds is not profitable under current law in terms of aftertax net benefit for nonfarmer-investors except at the 50-percent tax bracket and above, and then only if product prices and input costs approach the most favorable ones assumed in the analysis. These results, of course, reflect the assumptions made in the analysis.

In the most realistic case (table 5--product prices constant at 1970 levels and high input costs) the nonfarmer-investor has a net loss regardless of his income tax bracket. Had the 70-percent bracket investor remained in business the whole 15 years, his accumulated beforetax loss would be $275,000 and his aftertax loss would be $31,000. Had the investor's tax bracket been 50 or 32 percent, his aftertax losses would be considerably higher.

Under the same cost conditions, but at a product price constant at 20 percent above 1970 levels (table 6), only the 70-percent bracket investor would have made a profit. However, this $8,000 net benefit represents only a 1.1-percent average yearly return to owned capital.

If the law were changed to exclude the provision of offsetting nonfarm income with farm losses, nonfarmer-investors (tables 1-6) would realize a substantial loss (i.e., negative net benefit) even with the most favorable price and cost conditions 3/ The inclusion or exclusion of this provision has no effect on net benefit of a farmer-investor with no off-farm income.

3/ These conclusions reflect the provision of the Tax Reform Act of 1969 which requires an excess deductions account (EDA) for taxpayers with nonfarm incomes exceeding $50,000 and farm losses exceeding $25,000. The EDA is used to convert capital gain into ordinary income to the extent of funds in the EDA. In this study, this provision applies only to the 70 percent bracket taxpayer and has very little effect in recapturing taxable income which was offset by farm losses, since only in a few years for certain cases did farm losses exceed $25,000.

Table 1--Net benefits received from investing in a beef cow herd, nonfarmer-investor, produce price variable, low maintenance fee, low initial heifer cost

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	428	428	428	428	428	428
Cash disbursed 1/	559	559	559	559	559	559
Net, pre-tax	-131	-131	-131	-131	-131	-131
Net worth change 2/	0	0	0	0	0	0
Income tax (farm share)						
32% bracket	7	16	7	18	7	35
50% bracket	8	18	8	20	8	40
70% bracket	22	33	22	23	22	49
Nonfarm tax saving 3/						
32% bracket	56	48	56	56	0	0
50% bracket	103	87	103	103	0	0
70% bracket	156	131	156	156	0	0
Net benefit 4/						
32% bracket	-82	-98	-82	-98	-138	-166
50% bracket	-35	-62	-35	-47	-139	-171
70% bracket	4	-33	4	3	-152	-180
Receipts, ordinary income	294	428	294	294	294	428
Receipts, capital gain	134	0	134	134	134	0
Net operating loss used	0	0	0	0	0	0
Return to owned capital 5/	Average yearly percent					
32% bracket	-6.20	-7.25	-6.20	-7.04	-7.87	-9.49
50% bracket	-3.99	-6.02	-3.99	-5.38	-7.92	-9.77
70% bracket	.71	-5.09	.71	.48	-8.70	-10.27

1/ Before income tax. Includes all cash expenses including downpayments on livestock, facilities (if farmer-investor), and interest and principal on borrowed funds. 2/ Excludes net cash receipts. 3/ 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. 4/ Represents the total net monetary returns to the investor, computed as follows: Net benefit equals cash received minus cash disbursed plus net worth change minus income tax (farm share) plus nonfarm tax saving. 5/ Average yearly net benefit divided by average yearly owned investment.

Table 2.--Net benefits received from investing in a beef cow herd, nonfarmer-investor, product prices constant at 1970 levels, low maintenance fee, low initial heifer cost

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	469	469	469	469	469	469
Cash disbursed 1/	557	557	557	557	557	557
Net, pre-tax	-88	-88	-88	-88	-88	-88
Net worth change 2/	0	0	0	0	0	0
Income tax (farm share)						
32% bracket	10	20	10	24	10	45
50% bracket	12	23	12	27	12	50
70% bracket	26	38	26	32	26	60
Nonfarm tax saving 3/						
32% bracket	52	43	52	52	0	0
50% bracket	94	77	94	94	0	0
70% bracket	141	114	141	141	0	0
Net benefit 4/						
32% bracket	-47	-65	-47	-61	-98	-133
50% bracket	-5	-34	-5	-21	-100	-138
70% bracket	27	-12	27	21	-114	-148
Receipts, ordinary income	324	469	324	324	324	469
Receipts, capital gain	145	0	145	145	145	0
Net operating loss used	0	0	0	0	0	0
Return to owned capital 5/	Average yearly percent					
32% bracket	-3.99	-5.53	-3.99	-5.20	-6.38	-8.63
50% bracket	-.67	-3.86	-.67	-2.59	-6.47	-8.97
70% bracket	6.21	-2.16	6.21	4.78	-7.37	-9.60

Footnotes to table 1 apply.

Table 3.--Net benefits received from investing in a beef cow herd, nonfarmer-investor, product prices constant at 20 percent above 1970 levels, low maintenance fee, low initial heifer cost

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	562	562	562	562	562	562
Cash disbursed 1/	564	564	564	564	564	564
Net, pre-tax	-2	-2	-2	-2	-2	-2
Net worth change 2/	0	0	0	0	0	0
Income tax (farm share)						
32% bracket	17	32	17	36	17	64
50% bracket	20	37	20	40	20	71
70% bracket	35	54	35	47	35	83
Nonfarm tax saving 3/						
32% bracket	39	28	39	39	0	0
50% bracket	70	49	70	70	0	0
70% bracket	103	72	103	103	0	0
Net benefit 4/						
32% bracket	21	-6	21	2	-19	-66
50% bracket	48	10	48	29	-22	-73
70% bracket	66	16	66	55	-37	-85
Receipts, ordinary income	384	562	384	384	384	562
Receipts, capital gain	178	0	178	178	178	0
Net operating loss used	0	0	0	0	0	0
Return to owned capital 5/	Average yearly percent					
32% bracket	2.44	-0.67	2.44	0.24	-1.78	-6.19
50% bracket	8.44	1.45	8.44	5.01	-2.06	-6.82
70% bracket	24.06	3.70	24.06	19.90	-3.49	-7.91

Footnotes to table 1 apply.

Table 4.--Net benefits received from investing in a beef cow herd, nonfarmer-investor, product prices variable, high maintenance fee, high initial heifer cost

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	429	429	429	429	429	429
Cash disbursed 1/	746	746	746	746	746	746
Net, pre-tax	-317	-317	-317	-317	-317	-317
Net worth change 2/	0	0	0	0	0	0
Income tax (farm share)						
32% bracket	3	10	3	9	3	25
50% bracket	0	9	0	11	0	30
70% bracket	8	20	8	11	8	37
Nonfarm tax saving 3/						
32% bracket	70	70	70	70	0	0
50% bracket	163	152	163	163	0	0
70% bracket	267	249	267	267	0	0
Net benefit 4/						
32% bracket	-250	-258	-250	-256	-320	-343
50% bracket	-154	-174	-154	-165	-317	-347
70% bracket	-59	-88	-59	-61	-326	-354
Receipts, ordinary income 5/						
32 and 50% bracket	297	429	297	297	297	429
70% bracket	316	429	316	316	316	429
Receipts, capital gain 5/						
32 and 50% bracket	132	0	132	132	271	0
70% bracket	113	0	113	113	291	0
Net operating loss used	0	0	0	0	0	0
Return to owned capital 6/	Average yearly percent					
32% bracket	-10.08	-10.39	-10.08	-10.34	-8.02	-8.58
50% bracket	-8.50	-9.35	-8.50	-9.12	-7.95	-8.69
70% bracket	-5.59	-7.78	-5.59	-5.80	-8.16	-8.88

Footnotes to table 1 apply. 5/ These receipts would have been the same for investors in all three income tax brackets, except for the provision in the Internal Revenue Code dealing with persons with nonfarm incomes exceeding $50,000 and the excess deductions account required for farm losses in excess of $25,000. The investor in the 70-percent bracket was the only one affected by that provision. 6/ Average yearly net benefit divided by average yearly owned investment.

Table 5.--Net benefits received from investing in a beef cow herd, nonfarmer-investor, product prices constant at 1970 levels, high maintenance fee, high initial heifer cost

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	469	469	469	469	469	469
Cash disbursed 1/	743	743	743	743	743	743
Net, pre-tax	-275	-275	-275	-275	-275	-275
Net worth change 2/	0	0	0	0	0	0
Income tax (farm share)						
32% bracket	6	14	6	16	6	34
50% bracket	3	14	3	18	3	39
70% bracket	13	25	13	20	13	48
Nonfarm tax saving 3/						
32% bracket	70	70	70	70	0	0
50% bracket	157	144	157	157	0	0
70% bracket	256	232	256	256	0	0
Net benefit 4/						
32% bracket	-210	-219	-210	-221	-280	-309
50% bracket	-121	-144	-121	-136	-278	-314
70% bracket	-31	-68	-31	-39	-287	-323
Receipts, ordinary income 5/						
32 and 50% bracket	325	469	325	325	325	469
70% bracket	330	469	330	330	330	469
Receipts, capital gain 5/						
32 and 50% bracket	144	0	144	144	144	0
70% bracket	139	0	139	139	139	0
Net operating loss used	0	0	0	0	0	0
Return to owned capital 6/	Average yearly percent					
32% bracket	-9.25	-9.22	-9.25	-9.72	-9.30	-10.26
50% bracket	-7.31	-8.42	-7.31	-8.21	-9.21	-10.42
70% bracket	-3.30	-6.43	-3.30	-4.06	-9.53	-10.70

Footnotes to tables 1 and 4 apply.

Table 6.--Net benefits received from investing in a beef cow herd, nonfarmer-investor, product prices constant at 20 percent above 1970 levels, high maintenance fee, high initial heifer cost

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	562	562	562	562	562	562
Cash disbursed 1/	751	751	751	751	751	751
Net, pre-tax	-189	-189	-189	-189	-189	-189
Net worth change 2/	0	0	0	0	0	0
Income tax (farm share)						
32% bracket	11	23	11	26	11	52
50% bracket	11	25	11	29	11	58
70% bracket	22	38	22	34	22	68
Nonfarm tax saving 3/						
32% bracket	69	63	69	69	0	0
50% bracket	139	120	139	139	0	0
70% bracket	219	188	219	219	0	0
Net benefit 4/						
32% bracket	-130	-149	-130	-146	-199	-240
50% bracket	-60	-93	-60	-79	-199	-246
70% bracket	8	-39	8	-4	-211	-256
Receipts, ordinary income 5/						
32 and 50% bracket	386	562	386	386	386	562
70% bracket	391	562	391	391	391	562
Receipts, capital gain 5/						
32 and 50% bracket	176	0	176	176	176	0
70% bracket	171	0	171	171	171	0
Net operating loss used	0	0	0	0	0	0
Return to owned capital 6/	Average yearly percent					
32% bracket	-6.79	-7.24	-6.79	-7.59	-8.17	-9.85
50% bracket	-4.34	-6.32	-4.34	-5.71	-8.16	-10.08
70% bracket	1.10	-4.25	1.10	-.50	-8.63	-10.50

Footnotes to tables 1 and 4 apply.

Table 7.--Net benefits received from investing in a beef cow herd, farmer-investor, product prices variable, constant costs at 1970 levels

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	429	429	429	429	429	429
Cash disbursed 1/	449	449	449	449	449	449
Net, pre-tax	-21	-21	-21	-21	-21	-21
Net worth change 2/	67	67	67	67	67	67
Income tax	0	8	8	0	0	31
Nonfarm tax saving 3/	0	0	0	0	0	0
Net benefit 4/	46	38	38	46	46	15
Receipts, ordinary income	294	429	294	294	294	429
Receipts, capital gain	135	0	135	135	135	0
Net operating loss used	44	33	0	44	44	0
Land appreciation	67	67	67	67	67	67
	Average yearly percent					
Return to owned capital 5/	1.45	1.20	1.20	1.45	1.45	0.48

Footnotes to table 1 apply.

Table 8.--Net benefits received from investing in a beef cow herd, farmer-investor, product prices constant at 1970 levels, constant costs at 1970 levels

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	469	469	469	469	469	469
Cash disbursed 1/	448	448	448	448	448	448
Net, pre-tax	21	21	21	21	21	21
Net worth change 2/	67	67	67	67	67	67
Income tax	2	13	11	2	2	40
Nonfarm tax saving 3/	0	0	0	0	0	0
Net benefit 4/	87	75	78	86	87	49
Receipts, ordinary income	323	469	323	323	323	469
Receipts, capital gain	146	0	146	146	146	0
Net operating loss used	47	23	0	47	47	0
Land appreciation	67	67	67	67	67	67
	Average yearly percent					
Return to owned capital 5/	2.92	2.52	2.61	2.90	2.92	1.63

Footnotes to table 1 apply.

Table 9.--Net benefits received from investing in a beef cow herd, farmer-investor, product prices constant at 20 percent above 1970 levels, constant costs at 1970 levels

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	562	562	562	562	562	562
Cash disbursed 1/	454	454	454	454	454	454
Net, pre-tax	109	109	109	109	109	109
Net worth change 2/	66	66	66	66	66	66
Income tax	12	29	16	23	12	59
Nonfarm tax saving 3/	0	0	0	0	0	0
Net benefit 4/	163	146	159	152	163	115
Receipts, ordinary income	383	562	383	383	383	562
Receipts, capital gain	179	0	179	179	179	0
Net operating loss used	17	11	0	17	17	0
Land appreciation	67	67	67	67	67	67
	Average yearly percent					
Return to owned capital 5/	5.94	5.32	5.78	5.52	5.94	4.18

Footnotes to table 1 apply.

Table 10.--Net benefits received from investing in a beef cow herd, farmer-investor, product prices variable, increasing costs beginning at 1970 levels

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	429	429	429	429	429	429
Cash disbursed 1/	487	487	487	487	487	487
Net, pre-tax	-59	-59	-59	-59	-59	-59
Net worth change 2/	67	67	67	67	67	67
Income tax	0	3	7	0	0	27
Nonfarm tax saving 3/	0	0	0	0	0	0
Net benefit 4/	8	5	1	8	8	-19
Receipts, ordinary income	294	429	294	294	294	429
Receipts, capital gain	135	0	135	135	135	0
Net operating loss used	38	51	0	38	38	0
Land appreciation	67	67	67	67	67	67
	Average yearly percent					
Return to owned capital 5/	0.24	0.16	0.04	0.24	0.24	-0.57

Footnotes to table 1 apply.

Table 11.--Net benefits received from investing in a beef cow herd, farmer-investor, product prices constant at 1970 levels, increasing costs beginning at 1970 levels

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	469	469	469	469	469	469
Cash disbursed 1/	486	486	486	486	486	486
Net, pre-tax	-17	-17	-17	-17	-17	-17
Net worth change 2/	67	67	67	67	67	67
Income tax	0	7	9	0	0	36
Nonfarm tax saving 3/	0	0	0	0	0	0
Net benefit 4/	50	44	41	50	50	14
Receipts, ordinary income	323	469	323	323	323	469
Receipts, capital gain	146	0	146	146	146	0
Net operating loss used	52	45	0	52	52	0
Land appreciation	67	67	67	67	67	67
	Average yearly percent					
Return to owned capital 5/	1.61	1.39	1.31	1.61	1.61	0.46

Footnotes to table 1 apply.

Table 12.--Net benefits received from investing in a beef cow herd, farmer-investor, product prices constant at 20 percent above 1970 levels, increasing costs beginning at 1970 levels

Item	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Cash received	562	562	562	562	562	562
Cash disbursed 1/	492	492	492	492	492	492
Net, pre-tax	71	71	71	71	71	71
Net worth change 2/	66	66	66	66	66	66
Income tax	5	22	14	9	5	53
Nonfarm tax saving 3/	0	0	0	0	0	0
Net benefit 4/	131	114	122	128	131	84
Receipts, ordinary income	383	562	383	383	383	562
Receipts, capital gain	179	0	179	179	179	0
Net operating loss used	40	12	0	40	40	0
Land appreciation	67	67	67	67	67	67
	Average yearly percent					
Return to owned capital 5/	4.54	3.96	4.23	4.42	4.54	2.90

Footnotes to table 1 apply.

Table 13.--Loss to the Federal Treasury and gains to the nonfarmer-investor as a result of investment in a beef cow herd, various income tax brackets and tax law provisions 1/

Losses and gains	Current law	Current law except for provisions of:			
		Capital gain	Income averaging	Nonfarm tax saving	All three
	Total over 15 years ($1,000)				
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 2/					
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 3/					
32% bracket	-47	-65	-61	-98	-133
50% bracket	-5	-34	-21	-100	-138
70% bracket	27	-12	21	-114	-148

1/ This case is the same as reported in table 2. Ignored are the gains and losses of other segments of society, notably an expected increase in incomes and taxes paid by management companies and by ranch owners on whose land the managed herd is kept.

2/ Assume that maximum income taxes (farm share) would have been paid if provisions of capital gain, net operating loss, 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.

3/ Net benefit recorded in table 2.

Table 14.--Loss to the Federal Treasury and gains to the farmer-investor as a result of investment in a beef cow herd, various tax law provisions 1/

Losses and gains	Current law	Current law except for provisions of:				
		Capital gain	Net operating loss carryover	Income averaging	Nonfarm tax saving	All four
	Total over 15 years ($1,000)					
Loss to Federal Treasury:						
From using farm losses to offset nonfarm income	0	0	0	0	0	0
From reduced farm taxes 2/	38	27	29	38	38	0
Total	38	27	29	38	38	0
Gain to farmer-investor 3/	87	75	78	86	87	49

1/ This case is the same as reported in table 8.

2/ See footnote 2, table 13.

3/ Net benefit as recorded in table 8.

If from the current law, the provision of capital gain was excluded, nonfarmer-investors would realize substantial losses except at a marginal tax bracket of 50 percent or more and under the most favorable price and cost conditions assumed. Even under those conditions, the average yearly return to owned capital is less than 4 percent. Exclusion of the capital gain provision would also reduce the net benefits of farmer-investors by about 15 percent.

The net operating loss carryover provision is of no benefit to nonfarmer-investors who have positive total income. It is of some benefit to farmer-investors.

The exclusion of the income averaging provision would only slightly reduce the net benefit of nonfarmer-investors or farmer-investors.

As a result of Internal Revenue Code provisions providing incentives for nonfarm capital to enter the commercial beef breeding herd industry, the loss to the Federal Government, in terms of revenues not received, far outweighs the monetary benefit to nonfarmer-investors (table 13). This implies, other things equal, a substantial cost to society. The gain to farmer-investors, on the other hand, exceeds the loss in tax revenues to the Federal Government (table 14).

If one provision were to be selected for exclusion from the tax law to reduce the loss to the Federal Treasury, the provision of offsetting nonfarm income with farm losses would be the most likely candidate. The exclusion of this provision would completely destroy the incentive for the use of agricultural investments to reduce taxes from high nonfarm incomes; and it would have no effect on the net benefit of farmers who have no off-farm income. It would, however, reduce the net benefit of farmers who have off-farm income to the extent that their tax is reduced by offsetting farm losses against other income.

Implications for Nonfarm Investment in Beef Breeding Herds

If economic profits are indeed nonexistent for nonfarm investments in commercial beef breeding herds through management companies without the special tax provisions of capital gains and offsetting nonfarm incomes with farm losses, then the following actions might occur:

(1) The Securities and Exchange Commission might require a statement to that effect in the prospectus offerings of management companies dealing in commercial beef breeding herds.

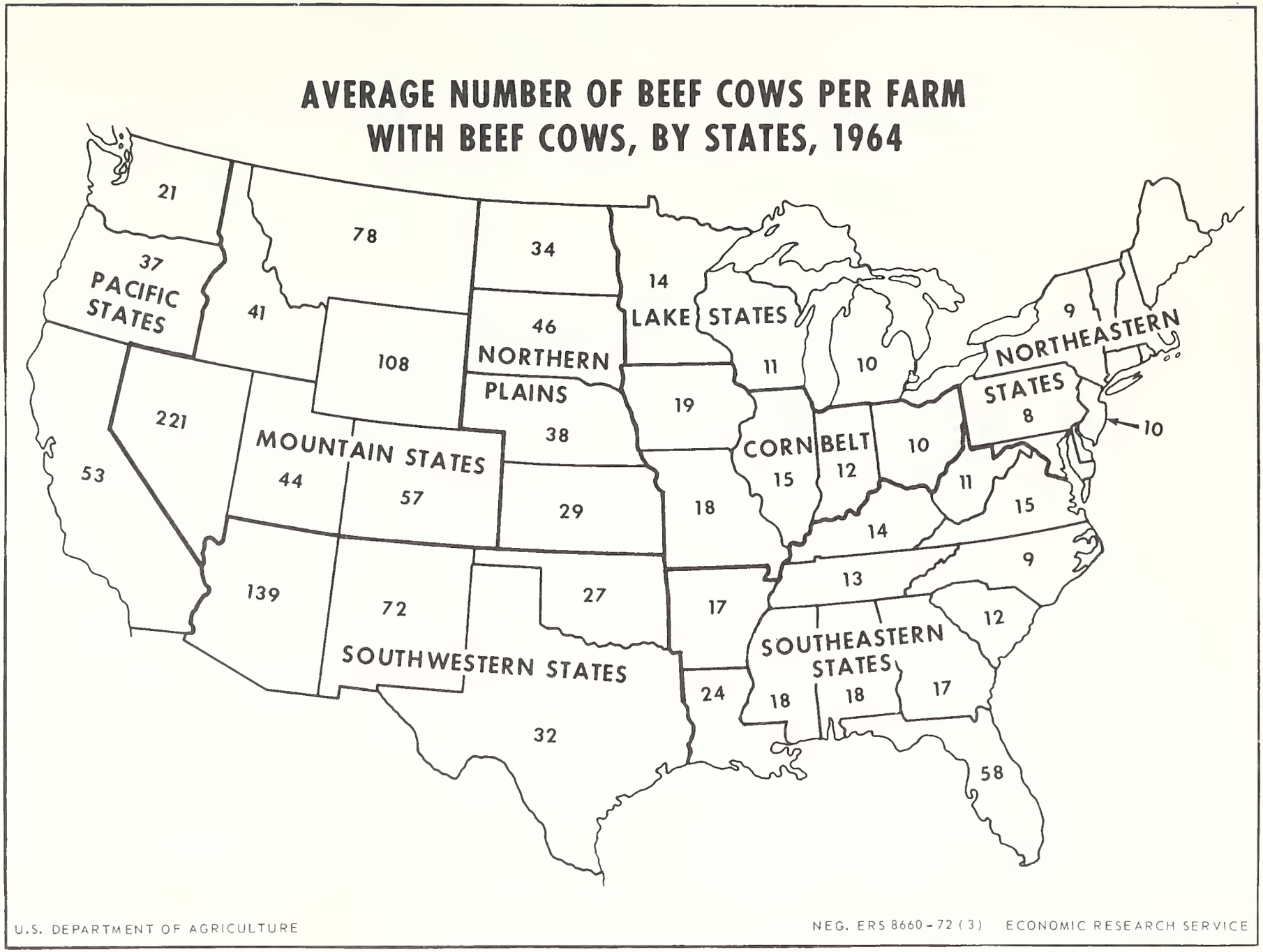
(2) The Internal Revenue Service could consider beef breeding herd investments through management companies by nonfarmers as "activities not engaged in for profit" (e.g., a hobby). The current law limits hobby deductions to the extent of hobby income. 4/

(3) Nonfarm investors will search elsewhere for tax preference investments, especially if (1) or (2) occurs.

If investment from nonfarm investors through management companies is greatly reduced or ceases altogether, it is not likely to have a significant adverse effect on the beef cattle numbers, beef prices, or returns to legitimate beef cattle producers in general. 5/ Contrary to its popular image, the average beef cow herd is quite small. In 1964, one-bull herds of 15 to 20 beef cows typified enterprises in the eastern half of the United States and much of the remainder of the country (fig. 1).

4/ However, some hobby expenses such as taxes, interest, and casualty losses are deductible beyond the limit. An activity is presumed not to be a hobby if profits result in 2 out of 5 consecutive years, unless the IRS proves otherwise.

5/ More precise analysis on these factors is not possible unless the amount of nonfarmer-investment in commercial beef breeding herds is known.


AVERAGE NUMBER OF BEEF COWS PER FARM WITH BEEF COWS, BY STATES, 1964
21
37
PACIFIC STATES
78
41
34
46
NORTHERN PLAINS
108
38
14
LAKE STATES
11
10
9
NORTHEASTERN STATES
8
10
221
53
MOUNTAIN STATES
44
57
29
19
18
CORN BELT
15
12
10
11
15
14
9
13
139
72
27
17
SOUTHWESTERN STATES
32
24
SOUTHEASTERN STATES
18
18
17
12
58
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Only in a few Mountain States where single-enterprise cattle ranches prodominate did the average herd size exceed the 100-cow level. Even in Texas, which boasts some of the largest cattle ranches in the country, 86 percent of the farmers and ranchers with cows had fewer than 50 head in 1964 (4, p. 11).

The significance of these data is twofold. First, most beef cows are presently in small herds on crop-livestock farms even in regions where cattle ranching is important. Second, the small herd size is indicative of the continuing supplementary character of feeder cattle production on a high percentage of farms. Thus, the bulk of beef cattle producers would be unaffected if funds from nonfarm investors in beef breeding herds were channeled elsewhere.

Currently, when a contract is made between a nonfarm investor and a commercial beef cattle management or investment company, several segments of society may be affected in some degree in terms of revenues. These include: (1) the nonfarm investor, who (according to our results) may obtain a positive net benefit under the current tax provisions, especially if he is in a high tax bracket; (2) the investment company, which is assured of profits as long as it stays in business, since its revenues are typically taken off the top regardless of the return to the investor; (3) the U.S. Treasury, which is assured of a loss of revenues that would have been received had not investors found a tax shelter for their income; 6/ (4) the ranch owner on whose land the animals are kept, 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) certain other individual ranchers who may be put at a competitive disadvantage due to actions of the management company; and (6) consumers, who pay more or less for beef products depending on whether the quantity or quality of beef animals are affected by the infusion of additional capital into the industry.

The gains and losses of the above six segments (and several more) must be evaluated to determine whether the sheltering of nonfarm income by investments in beef breeding herds is in the public interest. Data are not available to approximate the benefits and costs associated with all sectors of society. Table 13 indicates to some extent the pluses and minuses for two sectors--the nonfarm investor and the Federal Treasury. In terms of revenues not received, the loss to the Federal Treasury as a result of investment in a commercial beef breeding herd by nonfarm investors far outweighs any benefits nonfarm investors may accrue from this investment.

6/ Of course, additional taxes may be paid by the management company and the ranch owner on whose land the animals are kept.

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APPENDIX 1. FEDERAL INCOME TAX STRUCTURE AND AGRICULTURE

Federal income tax is the major producer of revenue to finance Federal expenditures. Taxes, including Federal income tax, can also assist in attaining 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 by nonfarmers 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 (now disallowed for citrus and almond growers) and (3) legislative action in 1951 3/ expanding the category of assets used in a trade or business and that may be entitled to capital gains treatment upon sale to include livestock held for draft, breeding, or dairy purposes.

The first two 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, i.e., marginal tax rates increase coincidentally with income. This 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, graduated or progressive income tax rates provide 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 expanse. If he does not spend it, a portion must be paid as income tax. If the taxpayer is in the 70-percent 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 bracket taxpayer. If he does not make the deductible expenditure, he must pay $14 as a tax. The real cost of a $100 business expenditure, then, is $86. Thus, the graduated income tax system results in a tax subsidy for business expenditures, where the amount of benefit is directly proportional to the size of the tax bracket. It nonetheless encourages investment, especially for high-bracket taxpayers.

A second area of preference deals with the tax treatment given the gain realized upon sale of capital assets. Not only are capital gains taxed at more favorable rates than ordinary income, but high-income taxpayers receive a proportionately greater benefit from this provision. All individuals realizing capital gains 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 high-bracket taxpayers.

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).]
4/ When a taxpayer's capital gain exceeds $50,000, the rate on the excess is 35 percent.

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

Regardless of the original intent behind special farm tax rules and regulations, questions of tax equity have been raised and the charge made that the special rules foster unfair competition for genuine farm operators. 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 farm investment.

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 industry. As an example of the way the tax law allows a reduction in taxes for high-bracket nonfarmers who invest in beef breeding herds, appendix table 1 shows the financial statement totaled over 15 years for a 70-percent marginal bracket nonfarmer-investor. This table provides more detail concerning the simulated case described in text table 2.

Net cash receipts for the nonfarmer-investor are $114,000 for the 15-year period. However, because of the many years of negative net farm returns, the investor has been able to offset nonfarm income and realize a tax saving on this income of $141,000. His net benefit from the investment for the 15-year period is thus $27,000. His average yearly return to owned investment is 6.21 percent.

Nonfarm Investors in Beef Cattle Breeding Herds

"Nonfarm investors" are those 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:

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

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), 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. 5/ The majority of these losses were generated from activities classified as "livestock farms."

The Securities and Exchange Commission 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. Prospectuses from 10 different beef cattle investment companies whose offerings appeared in 1970, and 9 whose offerings appeared in the first 8 months of 1971, were obtained from the 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, about $114 million of equity capital would be raised if all units were sold. 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, a significant infusion into the U.S. beef cattle industry.

5/ Internal Revenue Service, "Statistics of Income, Individual Income Tax Returns, 1969 Preliminary," U.S. Treasury Department, p. 22.

Appendix table 1.--Financial statement for 15 years of investment in a beef breeding herd 1/

Costs and returns	Total
	Thousand dollars
Total cash receipts	
Calf sales	272
Cow sales	167
Other livestock sales	30
Total	469
Total cash expenses	
Maintenance fees	488
Interest	10
Principal	53
Livestock downpayment	6
Income tax (70% bracket)	26
Total	583
Net cash receipts	-114
Nonfarm income tax saving	141
Net benefit	27

1/ This case is the same as reported in text table 2. Data pertain to nonfarm investors in the 70-percent bracket with prices constant at 1970 levels, low maintenance fees, and low initial heifer cost.

Appendix table 2.--Beef cattle prices used in the analysis

Year	Cull cows sold $/cwt	Weaner heifer sold $/cwt	Weaner steer sold $/cwt	Cull bulls sold $/cwt	Breeding bull purchased $/bull
	Level A. Prices varying as in 1959-70 but adjusted to begin near 1970 levels				
1	17.50	31.00	31.00	23.00	550
2	16.50	26.00	26.00	20.30	555
3	17.50	27.20	27.20	22.00	560
4	16.30	28.00	28.00	23.00	565
5	15.40	28.00	28.00	23.20	570
6	13.50	22.60	22.60	17.50	575
7	15.40	26.00	26.00	22.30	580
8	17.50	28.70	28.70	25.20	585
9	17.00	29.70	29.70	25.10	590
10	19.30	29.50	29.50	25.30	595
11	21.50	32.50	32.50	29.00	600
12	22.50	35.00	35.00	29.00	605
13	17.75	31.20	31.20	23.70	610
14	16.75	26.20	26.20	20.50	615
15	17.75	27.40	27.40	22.20	620
	Level B. Prices constant at 1970 levels				
1-15	19.00	32.00	32.00	27.00	555
	Level C. Prices constant at 20% above 1970 levels				
1-15	22.80	38.40	38.40	32.40	666

Appendix table 3.--Some input costs to farmer- and nonfarmer-investors

Selected costs	First year		Trend per year
	Dollars		Percent
To farmer-investor			
Feed purchased off farm per cow over 2 years	9.00		2.00
Grazing fee per animal over 6 months	3.00		2.00
Marketing fees per animal sold	3.00		2.00
Property taxes per cow, total farm	6.00		2.00
Labor per mature cow 1/	30.00		3.90
Other expenses per cow over 6 months	18.00		3.80
Initial heifer price	160.00		
To nonfarm-investor 2/	Level		
	A	B	
Maintenance fee for animals over 18 months	120	160	2.00
Maintenance fee for animals 6-18 months	100	140	2.00
Initial heifer price	250	400	

1/ Assumes $2.00 per hour hired wage with 3.9 percent increase per year. Family labor was charged at 1.25 times the hired wage rate. Labor hours per cow declined as herd size increased in accordance with the equation: Hours per cow equals 15 minus (.005) (number cows).

2/ Maintenance fees to nonfarmer-investors (based on actual prospectus offerings) include all costs except initial purchase price of the animals. Two levels of maintenance fees were assumed, the higher associated with cases involving increasing input costs and the lower with cases involving constant input costs.

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