Tax loss farming: a perennial problem

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Tax-shelter agricultural investments by nonfarm interests are influenced by such factors as the nature of the operation.

Tax loss farming by wealthy nonfarm investors has been the target of tax reform efforts over the last decade. These reform efforts have resulted in two major tax reform acts with specific provisions for agricultural investments. Agriculture, however, continues to offer tax shelter to the careful high income nonfarm investor. This analysis attempts to briefly summarize evidence on (1) the extent of tax shelter agricultural investments by nonfarm investors, (2) the economic impact of tax loss farming, and (3) tax reform efforts.

Extent of investment

Agricultural investments offer tax shelter for ordinary income through deferral and conversion to capital gains. Cash accounting permits the current deduction of costs that are associated with the production of income in a subsequent tax year. This premature deduction of costs defers realization of taxable income until the following tax year. Ordinary income can be converted to capital gains when development costs of a capital nature are currently deducted from other income (rather than being capitalized) and are subsequently recovered as capital gains upon sale of the asset.

Data related to tax shelter investments in agriculture are limited. Interstate public offerings are registered with the Securities Exchange Commission (SEC). Public offerings sold only intrastate have no SEC registration requirement but may be registered with a state agency. Neither the SEC nor the comparable state agencies publish data on offerings even when registered. Moreover, private placements and small private offerings have no registration requirements.

Examination of aggregate data on individual tax returns, published by the Treasury Department, reveals that the proportion of returns with farm losses increases with increases in gross income, and that taxpayers in the highest income categories have an amazing propensity to lose money farming. Whereas these data have been used to demonstrate that tax loss farming is prevalent, the conclusions that one can draw are necessarily limited.

The staff of the Joint Committee on Internal Revenue Taxation estimated that tax expenditures related to tax shelter investments in agriculture totaled just over $1 billion in fiscal 1976. Of this, $650 million was for expensing capital outlays and $365 million was for capital gains treatment of certain income. The estimated distribution of this subsidy by adjusted gross income class indicates that most (two-thirds to four-fifths) of the benefits probably go to ordinary farmers for whom tax shelter considerations are not the primary incentive.

After the Tax Reform Act of 1969, the limited partnership syndicate became the preferred legal form for public offerings of tax shelter investments to nonfarm investors. Large-scale syndicated offerings for cattle feeding, egg production, vineyard development, and orchard development grew rapidly in numbers and dollar value between 1970 and 1973 (see table). At their peak in 1973, there were at least 76 syndicated agricultural offerings with a maximum value of over $389 million. The total financial impact was much larger, however, because the capital raised by the funds was leveraged: the general partner typically borrowed $3 to $4 for each dollar furnished by investors. The decrease in number and value of offerings in 1974 and 1975 was due to severe losses in cattle feeding and reduced prices for grapes and some orchard crops.

Breeding cattle. Tax shelter investments in beef breeding cattle have received considerable publicity and legislative attention. Despite this publicity, available data indicate that tax shelter breeding cattle have been a relatively insignificant proportion of the total beef breeding herd. This conclusion is based on admittedly sketchy information.

Oppenheimer Industries, Inc., probably the largest breeding cattle management company, reported that they were managing 148,000 cattle in 1969 and 122,000 in 1970. Stanley Penn reported that Black Watch Farms, a registered Angus operation which gained some notoriety with its bankruptcy, managed some 15,000 cattle for 500 investors in 1970. William Scofield's analysis of SEC registrations revealed a total of 13 offerings for beef breeding herds in 1970-71. The maximum number of cattle offered to investors was 14,500 head; the maximum gross volume of the registration was almost $55 million. A special USDA survey of the ownership of breeding cows found that just over one million head of the January 1, 1974 herd of 53.6 million animals were owned by nonfarm interests.

Based on this data and reports of some intrastate offerings and private placements, the maximum number of beef breeding cows owned for tax shelter purposes by nonfarm investors (at any one time) could be estimated at 600,000 head—just over one
percent of the recent number of the U.S. cow herd.

Orchards and vineyards. Tax shelter investments in orchard and vineyard development have been concentrated in particular crops. Citrus and almonds were popular during the late 1960's but tax reform terminated their tax shelter advantages. Investor interest shifted to other crops, especially wine grapes and avocados. There was also significant nonfarm investment in development of walnuts and pistachios.

Scofield found that there were eight limited partnerships to establish orchards and vineyards registered with the SEC in 1970-71. The total acreage to be developed was about 22,000 acres with investor capital of approximately $40 million. Jeanne Dangerfield listed a Who's Who of syndicated farming which included offerings for orchard and vineyard development worth almost $53 million and covering 47,000 acres in California. There was undoubtedly some overlap in the syndicates listed by Scofield and Dangerfield. A large number of smaller syndications sold only within California and private placements were not included in either report.

The economic prospects for a perennial crop tend to outweigh tax considerations in the development decision. For example, total California grape acreage increased 26.6 percent between 1971 and 1976 while almond acreage increased 32.3 percent. Grapes offered tax shelter advantages but almonds did not. The increased acreage of California orchard and vine crops due to income tax incentives, while significant for a few crops, is a comparatively small proportion of total perennial crop acreage. For most perennial crops, the long-run impact on acreage is probably 0 to 5 percent. In the short run, however, the proportion of new plantings due to tax incentives can be much larger because of publicity, large-scale public offerings, and the "bandwagon effect."

Economic impacts

Input prices. Increased investments in crop and livestock enterprises increase demands for land, labor, capital, management services, nursery stock, feed, and feeder cattle. Tax shelter investments contributed to price increases of land suitable for avocados and premium varietal wine grapes. When cattle-feeding syndicates were popular, the traditional late fall decrease in feeder-cattle prices changed to an increase as feedlots attempted to fill their pens at the end of the tax year. Nurseries supplying trees and vines undoubtedly benefited from increased sales. Nursery interests have been involved in some of the large public offerings for orchard and vineyard development.

Product prices. Increased production due to tax incentives reduces product prices, and with inelastic demand, total revenue. Thus, producers' total after-tax income, including incentives, may be lower than it would have been without incentives. Even if the producer group benefits in total, individual producers who do not expand—with smaller or older plantings—may suffer. Consumers and marketing middlemen have benefited from increased production at lower prices.

Management practices. Special farm tax rules have an impact on optimum management practices. Timing of expenditures and sales is important in the maximization of after-tax income. Capital gains treatment for breeding livestock has an impact on culling practices, making it profitable to replace cows earlier than they would otherwise be replaced. The result is a younger age distribution for breeding livestock. There was evidence that the structure of management compensation for cattle feeding funds resulted in actions that were not typical industry practice.

Equity and structure. The income tax incentive is an open-ended subsidy program with the largest subsidy going to the taxpayer with the highest taxable income, whether from farming or other sources. While tax incentives appear to help the small producer, the resulting expansion in output and lower prices quite likely leaves him in a worse position. Any advantages to larger farms will certainly encourage larger and fewer farms.

Syndication problems. There are numerous examples of syndicated tax shelter offerings that have benefited neither agriculture nor the participating nonfarm investors. They have, however, provided a handsome return to those involved in packaging, promoting, and selling the offering. Dangerfield quoted a Los Angeles tax advisor as estimating "that probably half of all tax shelters are of no value—glib promoters can skim as much as 50% as their take." Few investors in agricultural tax shelters have made money, but the promoters have made substantial profits.

Instability. The existence of cycles of production and prices for agricultural products is well-known. Income tax incentives tend to accentuate cycles because investment occurs at a higher-than-normal rate when prices are high and because promoters not familiar with the industry usually ignore the problem of overexpansion until it is too late. The overexpansions of feedlot capacity and wine grape acreage are recent examples.

The legislative approach to agricultural tax reform has been to restrict nonfarm, tax-shelter investment while preserving special farm tax provisions for farmers. Preservation of farm tax rules for farmers has been a relatively complex approach; it is difficult to define a "legitimate farmer." As a result, the reform provisions have tended to be piecemeal, problem-specific, and of mixed effectiveness.

The Tax Reform Act of 1969. The Tax Reform Act of 1969 concentrated on the problem of converting ordinary income to capital gains, especially in livestock and citrus. The tax shelter benefits of breeding livestock, citrus groves, and almond orchards were substantially reduced.

Small and medium investments in orchard and vineyard development (other than citrus and almonds) and investments offering tax deferral (cattle feeding) were largely unaffected by the 1969 act. Investor interest shifted dramatically to large-scale syndicated offerings for cattle feeding, egg production, vineyard development, and orchard development. (The interest in agricultural syndication is reflected by data in the table.)

The Tax Reform Act of 1976. One target of the 1976 act was agricultural tax shelter syndications, especially those using prepaid expenses and nonrecourse loans to realize their objectives. The offering of tax shelter limited partnerships in agriculture, which had declined because of economic conditions from 1974 to 1976, has been effectively curtailed. Individual tax shelter investments in agriculture will continue, however, because the basic tax incentive before the 1976 act remains undisturbed. The individual high income investor can continue to realize the advantages of tax deferral and income conversion in agricultural investments. Likewise, the tax incentives have been preserved for farmers.

Although his legislation was rejected, Senator Metcalf introduced a simple solution in late 1968 which separated farm and nonfarm income. Essentially, the Senator's bill provided that a taxpayer having more than $15,000 of nonfarm income could deduct farm losses from other income only if he used accrual accounting with full capitalization of costs. This approach preserves cash accounting for farmers where a farmer is defined as a taxpayer with farm income and less than $15,000 from nonfarm sources.

The need for tax reform affecting tax incentives for farmers is questionable. Provisions requiring cost capitalization for citrus and almonds were enacted at the request of industry representatives. Leaders in the cattle and egg industries have privately
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Research on the aggregate impact of changing the provisions relating to cash accounting and capital gains treatment is desirable before formulating any recommendations for change. Aspects to be considered include: the price, income and output effects of any change; the relation of the results of any change to farm policy goals concerning food production, income parity between farm and nonfarm sector, and the family farmer; administration of the regulation and changes in tax collections; and changing relationships between agriculture and other sectors of the economy.

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INDEX

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