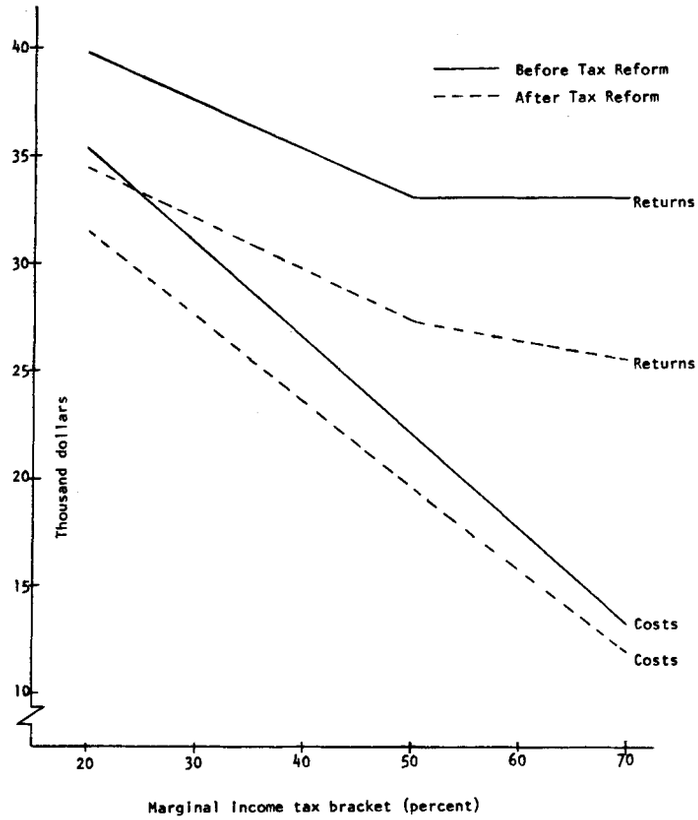

AFTER-TAX COSTS AND RETURNS FOR INVESTMENT IN A 100-COW BREEDING HERD BY MARGINAL INCOME TAX BRACKET OF THE INVESTOR, BEFORE AND AFTER THE TAX REFORM ACT OF 1969

TAX LOSS CATTLE INVEST

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THE INCOME TAX ADVANTAGES of certain agricultural investments and their use by high income investors (including entertainment and political personalities) have been well publicized. One of the most popular investments, the raising of beef breeding cattle, was an obvious target of recent income tax reform efforts—in which four of the eight agricultural provisions were applicable to breeding livestock.

Soon after passage of the Tax Reform Act of 1969, Black Watch Farms, Inc., a large registered Angus sales management firm located in New York State, filed for court protection under bankruptcy laws. It appeared that tax sheltered investments in beef breeding cattle had been dealt a devastating blow. However, recent news releases citing continued use of cattle investments by high income investors to reduce taxes raise several questions.

What are the tax advantages of livestock investments? How does a tax shelter investment in livestock work? What was the effect of Tax Reform on cattle investments? If beef cattle make a good tax shelter investment, why aren't ranchers making money? This article attempts to briefly answer these questions.

Tax shelter investments

Conversion of ordinary income to capital gains is the goal of tax sheltered investments whether they be in apartment houses, oil and gas exploration, or in agriculture. In agriculture, this conversion is usually accomplished through the current deduction of what are essentially capital expenses. When the assets are later sold they have a zero basis and all income is treated as capital gains. Beef breeding cattle fit these requirements. Costs of raising breeding cattle are deductible at the time incurred and purchased breeding stock are depreciable property. Cattle held for breeding purposes for more than two years are considered capital assets and any gain qualifies as capital gains.

Tax reform provisions

The Tax Reform Act of 1969 sought to limit income conversion via livestock investments with four provisions: (1) recapture of excess livestock depreciation; (2) an increase from one to two years in the holding period for cattle to qualify for long-term capital gains treatment; (3) a provision that exchange of male for female calves cannot be made without tax consequences; and (4) the establishment of an excess deductions account (EDA). 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. Other provisions which could affect tax motivated cattle investments include a tightening of hobby loss rules and an increase in the maximum tax rate on capital gains. An examination of the effect of these provisions on a medium-sized investment in beef breeding cattle is included here.

A budgeted example

A budget for a six-year tax sheltered investment in 100 beef breeding cows is shown in the table. A management company purchases bred cows for an investor, places them on a ranch under a maintenance contract, and manages the investment for a fee of 8.5 per cent of gross cash expenditures. The investor makes a down payment of 10 per cent on the cows and pays the balance of the loan in four years. Assumptions used in constructing the table are shown in the footnotes. Changes in maintenance costs, culling rate, prices of cattle, interest rates, or calving percentage will affect the profitability of the investment. While it is relatively simple to dispose of beef breeding cows, a return from the investment depends on maintaining the animals long enough to raise breeding stock. The investor must therefore be willing to tie up

The income tax advantages of cattle investments, and their use by nonfarm investors as a tax shelter, are examined in this study. A budgeted example is included showing that investors continue to realize positive returns, even after passage of the Tax Reform Act of 1969. Tax advantages in cattle investments are the greatest for taxpayers in the highest marginal income tax brackets.

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his money for an intermediate time period.

Total expenses for the six-year investment are $81,074 (see table). This is $17 more than pre-tax income of $81,057 which includes both capital gains and ordinary income. Inclusion of income taxes changes the income-expense situation. The annual losses are deductible from nonfarm income; thus, for a taxpayer in the 70 per cent marginal income tax bracket, each dollar of loss has an after-tax cost of only 30 cents. Before tax reform the investor had after-tax costs of $13,265 and after-tax revenue of $33,153 for a return of $19,888 (table). After-tax costs and returns for investors in other tax brackets are shown by the solid lines in the graph.

Tax reform has no effect on before-tax costs associated with the investment, but it does redistribute income between the capital gains and ordinary income categories. Capital gains decrease $13,752 after reform with recapture of excess depreciation accounting for $2,829 of the decrease and the one-year increase in holding period to qualify as long-term capital gains accounting for the remaining $10,923 (table). 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 the sixth year of the investment. This redistribution of income increases income taxes by $6,189 and decreases returns to $13,699 after tax reform. This 31 per cent decrease in returns for a taxpayer in the 70 per cent tax bracket is applicable to taxpayers in other brackets as illustrated in the graph.

Tax reform provisions reduce after-tax costs, after-tax returns, and the profitability of the investment. Annual losses are not large enough to create an EDA and capital gains are not large enough to raise the maximum capital gains tax rate above 25 per cent. The graph shows that taxpayers in all tax brackets can expect positive returns from the budgeted tax shelter investment. As before reform, the tax advantage is greatest for taxpayers in the highest brackets.

One should not conclude from the preceding discussion that the purpose of tax sheltered investments in breeding cattle is to lose money through inefficient ranch operations. Contracts are written to assure that ranchers caring for contract cattle are as efficient as possible in their operations. Operating losses are incurred in this type of investment because only half of the calf crop is sold each year.

In an Oklahoma study comparing returns to management and risk for typical ranchers operating with contract cattle and rancher-owned cattle, returns to the rancher were higher with contract cattle than with owned cattle for each of the five years 1962–1967. Gross returns for the contract cattle and rancher-owned cattle differed little in each of the five years considered, but contract cattle had lower costs due to lower capital requirements.

This article has attempted to briefly explain some of the tax advantages of livestock investments and how these advantages have been utilized by high income nonfarm investors. All investors realize net gains from the budgeted investment, but returns are highest for taxpayers in the highest income tax brackets. Tax reform decreases the profitability of tax sheltered investments in breeding cattle and will also tend to limit the size of these investments. Careful planning and good management, however, can still result in attractive tax advantages for investors in the highest tax brackets. Most ranchers, having little nonfarm income, will continue to face the familiar cost-price squeeze with low returns to management and capital.

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BUDGET FOR 100-COW INVESTMENT ILLUSTRATING CATTLE NUMBERS, SALES, EXPENSES, AND THE IMPACT OF TAX REFORM ON INCOME, AFTER-TAX REVENUE, AND NET GAIN OR LOSS FOR AN INVESTOR IN THE 70 PER CENT TAX BRACKET, SIX-YEAR PROJECTION

	Cattle numbers[a]					Cattle sales[b]					Expenses[c]					Income[d]					Tax picture - before reform[e]				Tax picture - after reform[e]			
																Before reform		After reform										
End of year	Purchased cows	Raised cows	Two's	Yearlings	Calves	Purchased cows	Raised cows	Two's	Yearlings	Calves	Interest	Maintenance	Management fees	Depreciation	Total	Capital gains	Ordinary income	Capital gains	Recapture of depreciation	Ordinary income	Short-term before tax loss (ordinary income minus expenses)	After-tax cost of short-term loss	After-tax revenue from capital gains	Actual gain or loss (after-tax revenue minus after-tax cost)	Short-term before tax loss (ordinary income minus expenses)	After-tax cost of short-term loss	After-tax revenue from capital gains	Actual gain or loss (after-tax revenue minus after-tax cost)
	number					number					dollars					dollars					dollars				dollars			
1	88				43	12				42	1,728	7,400	2,816	5,428	17,372	--	4,914	--	--	4,914	(12,458)	3,737	--	(3,737)	(12,458)	3,737	--	(3,737)
2	77			38	38	11			5	37	1,168	8,361	810	1,047	11,386	705	4,329	--	67	4,967	(7,057)	2,117	529	(1,588)	(6,352)	1,905	--	(1,905)
3	68		33	33	33	9		5	5	32	616	9,384	850	733	11,583	1,499	3,744	788	74	4,381	(7,839)	2,352	1,124	(1,228)	(7,128)	2,138	591	(1,547)
4	59	30	29	29	43	9	3	4	4	43	80	10,675	914	486	12,155	1,818	5,031	1,170	138	5,541	(7,124)	2,137	1,364	(773)	(6,476)	1,943	878	(1,065)
5	51	53	26	38	50	8	6	3	5	50	--	12,147	1,032	281	13,460	2,190	5,850	1,552	--	6,488	(7,610)	2,283	1,643	(640)	(6,972)	2,092	1,164	(928)
6	Sell all cattle					51	79	38	50	111	--	13,822	1,175	121	15,118	37,990	12,987	26,940	2,550	21,487	(2,131)	639	28,493	27,854	8,919	(2,676)	20,205	22,881
Total											3,592	61,789	7,597	8,096	81,074	44,202	36,855	30,450	2,829	47,778	(44,219)	13,265	33,153	19,888	(30,467)	9,139	22,838	13,699

a Represents numbers at the end of each contract year after culls and steer calves have been sold. The calving rate is 85 per cent, and one-half are assumed to be heifers.

b Culling is based on 12 per cent of the number of cattle at the beginning of the contract year. Net cull proceeds are computed at 75 per cent of the market value of cattle as breeding stock. The market value of cattle for breeding stock for this projection is: calves, $117; yearlings, $170; two's, $210; cows 3 to 5 years, $240; cows 6 to 7 years, $230; and 8 to 9 years, $200.

c Interest is 8 per cent of the mortgage balance. Maintenance is based on the following annual rates: cows and two's, $74; yearlings, $54; and calves, $43. Management fees are 8.5 per cent of gross cash expenditures (excluding mortgage payments). Depreciation is computed on a six-year life for purchased cows using the sum of the years' digits methods with $150 salvage value. There is a special depreciation allowance of 20 per cent on the first $20,000 for persons filing a joint return for contract year 1.

d Income subject to capital gains taxes consists of any gain over depreciated value of purchased cows plus total receipts from cull breeding stock raised. Ordinary income consists of income from calf sales. Recapture of depreciation is treated as ordinary income from tax computation.

e The excess of total expenses is deductible from nonfarm income. After-tax cost is based on a taxpayer in the 70 per cent marginal tax bracket. Each dollar of expenses has a real cost of only $30. After-tax revenue is income subject to capital gains taxes after deducting 25 per cent for taxes. Parentheses denote a negative number.