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Cattle Breeding as a Tax-Sheltered Investment

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CATTLE BREEDING AS A TAX-SHELTERED INVESTMENT

I. INTRODUCTION

Tax-sheltered investments[1] have been the subject of wide publicity and close congressional and administrative scrutiny over the past decade. Two major pieces of legislation, the Tax Reform Act of 1969[2] and the Tax Reform Act of 1976,[3] have curtailed the ability of high income taxpayers to reduce substantially their tax liabilities by investing in tax shelters.[4] The Revenue Act of 1978[5] aimed at a similar goal, although to a much lesser extent.[6] In addition, an increasingly hard line against arrangements characterized as tax shelters has been taken by the Inter-

1. The term tax-sheltered investment, as used by this author, refers to any transaction, or series of related transactions, which permits a taxpayer to reduce his tax liability on income generated from other sources (or is directed toward such a reduction in tax liability) and yet renders some form of economic benefit. The terms tax-sheltered investment and tax shelter will be used interchangeably in this comment, even though the former term generally has a narrower connotation. *See, e.g.*, 1 S. SURREY, W. WARREN, P. MCDANIEL, & H. AULT, FEDERAL INCOME TAXATION 392 (1972) [hereinafter cited as SURREY]; Lee, *Tax Shelters Under the Tax Reform Act of 1976*, 22 Vill. L. Rev. 223, 223 (1977).

2. Pub. L. No. 91-172, §§ 211-216, 83 Stat. 487 (1969).

3. Pub. L. No. 94-455, §§ 201-214, 90 Stat. 1525 (1976).

4. In regard to the 1976 Tax Reform Act, the House Ways and Means Committee reported:

> In recent years there has been a rapid growth of tax shelters, whereby individuals use artificial deductions, ones that do not accurately reflect their current expenses, to generate losses which they use to offset tax on unrelated income. Thus, many individuals with high economic incomes are now able to avoid, or at least postpone, payment of any significant income tax.
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> . . . .
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> Your committee believes that this bill will significantly reduce the abuses of tax shelters, while leaving the underlying tax incentives in place. It is essential that strong action be taken against *all* of the major tax shelter investments; otherwise, the bill will lead only to a redirection of shelter-seeking capital from shelters which are closed to the ones that are still open.

H.R. REP. No. 568, 94th Cong., 2d Sess. 8-9 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 2897, 2903-04.

In regard to the 1969 Tax Reform Act, *see* H.R. REP. No. 413, 91st Cong., 1st Sess. 208 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645; Cunnane, *Tax Shelter Investments After the 1969 Tax Reform Act*, 49 TAXES 450, 450 (1971).

5. Pub. L. No. 95-600, 92 Stat. 2763 (1978).

6. The House Committee on Ways and Means reported a bill which contained two changes in the tax law designed to limit the use of tax shelters, in an attempt to fill gaps in the law left by the Tax Reform Act of 1976. H.R. REP. No. 1445, 95th Cong., 2d Sess. 6, 67-78 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 288, 291, 345-56. These changes are minor in scope and quantity when compared to the 1969 and 1976 Tax Reform Acts. Hence, this comment is limited to an analysis of the 1969 and 1976 Acts.

nal Revenue Service[7] (IRS) and the Securities and Exchange Commission[8] (SEC). During this assault on tax shelters, much of the rhetoric has focused on the alleged ability of the taxpayer with a substantial income to invest in a program which permits him to eliminate or to reduce his tax liability without suffering any reduction of his income.[9]

This comment will analyze one particular type of tax-sheltered investment, the cattle-breeding operation, to show that, despite these legislative and administrative efforts, a taxpayer with a high nonfarm

7. In May, 1976, for instance, the IRS announced plans to use new computer programming methods to scan tax returns reflecting investment in tax shelter areas. Weekly Alert FED. TAX COORDINATOR 2d (RIA) Item 3 (May 20, 1976). In August, 1976, the IRS declared a renewed emphasis on its "Coordinated Tax Shelter Program," with an increase in auditing of returns showing deductions relating to oil and gas drilling, farming, real estate, and motion pictures. Weekly Alert FED. TAX COORDINATOR 2d (RIA) Item 2 (July 15, 1976). *See* Lee, *supra* note 1, at 224.

In November, 1976, then IRS Commissioner Donald C. Alexander indicated that the Service had adopted what the Commissioner termed an "unyielding stance" against tax shelters, and was challenging $300 million in tax sheltered investments in over 300 court cases. U.S. NEWS & WORLD REP., Nov. 29, 1976, at 35.

In January, 1978, IRS Commissioner Jerome Kurtz announced that the Service had plans to double the percentage of audits of partnership returns for fiscal year 1978, concentrating on high loss returns, with an expected coverage of 24% of returns showing losses in excess of $25,000. Kurtz noted that this audit policy, along with other policies, is aimed at undermining tax shelters. In enunciating the rationale for the IRS assault, Kurtz commented:

> The proliferation of tax shelters, many involving schemes that push well beyond any reasonable interpretation of the law, have an adverse effect on [taxpayer] confidence. Our [the IRS] program in this area includes increased efforts to identify questionable devices early and to issue revenue rulings promptly . . . . We hope the program will increase taxpayer confidence in the fairness of the tax system and in the ability of the IRS to respond effectively to tax avoidance schemes.

Remarks by IRS Commissioner Jerome Kurtz at the 30th Annual University of Southern California Tax Institute on Federal Taxation (Jan. 17, 1978), *published in* [1978] 9 Stand. Fed. Tax Rep. (CCH) ¶ 8300, at 75,506.

8. Because many tax-sheltered investments have been packaged and marketed in the form of limited partnerships or real estate investment trusts, they have become subject to federal securities regulation. The SEC has taken an active role over the past several years in scrutinizing various aspects of tax-sheltered investments. Primarily, the SEC has been involved with detailing the risks which must be disclosed to potential investors to prevent fraud. *See, e.g.*, STAFF OF JOINT COMM. ON INT. REV. TAX., 94TH CONG., 2D SESS., TAX REVISION ISSUES—1976: 1 TAX SHELTER INVESTMENTS 21 (Comm. Print 1976) [hereinafter cited as JOINT TAX COMM. REP.]; Lee, *supra* note 1, at 225.

9. For example, one congressional staff report in 1976 came to the conclusion that a taxpayer in a high income tax bracket can obtain "substantial tax benefits . . . on a break-even cattle breeding operation" even though the investment itself "neither made nor lost money apart from taxes." JOINT TAX COMM. REP., *supra* note 8, at 48-52.

Another 1976 congressional report emphasized that a major goal of the 1976 Tax Reform Act was to discourage investment in economically inefficient tax shelters. "Some investments are motivated by excessive concern with the tax benefits associated with them, not their economic merits . . . . The [Senate Finance Committee] amendment contains a number of provisions designed to curb these abuses without interfering with economically worthwhile investments." S. REP. NO. 938, 94th Cong., 2d Sess. 8-9 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3445 [hereinafter cited as S. REP. NO. 938, 94th Cong.]. The reasoning of this report presumes that an investor can invest in an economically worthless transaction and yet realize a profit through favorable tax treatment. Otherwise there would be no need for Congress to remove tax benefits in order to encourage economically worthwhile investments.

income can still shelter such income from federal taxation. The various elements of a cattle-breeding tax shelter will be evaluated in the context of the changes enacted by the Tax Reform Act of 1976. These elements are deductions, investment tax credit, deferral, leverage, and conversion of ordinary income to capital gain. In addition, the form of organization best suited to a cattle-breeding shelter will be analyzed.

II. An Overview of a Cattle-Breeding Operation

The basic attributes of a cattle-breeding operation are generally the same whether the initial operation consists of a small herd of twenty-five to thirty head owned by an individual investor, or a thousand-head herd operated by a large farming syndicate. The initial breeding herd will generally consist of one bull for every twenty-five to thirty heifers and cows.[10] The stock should be carefully selected for good breeding potential, and will preferably consist of registered purebreds.[11] A heifer will usually be bred at two to three years of age, and thereafter can be bred annually with hopes of producing one calf per year.[12] Generally the operation will sell most of the bull calves produced each year, while retaining most of the heifer calves for future breeding.[13] A number of heifers and cows, however, will be sold from time to time as culls—animals which lack the breeding characteristics desired in the herd due to age, disease, or other factors.[14]

While some income will be derived from the periodic sale of culls, most of the income from a breeding operation will come from the sale of animals which have been born into the herd. After five to seven years, the herd will have matured, its quality lines will have been established, and it will primarily comprise animals which have been born and raised in the herd.[15] At such a time, the entire mature herd will often be sold to realize a sizable gain.[16]

The utility of a cattle-breeding operation as a tax-sheltered investment results from the interaction of a number of factors. Large acqui-

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10. P. Putnam & E. Warwick, The Farm Beef Herd in 4 U.S. Dep't of Agriculture Farmer's Bull. No. 2126 (1975) [hereinafter cited as Putnam & Warwick].
11. *Id.* at 5-7.
12. *Id.* at 13.
13. Joint Tax Comm. Rep., *supra* note 8, at 48.
14. *Id.* For a discussion of some of the factors to consider in culling, see A. Duda & Sons, Inc. v. United States, 560 F.2d 669, 679-83 (5th Cir. 1977); Putnam & Warwick, *supra* note 10, at 7.
15. Joint Tax Comm. Rep., *supra* note 8, at 48.
16. *Id.*

sition costs,[17] availability of the investment tax credit,[18] and enhanced expense deductions[19] produce sizable losses during the initial years of a breeding program. These losses can be utilized by the investor to offset nonfarm income during those years. Proper timing of the sale of culls and bull calves can continue to produce losses until the mature herd is sold. Upon sale of the mature herd, a large part of the income is taxed at preferential capital gains rates.[20] Hence, the investor is able to defer[21] taxation on his nonfarm income and to convert ordinary income into capital gain.[22]

III. Expense Deductions

A. *Types of Deductions*

The taxpayer engaged in a cattle-breeding program incurs three principal types of expenses for which tax deductions may be taken: interest on indebtedness, operating and maintenance expenses, and depreciation.

1. Interest on Indebtedness

To generate sizable deductions and concomitant losses in the early years of a breeding program, many investors finance a large portion of their investments and often prepay the interest.[23] In the past, cattle-breeding investors generally have elected the cash method of accounting with the object of deducting expenses when they are paid.[24] Prior

17. The largest acquisition cost is incurred in the purchase of the original herd. *See* notes 10 & 11 *supra* and accompanying text.

18. See notes 84-87 *infra* and accompanying text.

19. See notes 23-68 *infra* and accompanying text.

20. See note 116 *infra* and accompanying text.

21. See notes 92-94 *infra* and accompanying text.

22. Additionally, he could roll over such gains by reinvesting in a second breeding program, thereby further extending the deferral period. *See, e.g.*, SURREY, *supra* note 1, at 401.

23. A recent congressional staff report suggests that prepaid interest is a common element in cattle-breeding shelters. JOINT TAX COMM. REP., *supra* note 8, at 48-51. It has also been considered an essential component in various other tax shelter arrangements, especially in those dealing with real estate. *See, e.g.*, Asimow, *Principle & Prepaid Interest*, 16 U.C.L.A. L. REV. 36, 37 (1968).

24. In testimony before the 1973 congressional hearings on tax reform, it was reported that "over 97 percent of those filing returns reporting farm income and losses [in 1968] used the cash basis." *Hearings on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 1074 (1973) (statement of Samuel P. Guyton). Most taxpayers engaged in the production of goods for sale are required to keep inventories and must, therefore, adopt the accrual method, unless the Treasury Secretary specifically determines that some other method would more clearly reflect income. Treas. Reg. § 1.471-1 (1960); Treas. Reg. § 1.446-1(c)(2) (1967). Taxpayers engaged in farming, on the other hand, may elect the cash method of accounting for their farm receipts and disbursements. Treas. Reg. § 1.162-12(a) (1958). *See generally* McDaniel, *Tax Expenditures in the Second Stage: Federal Tax Subsidies for Farm Operations*, 49 S. CAL. L. REV.

to 1976, the question of whether or not interest could be deducted when paid turned on whether it would result in a "material distortion of income."[25] With the Internal Revenue Code (I.R.C.) section added by the Tax Reform Act of 1976, however, a cash basis taxpayer is barred from deducting interest in the year of prepayment.[26] Instead, the taxpayer must capitalize the prepaid interest and deduct it as if he was on the accrual basis. Consequently, the tax advantage of prepaying interest no longer exists.

Despite the fact that the Tax Reform Act of 1976 eliminates the advantage of prepaying interest on indebtedness, the effect on the cattle-breeding investor has been minimal. The cattle breeder can still deduct interest charges as they accrue as an ordinary business expense.[27] In addition to deducting the cost of borrowing, the cattle breeder can use the borrowed funds to finance his operation, thus receiving a second deduction for the costs of purchasing[28] and raising[29] the cattle. Furthermore, the use of borrowed funds permits the elements of deferral[30] and leverage[31] to work to the cattle breeder's maximum advantage, as will be discussed in this comment.[32]

The only adverse effect of the new prepaid interest rule on the cattle-breeding tax shelter arises where a high income taxpayer seeks a shelter at the end of the year, without having made plans earlier in the year. For example, assume the taxpayer enters a cattle-breeding program on December 1, 1978, and finances a large part of his investment.

1277, 1283 (1976); Comment, *Planning & Operating a Ranch for Maximum Tax Advantages*, 22 OKLA. L. REV. 451, 453-59 (1969) [hereinafter cited as 22 OKLA. L. REV.]; Comment, *Farmers' Prepaid Feed Deductions*, 1974 WASH. U.L.Q. 485, 486-88.

25. Rev. Rul. 68-643, 1968-2 C.B. 76. *See generally* Note, *The Material Distortion of Income Test as Applied to Prepaid Interest & Points Paid by Partnerships*, 1973 DUKE L.J. 1318, 1321-25; Note, *Prepaid Interest—A Tax Shelter Collapses:* G. Douglas Burck, 11 TULSA L.J. 442 (1976).

26. Pub. L. No. 94-455, § 208(a), 90 Stat. 1525 (1976). The new section appears as follows:

> **(g) Prepaid Interest.—**
>
> **(1) In General**—If the taxable income of the taxpayer is computed under the cash receipts and disbursements method of accounting, interest paid by the taxpayer which, under regulations proscribed by Secretary, is properly allocable to any period.—
>
> (A) with respect to which the interest represents a charge for the use or forbearance of money, and
>
> (B) which is after the close of the taxable year in which paid, shall be charged to capital account and shall be treated as paid in the period to which so allocable.

I.R.C. § 461(g)(1).

27. I.R.C. § 163(a).

28. The cost of purchasing cattle will generally be deductible over time in the form of depreciation. See notes 57-68 *infra* and accompanying text.

29. The cost of raising the cattle will generally be currently deductible as accrued in the form of operating expenses. See notes 38-56 *supra* and accompanying text.

30. See notes 92-94 *infra* and accompanying text.

31. See notes 95-110 *infra* and accompanying text.

32. See notes 92-110 *infra* and accompanying text.

In so doing, he will be able to deduct only one month's interest expense in the 1978 tax year.[33] Had he entered the program on December 1, 1975 (before the Tax Reform Act of 1976), he could have paid a full year's interest in December and would have been entitled to deduct the full amount as having been paid in the 1975 tax year.[34] With proper planning, however, the same taxpayer could have entered the breeding program on February 1, 1978, paid interest on his indebtedness as it accrued, and then have been entitled to a deduction for the eleven month's interest accrued and paid.[35] Because a cattle-breeding program is at least a five to seven year venture,[36] any adverse effect from the new prepaid interest rule generally will be experienced, if at all, in the first year of the program. This is because any interest expense not deductible in that first year because of having been prepaid can be carried over and deducted in the following years.[37]

2. Operating and Maintenance Expenses

Like deductions for interest on indebtedness, deductions for operating and maintenance expenses[38] are an important element in a cattle-breeding tax shelter.[39] Furthermore, the practice of prepaying operating and maintenance expenses, like the practice of prepaying interest,[40] has been subject to attack both by Congress and by the IRS.[41] While the deduction of prepaid interest has been effectively eliminated by recent legislation,[42] however, the deduction of prepaid operating expenses enjoys continued vitality.

As a result of the IRS practice of disallowing deductions for prepaid operating and maintenance expenses, a series of judicial decisions, primarily dealing with feed expenses, have set out guidelines governing

33. I.R.C. § 461(g)(1). See note 26 *supra* and accompanying text.

34. This ability to take a full deduction in 1975 was in some cases limited by the material distortion of income test; otherwise, such prepaid interest was fully deductible. See notes 24 & 25 *supra* and accompanying text.

35. I.R.C. § 461(g)(1). See note 26 *supra* and accompanying text.

36. See notes 15 & 16 *supra* and accompanying text.

37. I.R.C. § 461(g)(1). The interest is deductible in the period to which it is allocable.

38. Under I.R.C. § 162(a) a taxpayer is allowed a deduction for "all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business."

39. *See* Note, Mann v. Commissioner: *Adding Fuel to the Fire in the Prepaid Feed Expense Controversy*, 19 S.D.L. REV. 224, 224-26 (1974) [hereinafter cited as 19 S.D.L. REV.]; Comment, *Farmers' Prepaid Feed Deductions*, 1974 WASH. U.L.Q. 485, 490.

40. See notes 23-26 *supra* and accompanying text.

41. See authority cited in note 39 *supra*.

42. See note 26 *supra* and accompanying text.

the deductibility of prepaid operating and maintenance expenses.[43] The IRS has summarized these guidelines in a three-part test:

> First, the expenditure must be a payment for the purchase of feed rather than a mere deposit; second, the prepayment must be made for a business purpose and not merely for tax avoidance; and third, the deduction must not result in a material distortion of income.[44]

Among the factors which indicate a purchase rather than a deposit are a binding agreement to accept delivery of a specific quantity of feed at a fixed price, the absence of any right to a refund or repurchase, and the seller's treatment of the transaction as a purchase.[45] The valid business purpose test is generally satisfied if the taxpayer has a reasonable expectation of receiving some business benefit as a result of the prepayment, such as the fixing of a lower price or the obtaining of an adequate supply in anticipation of a feed shortage.[46] Also to be considered in determining whether there was a business purpose is whether or not the prepayment was a condition imposed by the seller.[47] Even if the purchase test and the business purpose test are met, the deduction may still not be allowed if to so allow it in that year would produce a material distortion of income. The presence of such a distortion is determined by such factors as the customary business practice of the taxpayer, the time of the year the payment was made, and the materiality of the expenditure in relation to the taxpayer's income for that period.[48]

The above guidelines still govern the deductibility of feed expenses for most farmers. The Tax Reform Act of 1976, however, imposed new guidelines for those operations characterized as farming syndicates.[49]

43. *See generally* Pinney & Olsen, *Farmers' Prepaid Food Expenses*, 25 TAX LAW. 537 (1972); 19 S.D.L. REV., *supra* note 39, at 229-30.

44. Rev. Rul. 75-152, 1975-1 C.B. 144.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. The 1976 Tax Reform Act added § 464 to the Internal Revenue Code, which established a new type of organization denominated a farming syndicate. Basically, a farming syndicate is defined as a partnership or other enterprise (other than an electing small business corporation) engaged in the business of farming where (1) any interest of the partnership or enterprise have been offered at any time for sale in an offering required to be registered with the SEC, or (2) more than 35 percent of the losses in any period are allocable to limited partners or limited entrepreneurs. I.R.C. § 464(c)(1).

An individual holding an interest in a farming partnership or enterprise is not considered a limited partner or entrepreneur in four situations: (1) where his interest is attributable to his active participation in the management of the farming business for at least five years; (2) where he lives on the farm; (3) where he actively participates in a livestock business which processes the

If a cattle-breeding operation comes within the definition of a farming syndicate, the deductions for feed and other farm supplies expenses are allowable only in the taxable year in which they are actually used or consumed.[50] Thus, investors in syndicated cattle-breeding programs will not be able to generate sizable deductions early in the operation to as great an extent as individual investors or family farmers.[51]

Despite these judicial and administrative restrictions on the deductibility of prepaid operating and maintenance expenses, the effect on the cattle-breeding investor has been minor. Those investors who are not involved in farming syndicates are still able to deduct prepaid operating and maintenance expenses when they are paid as long as the IRS's three-pronged test is met.[52] Proper planning can avoid the farming syndicate characterization[53] as well as ensure the deductibility of prepaid operating and maintenance expenses.[54] Moreover, even where such expenses are not deductible as prepaid expenses, the taxpayer can still deduct the expenses as they accrue.[55] Because of the long-term nature of a cattle-breeding investment, this simply means that the deduction will be postponed.[56]

3. Depreciation

A third type of expense deduction is depreciation. Unless a cattle breeder elects to include animals purchased for breeding purposes in inventory, he must regard such purchases as investments of capital subject to depreciation.[57] Most cattle breeders will choose to capitalize these purchases, reflecting the general view that, in terms of cost recovery, treating breeding animals as capital assets is a more desirable accounting practice than the alternative of treating such animals as inventory.[58] By charging the cost of his breeding cattle to a capital

livestock it raises; and (4) where he is a member of the family, or a spouse of any such member, of a grandparent of someone who is not treated as a limited partner or entrepreneur in the other three situations. I.R.C. § 464(c)(2). See notes 133, 142-47 *infra* and accompanying text.

50. I.R.C. § 464(a).

51. For further discussion of how the form of organization affects the cattle-breeding tax shelter, see notes 131-47 *infra* and accompanying text.

52. See notes 44-48 *supra* and accompanying text.

53. See notes 49 & 50 *supra* and accompanying text.

54. See notes 44-48 *supra* and accompanying text.

55. I.R.C. § 162(a).

56. Thus, the only adverse effect of disallowance of prepaid operating and maintenance expense deductions arises where expenses are incurred at the end of the year without proper planning. *Cf.* notes 33-37 *supra* and accompanying text.

57. Treas. Reg. § 1.162-12(a), T.D. 7198, 1972-2 C.B. 166.

58. *See, e.g.*, Allington, *Current Rules Using Inventory Method for Livestock Undesirable from Tax Viewpoint*, 46 J. TAX. 368, 368 (1977).

account, the breeder is entitled to a deduction for an annual depreciation allowance,[59] and he will also qualify for the investment tax credit.[60] Cattle held for breeding purposes usually also qualify for an additional depreciation deduction during the first year of acquisition equal to twenty percent of the cost, up to a maximum deduction of $4,000.[61] Any one of several methods of depreciation may be selected, including accelerated depreciation methods which permit larger allowances in the early years of the asset's life.[62]

If the cattle breeder subsequently sells an animal (*e.g.*, as a cull) for which depreciation has been allowed, that depreciation will be subject to recapture if a gain is realized on the sale.[63] Recapture in the form of ordinary income will result for that portion of any gain realized to the extent that it is attributable to the recovery of depreciation.[64] Capital gain treatment, however, will still be available for any gain in excess of the amount attributable to recovery of depreciation, provided that the animal has been held for at least twenty-four months.[65]

Even though breeding cattle are subject to depreciation recapture, the effect on the cattle-breeding tax shelter generally will be insignificant. If the depreciation method chosen reasonably reflects the actual decline in the value of the animal, the depreciation will be a proper reduction of current income and will not have to be paid back because the animal will have been sold at its current market value.[66] Moreover, culls are usually the only depreciated animals sold before the herd matures, and the number of such animals will probably be small in rela-

59. I.R.C. § 167.

60. While an argument can be made that breeding cattle which are included in inventory should qualify for the investment tax credit, the wording of § 48(a)(1) would seem to preclude qualification for the investment tax credit unless the cattle are carried on a capital rather than on an inventory account. Allington, *supra* note 58, at 370-73. See notes 84-87 *infra* and accompanying text.

61. I.R.C. § 179. The $4,000 maximum deduction applies to a married couple filing jointly where the total cost of cattle purchased equals or exceeds $10,000. This additional first year depreciation deduction only applies to assets with a useful life of six or more years. The asset guideline period assigned by the IRS is seven years. Rev. Proc. 72-10, 1972-1 C.B. 721. Thus, breeding cattle may qualify as assets with a useful life of six or more years and thereby also qualify for an additional first year depreciation deduction.

62. I.R.C. § 167(b) permits the straight-line, declining balance, and sum of the years-digits methods, or "any other consistent method" of depreciation, as long as the deductions in the first two-thirds of the useful life of the cattle do not exceed those allowable under the double-declining balance method. For a discussion of the various methods of depreciation, *see generally* Allington, *supra* note 58; 22 OKLA. L. REV., *supra* note 24, at 451.

63. I.R.C. § 1245.

64. *Id.*

65. I.R.C. § 1231. See notes 116-21 *infra* and accompanying text.

66. *See* J. O'BYRNE, FARM INCOME TAX MANUAL § 552 (5th ed. 1977). Note that no substantial gain is likely from this type of sale.

tion to the size of the herd.[67] Finally, even if depreciated cattle are sold for a substantial gain on disposition of the mature herd, making the cattle breeder liable for recapture, he has still benefited by deferring that recapture for several years.[68]

B. *Restrictions on Deductions*

The three expense deductions just analyzed are limited by three extrinsic factors: profit motives, at risk limitations, and excess deduction account (EDA) provisions.

1. Profit Motive

Losses from the operation of a farm as a business are deductible in the same manner as losses from any other trade or business.[69] If the farm is not operated for profit, however, no losses from the farming operation may be applied as a deduction from nonfarm income.[70] A presumption that the farming operation is engaged in for profit is established if the gross income exceeds the deductions for at least two out of five consecutive taxable years.[71] Once such a presumption is established, the IRS must prove the absence of profit motive to disallow the farm losses.[72] If the cattle-breeding venture fails to produce a profit in the requisite two out of five years, however, the taxpayer may still be able to establish profit motive, and thus overcome any IRS disallowance of loss deductions.[73]

2. Excess Deduction Account Recapture Provisions

Another restriction on expense deductions is the EDA recapture provisions. Prior to the Tax Reform Act of 1976, cattle breeders were required to maintain EDA's so that gains on later sales of certain farm property could be recaptured as ordinary income.[74] In its 1976 tax legislation, however, Congress decided to cut back severely the EDA requirements, reasoning that other new provisions of the 1976 Act would

67. See notes 14 & 15 *supra* and accompanying text.

68. See notes 92-94 *infra* and accompanying text.

69. I.R.C. § 165 provides the general rule of deductibility of losses incurred in a trade or business. The Treasury Regulations explicitly make § 165 applicable to farming operations. Treas. Reg. § 1.165-6 (1960).

70. I.R.C. § 183.

71. I.R.C. § 183(d).

72. *Id.*

73. I.R.C. § 183. For a discussion of ways in which the requisite profit motive may be established, *see, e.g.*, 22 OKLA. L. REV., *supra* note 24, at 463-65.

74. I.R.C. § 1251 (1975). *See* S. REP. No. 938, 94th Cong., *supra* note 9, at 64.

sufficiently recapture prior farm loss deductions.[75] The 1976 amendments provide that no additions to an EDA need be made for net farm losses that are sustained in taxable years beginning after December 31, 1975.[76] The recapture rules, however, continue to apply for EDA's required to be maintained for taxable years beginning before January 1, 1976.[77] Therefore, the future applicability of the EDA recapture provisions has been considerably limited, and the investor beginning a cattle-breeding program today need not be concerned with the possibility of recapture through the EDA provisions of section 1251.

3. At Risk Limitations

In addition to the profit motive and EDA recapture provisions, a third restriction on expense deductions limits such deductions to the amount at risk. The Tax Reform Act of 1976 amended the I.R.C.[78] to limit the deductibility of losses from farming activities[79] to the amount the taxpayer has at risk. The amount which a taxpayer is considered to have at risk includes (1) the amount of money and the adjusted basis of other property contributed by the taxpayer to the cattle-breeding venture and (2) the amounts borrowed with respect to the venture.[80] In regard to amounts borrowed, the taxpayer will be considered at risk to the extent he is personally liable for repayment or has pledged property (other than that used in the cattle-breeding operation) as security for the loans.[81] Even if the above loan requirements are met, however, the taxpayer's loans will not be included in the amount at risk if the lender has an interest in the venture other than as a creditor,[82] or if certain ties (such as family) exist between the taxpayer and the lender.[83]

75. S. REP. No. 938, 94th Cong., *supra* note 9, at 65. The Senate Report also observed that the old EDA provisions were overly complex, difficult to apply, and of only limited effectiveness.

76. Tax Reform Act of 1976, Pub. L. No. 94-455 § 206, 90 Stat. 1525 (1976), *enacting* I.R.C. § 1251(b)(2)(E).

77. I.R.C. § 1251. *See* H.R. REP. No. 658, 94th Cong., 2d Sess. 93 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 2897, 2988 [hereinafter cited as H.R. REP. No. 658, 94th Cong.].

78. I.R.C. § 465.

79. I.R.C. § 465(c)(1)(B) provides that the at risk limitations apply to a taxpayer engaged in farming as defined in § 464(e)(1), which includes the "raising, . . . feeding, caring for . . . and management of animals." Therefore, the definition of farming activities includes cattle breeding, and the at risk provisions provide new restrictions on the ability of the cattle-breeding investor to generate deductible losses.

80. I.R.C. § 465(b)(1).

81. I.R.C. § 465(b)(2).

82. I.R.C. § 465(b)(3)(A). On whether a lender is a creditor or a partner, *see, e.g.*, *Martin v. Peyton*, 246 N.Y. 213, 158 N.E. 77 (1927).

83. I.R.C. § 465(b)(3)(B). The disfavored relationships are listed in § 267(b), and include, among others, family members, both a corporation and an individual who owns the majority interest in it, and both a grantor and a fiduciary of a trust. In addition, the use of arrangements

IV. INVESTMENT TAX CREDIT

Expense deductions aside, another source of gain from the cattle-breeding tax shelter is the investment tax credit. Investors in livestock became eligible for the investment tax credit for the first time in 1971.[84] Under the current investment credit provisions of the I.R.C., the taxpayer who purchases cattle for breeding purposes is allowed a tax credit of ten percent of his qualified investment.[85] The taxpayer's qualified investment is a specified percentage of the cost of used livestock, that is, livestock placed into service by the taxpayer during the taxable year.[86] For instance, if the taxpayer acquires cattle with a useful life of six years at a cost of $10,000, he is entitled to a credit of $667.[87]

If a breeder has claimed an investment tax credit for a certain animal, but later disposes of that animal before the close of the useful life employed to compute the credit, the breeder is liable for recapture.[88] Because the cattle breeder often does not hold cattle for the full duration of their useful breeding lives, he should be aware of the provisions for recapture of part of the investment tax credit. Recapture here means that an additional tax will be imposed in the year of early disposition. The additional tax will offset part, or perhaps all, of the credit, depending on how long the cattle were actually used for breeding.[89] Thus, in the example cited above,[90] if the breeder sold all of the cattle four years after placing them in use, he would be subject to an additional tax of $333 in the taxable year in which the sale occurred.[91]

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such as nonrecourse financing, guarantees, and stop loss agreements to protect against loss will preclude the taxpayer from being considered at risk. I.R.C. § 465(b)(4). *See generally* Lee, *supra* note 1, at 253-59.

84. The Revenue Act of 1971, Pub. L. No. 92-178, § 104(e), 85 Stat. 497 (1971), *amending* I.R.C. § 48(a)(6) to include livestock as property eligible for the credit. The investment tax credit is generally considered to be available only with respect to cattle which are accounted for as capital assets rather than those which are accounted for in inventory. Arguably, however, even those breeding cattle held in inventory should be available for the credit. See note 60 *supra*.

85. I.R.C. § 46(a)(2).

86. I.R.C. § 46(c). The applicable percentage depends on the useful life of the livestock, which must be the same useful life employed in computing the taxpayer's § 167 depreciation allowance. If the useful life is three years or more but less than five years, the applicable percentage is 33 1/3; if the useful life is five years or more but less than seven years, the applicable percentage is 66 2/3; and if the useful life is seven years or more, the applicable percentage is 100.

87. The computation is as follows: $10,000 basis times applicable percentage of 66 2/3 times 10% credit = $667. See note 86 *supra*.

88. I.R.C. § 47(a)(1).

89. *Id.*

90. See note 87 *supra* and accompanying text.

91. The computation is as follows: $10,000 basis times applicable percentage of 33 1/3 times 10% credit = $333. The applicable percentage drops to 33 1/3 from 66 2/3 because the breeder has shortened the useful life by early disposition. *See* notes 86-87 *supra*.

V. DEFERRAL

The concept of deferral in tax-sheltered investments is simple. A taxpayer with current income which he wishes to shelter makes an investment which he expects will generate losses. He then uses those losses to offset his current income. To the extent that the losses experienced in the investment offset the taxpayer's other income, the taxpayer's current tax liability is reduced. If, in the following year, his investment matures and he makes a profit, the taxpayer will pay tax on this extra income in that year. The taxpayer in this hypothetical has not avoided taxation but has merely deferred his tax liability from one year to the next.[92]

The advantages of deferral can be twofold. First, the taxpayer may be in a lower tax bracket in the year he actually pays the tax. Second, even if the taxpayer's bracket is the same in the later year, the taxpayer has had the use of that money he would have paid in taxes in the earlier year. The value of such use of money may be substantial.[93]

Deferral in cattle breeding is usually accomplished by deducting the costs of development of the breeding herd over a period of five to seven years, during which time the herd operates at a loss.[94] The deferral period ends when the mature herd is sold in the sixth or seventh year. While income is realized upon sale of the mature herd, the investor will have already received the value of deferring the payment of income tax for up to seven years.

VI. LEVERAGE

In addition to expense deductions, the investment tax credit, and deferral, the concept of leverage has long been utilized by investors to increase the profitability of their business ventures. Leverage refers to the situation in which an investor is able to borrow funds at a lower interest rate than the rate of return he will make on his investment. In such a situation, the investor can increase his total profitability by borrowing cheaply and investing the funds at an advantageous return.[95] For example, assume A invests \$10,000 from his own funds and receives a twenty percent return one year later. A's gross, as well as net, profit is \$2,000. Assume instead, however, that A borrows \$5,000 at ten percent annual interest and invests only \$5,000 from his own funds for

92. *See generally*, SURREY, *supra* note 1, at 413-19.
93. *Id.*
94. See notes 15 & 16 *supra* and accompanying text.
95. SURREY, *supra* note 1, at 419.

the same total investment of $10,000. One year later, A's gross profit is $2,000, but his net profit is only $1,500 since the loan cost $500. The rate of return on the $5,000 investment of his own funds has increased from twenty to thirty percent, or a $1,500 return on a $5,000 investment.[96] Thus, had A invested only the $5,000 of his own funds, his net profit would have been $1,000, and A is said to have gained $500 leverage by the investment of the borrowed funds along with his own.

The advantages of leverage to an investor are further magnified by the investor's ability to include the cost of borrowing as an expense deduction[97] to reduce his income tax liability.[98] In effect, the expense deduction for interest reduces the investor's net cost of borrowing by reducing the tax he would have paid had he not incurred the indebtedness.

The extent to which the investor's net cost of borrowing is reduced depends upon the investor's marginal tax bracket.[99] The higher the investor's bracket, the lower will be his net cost of borrowing, and the greater will be the benefit of leverage to him. To illustrate, consider the example used above. If A invests $5,000 from his own funds and $5,000 borrowed at ten percent annual interest, A's position at the end of one year (assuming a twenty percent return on investment and a fifty percent marginal tax rate), would be as follows:

Step 1:	Interest expense	$500	
	Deduction for interest		$500
	Less Tax Savings at 50%	−250	
	Net cost of borrowing	$ 250	
Step 2:	Gross profit at 20%	$2000	
	Less net cost of borrowing	−250	

96. Another way to illustrate the advantage of leverage in this example is as follows: Assume A has $10,000 from his own funds to invest and can borrow an additional $5,000 at 10%. A can realize a net profit of $2500 (after deducting the $500 interest expense) by borrowing that $5000. Hence, by borrowing $5,000 A can receive an extra $500 on his investment without increasing his out of pocket expense.

97. See notes 23-32 *supra* and accompanying text.

98. The general rule allowing a deduction for interest on indebtedness is found in I.R.C. § 163(a). However, there are a number of limitations on the deductibility of interest. See notes 102-07 *infra* and accompanying text.

99. The so-called marginal tax bracket is the offspring of the progressive rate structure of the federal income tax. The rate of taxation increases as the level of income increases, with income levels set up in increments of $1,000-2,000. As a taxpayer's taxable income reaches each higher increment or bracket, a higher rate of taxation is applied to that income. The marginal tax bracket is the highest increment which the taxpayer's taxable income reaches. Marginal tax rate means the percentage rate at which that income is taxed.

	Net profit	$1750	
Step 3:	Rate of return on investment	$\frac{1750}{5000}$	= 35%

The advantage of leverage is apparent. The unleveraged investor receives a twenty percent return on his investment, and the leveraged investor receives a thirty percent return. Further, the leveraged investor in a fifty percent tax bracket receives a thirty-five percent return.

Along with other elements of tax shelters such as expense deductions, the practice of leveraging by borrowing funds to finance investment was attacked by Congress in the 1969 Tax Reform Act,[100] and again in the 1976 Tax Reform Act.[101] The result of these congressional reforms is that under current law the deductibility of interest on investment indebtedness is limited to $10,000 per year, plus the taxpayer's net investment income.[102] Interest deductions in excess of $10,000 which are disallowed in one year can be carried forward and deducted in future years.[103] Even before these reforms, the I.R.C. had disallowed deductions for interest payments on insurance, endowment, or annuity contracts;[104] interest relating to tax-exempt income;[105] carrying charges chargeable to a capital account;[106] and interest with respect to transactions between related taxpayers.[107]

Despite these exceptions to the general rule that interest on indebtedness is deductible, the cattle breeder who borrows to finance his breeding operation will generally be able to deduct fully the interest on

100. *See generally* Barker, *The Impact of Tax Peferences and the Limitation on Investment Interest Deductions in Real Estate Transactions*, 29 N.Y.U. TAX INST. 1085 (1971); Davenport & Goldman, *The Minimum Tax for Tax Preferences and the Interest Deduction Limitation Under the Tax Reform Act of 1969*, 16 WAYNE L. REV. 1223 (1970); Gabinet, *The Interest Deduction: Several New Installments in a Continuing Saga*, 21 CASE W. RES. L. REV. 466 (1970).

101. *See* H.R. REP. No. 658, 94th Cong., *supra* note 77, at 10, 102-06. S. REP. No. 938, 94th Cong., *supra* note 9, at 106-07. H.R. CONF. REP. No. 1515, 94th Cong., 2d Sess. 417-18 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4128-29.

102. I.R.C. § 163(d). Prior to the 1976 Tax Reform Act the limitation on the deductibility of interest on investment indebtedness was $25,000 per year plus the taxpayer's net investment income and long-term gain plus one-half of any interest in excess of these amounts. Prior to the 1969 Tax Reform Act, no such limitation existed.

103. I.R.C. § 163(d)(2).

104. I.R.C. § 264.

105. I.R.C. § 265.

106. I.R.C. § 266.

107. I.R.C. § 267.

that indebtedness as it accrues or is paid,[108] even where that interest exceeds $10,000. This is because such interest is generally not considered interest on investment indebtedness, but rather an ordinary and necessary business expense under section 162.[109] As long as the taxpayer can establish that he is raising breeding cattle for profit, the cost to him of borrowing in the course of that business should be deductible.[110]

VII. Conversion from Ordinary Income to Capital Gain

This comment has thus far established that the taxpayer who holds an interest in a cattle-breeding herd is permitted to deduct currently most of the expenses incurred in the operation.[111] Furthermore, where the expense must be capitalized (*e.g.*, the purchase of new breeding animals), the taxpayer is permitted depreciation deductions at an accelerated rate.[112] Sizeable expenses coupled with insignificant revenue during the first few years of developing a cattle-breeding herd, cause most breeding operations to show a loss for the first three to five years.[113] These losses are treated as ordinary losses and may be used by the cattle breeder to offset nonfarm income.[114] Obviously this is a desirable offset which allows the taxpayer to retain the use of funds which otherwise would have been lost.[115] In addition, once the animals have been held for twenty-four months, they will generally qualify for capital gain treatment upon sale.[116]

The process of taking current deductions against ordinary income for the expense of raising breeding animals (*i.e.*, the development of a capital asset) and subsequently selling the raised animals for a profit results in a conversion of ordinary income to long-term capital gain. To the taxpayer, this conversion can mean a considerable tax savings. For example, assume A has $40,000 in ordinary nonfarm taxable in-

108. As to whether such interest is deductible when paid or when accrued, see notes 23-27 *supra* and accompanying text.

109. *See, W.E. Bevan*, 30 T.C.M. (CCH) 1337, 1345 (1971), *aff'd*, 472 F.2d 1381 (6th Cir. 1973); *J.T. Dorminey*, 26 T.C. 940, 947 (1956).

110. I.R.C. §§ 162(a), 163(a). Whether the taxpayer is a limited partner in a syndicated breeding program, or a full-time cattle rancher, he may qualify as being in the business of raising cattle for breeding purposes. *See generally* J. O'Byrne, *supra* note 66, §§ 100, 101, 329.

111. See notes 23-56 *supra* and accompanying text.

112. See notes 57-68 *supra* and accompanying text.

113. *See* S. Rep. No. 938, 94th Cong., *supra* note 9, at 54.

114. *Id.*

115. See notes 92-94 *supra* and accompanying text.

116. I.R.C. § 1231. For exceptions to this general rule, see notes 122-27 *infra* and accompanying text.

come (such as wages and dividends) in 1977, and in the same year he begins a cattle-breeding program which generates $40,000 in deductions (such as depreciation, feed, and interest). A's tax liability for 1977 would be zero.[117] Without the cattle-breeding deductions, A would have had to pay $10,700 in federal income taxes for 1977.[118] Assume further that from 1979 through 1982 A sells some of the cattle he purchased in 1977 for profits of $10,000 in each year, for a total profit of $40,000 profit. Under current law, those profits would be taxed at preferential long-term capital gains rates.[119] Assuming A's nonfarm income for each of those years to be $40,000, A's additional tax liability generated by the sale of cattle would be $2,288 for each year, for a total tax liability of $9,152, and a tax savings of $1,548.[120] The $1,548 tax savings is further enhanced by the value to A of deferring the tax over a period of years.[121]

While the cattle-breeding taxpayer may look eagerly to the tax savings to be derived from conversion of ordinary income to capital gain, not all of his cattle sales will not qualify for the preferential capital gains treatment. Specifically, the sale of two categories of cattle will result in ordinary income rather than capital gain. First, those cattle which have been held by the taxpayer for less than twenty-four months will not qualify for capital gains treatment when sold.[122] Hence, the profits on any calves from the herd which are sold before reaching the age of twenty-four months will be ordinary income. Even mature cows

117. A shows a loss in his cattle business of $40,000, which fully offsets his taxable income of $40,000.

118. Based on married individuals filing a joint return. I.R.C. § 1(a).

119. I.R.C. § 1231.

120. Under 1977 tax rates, only 50% of long-term capital gains are taxed. I.R.C. § 1202. Hence, a $10,000 gain realized from the sale of cattle in each year would add $5,000 to A's taxable income for each year. With a taxable income of $45,000, A's total tax liability for each year would be $12,988. *See* I.R.C. § 1(a). This tax is $2,288 more than A would have paid on his $40,000 nonfarm income. See note 118 *supra* and accompanying text. Over the four years of 1979-1982, A's additional tax liability resulting from his cattle business is: 4 times $2,288 = $9,152. The difference between the $10,000 tax saved in 1977 and the $9,152 tax paid in 1979-1982 is a net tax savings of $1,548.

121. By investing in this hypothetical breeding program, A was relieved from paying $1,548 in taxes in 1977 and was able to defer the payment of $9,152 in taxes over six years. One measure of the value of this deferral to A is the tax-free income A could earn on the tax savings over the six year deferral period. See notes 92-94 *supra* and accompanying text.

122. I.R.C. § 1231(b)(3). Prior to the Tax Reform Act of 1969, cattle held for breeding purposes were only subject to a one-year holding period before qualifying for capital gain upon sale. The extension of the holding period to two years was motivated by congressional desire to "draw a more realistic distinction between livestock which is held for draft, breeding, or dairy purposes and livestock which is held for purposes of sale and to lessen the attractiveness of tax-motivated investments in livestock." H.R. REP. No. 413, 91st Cong., 1st Sess. (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1716 [hereinafter cited as H.R. REP. No. 413, 91st Cong.].

and bulls which are acquired and bred for one year but sold within two years of acquisition will not qualify for capital gains treatment.[123]

Second, those cattle which are not actually held by the taxpayer for breeding purposes are not eligible for capital gains treatment regardless of how long they have been held.[124] One recent case[125] set out three factors to be considered in determining whether cattle are held for purposes of breeding or for sale: (1) the substantiality and frequency of sales, (2) the extent of solicitation and advertising efforts, and (3) the method by which the taxpayer differentiates the cattle he sells and those he retains in the breeding herd.[126] Thus, the cattle breeder who holds cattle the requisite twenty-four months, sells a great number of those cattle through extensive advertising and solicitation, and does so without a sound basis for distinguishing cattle retained for further breeding, runs the substantial risk that any profits will be treated as ordinary income rather than as capital gain.[127]

With the recent congressional action which substantially lowers the rate of taxation of capital gains,[128] the ability to convert ordinary income to capital gain may offer the cattle breeder his most favorable opportunity to save taxes.[129] This is especially true since the EDA recapture rules are no longer applicable.[130]

VIII. FORM OF ORGANIZATION

The elements of a cattle-breeding tax shelter have been analyzed, namely: deductions, investment tax credit, deferral, leverage, and conversion of ordinary income to capital gain. While these elements may exist regardless of how the particular shelter is organized, the yield ob-

123. Under the House version of the 1969 Amendment to section 1231(b), such a sale would qualify for capital gains treatment. H.R. REP. No. 413, 91st Cong., *supra* note 122. However, the Conference Committee opted to go with the straight two year holding period as proposed by the Senate. *See* S. REP. No. 552, 91st Cong., 1st Sess. (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2130-32; CONF. REP. No. 782, 91st Cong., 1st Sess. (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2412.

124. I.R.C. § 1231(b)(3).

125. A. Duda & Sons, Inc. v. United States, 560 F.2d 669 (5th Cir. 1977).

126. *Id.* at 680-81.

127. This is the problem the Duda operation faced. *Id.* at 679-83. However, the extension of the holding period from 12 months (the period applicable in *Duda*) to 24 months should eliminate the vast majority of questions over whether cattle are being held for breeding or for sale. Seldom will an animal be held for more than 24 months unless it is held for breeding purposes. *See* J. O'BYRNE, *supra* note 66, § 329.

128. Revenue Act of 1978, Pub. L. No. 95-600, § 402, 92 Stat. 2763 (1978). Previously, an individual was allowed a deduction equal to 50% of net capital gains; however, the deduction now is 60% for sales or exchanges after November 1, 1978. I.R.C. § 1202.

129. *See, e.g.*, J. O'BYRNE, *supra* note 66, § 317.

130. See notes 74-77 *supra* and accompanying text.

tained from each element varies depending on the form of the organization. Moreover, the form of business entity used to conduct a cattle-breeding operation took on a new dimension following the passage of the Tax Reform Act of 1976.

Prior to the 1976 Act, most syndicated cattle-breeding programs were organized as limited partnerships, with partnership shares sold to high-income taxpayers looking for a tax shelter.[131] The popularity of the limited partnership form stems from a number of its favorable attributes, including the limited partners' limited liability, the passage of gains and losses through the partnership to the limited partners, the increased basis available to the limited partners by their assuming partnership nonrecourse liabilities, and partnership discretion to allocate tax items retroactively or specifically to individual limited partners.[132] With the Tax Reform Act of 1976, however, Congress enacted several provisions which were intended to curtail favorable tax treatment of passive investors in farming syndicates, especially limited partnerships, while continuing favorable tax treatment for farmers actively engaged in farm operations.[133]

Three new provisions are specifically aimed at reducing the effectiveness of the partnership as a tax-shelter vehicle. One such provision requires that all organizational and selling expenses of the partnership be capitalized, with an option to treat organizational expenses as deferred expenses amortizable over a period not less than five years.[134] Previously such expenses were often currently deducted and the deduc-

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131. S. REP. No. 938, 94th Cong., *supra* note 9, at 54-58.

132. Comment, *Tax Shelters After the Tax Reform Act of 1976*, 46 U.M.K.C. L. REV. 69, 73 (1977). However, the general partnership entity is sometimes used to avoid securities regulation. Lee, *supra* note 1, at 227.

133. The Senate Finance Committee asserted:

> These special farm tax rules have been utilized not only by taxpayers who are actively engaged in farming enterprises with the intention of making a profit, but also by passive investors whose motivation, in large part, consists of a desire to use these farming rules to shelter income from other sources. These passive investors are frequently members of "farming syndicates" formed by a promoter or operator.
>
> . . . .
>
> . . . . The committee believes that the special farm tax rules should be continued for most farmers who are actively engaged in farm operations, but that such special farm tax rules should be severely curtailed for farming syndicates in which a substantial portion of the interest is held by taxpayers who are motivated, in very large part, by a desire to make a profit in the particular farming operation.
>
> The committee believes that reducing tax incentives for high-bracket taxpayers who invest in syndicated farming operations will improve the competitive position of full-time farmers who must look to the income generated from farm operations for all or most of the return on their investment in farm operations.

S. REP. No. 938, 94th Cong., *supra* note 9, at 57-58.

134. I.R.C. § 709.

tions passed on to the partners.[135]

Another provision[136] attempts to restrict, with less than complete success,[137] the practice of retroactively allocating partnership losses incurred over a full taxable year to a partner who came into the partnership at the end of the taxable year.[138]

A similar provision[139] attacks the practice of making special allocations by a series of priorities whereby the investors/limited partners are allocated all of the first partnership losses up to a certain point, after which the promoter/general partner is allocated a greater percentage of the losses.[140] These three provisions have succeeded in frustrating, to a large extent, the manipulation of the pass-through features of partnership taxation to create favorable tax sheltering for limited partners. However, these new restrictions have not totally eliminated the use of the partnership entity as a tax-shelter vehicle.[141]

The Tax Reform Act of 1976 attacked farming syndicates[142] in yet another way by requiring them to deduct expenses for feed and other farm supplies in the taxable year in which the supplies are actually used or consumed.[143] Thus the prevalent practice of prepaying such expenses and generating sizable deductions early in the cattle-breeding program has been greatly frustrated. In addition, Congress has enacted a new requirement that farming corporations use the accrual method of accounting.[144] The effect of this provision is diminished considerably by the exceptions of subchapter S corporations,[145] family corporations,[146] and corporations with gross receipts of $1,000,000 or less.[147]

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135. *See* Lee, *supra* note 1, at 227-30; Sexton & Charyk, *Partnerships as Vehicles for the Tax Shelter Arrangements Severely Curtailed by TRA*, 45 J. TAX. 338, 342 (1976).

136. I.R.C. § 706.

137. *See* Lee, *supra* note 1, at 231-35; Sexton & Charyk, *supra* note 135, at 339-41.

138. Such a practice results from the fact that many taxpayers wait until the end of the year before seeking tax shelter losses to offset high income for that year, and then they want to generate the highest possible losses. The eager tax shelter promoters gladly allocate the partnership losses retroactively to such taxpayers who invest at the eleventh hour.

139. I.R.C. § 704.

140. *See* Lee, *supra* note 1, at 235-38; Sexton & Charyk, *supra* note 135, at 338-39.

141. Rather, the restrictions have succeeded in foreclosing some of the allocation benefits. The pass through features of partnerships are still available. *See* Lee, *supra* note 1, at 227.

142. See notes 49-51 *supra* and accompanying text.

143. I.R.C. § 464. See notes 38-51 *supra* and accompanying text.

144. I.R.C. § 447. The provision also included partnerships where any partner is a corporation.

145. I.R.C. § 447(c)(1). Subchapter S corporations are defined in I.R.C. § 1371(b).

146. I.R.C. § 447(c)(2). A family corporation is defined as one in which 50% of all stock is owned by members of the same family. A family includes spouse, ancestors, descendants, and siblings and their ancestors, descendants and spouses.

147. I.R.C. § 447(c)(3)(e). Any year in which gross receipts exceed $1,000,000 will require the corporation to adopt the accrual method.

Hence, it is primarily large farming corporations and syndicates that are adversely affected, while the smaller operation retains most of the advantages of the cash method of accounting.

IX. Conclusion

Despite rhetoric to the contrary, neither Congress nor the IRS has eliminated the tax benefits most often associated with cattle breeding. The potential for using cattle breeding as a tax shelter still exists. For example, the cattle breeder is still entitled to depreciation deductions and the investment tax credit. Deductions for interest and feed are still available, and, even though prepayments of such expenses must often be deducted as if the taxpayer is on the accrual accounting method, no greatly adverse tax impact will result for a breeding operation of five to seven years duration. The profit motive and at risk restrictions tend to encourage investment in cattle breeding by those who are sincere about making a profit in the venture apart from taxes and who are willing to stake personal assets on the venture's success. Moreover, the loosening of the EDA recapture provisions removes one former barrier to tax sheltering through cattle breeding. The prospect of deferring taxation on income over several years is still available to a cattle-breeding investor. In addition, the recent lowering of capital gains tax rates provides a fresh boost to the favorable conversion of ordinary income to capital gain.

Congress has, it appears, succeeded in making cattle breeding attractive tax-wise primarily for the nonsyndicated, individual, or family farmer/investor who has nonfarm income and who is serious about making a profit in the cattle-breeding business. If proper timing and planning are used and if cattle market conditions continue to improve, such a taxpayer can find cattle breeding a favorable tax-sheltered investment.

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