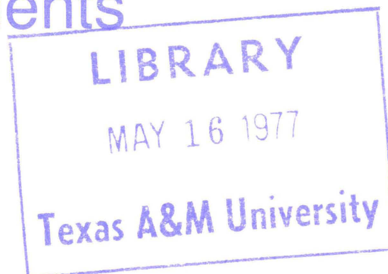
January 1977

Limited Partnerships in Texas Feedlots

Investor Characteristics
Investment Incentives
Fund Arrangements



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in cooperation with
U.S. Department of Agriculture

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Highlights

Limited partnership arrangements, commonly referred to as "cattle feeding funds," were first established in the Texas cattle feeding industry in the late 1960's. Since the cattle feeding industry requires relatively large amounts of capital inputs, numerous Panhandle Plains feedlot firms organized cattle feeding funds to raise equity capital and to increase feedlot utilization rates and merchandise management services. This study focuses on the general arrangements and characteristics of these partnerships, the socio-economic characteristics of the limited partners, and investor incentives in order to draw implications concerning the use of these public investment offerings to finance cattle feeding operations.

More than half of the 33 prospectuses examined were organized specifically for cattle feeding, and most were a series of partnerships that could be formed under one registration. The average life of a fund was about 6 years. The maximum amount of capital specified by any one of the registrations ranged between $0.5 million and $20 million, but most were in the $5- to $10-million range. The general partners leveraged this capital by borrowing about $3 from financial institutions for each $1 of capital supplied by the cattle feeding funds. Total cost of raising capital through these limited partnership offerings approached 8 to 10 percent of the capital raised and was borne by the limited partners upon activation of a partnership. Most partnerships were not activated unless subscriptions equivalent to $250,000 or more were sold by a prescribed date.

In managing cattle feeding funds, general partners attempted to prepay expenses and defer the recognition of ordinary income as a tax deferral incentive. With profitable operations, this practice would cluster the taxable income at the end of a partnership. These limited partnership arrangements specified distribution policies regarding taxable income during the life of the partnership as well as income distribution procedures upon liquidation or termination of the partnership.

The limited partners were assessed service fees comparable with typical custom cattle feeding charges. In addition, most funds specified that the general partner would receive a percentage of the profits of the partnership for management services supplied, provided the limited partners received cash distributions equal to all or a stated percent above their original contributions. Most funds allowed the limited partners to redeem their investment prior to termination of the partnership, but early withdrawals were generally subject to penalties.

More than half of the limited partners subscribing to the Texas cattle feeding funds during 1972-74 were physicians, dentists, engineers, contractors, executives, managers, bankers, brokers, professional investors, or attorneys. The estimated average annual gross income per investor was in excess of $80,000.

About 60 percent of all limited partners surveyed indicated that the tax deferral incentive was the primary criterion for investment in cattle feeding. Almost 31 percent ranked potential returns on investments as the most important investment incentive. Future investor demand for these funds will depend, among other things, upon the extent to which these funds provide tax or other benefits comparable to other forms of investments.

Recent 1976 Federal tax legislation prohibits "farming syndications" or limited partnerships from receiving tax deductions for prepaid expenses for items not consumed in the year purchased. The new ruling also limits total deductions to the amount of their capital "at risk," and capital leveraging may not increase the level of deductible expenses. These two provisions nullify much of the tax incentives provided by past cattle feeding funds since they have been used to defer the payment of taxes. Consequently, the value of funds as a tax management vehicle may not be as great in the future compared to alternative forms of investments in cattle feeding. Although Internal Revenue Service (IRS) interpretations are pending, custom feeding clients who feed their own cattle apparently may continue to operate under the old income tax rules whereby prepaid expenses may be deducted from current income even though the items purchased are not used until the following year.

Under these conditions, investors might feed cattle as individual custom feeding clients, rather than as limited partners, in order to retain tax benefits. As a source of capital these types of investors, rather than limited partnership operations, have been more important in terms of the growth, development, and operation of the large commercial feedlots in the Southern Plains. The recent tax legislation is not likely to have a major impact on the operation of large custom cattle feedlots unless these custom feeding clients do not fall into the legally permissible categories for claiming prepaid deductions.

Acknowledgments

The authors gratefully acknowledge the assistance provided by the Texas State Securities Board in obtaining copies of various prospectuses filed with the Board during 1972-74. Helpful comments and suggestions were provided by Agricultural Economics Department review committee members J. Bruce Hottel and Donald Farris and by Lowell Schake of the Animal Science Department. Helpful comments and suggestions were also provided by W. H. Scofield, Charles Sissons, and Fred Woods of the U.S. Department of Agriculture.

Limited Partnerships in Texas Feedlots

Investor Characteristics
Investment Incentives
Fund Arrangements

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Increasing numbers and sizes of large commercial cattle feedlot operations during the last decade brought about increasing demands for various resource inputs, including operating and long-term capital (1, 2). With the advent of large commercial feedlots during the 1960's, cattle feeding became "big business," requiring sophisticated management techniques not only in feeding and marketing cattle but also in acquiring the necessary capital for maintaining and/or expanding feedlot operations.

During the late 1960's, cattle feedlots in the Texas Panhandle-Plains were dependent predominantly upon financial institutions, private sources and other individuals, profits and services rendered to custom clients, public stock offerings, and, to a small extent, limited partnership arrangements (cattle feeding funds) for sources of operating and long-term capital (1). Since limited partnership arrangements were not used by the cattle feeding industry as a source of capital until the 1967-68 period, data were generally not available concerning limited partnerships or of investors in such cattle feeding funds in Texas feedlots. However, the number of limited partnerships increased rapidly in the Texas feedlot industry from 1970 to 1974.

Accordingly, a study was initiated to provide an in-depth analysis of the organizational and structural characteristics of limited partnership arrangements in Texas feedlots for 1972-74. The analysis was also designed to provide information on the socio-economic profile of investors in cattle feeding funds, their investment criteria and major occupation, and major incentives for investing in cattle feeding funds.

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Data for this analysis were obtained from the various prospectuses filed with the Texas State Securities Board from 1972 to 1974. Data concerning the socio-economic profile of investors in cattle funds and related information dealing with investment strategies and criteria were obtained from a mail questionnaire to individual investors in Texas cattle feeding funds during 1972-74. Potential respondents for the mail questionnaire were selected at random to represent two-thirds of the investors in Texas cattle feeding funds as filed with the Texas Secretary of State by the General Partners of the various funds. The mail questionnaire was forwarded to 1,634 investors throughout the United States. Total questionnaires returned represented more than 34 percent of the population sampled. Total useable questionnaires represented 26 percent of the investors sampled or almost 18 percent of the total number of investors in cattle feeding funds on file in the Office of the Texas Secretary of State for 1972-74. The non-response bias of individual investors not returning questionnaires was not considered significant because the general parameters of the investor data relative to age, income, investment criteria, etc., did not differ substantially from previous research of non-cattle feeding agricultural limited partnerships in Texas (3).

Organization, Purpose, and Legal Requirements of Cattle Feeding Funds

Organization

Most cattle feeding funds are organized as limited partnerships. Limited partnerships are composed of one or more general partners and one or more limited partners. The assets of the general partner stand liable for the debts and obligations of the limited partnership. Each limited partner's liability is limited to his investment. His personal assets cannot be reached to satisfy the financial obligations of the limited partnership.

Creation of a limited partnership in Texas necessitates a written limited partnership agreement specifying each limited partner's share of profits (or losses) and the

agreement must be recorded with the Secretary of State. Limited partners cannot participate in management decisions nor can their names be used as a part of the limited partnership name. So long as these formalities are observed, the limited partners will receive limited liability.

The general partner is frequently a corporation in cattle feeding funds. While the corporate assets may be used to satisfy partnership debts and obligations, the personal assets of the corporate owners are protected. In this manner a limited partnership may be organized so as to provide limited liability for all investors.

The General Partner's Perspective

From the general partner's perspective, a major purpose of cattle feeding funds is to raise equity capital, increase feedlot utilization rates, and generate revenue. Feedlots generally generate revenue through (1) profits on feedlot owned cattle, (2) services rendered to custom clients, or (3) services rendered to cattle feeding fund clients. In some cases, equity capital is sought via limited partnerships simply because feedlots are nearing their capacity to acquire debt capital. In addition, feedlots may perceive the cost of acquiring equity capital through cattle feeding funds as being less expensive than the interest expense associated with debt capital.

However, equity capital acquired via cattle feeding funds does not come free. Rather, state and federal registration requirements, as well as brokerage commissions, constitute the cost of obtaining same. As a general rule, registration with the State Securities Board may require up to 6 months and cost $10,000 to $12,000. Federal Securities and Exchange Commission registration may take up to 2 years, and all offering expenses may exceed $100,000. Major offering expenses include such items as legal fees and prospectus printing costs. In many cases, these offering expenses ultimately are paid from limited partners' contributions. Sales commissions are typically 8 percent, the same as for mutual funds.

Efforts are often made to reduce the cost of creating cattle feeding funds. For this reason, one or more limited partnerships may be marketed under one prospectus. Investment in one limited partnership in no way obligates an investor to invest in other limited partnerships marketed under the same prospectus. Marketing several limited partnerships under one prospectus has the effect of lowering the acquisition costs of equity capital.

Finally, it should be noted that limited partnerships may be viewed as something other than a vehicle for bringing outside capital into the industry. In some cases, general partners may see them as a method of marketing feedlot management services. This is a plausible viewpoint, given the various types and rates for compensable services provided under some limited partnerships and as described in various prospectuses.

The Limited Partner's Perspective

Regardless of the kind of investment, in addition to the rate of return on investment, investors are generally interested in three things: (1) limited liability, (2) some assurance that the investment is readily marketable at all times, and (3) income tax minimization and/or management. Investors may invest as direct owners under a tenancy in common type of ownership. While this provides the desired income tax treatment, they are vulnerable to unlimited liability, and marketability of their ownership interest may be a problem in a case of the death or divorce of one of the investors.

Investors may also choose to invest in either a subchapter C or a subchapter S corporation. Both keep title clear (ensuring marketability) and provide the desired limited liability. However, a subchapter C type of corporation does not provide the desired tax treatment because capital gains and operating expenses and losses are not passed through to the shareholder level. While the subchapter S type of corporation does provide the preferred tax treatment, it is seldom used in cattle feeding funds simply because of the difficulty of raising needed amounts of capital with ten or fewer shareholders — one of several initial qualifying requirements for subchapter S income tax treatment. Another inhibiting factor is that subchapter S shares generally are not readily marketable.

It is also possible for cattle feeding funds to be organized as a general partnership. However, a general partnership does not provide either limited liability or assurance that the interest will be marketable at all times.

A limited partnership, on the other hand, does provide all three of the desired investor characteristics, although the limited partnership agreement may severely restrict opportunities to liquidate one's investment prior to termination of the cattle feeding fund. Unlike in the subchapter S corporation, the tax treatment provided by a limited partnership is not limited by the number of investors. Thus, it is the form of business organization used most often by cattle feeding funds to obtain outside equity capital.

Major Characteristics of Texas Cattle Feeding Funds

Primary Activities of Limited Partnerships

An analysis of 33[1] limited partnership prospectuses or certificates dealing with cattle feeding on file at the Texas State Securities Board during 1970-74 revealed that 55 percent of the limited partnership arrangements were organized to feed cattle only (Table 1). Another one-third were organized to feed and grow cattle, while the activities of the remainder, about 12 percent, included feeding, growing, and breeding. Depending upon the cost/price relationship of feeder cattle, pasture or forage costs, and feeding costs per pound of gain, "growing" feeder cattle often allows feedlots to add additional pounds of gain below feedlot costs on pasture or improved pastures prior to placement on feed in the feedlot. Depending also upon nearby feeder cattle price

[1]Duplicate prospectuses, those with minor revisions, and preliminary drafts were not included in this study.

TABLE 1. PRIMARY ACTIVITIES OF CATTLE FEEDING FUND LIMITED PARTNERSHIP ARRANGEMENTS, TEXAS, 1970-74

Item	Number of prospectuses examined	Primary activity: Feeding only	Feeding and growing	Feeding, growing, and breeding
	Number	Percent		
Number and distribution of primary activity	33	54.6	33.3	12.1

trends, feedlots are able to effect savings by purchasing feeder cattle prior to a price rise.

Underwriting Commission Rates and Offering Expenses

Cattle feeding limited partnership subscriptions are generally offered to the general public on a "best efforts" basis through selected members of the National Association of Securities Dealers, Inc. (NASD). Some general partners also reserved the right to sell directly to the general public at the commission rates received by the NASD dealers, generally from 7 to 8 percent (Table 2). Specified dealer commission rates varied by prospectus depending upon numbers of subscriptions sold.

Offering expenses, including legal, accounting, printing and filing, were generally specified not to exceed 2 percent of the offering price and were borne by the partnerships formed on a pro rata basis. Offering expenses, as estimated in some of the prospectuses, varied from about $40,000 to $120,000. However, numerous prospectuses specified that offering expenses were not to exceed a fixed amount, generally from $50,000 to $75,000.

TABLE 2. UNDERWRITING COMMISSION RATES, BY MAXIMUM AGGREGATE AMOUNT OF OFFERING PER PROSPECTUS, CATTLE FEEDING FUNDS, TEXAS, 1970-74

Maximum offering per prospectus	Percent per unit of subscription: Under 7	7	8	Over 8	Other	Total
	Percent					
Under $5 million	22.2	22.2	33.4	11.1	11.1[1]	100.0
$5 million to less than $10 million	(2)	31.2	56.3	12.5[3]	(2)	100.0
$10 million to $15 million	(2)	62.5	12.5	25.0[4]	(2)	100.0
Over $15 million	(2)	(2)	(2)	100.0[5]	(2)	100.0
Total	5.7	34.3	37.2	17.1	5.7	100.0

[1] General Partner paid for NASD fees after receiving 5 percent of gross profits and in another instance 1½ percent of the cumulative gross profits on a quarterly basis.

[2] None specified in prospectuses examined.

[3] Rates were .0875 percent and 10.0 percent.

[4] General Partner paid for NASD fees after receiving 6 percent of the gross proceeds.

[5] The rate was .0875 percent.

Terms of Offerings and Use of Proceeds

Terms of the limited partnership offerings generally include statements concerning the maximum aggregate dollar volume of the subscriptions offered, the minimum number or dollar volume of subscriptions required to activate a partnership, and a minimum price per subscription. Included also generally were commitments to invest payments received within a specified time period, usually 90 days, or the custodian was to promptly return the funds if the minimum subscriptions to initiate a partnership were not received. Investor suitability requirements, in which investors represent that their financial status meets the minimum levels specified in the prospectus, are required in some states to insure that subscribers have the financial capacity to withstand risks associated with the programs specified.

Approximately 44 percent of the prospectuses specified maximum capitalization levels from $5 million to $9.99 million (Table 3). The remaining prospectuses were about equally divided between those specifying maximum levels of $10 million or more and less than $5 million.

While 72 percent of the certificates required subscriptions ranging from $250,000 to $999,999 prior to activation of a partnership, almost 90 percent of these specified minimum levels of $250,000 for formation of a partnership. Prospectuses specifying minimum subscription levels of $250,000 prior to formation of a partnership represented about 67 percent of the total, compared to 12 percent with minimum levels under $250,000, 5 percent with minimum levels over $250,000 and up to $999,999, and 16 percent with minimum activation levels from $1 million to $4 million.

The predominant minimum subscription price was $5,000 with an allowance for additional subscriptions in increments of $1,000 (Table 3). The next most important minimum subscription price ranged from $2,500 to $4,999, followed by minimum subscription prices of $7,500 or more per unit.

More than 70 percent of the registrations were organized such that a series of partnerships could be formed under one offering or prospectus (Table 3). For example, 40 partnerships could theoretically be formed from one registration which had a specified aggregate maximum of $10 million along with a specified minimum activation limit of $250,000 per partnership.

The average specified life of a partnership was 6 years during 1970-74 (Table 4). Although the specified life of the partnerships ranged from 2 to 10 years, most partnerships were established for 5, 6 or 7 years' duration.

Suitability Requirements

Prerequisites of suitability requirements for investing in limited partnerships were stipulated by more than 60 percent of the prospectuses examined during 1970-74 (Table 5). These requirements stipulated that investors must have either (1) a net worth exclusive of home, furnishings, and personal automobiles of at least $200,000

TABLE 3. MAXIMUM AGGREGATE AMOUNT OF OFFERING PER PROSPECTUS, MINIMUM UNIT SUBSCRIPTIONS, MINIMUM SUBSCRIPTIONS PER FUND, AND PERCENT ORGANIZED FOR SERIES OF LIMITED PARTNERSHIPS, CATTLE FEEDING FUNDS, TEXAS, 1970-74

Maximum offering per prospectus	Distribution of total prospectuses	Minimum subscription to activate a fund: Under $250,000	Minimum subscription to activate a fund: $250,000 to $999,999	Minimum subscription to activate a fund: $1 million to $4 million	Minimum unit subscriptions: $2,500 to $4,999	Minimum unit subscriptions: $5,000	Minimum unit subscriptions: $7,500 and over	Organized for series of limited partnerships: Yes	Organized for series of limited partnerships: No
	Percent								
Under $5 million	28.1	22.2	66.7	11.1	22.2	66.7	11.1	44.4	55.6
$5 million to less than $10 million	43.8	7.1	78.6	14.3	14.3	71.4	14.3	85.7	14.3
$10 million to $15 million	25.0	12.5	62.5	25.0		100.0		75.0	25.0
Over $15 million	3.1		100.0		100.0			100.0	
Total	100.0	12.5	71.9	15.6	15.6	75.0	9.4	71.9	28.1

TABLE 4. TERM OF PARTNERSHIP SPECIFIED BY PROSPECTUSES AND USE OF PROCEEDS, BY MAXIMUM AGGREGATE AMOUNT OF OFFERING PER PROSPECTUS, CATTLE FEEDING FUNDS, TEXAS, 1970-74

Maximum offering per prospectus	Average term of partnerships	Proportion of initial net proceeds used for purchasing[1]: Feeder cattle	Feed grain	Non-feed[2] items	Other[3]	Total
	Years	Percent				
Under $5 million	6.00	67.6	31.4	1.0	(4)	100.0
$5 million to less than $10 million	5.75	57.2	35.7	2.3	4.8	100.0
$10 million to $15 million	6.62	65.0	34.1	.9	(4)	100.0
Over $15 million	6.00	60.0	38.0	2.0	(4)	100.0
Total	6.05	61.9	34.2	1.6	2.3	100.0

[1] Initial net proceeds include proceeds from offerings less NASD commissions and offering expenses.

[2] Non-feed items include hauling and storage expenses, veterinarian expenses, and other direct expenses associated with cattle feeding.

[3] Leased grazing land or feedlots.

[4] None specified.

or a combined net worth of $50,000, and a taxable income, some of which was subject (a) during the last tax year, or (b) estimates that it will be in the current year, to a Federal income tax of 50 percent or more; (2) a net worth exclusive of home, furnishings, and personal automobiles of $100,000 or a combined net worth of $50,000 and a taxable income, some portion of which during the last tax year, or estimates that it will be in the current year, subject to a Federal income tax of 39 percent or more; or (3) generally stated that the suitability requirement was dependent upon the state in which subscriptions were offered or in other instances specified only an income tax bracket. The types or combinations of suitability requirements listed above were about equally split among the prospectuses containing such requirements.

Leverage Ratios

Leveraging in the cattle feeding industry is a practice whereby cattle feeders borrow capital from commercial banks and other financial institutions equal to about one-half to three-fourths of the cost of the cattle plus all or varying proportions of the cost of feeding. Given a margin requirement of 35 percent, $150 would be required in equity funds to finance an enterprise which requires a total investment of $400 per head. Margin requirements in the cattle feeding industry vary according to such factors as available collateral, feeding experience, and potential market conditions.

Leverage ratios specified in the Texas cattle feeding fund registrations during 1970-74 averaged 2.7:1 (Table 6). The leverage ratios specified ranged from 2:1 to 4:1, and the average maximum leverage ratio was 3.2:1.

Cash Distribution

Approximately 41 percent of the registrations did not contain specific cash distribution policies. Another 33 percent stated that cash distributions would be at the discretion of the general partner up to 50 percent of the taxable income as it became available. Another 15 percent stated that cash distributions were not anticipated the first 3 to 5 years and thereafter could be made at the discretion of the general partner. The remaining 11 percent stated that profits would be distributed on an annual basis and up to 50 percent of the taxable income as it became available.

TABLE 5. SUITABILITY REQUIREMENTS, BY MAXIMUM AGGREGATE AMOUNT OF OFFERING PER PROSPECTUS, CATTLE FEEDING FUNDS, TEXAS, 1970-74

Maximum offering per prospectus	Prospectuses specifying suitability requirements	Suitability requirements: Net worth of $200,000 or combined net worth of $50,000 and 50% income tax bracket	Net worth of $100,000 or net worth of $50,000 and 39% income tax bracket	Other[1]
	Percent			
Under $5 million	22.2	(2)	50.0	50.0
$5 million to less than $10 million	78.6	45.5	18.2	36.3
$10 million to $15 million	75.0	33.3	33.3	33.4
Over $15 million	100.0	(2)	100.0	(2)
Total	62.5	35.0	30.0	35.0

[1]Generally stated that the suitability requirement was dependent upon the state in which subscriptions were offered or often specified only an income tax bracket.
[2]None reported in prospectuses examined.

Withdrawal Provisions

Withdrawal provisions, which generally specified annual withdrawal dates, pre-withdrawal notice provisions, and penalties for early withdrawals were specified in all prospectuses. The withdrawal provisions generally allow investors to redeem their partnership interest on any anniversary date or on a specified annual date, provided a written notice is made to the General Partner by letter postmarked at least 30 days prior to the valuation date (the anniversary or specified date). Some partnerships allow investors to withdraw their interests on the last day of any quarter, provided a 30-day written notice prior to the valuation date is given to the General Partner.

Early withdrawals were generally classified as redemptions during the first 3 or 5 years of the partnership, and the most common penalty was 10 percent of the original contributions. However, penalties may be as high as 30 to 40 percent during the first 1 or 2 years depending upon guarantees and other stipulated conditions. Revenues derived from such penalties were either (1) redistributed to the remaining partners in the Partnership on a pro rata basis relative to their capital contributions, (2) allocated in total to the General Partner, or (3) allocated to the General Partner and the partnership interests on a specified proportionate basis.

TABLE 6. LEVERAGE RATIOS AND MAXIMUM LEVERAGE RATIOS SPECIFIED, BY MAXIMUM AGGREGATE AMOUNT OF OFFERING PER PROSPECTUS, CATTLE FEEDING FUNDS, TEXAS, 1970-74

Maximum offering per prospectus	Average leverage ratio	Average maximum leverage ratio
	Ratio	
Under $5 million	2.7:1	3.4:1
$5 million to less than $10 million	2.7:1	3.0:1
$10 million to $15 million	2.7:1	3.4:1
Over $15 million	3.0:1	3.0:1
Total	2.7:1	3.2:1

The valuation of the partnership interests in the various partnership assets (cattle, feed, and such) is based on the current market value at the close of the business day on the valuation date after reflecting profits or losses accredited to such interests. The net market value of the partnership interests is defined as the current market value minus the stipulated penalty and redemption expense to the General Partner, which often range from $50 to $100. Further, the General Partner may also assess a management fee of, for example, 20 percent, against the assets of the redeeming partner in excess of the original contributions, plus prior distributed profits, less the assessed penalties. The remaining interests in the withdrawing Limited Partner's account are then paid out to the withdrawing limited Partner by the Partnership.

Remuneration and Dissolution

Charges assessed the Limited Partners by the General Partner for services performed and ingredients consumed or used in the feeding program often include most or all of the following: buying services, feed purchasing and storage, pasture leasing and backgrounding services, yardage at the feedlot, feed and medication, and management services. Charges for specific items varied by General Partner and according to feeding practices in the general locale. Charges to the Limited Partners or remunerations to the General Partner which were quoted most frequently in the various prospectuses were (1) buying feeder cattle, $0.25 per hundredweight; (2) backgrounding feeder cattle, $0.30 per pound of gain; (3) pasture lease for growing out cattle, $0.18 to $0.20 per head per day; (4) feeding costs, stipulated as basic feed costs plus a mark-up not to exceed 20 percent on basic feed costs with the basic feed cost defined to include a milling charge of $4 per ton; (5) medication charges, stipulated to include basic medication costs plus a percentage mark-up to cover breakage; (6) grain costs,

which often included a purchase fee of $0.30 to $0.40 per hundredweight for grain purchased from the feedlot or affiliated elevators, plus a $0.03 to $0.05 per hundredweight monthly elevator storage fee. Some prospectuses also stipulated a yardage fee ranging from $0.02 to $0.05 per head per day. In addition, others stipulated a management incentive fee of $0.004 per pound of gain not to exceed $2 to $2.50 per head and which, in most instances, was to be returned to the Limited Partners in the event of losses.

Upon dissolution or at the close of the partnership, most prospectuses stated that the General Partner was to participate in net profits, provided the Limited Partners had received distributions equal to or a stated percent above their original contribution. Statements relative to dissolution and the order in which proceeds from the partnership were to be applied were generally as follows: (1) Proceeds were to be applied against any outstanding obligation of the partnership, (2) each Limited Partner and the General Partner, to the extent of their capital contribution, was entitled to receive payments in cash equal to, and in some instances up to 135 percent, their original contribution in the partnership, (3) after distributions were made as specified in (1) and (2) above, the General Partner was to receive payments ranging from 10 percent to 20 percent of the remaining assets in the partnership, (4) any remaining assets were then either divided on a percentage basis as 75 percent to the Limited Partners and 25 percent to the General Partner or in proportion to their original contribution to the partnership. Some prospectuses specified that the General Partner was to receive a certain proportion — for example, 5 percent of the net income on a specified quarterly, semi-annual, or annual accounting date. Other remuneration statements specified that the General Partner was to receive a stated percentage — for example, 12 percent of the cumulative adjusted gross income at a stated date, and thereafter the General Partner was to receive no other payments other than for services and resources utilized in acquiring, caring for, and feeding cattle.

Socio-Economic Profile of Subscribers

Age and Income

Subscribers to Texas cattle feeding funds during 1972-74 averaged 50 years of age with an average annual gross income in excess of $80,000 (Tables 7 and 8). Two-thirds of the fund investors ranged in age from 45 to 64 years with another 22 percent in the 35- to 44-year group. These results are similar to those of a recently completed study of Texas Agricultural Limited Partnerships (3). The proportion of investors in the under 35-year and over 65-year ranges were relatively small since annual discretionary incomes for this group are generally not as high as for the 35- to 64-year group. Additionally, the suitability requirements of most funds are often too high for investors in the under 35-year age group.

Although the estimated annual average gross income of all cattle fund investors surveyed was in excess of $80,000, more than 40 percent of the fund subscribers reported annual gross incomes varying from $40,000 to $79,999 (Table 8). The second highest income range was the $80,000 to $119,999 group followed by the under $40,000 group. More than 15 percent of the investors reported annual gross incomes in excess of $120,000.

TABLE 7. AGE RANGES OF SUBSCRIBERS TO TEXAS CATTLE FEEDING FUNDS, 1972-74

Age range (years)	Percent
Under 25	.2
25-34	4.7
35-44	22.3
45-54	38.1
55-64	27.0
65 and over	7.7
Total	100.0

TABLE 8. AVERAGE ANNUAL GROSS INCOME, TEXAS CATTLE FEEDING FUND SUBSCRIBERS, 1972-74

Annual gross income	Percent of subscribers
Dollars	Percent
Under 40,000	16.8
40,000- 79,999	43.9
80,000-119,999	24.2
120,000-159,999	7.1
160,000-199,999	2.1
200,000 and over	5.9
Total	100.0

Primary Occupation

The primary occupation of over 90 percent of the cattle feeding fund investors in Texas feedlots during 1972-74 was non-agriculturally related (Table 9). The largest category of investors, by primary occupation, was physicians and dentists who comprised almost 20 percent of the fund investors. The next largest occupation categories were engineers/contractors, followed by executives/management personnel. Other primary occupation categories, which comprised from 5.5 percent to 7 percent of the fund investors, included banking/investments, attorneys, retired individuals, sales, and farming/ranching. Respondents reported numerous other primary occupations (Table 9).

Investment Advisers

Almost 60 percent of the investors in cattle feeding funds relied on investment advice fron stockbrokers prior to investing in cattle feeding limited partnership arrangements (Table 10). Although some subscribers in cattle feeding funds relied on more than one investment adviser, both financial investment firms and certified public accountants were used by about one-fifth of the cattle feeding fund subscribers. Attorneys and bankers were used by a small proportion of the fund subscribers.

TABLE 9. PRIMARY OCCUPATION OF CATTLE FEEDING FUND SUBSCRIBERS, TEXAS FEEDLOTS, 1972-74

Primary occupation	Percent
Physician/dentist	19.3
Engineer/contractor	9.8
Executive/management	8.6
Banking/broker/investments	7.0
Attorney	5.9
Retired individual	5.9
Sales (including automobiles)	5.7
Farming/ranching	5.5
Manufacturing	4.3
Housewife/self-employed	2.7
Real estate/realtor	2.3
Scientist	1.8
Insurance	1.8
Cattle feeding	1.6
Other[1]	17.8
Total	100.0

[1]Included are such occupations as merchandising, publishing, advertising, restaurant operations, fisherman or seaman, home furnishings and plumbing, architect, teaching and university administration, entertainment, accounting, trucking, quarry, and nurseryman all of which accounted for 1.5 percent or less per occupational category.

TABLE 10. INVESTMENT ADVISERS USED BY SUBSCRIBERS TO TEXAS CATTLE FEEDING FUNDS, 1972-74

Type of investment adviser	Percent of subscribers[1]
Attorney	7.2
Stockbroker	58.4
Financial investment firm	22.3
Certified public accountant	20.2
Banker	4.4
Other	4.2
None	11.4

[1]Percentage figures will total more than 100 since some subscribers relied on more than one type of investment adviser.

More than 11 percent of the Texas cattle feeding fund investors did not rely on investment advisers prior to investing in feeding funds.

Year Initiated, Number and Type of Other Funds

Almost three-fourths of the subscribers began feeding cattle under a limited partnership arrangement during 1972-73 with more than 45 percent of the subscribers initiating feeding programs in 1973 (Table 11). Less than two percent of the subscribers acknowledged involvement in cattle feeding fund programs prior to 1970. However, a few subscribers reported investments in cattle-feeding limited partnership arrangements in the early 1950's.

Two-thirds of the respondents reported feeding cattle under a limited partnership arrangement as of June 1975. Of these, three-fourths of the investors reported participation in one fund, while 16 percent reported participation in two funds (Table 12). Almost 3 percent of the subscribers feeding cattle as of June 1975 were feeding in as many as four funds.

TABLE 11. YEAR IN WHICH TEXAS CATTLE FEED FUND SUBSCRIBERS BEGAN FEEDING CATTLE UNDER LIMITED PARTNERSHIP ARRANGEMENTS

Year	Percent
Prior to 1970	1.6
1970	5.1
1971	10.6
1972	28.6
1973	45.6
1974	8.5
Total	100.0

TABLE 12. NUMBER OF TEXAS CATTLE FEEDING FUNDS PARTICIPATED IN PER SUBSCRIBER, JUNE, 1975

Cattle feeding funds per subscriber	Percent
1	75.8
2	15.9
3	5.4
4	2.9
Total	100.0

More than 68 percent of the cattle feeding fund subscribers also invested in limited partnership arrangements other than cattle feeding during 1972-74 (Table 13). Limited Partnerships in real estate and oil and gas were the predominant non-cattle feeding funds favored by cattle feeding fund subscribers. This is to be expected since agriculture, real estate, and oil and gas are the three major tax sheltered investments available.

Future Investment Plans and Fund Length

Since subscribers to Texas cattle feeding funds were surveyed in 1975, at a time when large financial losses had occurred and were still occurring throughout the cattle feeding industry, when equity positions were being eroded, and some feedlots were being closed along with bankruptcy of some cattle feeding funds, responses to future investment plans in cattle feeding funds were not anticipated to be highly favorable. Survey results revealed that more than three-fourths of the respondents did not plan to continue investment programs in cattle feeding funds (Table 14). Further, more than 95 percent of the subscribers did not plan to continue investment programs in cattle feeding funds in the event the U. S. Treasury imposed limitations on artificial accounting losses whereby losses derived from agriculture could not be deducted from nonagricultural income for federal tax purposes.

Almost 80 percent of the respondents favored a limited partnership cattle feeding program from 3 to 5 years (Table 15). The 5-year programs were desired by the highest proportion of subscribers, about 43 percent. Approximately 3 percent of the subscribers desired limited partnership arrangements of more than 7 years duration.

TABLE 13. PERCENT OF TEXAS CATTLE FEEDING FUND SUBSCRIBERS INVESTING IN NON-CATTLE FEEDING LIMITED PARTNERSHIPS, BY TYPE OF NON-CATTLE FEEDING FUND, 1972-74

Item	Percent
Limited partners investing in non-cattle feeding funds	68.6
Non-cattle feeding funds invested by cattle feeding limited partners:	
Real estate[1]	41.5
Oil and gas	36.6
Other[2]	21.9
Total	100.0

[1]Real estate includes income producing properties such as shopping centers, office buildings and apartments, and non-income producing properties as raw land investments for speculative purposes.

[2]Includes cattle breeding, orchards and specialty crops, eggs, motion picture production, equipment leasing, radio stations, and mobile homes.

Accuracy of Prospectuses and Suitability Requirements

Approximately 82 percent of the respondents reported that the information contained in the prospectus was sufficiently detailed and accurate for making investment decisions. The following are some representative suggestions from respondents who desired more detailed information in the prospectuses:

1) Background of all management personnel should be provided in greater detail. More information should be provided concerning the "track records of management and their financial handling ability."
2) The General Partner (via the feedlot) should provide evidence that he has sufficient equity to withstand unfavorable feeding and market conditions.
3) Use of partnership capital should be spelled out in detail.
4) More detailed information is necessary on tax liabilities in the event of bankruptcy and when losses exceed investment. (However, if General Partners give this type of advice, such information may be interpreted as providing legal advice rather than investment information, and the General Partners could be subject to fines for practicing law without a license. This is the reason most prospectuses suggest that potential investors consult their tax advisers or attorneys prior to investments in cattle feeding funds).

Respondents were also asked to provide suggestions concerning what changes, if any, should be considered in establishing limited partnership arrangements in the cattle feeding industry. Suggested changes in establishing limited partnerships most frequently mentioned were

1) Require greater participation by the General Partner in the cattle feeding funds and more loss/profit sharing by the General Partner with the Limited Partners.
2) Require financial statements from General Partner to Limited Partners on at least a semiannual or frequent basis.
3) Permit withdrawal from partnership at the end of any feeding cycle or at least within 12 months after initiation of the partnership.
4) Provide a floor or limit on potential losses.
5) Require brokers to obtain a working knowledge of the feedlot industry and to make "on the scene" analysis of the limited partnership arrangement prior to offering subscriptions for sale to the public.
6) Require General Partner to post a fidelity bond and to post bonds to cover "down-side" losses.
7) Reduce leverage to minimize risks.
8) Assure that General Partner has adequate assets and 5 years or more experience in commercial cattle feeding.
9) Provide for greater liquidity and more open trading of partnership interests.

More than 80 percent of the respondents expressed satisfaction with the existing investor suitability requirements (Table 16). However, almost 12 percent of the subscribers, who were primarily in the $80,000 and under annual gross income range, suggested that such requirements were too high.

TABLE 14. PERCENT OF SUBSCRIBERS PLANNING TO CONTINUE INVESTMENT PROGRAMS IN CATTLE FUNDS AND PERCENT PLANNING TO CONTINUE INVESTMENT PROGRAMS IN THE EVENT OF IMPOSITIONS OF LIMITATIONS ON ARTIFICIAL ACCOUNTING LOSSES BY THE U.S. TREASURY DEPARTMENT, TEXAS, JUNE 1975

Item	Yes	No	Depending upon marketing conditions	Total
	Percent			
Planning to continue investment program	16.8	76.0	7.2	100.0
Planning to continue in the event of LAL[1]	4.5	95.5		100.0

[1]LAL implies limitations on artificial accounting losses.

TABLE 15. LENGTH OF CYCLE OF FEEDING PROGRAM DESIRED BY TEXAS CATTLE FEEDING FUND SUBSCRIBERS, JUNE 1975

Years	Percent of subscribers
1	4.1
2	5.5
3	19.6
4	16.9
5	42.6
6	4.1
7	3.8
over 7	3.4
Total	100.0

TABLE 16. TEXAS CATTLE FEEDING FUND SUBSCRIBERS' OPINIONS RELATIVE TO SUITABILITY REQUIREMENTS, JUNE 1975

Item	Too high	Too low	About right	Total
	Percent			
Subscribers' opinions relative to suitability requirements	11.9	6.9	81.2	100.0

Investment Criteria of Subscribers

Subscribers to Texas cattle feeding funds were asked to rank their investment criteria from 1 to 5, with 1 receiving the highest rank in terms of importance. These criteria were designed to gain an insight concerning incentives or motives for investments in cattle feeding funds. The results, without regard to annual income level, are shown in Table 17. "Tax deferral incentive" was ranked first by more than 63 percent of the respondents while "potential return on investment" was ranked first by another 31 percent. The overall results of Table 17 may be summarized as follows: "tax deferral incentive" was ranked first by the predominant majority of the respondents; "potential return on investment" was the leader among the criteria ranked second although it also received considerable support for number one position; "ability to pool capital" and "limited liability" were the leaders among the criteria relegated to third and fourth positions; and "enjoy feeding cattle" was the predominant choice for fifth position.

TABLE 17. RANKING OF INVESTMENT CRITERIA, TEXAS CATTLE FEEDING FUND SUBSCRIBERS, 1972-74

Investment criteria	Ranking					
	1st	2nd	3rd	4th	5th	Total
	Percent					
Potential return on investment	30.7	41.2	20.4	6.1	1.6	100.0
Ability to pool capital	1.6	9.8	31.7	51.5	5.4	100.0
Tax deferral incentive	63.2	25.3	6.7	3.5	1.3	100.0
Enjoy feeding cattle	1.3	2.6	3.8	5.1	87.2	100.0
Limited liability	3.2	21.1	37.4	33.8	4.5	100.0
Total	100.0	100.0	100.0	100.0	100.0	

Ranking of primary investment criteria in cattle feeding funds by income level reveals two distinct patterns (Table 18). First, tax deferral incentives became more important as income levels increased. More than 86 percent of the respondents in the $200,000 and over annual gross income level revealed that tax deferrals were a primary investment incentive compared to 43 percent of the respondents in the lowest annual gross income level or under $40,000. Second, potential return on investment was the most important primary incentive for investors in the lowest income level while it was relatively unimportant for almost all cattle feeding fund investors in the highest annual gross income level. Other investment criteria including "limited liability," "ability to pool capital," and "enjoy feeding cattle," regardless of income level, received only minimal support as a primary cattle feeding fund investment criteria.

Future Legal and Tax Considerations

In recent years, concern has been registered about high income investors using limited partnerships to manipulate their taxable income. At the federal level, 1976 legislation limits the use of agricultural and other limited partnerships in providing opportunities for such tax management. In one sense, it is somewhat ironic for such tax management to be criticized when done under the guise of a limited partnership, given that the Internal Revenue Code income averaging provisions are specifically designed to provide relief for taxpayers with widely fluctuating incomes. In either case, taxpayers strive to stabilize income over the long run to achieve lower marginal tax brackets.

However, the inconsistency between permitting income averaging but denying certain tax management opportunities is more apparent than real. Income averaging is specifically permitted because the nature of our graduated income tax system would otherwise require those with fluctuating incomes to pay more income taxes over time (as compared to taxpayers with relatively constant incomes). Thus, the philosophy behind income averaging is to avoid or lessen inequities among taxpayers. In a similar fashion, preventing and delaying certain deductions is also based on an equity philosophy. That is, certain deductions, if used abusively, can result in "milking" the tax laws. This in turn is inequitable from

TABLE 18. PRIMARY INVESTMENT CRITERIA, BY INCOME RANGE, TEXAS CATTLE FEEDING FUND SUBSCRIBERS, 1972-74

Annual gross income range	Investment criteria					
	Potential return on investment	Ability to pool capital	Tax deferral incentive	Enjoy feeding cattle	Limited liability	Total
Under $40,000	48.2	3.6	42.8	3.6	1.8	100.0
$40,000-$79,999	29.5	(1)	65.5	1.4	3.6	100.0
$80,000-$119,999	28.7	3.8	65.0	(1)	2.5	100.0
$120,000-$159,999	17.6	(1)	76.5	(1)	5.9	100.0
$160,000-$199,999	16.7	(1)	83.3	(1)	(1)	100.0
$200,000 and over	6.7	(1)	86.6	(1)	6.7	100.0
Average	30.7	1.6	63.2	1.3	3.2	100.0

[1]None reported by respondents surveyed.

the standpoint of other taxpayers, because they then are shouldering a relatively larger proportion of the total federal income tax burden. This was the apparent logic behind the 1976 tax law revision.

The 1976 tax legislation could very well affect the ability of feedlots to utilize limited partnerships as a source of equity capital and/or to increase feedlot utilization rates. Some of the major income tax changes are outlined and their implications discussed in the following.

Organizational Expenses

The expenses of organizing a limited partnership are no longer deductible when incurred. Rather, they must be capitalized and amortized over a 5-year period (or the duration of the limited partnership, if less than 5 years). For the most part, this change will affect the timing of deductions rather than the long run total income tax liability. This will, of course, be less advantageous to the taxpayer in that it will increase the present value of his income taxes over time. In short, the advantage of deferring taxes will be lost.

Purchasing Losses

Under the new law it is no longer permissible for a December investor to deduct a full year's share of limited partnership losses. Rather his deductible losses (if any) are limited to a proportion of the year's losses based on the length of time he has been an investor. Historically, cattle feeding funds have not involved the purchase of an interest in an *ongoing* enterprise. That is, cattle feeding funds start a new enterprise as a new group of cattle are placed on feed. Thus, legal change should have little effect on cattle feeding funds.

Rules for Public and Certain Private Syndications

Public syndications (for example, those registered with the SEC) and private syndications in which at least 35 percent of the deductions are reported by "passive" investors are subject to two new rules. First, a taxpayer's deductions are limited to the amount of capital he has "at risk" This likely will largely eliminate the use of nonrecourse financing in limited partnerships.

Second, "farming syndications"(including cattle feeding funds) cannot deduct expenditures for feed, seed, fertilizer, and other farm supplies until they are used. Disallowing the deduction for prepaid feed expenses likely will substantially reduce the investor appeal of cattle feeding funds because such deductions, when highly leveraged with non-recourse loans, provided the major vehicle for tax losses. Their inclusion in the new legislation may well affect equity capital flows into cattle feeding funds.

The rules set out above specifically do not apply to "active" partners, such as farm managers, farm residents, family members, and cattle feeders feeding their own cattle. They will continue to operate under the old income tax rules. In addition, public syndications approved for sale by the SEC prior to January 1, 1976, will operate under the old rules for 1 year.

Logically, disallowing prepaid deductions has a greater effect on short term investment ventures than on long term business enterprises. The financial advantage gained by such prepayment is that of simple deferral of tax liability to a future year. But if one makes the same size prepaid deduction for each of several successive years, other things equal, his sole financial advantage is one year's deferral. Clearly this is true because the prepaid deductions paid in year one would have been current deductions in year two, prepaid deductions paid in year two would have been current deductions in year three, etc. Thus, the tax advantages of prepaid expenses are not overly large for someone who is in the business to stay. Consequently, there is no great inequity in permitting these taxpayers to claim prepaid deductions.

Interest

The 1976 tax legislation also changed rules affecting deductibility of interest. Effective January 1, 1976, an individual taxpayer's total annual interest deduction is limited to $10,000 plus his net investment income. This limit may well affect investment decisions by taxpayers making extensive use of leverage. But interest not deductible currently can be carried forward and deducted in future years. Again, however, delaying deductibility will increase the present value of taxes paid over time or, stated alternatively, will decrease the discounted present value of the projected after-tax income stream.

For cash basis taxpayers, deductions will also be disallowed where interest is prepaid when such interest will not accrue until future taxable years. Rather, such prepaid interest, together with any "points" charged on loans (other than a homeowner's mortgage), must be deducted over the period of the loan. This may substantially eliminate the practice of prepaying interest as a tax management device.

Effect on Equity Capital Flows

Any tax law change may potentially affect flows of equity capital, and the 1976 legislation is no exception. This tax package is broad and affects such traditional tax shelters as real estate, and oil and gas. Therefore, its net effect is difficult to assess at this date. In general, however, eliminating the deduction for prepaid feed, limiting loss deductibility to capital "at risk," and placing a lower ceiling on interest deductions may well result in some out migration of equity capital from the cattle feeding industry. Economic theory suggests, to the extent that such capital cannot be replaced from traditional debt or equity capital sources at comparable costs, over the intermediate run, the net result will be fewer cattle fed. Logically, this could then be translated into higher fed cattle prices and the potential for increased profits from feeding. In turn, this would likely generate sources of capital not previously available into cattle feeding enterprises. Increasing prices for fed beef could also increase the demand for forage fed beef.

Implications

This analysis has focused on the characteristics of limited partnerships in the Texas cattle feeding industry in order to draw implications concerning the use of these

public investment offerings as a means of financing cattle feeding operations. Large scale commercial cattle feedlot owners often face problems in obtaining an adequate and dependable source of working capital from financial institutions and other previously developed sources (1). Consequently, large commercial feedlot firms often seek alternative means for developing capital sources as custom feeding, which has been important in terms of the growth, development and operation of these large feedlots. The development of limited partnerships in cattle feeding in the late 1960's and early 1970's provided feedlots with another important source of capital.

Limited partnerships provide several desirable characteristics for feedlot management. The major advantage is that feedlot owners can acquire equity capital and maintain control of such capital as specified in the respective prospectus. Cattle feeding funds, once established, generally assure feedlots that a certain proportion of their feeding facilities will be utilized during the life of the partnership. Custom feeding clients, in contrast, can exercise their option with considerably greater ease to enter or exit from a feeding enterprise at the end of each feeding period (lot closeout). To the extent that feedlots were able to raise equity capital through cattle feeding funds, this tended to decrease feedlot management concern with the lot utilization problems. However, as the immediate past has revealed, cattle funds can provide this stability feature to the feeding industry in the longer run only if subscribers to funds can realize returns from cattle feeding funds comparable to those from other forms of investments.

While somewhat more stable and profitable returns to cattle feeding enterprises would likely encourage reentry into cattle feeding by prior custom clients or fund subscribers, profit incentives are not always the sole investment criteria. Much of the demand for cattle feeding fund investments will depend upon the extent to which tax benefits exist in connection with them — more than 60 percent of all limited partnership respondents indicated that the tax deferral incentive was the primary criterion for their investment in cattle feeding funds during 1972-74.

It is not possible to assess the full impact of the recent 1976 Federal tax legislation on cattle feeding funds because IRS interpretations are pending. However, one of the major changes that affects "farming syndications" or limited partnerships is that they will not be allowed to receive a tax deduction for prepaid feed and other expenses. This may have a substantial effect on cattle feeding funds because their value as a tax management tool was in the deferral of tax liability to a future year. This was their primary tax benefit because any income derived by limited partnership operations has always been taxed as ordinary income, rather than at capital gain rates. Thus, cattle feeding funds are not traditional "tax shelters" because they involve only deferral and do not receive capital gain tax treatment.

A major factor in terms of decreasing the use of cattle feeding funds in the future may be that, within a competitive framework, the potential tax management and/or income generating ability of funds may not be as great as other forms of investment in cattle feeding. Custom feeding clients who feed their own cattle apparently may continue to operate under the old income tax rules whereby prepaid feed expenses may be deducted from current income. Thus, a high income investor might logically invest in cattle feeding as an individual custom feeding client rather than as a limited partner in order to deduct prepaid feed expenses and maintain the value of his investment as a tax benefit as well as an income generating one. This assumes he falls within one of the classes of taxpayers for which this is permissible under the 1976 tax package.

The recent tax legislation is not likely to have a major impact on the operation of large scale commercial cattle feedlots because nonsyndicated custom cattle feeders may still receive a tax deduction for prepaid expenses. Limited partnership investments have never constituted the major proportion of the total investment in cattle feeding, even in the Southern Plains (1, 2). These large feedlots are heavily dependent upon the investments of custom feeding clients, but most custom feeding clients are not associated with syndicates and consequently may not be affected by the recent tax legislation (unless they are "passive" investors or otherwise do not fall into the legally permissible categories for claiming prepaid deductions, and so forth).

There is concern over the high and continuously increasing capital requirements in agriculture — over how the future capital requirements will be met. However, capital limitations existing in connection with a profitable enterprise lead to changing methods of financing. Furthermore, the large number of investors with large quantities of capital that obviously seek good investment opportunities supports a hypothesis that the means of acquiring capital is more of a limiting factor than the availability of capital. This has implications for financial institutions that currently service commercial agricultural firms. Many of these institutions are knowledgeable about agricultural production opportunities and are in a position to assess the investment opportunities and communicate the investment needs of agriculture. These institutions must continue to evaluate their services and to develop new and innovative financial policies and services when needed.

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