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Note, Agrigultural Taxation After the TRA: Unintended Results from and Ill-Sown Seed

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AGRICULTURAL TAXATION AFTER THE TRA: UNINTENDED RESULTS FROM AN ILL-SOWN SEED

The ample supply of resources that America enjoyed in the past century has undergone radical change in recent years. This change is typified by the national shortage in agricultural products, particularly meat and grain, which materialized in the early part of 1973. Decreased supply sent food costs skyrocketing and focused the nation's attention on the farmland and the farmer.

It did not take a crisis, however, to spur an interest in agriculture among those soliciting and managing the finances of the so-called "Wall-Street Cowboys."[1] Prior to 1969, shelter opportunities within the Internal Revenue Code produced innumerable methods of tax avoidance, resulting in glaring abuses of the tax laws.[2] These abuses, coupled with the well-publicized existence of non-taxpaying millionaires, led to a cry for reform, which reached a crescendo in the late sixties and resulted in the enactment of the Tax Reform Act of 1969 (TRA).[3] Although viewed by some as reform in name only,[4] the Act did include at least six specific reforms directed at the farming industry[5] and one other of broader scope but still of prime importance to the individual farmer or quasi-farmer.[6] After discussing the historical development of the farm tax shelters, this note examines these reforms and the reasons for their enactment, with particular emphasis on the newly enacted agricultural recapture provisions. It also analyzes the problems arising from the congressional reform efforts and considers alternatives for dealing with the abuses those reforms were meant to correct.

HISTORICAL DEVELOPMENT OF THE PROBLEM

The Cash Method Election

The development of numerous tax shelter opportunities in agriculture was due primarily to the ability of taxpayers to use the cash method of reporting income and expenses from agricultural activities. The so-called farmer's cash

1. Griffith & Joy, *What the Act Does to the Farmer: Farm Parity or Class Discrimination?*, 23 TAX LAW. 495 (1970).

2. See text accompanying notes 36-56 *infra*.

3. Act of Dec. 30, 1964, Pub. L. No. 91-172, 83 Stat. 487 [hereinafter cited as the TRA].

4. *See, e.g.*, Davenport, *Farm Losses Under the Tax Reform Act of 1969: Keepin' 'Em Happy Down on the Farm*, 12 B.C. IND. & COM. L. REV. 319 (1971); Note, *Cattle and Taxes Under the 1969 Tax Reform Act*, 17 U.C.L.A.L. REV. 1251 (1970).

5. INT. REV. CODE OF 1954, §§278, 1031(e), 1231(b)(3), 1245(a)(3), 1251, 1252. In addition to these agricultural reforms, the TRA also included a relief provision for farmers who receive insurance proceeds as a result of destruction or damage to crops. INT. REV. CODE OF 1954, §451(d). See text accompanying notes 179-181 *infra*.

6. INT. REV. CODE OF 1954, §182. This section replaced §270, which was repealed by the TRA.

method is not limited to the usual election available to all taxpayers,[7] but also allows farmers, in certain instances, to deduct current expenditures that will not produce income until some future tax year.[8]

This special treatment is well established, dating from pre-1920 administrative decisions that allowed farmers to dispense with normal accounting methods in the reporting of income.[9] Moreover, these decisions permitted the farmer to deduct, rather than capitalize, the costs of raising livestock[10] and, later, the expenses for orchard and ranch development.[11] Initially these rulings were quite supportable in the light of contemporary economic and political considerations and the small size of the typical farm operation of the time.[12] Later, under very different circumstances, they formed the basis for shelter opportunities. The principal tax benefit was that a taxpayer could create "artificial" losses to deduct against current income, deferring tax liability until income was realized from the product incurring the expense. Given a long-range view of a farm operation, it could be assumed that this deferral would

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7. INT. REV. CODE OF 1954, §446.

8. Normally, the election available to taxpayers is limited under TREAS. REG. §1.446-1(a)(4), which requires taxpayers to include the costs attributable to both beginning and ending inventories in all cases in which inventories are material income-producing factors. TREAS. REG. §§1.61-4, 1.162-12, 1.446-1(c) exempt farmers from this requirement, however, and permit them to use the cash method even when inventories are a material factor. *See, e.g.*, Allington, *Farming as a Tax Shelter,* 14 S.D.L. REV. 181 (1969); Note, *supra* note 4.

9. T.D. 2153, 17 TREAS. DEC. INT. REV. 101 (1915), *as amended,* T.D. 2665, 20 TREAS. DEC. INT. REV. 45 (1918). For a fuller discussion of the historical development of the special tax provisions for agriculture, see Davenport, *A Bountiful Tax Harvest,* 48 TEXAS L. REV. 1 (1969).

10. Treas. Reg. 33, art. 4 (1917).

11. Treas. Reg. 45, art. 110 (1919).

12. Although the American economy as a whole underwent a post-war boom that extended until 1929, agricultural prices collapsed in 1920 and the farmer never reestablished the relative prosperity he had enjoyed in the years immediately following the war. It was during this period of agricultural decline amidst general prosperity that the "Farm Bloc" arose and gained considerable power in the Congress. As a result of the power of the Farm Bloc, many tariff provisions were passed by Congress in an attempt to raise declining prices. *See generally* A. LINK & W. CATTON, AMERICAN EPOCH — A HISTORY OF THE UNITED STATES SINCE THE 1890's 253-54, 319-24 (3d ed. 1967).

In addition to such direct congressional attempts to aid the farmer, the Treasury's decisions were also intended to assist him and were further influenced by several practical considerations. The use of an accrual method or any system requiring specific identification of costs relative to particular animals would pose considerable accounting problems even with today's modern accounting methods; certainly they were even more formidable during this earlier era. Furthermore, as one commentator observed: "[T]here was undoubtedly some notion that the average farm did not represent the type of investment or financial acumen usually found in other business operations. To ask that expensive accounting techniques be employed would not only have overburdened the investment, but would also have overtaxed the farmer's financial management capacity. In a sense, farms were just not considered businesses." Davenport, *supra* note 9, at 2. As a result of these factors, the Treasury reached a result seemingly contrary to that which would have been reached had the issue been left to the courts. *See, e.g.*, Ribbon Cliff Fruit Co., 12 B.T.A. 13 (1928); Harry B. Hooper, 8 B.T.A. 397 (1927). Given the economic conditions and the relatively low tax rates of the times, however, the rules conformed to the needs and capabilities of the typical farmer without constituting a grievous raid on the Treasury.

be equalized, thereby creating a minimal benefit.[13] Nevertheless, later developments established tax deferral as only a secondary consideration, for the farmer in some instances was able to change the characterization of realized income from ordinary to capital gain. This possible conversion combined with the cash method election to become the foundation of the shelter opportunities available prior to the TRA.

Creation of Capital Gains Possibilities for the Farmer

Soon after the above rules were promulgated by the Treasury, Congress created a special category of income,[14] allowing gains from the sale of capital assets to be taxed at a lower rate than so-called ordinary income.[15] Depreciable property used in a trade or business, however, was not considered a capital asset, purportedly to allow full deductibility of losses.[16] While this treatment was initially adequate, the events of World War II created an intolerable condition. The exceedingly high tax rates[17] and appreciated property values, combined with the condemnations[18] brought about by the war effort, often resulted

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13. When the time value of money is considered, the ability to delay tax payments until future years certainly creates a benefit, although this benefit may diminish over a period of several years. Thus, while there may be a delay in realizing income attributable to currently deductible expenses, after the first or second year of an operation the realized gains on deferred income should tend to offset the ability to deduct these expenses against the non-farm income, especially for the true farmer whose outside income is relatively low. If the farmer's operations were relatively consistent in expenses and income, the benefit would disappear entirely after the income began exceeding the current expenses and the operating losses accrued in the first several years were depleted. Such is not usually the case of course, and the fluctuations of a farmer's income, combined with the ability to use the cash method, allow him to reduce taxes in good years by increasing expenditures that will benefit him in future years. *See generally* S. SURREY, PATHWAYS TO TAX REFORM 108-12 (1973).

14. Revenue Act of 1921, §206. The provision was applicable only to individual taxpayers and initially provided no restriction on the deductibility of capital losses. *See* Delancey Nicoll, 16 B.T.A. 868, *aff'd,* 41 F.2d 1008 (2d Cir. 1930). By 1924, however, limitations were included on the deduction of capital losses to avoid conferring a greater benefit on the taxpayer than originally intended by Congress. Revenue Act of 1924, §208(c).

15. This preferential treatment continues today in Subchapter P of the Code. Although the TRA made some attempts to reduce the preference by increasing the alternative tax in §1201 and subjecting capital gain income to the new minimum tax in §§56-57, all capital gains are still allowed the §1202 deduction, which, in general effect, permits them to be taxed at only 50% of the rate of the taxpayer's ordinary income.

16. H.R. REP. No. 2333, 77th Cong., 2d Sess. (1942), 1942-2 CUM. BULL. 415. *See* Davenport, *supra* note 9, at 3 & n.7.

17. During this period, the marginal tax rates were as great as 88%. 1942-1 CUM. BULL. 378-79. This was increased in 1944 to a maximum surtax of 91% in addition to the 3% normal tax, a total marginal rate of 94%. 1944-1 CUM. BULL. 825.

18. Some taxpayers were able to partially avoid the confiscatory effects of these condemnations by utilizing the involuntary conversion provisions of the Code. Int. Rev. Code of 1939, §112(f) (now INT. REV. CODE OF 1954, §1033). Thus, by expending the proceeds from the condemnation for the "acquisition of other property similar or related in service or use to the property so converted" the taxpayer avoided the recognition of gain or loss. Further aid was extended by Congress in 1942, when the section was amended to provide for full recognition of uninsured losses. Revenue Act of 1942, §151(d). *See* Filippini v. United States, 200

in the virtual confiscation of property.[19] To remedy this, Congress in effect extended capital gain treatment to depreciable property used in a trade or business, but preserved full deductibility of losses resulting from sales of such property.[20]

Farmers quickly applied the new tax rules to their sale of breeding animals. After some initial uncertainty,[21] this treatment was sanctioned when, in 1951, Congress enacted a provision allowing capital gain treatment for the sale of certain livestock held for more than twelve months.[22] This gave the taxpayer statutory authority for a benefit even greater than that accruing from mere deferral of tax.[23] By combining the deferral benefit with capital gain treatment, taxes could be not only deferred, but indeed reduced. This effect can be seen in the following simplified example: Farmer owns a cow that produces one calf a year. In Year 1 he pays $300 for the full expense of raising the new calf, which he sells at the end of Year 3 for $500.

If the calf is held primarily for sale, any proceeds are ordinary income; if it is held primarily for draft, breeding, or dairy purposes, the proceeds are treated as capital gains.[24] In the former instance, Farmer would have $300 of

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F. Supp. 286, 9 A.F.T.R.2d 313 (N.D. Cal. 1961). It was perhaps in recognition of the fact that the increasing demands of the wartime economy precluded many taxpayers from replacing their condemned property that Congress also enacted the predecessor to §1231. See note 20 *infra* and accompanying text.

19. *See* Maurer v. United States, 284 F.2d 122, 6 A.F.T.R.2d 5971 (10th Cir. 1960).

20. Int. Rev. Code of 1939, §117(j) (now INT. REV. CODE OF 1954, §1231). *See* Maurer v. United States, 284 F.2d 122, 124, 6 A.F.T.R.2d 5971, 5972 (10th Cir. 1960); Davenport, *supra* note 9, at 3-4. The enactment of this provision also corrected an anomoly in the existing law. Prior to 1942 the exclusion from the definition of a capital asset of depreciable property used in a trade or business did not apply to real property. Thus, any sale of improved real property required ordinary income treatment for the improvements and capital gain treatment for the land. *See* Rodgers v. United States, 69 F. Supp. 8 (D. Conn. 1946). The Senate recognized this discrepancy and provided for the application of the new statute to both real and depreciable property, S. REP. No. 1631, 77th Cong., 2d Sess. (1942), 1942-2 CUM. BULL. 504, 594.

21. The Treasury initially contested this treatment in a series of administrative rulings, asserting that animals "culled" for inferior characteristics or to maintain the herd size were to be treated in the same manner as animals normally held for sale and were therefore not qualified for §117(j) (now §1231) treatment. I.T. 3666, 1944-1 CUM. BULL. 270; I.T. 3712, 1945-1 CUM. BULL. 176; mim. 6660, 1951-2 CUM. BULL. 60. The Eighth Circuit, however, affirmed the taxpayer's position in Albright v. United States, 173 F.2d 339, 37 A.F.T.R. 1125 (8th Cir. 1949), holding that the sale of cattle to maintain herd size and eliminate unproductive cattle was within §117(j) because the sales were only incidental to the taxpayer's primary business.

22. Revenue Act of 1951, §324. This treatment is now allowed under §1231, although the holding period for horses and cattle was increased to 24 months by the TRA. See note 163 *infra*.

23. See note 13 *supra*.

24. Section 1231(b)(3) defined the permissible farm activities that would be accorded §1231 treatment. This definition was expanded by the TRA to include sporting animals. See notes 165-166 *infra* and accompanying text. It should be noted, of course, that §1231 does not automatically confer capital gain treatment on every qualifying transaction. Basically, the section requires that all gains from sales or exchanges of property used in a trade or business (as well as certain involuntary conversions) be aggregated and offset (in the so-

ordinary deductions in Year 1 and $500 of ordinary income in Year 3. His only tax advantage over a taxpayer using inventories on the accrual method is that net income in the early years of his operation is reduced and he is better able to "smooth" his income by prepaying expenses in the years of peak income.[25]

If the proceeds are treated as capital gain, however, Farmer many claim not only the $300 ordinary deduction in Year 1, but also a $250 capital gain deduction[26] in Year 3, thereby avoiding any net tax liability over the three-year period.[27] He would thus profit from both a deferral and a reduction benefit.[28]

Originally, the reduction benefit was not used exclusively by farmers, but was available to any taxpayer who sold section 1231 property at a gain. Nevertheless, only agricultural operations could generate the added benefit of a special cash method election, thus maximizing the reduction effect of section 1231.[29] In 1962, however, Congress closed this preference to all taxpayers, except those holding real property or livestock, by introducing the "recapture" concept whereby gains resulting from sales of depreciable property are taxed as ordinary income, rather than capital gain.[30] The amount thus recaptured, however, cannot exceed the previously allowable depreciation of the property.[31] In 1964 the benefit was further limited with the addition of section

called "hotchpot") against losses resulting from the same kinds of dispositions. If the gains exceed the losses, the excess is treated as a long-term capital gain, while if the losses predominate they are considered ordinary losses. In the example, however, Farmer is presumed to have no other §1231 transactions. Thus, the entire gain is accorded long-term capital gain treatment.

25. Even if the taxpayer has no nonfarm income to be offset by the initial expenses, he is still able to defer and reduce his farm tax liability by prepaying expenses in high income years, thus reducing the marginal tax rate and the resulting tax liability. *See* Lewis, *Farm and Hobby Losses After Tax Reforms,* U. So. CAL. 1971 TAX INST. 627, 631. In low income years the supplies previously purchased are consumed. While this increases farm income in those years (by reducing the need for purchases that would have otherwise been deducted) the long-term tax liability is reduced due to the progressive nature of the tax rates. There have been some limitations, however, on the nature and amount of deductible prepayments. See note 35 *infra* and accompanying text.

26. Provided by §1202.

27. Under these facts, he actually has an excess deduction of $50, which may be used to offset nonfarm income and thereby reduce his tax liability.

28. The deferral benefit has been discussed previously. See note 13 *supra.* The reduction benefit occurs because the §1202 deduction allows one-half of the sale proceeds to escape taxation. Thus, the $200 economic profit realized by Farmer in the example escapes any tax, while some of the costs incurred to produce this profit ($50 in this example) may be permitted to reduce his nonfarm income. Farmer will enjoy this result until his economic profit margin exceeds 100%, because only 50% of his income is subject to tax. For an extended discussion of this benefit, see Davenport, *supra* note 9, at 6-9. Both benefits are still available after the TRA, although in a reduced amount. See text accompanying notes 237-241 *infra.*

29. The ordinary deduction-capital gain treatment enjoyed by nonfarmers was limited to only certain expenses (such as depreciation) by the restrictions on the cash method election by nonfarmers in TREAS. REG. §1.446-1(a)(4). See note 8 *supra.*

30. INT. REV. CODE OF 1954, §1245.

31. The section requires the taxpayer to calculate the "recomputed basis" on the disposed property by adding to the adjusted basis all adjustments made for depreciation of the property. The amount by which the lower of this recomputed basis or the amount realized (or the fair market value in transactions in which there is no amount realized)

1250, applying the recapture concept to "excess depreciation" taken on real property.[32] In spite of a proposal to subject livestock to a recapture provision,[33] no action was taken initially, thus preserving for a time the captial gain-ordinary deduction treatment for the farmer and the farm investor.[34]

Attempts to maximize this loophole by a convenient prepayment of all the expenses of raising stock met with only limited success. Deductions were sustained when the courts discerned a business motive for the prepayment and were denied when the payment appeared to be a deposit primarily induced by a tax reduction motive.[35] Despite this limitation, however, farm investment remained a highly attractive shelter opportunity for the high-income taxpayer.

Agricultural Shelters Prior to the TRA

Although the legal framework for the use of agricultural investments as tax shelters devoted solely to the generation of farm losses had long existed, it was not until the early 1960's that Congress became concerned with their extensive use and the resulting ill effects on the farm economy.[36] During the late fifties and throughout the sixties, these shelter opportunities were utilized by many companies organized solely to solicit and manage high-income taxpayers' investments in livestock and citrus operations.[37] The companies' success was based predominately on their ability to turn the investor's marginal economic profits (or even losses) into large after-tax profits, utilizing the preferred treatment accorded farm operations.[38]

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exceeds the adjusted basis is treated as ordinary income. *Id.* Thus, in the unusual situation in which a taxpayer sells used personal property for an amount greater than his original cost, only the amount of the difference between the original cost and the adjusted basis is treated as ordinary income. The balance will be accorded §1231 treatment. *Cf.* Fribourg Navigation Co. v. Commissioner, 383 U.S. 272, 17 A.F.T.R.2d 470 (1966).

32. INT. REV. CODE OF 1954, §1250.

33. See text accompanying notes 57-58 *infra.*

34. Prior to the TRA, §1245(a)(3) defined "section 1245 property" as "any property (other than livestock) which is or has been property of a character subject to the allowance for depreciation . . . ." See text accompanying notes 149-154 *infra* for a discussion of the removal of the exclusion.

35. *Compare* Mann v. Commissioner, 73-2 U.S.T.C. ¶9618 (8th Cir. 1973) (deduction allowed for prepayment made to insure the amount of feed costs), *and* Cravens v. Commissioner, 272 F.2d 895, 4 A.F.T.R.2d 5984 (10th Cir. 1969) (allowing a deduction for a prepayment made to avoid the consequences of a drought), *with* Tim W. Lillie, 45 T.C. 54 (1965) (denying a deduction where a portion of the prepayment was later refunded), *and* Shippy v. United States, 308 F.2d 743, 10 A.F.T.R.2d 5837 (8th Cir. 1962) (refundable deposit denied deduction). Another determinative factor in several decisions seems to have been whether the payment was absolute or refundable and therefore a deposit. *E.g.,* Shippy v. United States, 308 F.2d 743, 10 A.F.T.R.2d 5837 (8th Cir. 1962) (specific finding that seller considered payment a deposit outweighed taxpayer's motive of smoothing income); John Ernst, 32 T.C. 181 (1959) (nonrefundable prepayment allowed deduction). Nevertheless, in all the cases where the deduction was sustained, the controlling factor seems to have been the existence of a business-related motive underlying the prepayment.

36. See notes 57-58 *infra* and accompanying text.

37. *See, e.g.,* Davenport, *supra* note 4, at 321; Note, *supra* note 4, at 1252 n.8.

38. The programs combined the deferral and reduction benefits discussed in notes 13 and 28 *supra.*

There were basically two forms of shelters designed to accomplish this result: livestock breeding operations, and the development of citrus and other crops possessing a long life but requiring a lengthy cultivation period.[39] Both were founded on the same underlying principle, which may be seen in the following example of a typical cattle breeding program: Investor, a 70 per cent taxpayer, purchases a herd of 100 cows for $70,000, financing 90 per cent of the purchase price on a nonrecourse note.[40] The herd has an annual calf crop of 100, of which 50 per cent are bulls that are sold each year for $300 per head.[41] (After the third year, the crop increases as the retained young heifers mature and breed.) Investor pays $250 a year for the feed, mainteance, and breeding expenses of each animal.[42] The net expenses, after offsetting the sales proceeds of the bull calves, would be deductible from Investor's nonfarm income in the year incurred.

If Investor held the cattle for five years, disposing of the entire herd at that time, he would have had a net cash outlay of $199,500 prior to the sale.[43] Of this amount, all but the $7,000 downpayment would have been deducted from his nonfarm income, resulting in a net tax savings of $134,750. His after-tax investment in the herd would thus be reduced to only $64,750. Assuming the mature cows were sold for $600 each and the yearlings for $300 each, the total sale proceeds would be $195,000, of which only $30,000 would be ordinary income from the sale of animals that were held for less than one year. After paying a tax of $44,750 on the sale, Investor would have an economic loss of $67,500, but due to the deferral and reduction benefits, his after-tax profit

39. Davenport, *supra* note 9, at 10-11. For a detailed discussion of these shelters and their benefits, see S. SURREY, *supra* note 13, at 92-125.

40. This arrangement would allow Farmer "to receive the full tax savings on a large herd without tying up too much of his own capital, and, at the same time, would provide protection from personal liability in the event that a disaster, such as a drought, destroyed his herd." Note, *supra* note 4, at 1253.

41. The actual calf crop would be between 85-90% of the number of mature cows in the herd.

42. For the purpose of this example, it is assumed that no maintenance expenses are paid for the calves until they are one-year old. In actual practice, the maintenance expenses would begin about six months after calving. Also, to simplify the example, deductions for interest and depreciation, which would increase the yearly "losses" and the resultant after-tax profits, are disregarded.

43. This may be seen by the following charts:

INCREASE IN HERD SIZE

YEAR	BREEDING HERD	TOTAL HEIFERS	BULLS (SOLD YEARLY)
1	100	100	-0-
2	100	150	50
3	150	200	50
4	200	275	75
5	275	375	100

(This chart continued on next page)

would be $67,250 (his $134,750 tax savings less his $67,500 economic loss): an after-tax rate of return of 12.65 per cent.

This example illustrates the benefit that accrued to the investor in livestock breeding operations prior to the TRA. Similar benefits were available to taxpayers investing in citrus development operations.[44] For those interested only in the deferral benefit of investment in agriculture, cattle feeding programs were developed to permit investors to shift taxable income to the following tax year.[45]

ANNUAL INVESTMENT

Year	Cash Expenses	Sale of Bulls	Net Economic Investment	After-Tax Investment
1	$ 32,000*	-0-	$ 32,000*	$ 14,500**
2	37,500	$ 15,000	22,500	6,750
3	50,000	15,000	35,000	10,500
4	68,750	22,500	46,250	13,875
5	93,750	30,000	63,750	19,175
Totals	$282,000	$ 82,500	199,500	64,750
Note Payoff (out of Sale Proceeds)			63,000	63,000
Total Investment			$262,500	$127,750
Sale Proceeds:				
100 Yearlings		$ 30,000		
275 Heifers		165,000	195,000	195,000
Profit (Loss)			$(67,500)	67,250
Total Liability:				
Ordinary Tax on Yearling Sales			$ 21,000	
Capital Gain Tax on Heifer Sales (Less $70,000 basis)			23,750	44,750
After-Tax Profit				$ 22,500
Average Actual Investment				$ 35,575
Annual After-Tax Rate of Return				12.65%

*Includes $7,000 downpayment on herd purchase
**30% of $25,000 deductible expenses + $7,000 capital investment

44. These shelters allowed the investor to receive an especially large deferral benefit, due to the taxpayer's ability to elect current deduction of all development costs of the groves, combined with the relatively long period required before a grove reached the production stage. Indeed, citrus investment had become so popular that it was the subject of a special provision in the TRA. See text accompanying notes 168-178 *infra*. *See* S. SURREY, *supra* note 13, at 100-25.

45. Unlike breeding or citrus programs, feeding operations were primarily short-term investments whereby the investor purchased feeder cattle, grew them to a desired weight in a feedlot and then sold them to meat packers. The process normally took 120 to 180 days, beginning at the end of one tax year, and carrying over into the next. All expenses, includ-

In addition to these primary methods of sheltering nonfarm income, another advantage accrued to the agricultural investor through statutory provisions controlling the deduction of capital expenditures; provisions still in effect today. Supplementing the authorized deductions for items conventionally viewed as expenses of raising crops or animals, these sections provide for the deductibility, rather than capitalization, of expenditures for soil and water conservation,[46] fertilizer,[47] and land clearing.[48] This advantage has also been utilized by the nonfarmer, who generally purchased wornout and unprofitable farm land still capable of generating gross income. The taxpayer then deducted the above expenditures,[49] later selling the land for the increased value or subdividing it and selling the individual lots. In either instance the proceeds were capital gains, providing the investor the advantage of both the deferral and the reduction benefits.

Although the Treasury sought to close these obvious loopholes, it met with only limited success. The only major bases for attack were section 270[50] and two provisions of the Regulations that required the farm to be operated for profit.[51] Thus, the majority of cases turned on the taxpayer's profit motive in operating the farm.[52] Despite predictable variations in the concept of profit expectations,[53] some uncertainty was removed in the case of *Billy v. Wann.*[54] Following an earlier, nonfarm related opinion of the Second Circuit[55] the Tax

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ing feed costs and management fees, were prepaid and deducted in the first year, thereby reducing nonfarm taxable income in that year. *See* TAX SHELTER ADVISORY SERVICES, INC., INVESTMENTS IN TAX SHELTERS 16-17 (1971). The sale proceeds were not realized until the following year, thus allowing the investor to benefit from the deferral advantage discussed in note 13 *supra.* The shelter was especially helpful for the taxpayer with unusually high income in a particular year, as the investment would allow him to "smooth" his income. See note 25 *supra.* The liberalization of the income averaging provisions by the TRA has lessened the taxpayer's need for such a shelter. INT. REV. CODE OF 1954, §§1301 *et seq.*

46. INT. REV. CODE OF 1954, §175.

47. INT. REV. CODE OF 1954, §180.

48. INT. REV. CODE OF 1954, §182.

49. This produced the deferral benefit discussed in note 13 *supra.*

50. This section, which was repealed by the TRA, required a recomputation of income if a taxpayer's business had more than $50,000 in losses for five consecutive years. See text accompanying notes 182-197 *infra.*

51. TREAS. REG. §§1.162-12, 1.165-6(a)(3).

52. *E.g.,* Bessenyey v. Commissioner, 379 F.2d 252, 19 A.F.T.R.2d 1566 (2d Cir. 1967) (farm loss deduction denied when the farm was operated primarily for the personal satisfaction of the taxpayer); Mercer v. Commissioner, 376 F.2d 708, 19 A.F.T.R.2d 1402 (9th Cir. 1967) (deduction allowed due to the taxpayer's good faith expectations of profit, even though the expectations may have been unreasonable); Teitelbaum v. Commissioner, 346 F.2d 266, 15 A.F.T.R.2d 1080 (7th Cir. 1965) (deduction denied when no substantial evidence introduced to show a profit motive); Tatt v. Commissioner, 166 F.2d 697, 36 A.F.T.R.2d 834 (5th Cir. 1948) (holding that the taxpayer's intention at the outset is the controlling factor in determining the existence of a profit motive). For a collection of numerous cases involving prepayment of agricultural expenses, see Allington, *Farming as a Tax Shelter,* 14 S.D.L. REV. 181, 189-91 n.59 (1969).

53. Allington, *supra* note 52, at 191-95.

54. 27 CCH Tax Ct. Mem. 1301 (1968).

55. Goldstein v. Commissioner, 364 F.2d 734, 18 A.F.T.R.2d 5328 (2d Cir. 1966).

Court held that the expectation must be based on economic profits rather than mere after-tax benefits.[56] Even with this restriction, however, the Treasury was still largely ineffectual in curtailing widespread use of agricultural shelters by nonfarmers, because a determination of the taxpayer's intent was still required.

ADMINISTRATIVE AND LEGISLATIVE PROPOSALS FOR CURTAILING THE SHELTERS

Throughout the 1960's various proposals were advanced for the wholesale reform of the agricultural provisions of the Code. The first affirmative proposal was the Treasury's statement in 1963, calling for the recapture of farm losses through an excess deductions account (EDA).[57] The proposal would have required the establishment of an EDA by all taxpayers with nonfarm income of more than $15,000 and farm losses of any amount. All farm losses would have been added to the account and any farm income would have reduced it. Any capital gains from the sale of farm assets would have been taxed as ordinary income to the extent of the EDA balance.[58]

By 1969 the Treasury had changed its proposed solution for dealing with farm shelters.[59] Included in the new proposal was a change from the EDA approach to a disallowance provision whereby deductions for farm expenses[60] in any taxable year would be limited to the amount of farm income[61] plus $15,000 of nonfarm income. While the provision would have allowed a carry-over of any expenses in excess of this limitation[62] such carried over expenses would be deductible only to the extent of the net farm income in other years and could not be used to reduce other income in those years.[63] Deductibility of these excess expenses would be disallowed to the extent of one-half of the

56. 27 CCH Tax Ct. Mem. 1301, 1307 (1968). The court disallowed loss deductions equal to approximately 50% of the taxpayer's nonfarm income, because the taxpayer had discontinued operations when the deductions were questioned by the Service and it thus appeared that tax savings, rather than actual profits, were the only benefit anticipated.

57. *See Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means,* 88th Cong., 1st Sess., pt. 1, at 144 (1963) [herinafter cited as *1963 Hearings*].

58. As might have been expected, the proposed reform met with vigorous opposition from the agricultural community. The primary arguments against this approach were the same as those later asserted in the hearings on the TRA, which adopted a modified EDA system. *Compare 1963 Hearings, supra* note 57, at 1953-97, *with Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means,* 91st Cong., 1st Sess. at 2001-183 (1969) [hereinafter cited as *1969 Hearings*]. *See also* Davenport, *supra* note 9, at 43-49; Note, *supra* note 4, at 1254-58. Although the arguments were not as successful in 1969, their impact was still such that the EDA provisions enacted by Congress were considerably more lenient than those proposed in 1963.

59. *See* UNITED STATES TREASURY DEP'T, HOUSE COMM. ON WAYS AND MEANS & SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS 156 (1969).

60. These were defined as all those allowable as deductions in connection with a business of farming, excluding taxes, interest, casualty losses, and disposition losses. *Id.* at 161.

61. This was defined as "all gross income from farming activities." *Id.*

62. These excess expenses could be carried back three years and forward five years. *Id.* at 162.

63. *Id.*

long-term capital gains resulting from farm operations in any year to which the carryover applied.[64]

Although the Treasury soon changed its position in accord with the attitude of the new Nixon Administration,[65] these proposals, with one modification, were adopted by Senator Metcalf in his bill for farm tax reform.[66] While the Treasury proposal would have allowed the farm investor to shelter $15,000 a year of nonfarm income, the Metcalf Bill revised the amount of excess farm expenses that would be allowable as deductions. The base of $15,000 was retained but would be reduced, dollar-for-dollar, by any nonfarm income in excess of that amount.[67] Thus, investors with more than $30,000 nonfarm income would be unable to deduct any farm expenses exceeding the amount of their farm income.[68] Moreover, the adoption of the carryover provisions of the Treasury's disallowance proposal would have prevented the disallowed expenses from ever reducing future year's nonfarm income. The excess expenses could only be used to offset future farm income, subject to a reduction of fifty per cent of the long-term capital gain realized from farm operations.

In spite of the greater effectiveness of the Metcalf approach in reducing the possibilities for farm tax shelters,[69] the bill that passed the House[70] was a return to the EDA concept first proposed in 1963, although with more lenient provisions.[71] This approach was supported by the Nixon Administration[72] and with minor changes became the basis of the act passed by Congress.[73]

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64. *Id.*

65. The Administration proposed a return to the EDA concept, first calling for the establishment of an EDA whenever farm losses amounted to $5,000, regardless of the taxpayer's nonfarm income. *1969 Hearings, supra* note 58, at 5537. This was later modified to require an EDA only when the taxpayer had nonfarm income in excess of $25,000 and more than $15,000 in farm losses. *Hearings on the Subject of Tax Reform Before the Senate Comm. on Finance,* 91st Cong., 1st Sess. at 574 (1969) [hereinafter cited as *Senate Hearings*].

66. S. 500, 91st Cong., 1st Sess. (1969).

67. *Id.* §277(a). The only exception to this restriction was that farm interest, taxes, and losses from casualties or sale of farm assets would remain fully deductible.

68. A taxpayer with only $15,000 in nonfarm income and an equal amount of net farm losses would have had no taxable income. Due to the reduction in the allowable excess deductions, however, if the same taxpayer had $30,000 in nonfarm income he would have had no farm loss deduction from this income. For a fuller discussion of the Metcalf Bill, see Davenport, *supra* note 9, at 21-24; Halperin, *Capital Gains and Ordinary Deductions: Negative Income Tax for the Wealthy,* 12 B.C. IND. & COM. L. REV. 387, 399-406 (1971); Note, *supra* note 4, at 1261-63.

69. See text accompanying notes 105-11 *infra.*

70. H.R. 13,270, 91st Cong., 1st Sess. §211 (1969).

71. This bill called for the establishment of an EDA only if the taxpayer had nonfarm income exceeding $50,000 and more than $25,000 in farm losses, as opposed to the 1963 proposal, which required an EDA for all taxpayers with nonfarm income in excess of $15,000 and farm losses of any amount.

72. See note 65 *supra.*

73. INT. REV. CODE OF 1954, §1251. Possible reasons for the House Bill prevailing are suggested in Note, *supra* note 4, at 1269.

THE CONGRESSIONAL "SOLUTION" — RECAPTURE RATHER THAN DISALLOWANCE

Congressional adoption of the recapture concept not only encompassed the EDA approach of the House, but also a Senate proposal for recapture of land expenses.[74] Additionally, several other proposals directed at specific abuses of the existing law were also enacted. Although this piecemeal approach did not eliminate the farm shelters, several of these latter provisions did solve some of the preexisting problems. After detailing the mechanics of the farm recapture provisions, these other reforms will be examined in the following section.

Recapture of Farm Losses

While probably not the most effective provision,[75] the heart of the congressional farm tax reform effort is section 1251. Rejecting the more effective disallowance approach of the Senate,[76] the section adopts the EDA concept introduced in the 1963 Treasury proposal and requires certain taxpayers to record farm losses, which may later be recaptured as ordinary income upon the disposition of most farm assets. Prior to this enactment those assets would have generally been entitled to section 1231 treatment.

As the section was intended to prevent the sheltering of nonfarm income, the only individuals required to establish an EDA are those cash basis taxpayers with more than $50,000 of nonfarm adjusted gross income[77] who also have in excess of $25,000 in farm losses for the year.[78] Regular corporations and all trusts, however, must establish an EDA in any year in which they have farm losses of any amount, without regard to the amount of their nonfarm income.[79]

Subchapter S corporations fall in between these two extremes. As originally enacted a glaring loophole existed in the statute because such corporations were allowed the same exclusions as an individual unless a shareholder had a farm net loss for the year. It was no problem for the agricultural investor to transfer all his agricultural investments to a Subchapter S corporation formed exclusively for this purpose. In this manner, the investor would have no farm losses, the corporation no nonfarm income, and neither would be required to

74. INT. REV. CODE OF 1954, §1252. See text accompanying notes 112-48 *infra*.

75. Griffith & Joy, *supra* note 1, at 506.

76. See text accompanying notes 59-68 *supra*.

77. INT. REV. CODE OF 1954, §1251(b)(2)(B)(i). Nonfarm adjusted gross income is defined as "adjusted gross income . . . computed without regard to income or deductions attributable to the business of farming." INT. REV. CODE OF 1954, §1251(b)(2)(D). Although technically the section applies to anyone with an EDA balance or a farm net loss (see §1251(e)(2)) for the year, no recapture is required unless there is a balance in the EDA at the end of the taxable year.

78. INT. REV. CODE OF 1954, §1251(b)(2)(B)(ii).

79. Section 1251(b)(1) generally requires each taxpayer to establish an EDA if he has a farm net loss for the year. The limitations based on the amount of farm losses or on nonfarm income apply only to individuals and electing small business corporations. INT. REV. CODE OF 1954, §1251(b)(2)(B).

establish an EDA.[80] In 1971, however, Congress amended the statute to require a Subchapter S corporation to include in its nonfarm income the largest amount of nonfarm income of any shareholder.[81] To prevent the possible formation of several small business corporations, each with farm losses less than $25,000, amended section 1251 requires that the farm losses of the corporation include not only the losses of the shareholders, but also those of any other Subchapter S corporations in which they are shareholders.[82]

A taxpayer may avoid the operation of section 1251 by electing to use inventories and to capitalize all expenditures properly chargeable to capital accounts, including those that the statute allows to be expensed or capitalized on an election basis.[83] This exemption is easily understandable as the accrual method taxpayer is unable to benefit from the shelters the section is designed to curtail.

A taxpayer not qualifying for one of the exemptions indicated above is required to establish and maintain an EDA, which is an on-going record of farm net losses.[84] Once established, it remains part of the taxpayer's permanent records so long as a balance exists in the account.[85] In the case of an individual or an electing Subchapter S corporation, the only losses necessarily included in the EDA are those exceeding $25,000 per year. The section thus allows a taxpayer to continue sheltering some nonfarm income with no adverse consequences, merely placing a limit on the amount that may be sheltered without possible recapture in the current or future tax years.[86] Even this limitation is avoided if the taxpayer has no more than $50,000 in nonfarm income in a particular year, because qualification under either exemption permits the taxpayer to avoid making additions to the EDA account, whether or not an account is currently being maintained.

The EDA must be established in the first year after 1969 in which there is a prescribed farm net loss as determined above. The balance of the account is increased by all prescribed farm net losses in each succeeding tax year[87] and is decreased by the amount of "farm net income"[88] for those years and by the

80. Hjorth, *Farm Losses and Related Provisions*, 25 TAX L. REV. 581, 592 (1970).

81. Revenue Act of 1971, §305, *amending* INT. REV. CODE OF 1954, §1251(b)(2).

82. *Id.*

83. INT. REV. CODE OF 1954, §1251(b)(4).

84. A farm net loss is the amount by which deductions related to the business of farming exceed the gross income from such business, except that gains or losses on the disposition of "farm recapture property" (see §1251(e)(1)) are not included in the computation. INT. REV. CODE OF 1954, §1251(e)(2).

85. PROPOSED TREAS. REG. §1.1251-2(a)(1), 36 Fed. Reg. 25,019 (1971).

86. As the first $25,000 of an individual's net farm losses are excluded from the EDA, he may continue to shelter this amount with his only worry being the possible application of §183. See text accompanying notes 182-197 *infra*. Assuming that §183 is inapplicable, he may continue to shelter up to $50,000 a year if his nonfarm income is less than $50,000. Any losses exceeding this amount would likely be available to reduce other years' income through the net operating loss provisions of §172.

87. INT. REV. CODE OF 1954, §1251(b)(2).

88. This is defined as the amount by which gross income from a business of farming exceeds the deductions relating to such business. Again, gains or losses on the disposition of "farm recapture property" (see §1251(e)(1)) are not included in the computation. INT. REV. CODE OF 1954, §1251(e)(3).

amount of farm deductions that did not result in a tax reduction.[89] There is a further reduction for any amount recaptured as ordinary income solely by operation of the section.[90] The aggregate of these deductions, however, may not result in a negative EDA.[91]

Once an EDA is established, any gain resulting from the disposition of "farm recapture property" is treated as ordinary income to the extent of the balance in the account at the end of the tax year.[92] "Farm recapture property" is generally defined as section 1231 property, excluding section 1250 property, that has been used in the business of farming.[93] As regards farmland, gain will be recaptured as ordinary income upon its sale or exchange only to the extent of the lesser of the EDA balance or the section 175 and 182 deductions taken in the taxable year and the four previous years.[94] In the case of a disposition of other "farm recapture property" the taxpayer must treat the lower of (1) the gain resulting from the disposition or (2) the balance of the EDA at the close of the tax year as ordinary income. This is illustrated in the following example: Taxpayer has $40,000 in farm net losses in 1970, ordinary farm income of $10,000 in 1971 as well as $30,000 in sales of farm recapture property having an adjusted basis of $19,000.[95] The balance in Taxpayer's EDA is $5,000, determined by subtracting the $10,000 farm net income for 1971 from the $15,000 balance of the EDA at the beginning of the year ($40,000 net farm loss in 1970 less the $25,000 exclusion). Thus, only $5,000 of the $11,000 gain on the sale of farm recapture property is recaptured as ordinary income under section 1251(c); the remaining $6,000 is treated as gain from the sale of section 1231 property, and the EDA balance at the end of 1971 is zero.

On the other hand, if Taxpayer had no farm net income or loss in 1971, the EDA balance would have remained at $15,000. In that case, the entire gain of $11,000 would have been recognized as ordinary income under section 1251(c) and the balance remaining in the EDA would have been $4,000.

As with the other recapture provisions in the Code, certain transfers are either fully or partially exempt from the operation of section 1251. Transfers at death are fully exempt,[96] and certain gifts of farm recapture property have

89. INT. REV. CODE OF 1954, §1251(b)(3)(A).

90. INT. REV. CODE OF 1954, §1251(b)(3)(B).

91. INT. REV. CODE OF 1954, §1251(b)(3).

92. INT. REV. CODE OF 1954, §1251(c). The amount subject to recapture is determined by first making all other additions and subtractions to the EDA.

93. There is another exception to the definition of farm recapture property, which is of particular interest in Florida. The definition is phrased in terms of property generally described in §1231(b), but omits paragraph 2 of that section from the description. Therefore, *timber,* coal, and domestic iron ore operations are *not* subject to the provisions of §1251. INT. REV. CODE OF 1954, §1251(e)(1)(A). All other property described in §1231(b) that is or has been used in the business of farming is subject to §1251 whether or not acquired after 1970. *Id.*

94. INT. REV. CODE OF 1954, §1251(e)(5). See text accompanying notes 210-212 *infra,* for a possible trap.

95. For simplicity, the example assumes that Taxpayer is either single or files a joint return, that the property sold was not farmland, and that none of the $11,000 realized gain is recognized under §1245.

96. INT. REV. CODE OF 1954, §1251(d)(2).

no immediate tax consequences.[97] If, however, the potential gain[98] of the gift, or of all gifts by the donor within a one-year period, exceeds 25 per cent of the donor's potential gain in all farm recapture property, the donee must assume a proportional amount of the donor's EDA.[99] Similarly, disposition by way of a like-kind exchange or an involuntary conversion invokes a recapture of the amount of gain recognized (without regard to the recapture section), plus the fair market value of any property received that is not farm recapture property.[100] Installment sales are treated in the same manner as under section 1245,[101] while some transactions involving partnerships and corporations qualify for special statutory exceptions.[102]

Even as amended, the section fails to effect the announced congressional purpose of eliminating the abuses of the farm shelters. Some of the benefits may have been reduced, but the farm tax provisions still constitute an attractive method of sheltering nonfarm income.[103] Although it may be true that Congress took this approach to protect the dirt farmer,[104] it would seem that the result protects only the farmer who is dirt poor and the high-income investor-farmer who can afford continual tax advice. For the middle-income farmer, the section and its relationship to the entire reform package seem to be more a trap for the unwary than an effective device for curtailing tax shelters; certainly it is less effective than the Metcalf Bill would have been in effectuating the announced purpose of the TRA.

Comparison of the Disallowance and Recapture Approaches

The greater effectiveness of the Metcalf Bill in removing the shelter possibilities of the agricultural tax provisions can be seen by a modification of the

97. INT. REV. CODE OF 1954, §1251(d)(1).

98. Potential gain is defined in §1251(e)(5) as the excess of the fair market value of the property over its adjusted basis.

99. INT. REV. CODE OF 1954, §1251(b)(5)(B).

100. INT. REV. CODE OF 1954, §1251(d)(4). Of course, the amount of recapture can never exceed the balance of the EDA.

101. PROPOSED TREAS. REGS. §1.1251-1(e)(6), 36 Fed. Reg. 25,019 (1971). See text accompanying notes 138-140 *infra.*

102. Section 1251(d)(5)(B) provides that if a partner transfers farm recapture property to a partnership in a transaction otherwise qualifying for nonrecognition under §721, gain is recognized only to the extent that the value of the farm recapture property transferred by him exceeds the value of his partnership interest attributable to that property. If, however, the partnership agreement provides that any gain resulting from the subsequent sale of that property will be allocated to the contributing partner, no gain need be recognized on the transfer.

If farm recapture property is transferred to a corporation in a transaction otherwise qualifying for nonrecognition under §§332, 351, 361, 371(a), or 374(a) gain is recognized only to the extent recognized by operation of those sections. INT. REV. CODE OF 1954, §1251(d)(3). If the transfer is governed by the provisions of §381, the acquiring corporation succeeds to the EDA of the transferor. INT. REV. CODE OF 1954, §1251(b)(5)(A). Otherwise, the transferor must treat the stock or securities received in the transaction as farm recapture property to the extent they are attributable to the fair market value of the transferred property. INT. REV. CODE OF 1954, §1251(d)(6).

103. See text accompanying notes 237-241 *infra.*

104. Griffith & Joy, *supra* note 1, at 496.

first example considered,[105] where Farmer spent $300 in Year 1 and realized $500 at the end of Year 3. In this case his cow continues to produce a calf every year, for which he prepays $300 in expenses a year, realizing $500 a year beginning with Year 3. Assuming Farmer has at least $30,000 of nonfarm income, the Metcalf Bill would not have allowed any deductions in Years 1 or 2. Instead, Farmer would have a farm loss carryover of $300 in each year, or a total of $600 at the end of Year 2. In Year 3, his net farm income would still be $250, after the $1,202 deduction, but this would be entirely offset by the $300 in expenses. The remaining $50 in expenses, however, would not be added to the carryover. Both this amount and $200 of the existing carryover would be absorbed by the untaxed $250 of capital gain, leaving a carryover balance of $350. There would be no taxable income from the farm operations in either Years 4 or 5, and the remaining carryover balance would be entirely absorbed by the untaxed capital gains in those years. Thus, under the Metcalf approach, Farmer would still be relieved of paying any tax on farm operations until the profit margin exceeds 100 per cent,[106] but he would be unable to shelter any nonfarm income.

By adopting the EDA approach, on the other hand, section 1251 does allow the taxpayer to continue sheltering a portion of nonfarm income. Even assuming Farmer is required to establish an EDA,[107] he may still deduct the $300 in expenses from nonfarm income in Years 1 and 2. This will be added to his EDA, giving him a balance at the end of Year 2 of $600. In Year 3, the $300 in expenses will be added to the EDA for a total balance of $900 before the sales proceeds are taken into account. Because the EDA exceeds the sales proceeds, the entire $500 will be taxed as ordinary income[108] (resulting in a farm net income of $200 after the $300 in expenses is deducted). The $500 is then subtracted from the EDA, leaving a balance of $400 at the end of Year 3.[109] The same result will occur in Years 4 and 5 leaving an EDA balance of $200 at the end of Year 4 and a zero balance at the end of Year 5. In the following years, $300 of the proceeds will be taxed as ordinary income, offsetting the $300 in expenses, and $200 will be capital gain.

The EDA approach thus allows Farmer a deferral benefit on his initial

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105. See text accompanying notes 23-28 *supra*.

106. See note 28 *supra*.

107. Under both the House Bill and §1251 as finally passed, Farmer would be required to establish an EDA if his nonfarm income exceeded $50,000 and he had other farm losses of at least $25,000. If Farmer did not meet these requirements, he would experience the same benefits as in the first example. See text accompanying notes 26-28 *supra*.

108. Thus, once an EDA is established it is immaterial whether a bull calf or a two-year-old heifer is sold. In the former case, the sale results in ordinary gain because it is not within the provisions of §1231. In the latter case the proceeds are treated as ordinary income pursuant to the provisions of §1251(c) and (e).

109. INT. REV. CODE OF 1954, §1251(b)(3)(B). The subtraction from the EDA is not made under subparagraph (A) because the $500 is not within the definition of farm net income. Thus, the subtraction from the account for amounts recaptured under the section is made only after all additions and all substractions for the amount of farm net income have been made.

"losses" until the EDA balance is reduced to zero.[110] Thereafter 50 per cent of his farm net income is added to his taxable income from other sources.[111] In contrast to this result, the Metcalf Bill would have denied any shelter benefits to his nonfarm income, although his farm profit would have escaped tax due to the capital gain deduction. Nevertheless, since most shelter programs offered much lower economic profit margins than the above example in order to maximize the shelter effect, the elimination of the shelter benefit would have greatly limited their attractiveness to the nonfarm investor.

Recapture of Certain Expenditures Upon Disposition of Farm Land

In an attempt to reduce the attractiveness of another popular form of shelter, the TRA adopted a second recapture provision aimed specifically at agricultural land developers. Section 1252 was intended to eliminate the abuse of tax incentives that encouraged certain farm expenditures considered beneficial to the industry and the economy as a whole.[112] To prevent abuse by farm investors without removing the incentive for the true farmer,[113] section 1252 requires recapture, upon a disposition of farmland, of certain prior deductions for expenditures on the land. A decreasing percentage of these deductions (based on the period the land has been held) is accorded ordinary income treatment. Such an approach prevents the taxpayer from obtaining the benefit of converting ordinary deductions into capital gains, but does nothing to reduce the deferral benefit.[114]

The section itself is relatively simple, providing that any gain realized on the sale[115] of farmland after December 31, 1969, shall be treated as ordinary income to the extent of the "applicable percentage" of the total deductions previously allowed under sections 175 and 182.[116] "Farmland" is defined as any land with respect to which these deductions have been previously allowed,[117] but the section applies only to deductions allowed since 1969.[118] As the deuc-

110. Additionally, the approach allows him both the deferral and reduction benefits on the first $25,000 in farm losses.

111. To avoid adding to his other income in this manner, Farmer could either reduce his annual net farm losses below $25,000 or terminate operations temporarily and restart the cycle in a year.

112. S. REP. No. 91-552, 91st Cong., 1st Sess. 105 (1969). These prior abuses are discussed in the text accompanying notes 46-49 *supra.*

113. *Id.* As one commentator has observed, however: "[I]f the activity to be encouraged from the allowance of the deductions under sections 175 and 182 is actually beneficial, it is difficult to understand the theory behind recapturing these deductions . . . ." Davenport, *supra* note 4, at 333. On the other hand, this is not the first instance in which Congress has allowed increased deductions to encourage certain investments and then required the taxpayer to hold the property for a specified period or face recapture. *See* INT. REV. CODE OF 1954, §1250.

114. See note 13 *supra.*

115. If the land is subject to another form of disposition, then the amount of potential recapture is the excess of the fair market value of the land over the adjusted basis.

116. INT. REV. CODE OF 1954, §1252(a)(1).

117. INT. REV. CODE OF 1954, §1252(a)(2).

118. INT. REV. CODE OF 1954, §1252(a)(1)(A).

tions themselves are elective, the applicability of 1252 is dependent upon the taxpayer himself.[119]

Once the deductions have been taken, the amount recaptured depends in part on the length of time the property has been held by the taxpayer.[120] If the holding period is five years or less, the "applicable percentage" is 100, requiring full recapture of the deductions to the extent of gain. For every year held after five years, the amount recaptured is reduced by 20 per cent.[121] Because of a drafting error, however, the section fails to provide an applicable percentage in the tenth year,[122] even though the section purports to require a holding period of 10 years or more before there is no recapture.[123] This omission is recognized in the Proposed Regulations, which require only a nine-year holding period.[124]

There is one difference between the "applicable percentage" approach under the new section and that of section 1250. The percentage under the latter section applies to either the amount of the "excess depreciation" deductions or the gain, whichever is less.[125] The percentage under section 1252, however, is never applicable to the gain, but only to the total deductions.[126] Thus, the amount recaptured is limited to the lower of the applicable percentage of deductions or the full amount of the realized gain.[127]

Under the authority of the statute[128] the Treasury has proposed regulations similar to those promulgated under section 1245. Thus, while the section purports to override other sections of the Code,[129] the Proposed Regulations exempt transfers at death from the operation of the section[130] and allow at least a deferral of recapture for transfers by gift,[131] for certain specified corporate and partnership transfers,[132] and for like-kind exchanges or involuntary conversions.[133] If a portion of the gain is recognized without regard to section 1252, only the lesser of such gain or the applicable percentage of the deduc-

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119. J. O'BYRNE, FARM INCOME TAX MANUAL 566-57 (3d ed. 1972).

120. INT. REV. CODE OF 1954, §1252(a)(3).

121. *Id.*

122. Lewis, *supra* note 25, at 655.

123. Recapture under §1252 supposedly applies "if farm land which the taxpayer has held for less than 10 years is disposed of during a taxable year beginning after December 31, 1969." INT. REV. CODE OF 1954, §1252(a)(1).

124. PROPOSED TREAS. REGS. §1.1251-1(b)(1), 36 Fed. Reg. 25,036 (1971).

125. INT. REV. CODE OF 1954, §1250(a).

126. See text accompanying notes 146-148 *infra* for an example of the effect of this difference in approach.

127. INT. REV. CODE OF 1954, §1252(a)(1).

128. INT. REV. CODE OF 1954, §1252(b).

129. "Such gain shall be recognized notwithstanding any other provision of this subtitle, except that this section shall not apply to the extent section 1251 applies to such gain." INT. REV. CODE OF 1954, §1252(a)(1).

130. PROPOSED TREAS. REG. §1.1252-2(b), 36 Fed. Reg. 25,037 (1971).

131. PROPOSED TREAS. REG. §1.1252-2(a), 36 Fed. Reg. 25,036-37 (1971).

132. PROPOSED TREAS. REG. §1.1252-2(c), 36 Fed. Reg. 25,037 (1971).

133. PROPOSED TREAS. REG. §1.1252-2(d), 36 Fed. Reg. 25,038 (1971). In this case recapture is limited to the recognized gain and the fair market value of nonfarm land received in the exchange.

tions is recaptured.[134] In all cases other than transfers at death,[135] the remaining recapture potential is shifted to the transferee, whose holding period will include the time the property was held by the transferor.[136] If the property is the subject of a charitable contribution, however, there is no recapture per se, but the section 170 deduction will be reduced by the amount that would have been recaptured on a sale.[137]

Consistent with the treatment of installment sales under section 1245, if section 1252 property is sold and reported under section 453, the income on each installment payment is treated as ordinary income until the entire amount of the recapture is reported.[138] If only a portion of the land is sold, however, the taxpayer fares a little better. Assuming he can establish the portion of the total deductions actually attributable to the particular parcel sold, the realized gain will be recaptured only to the extent of the "applicable percentage" of that portion of the deductions.[139] Otherwise, the Service will require an allocation of the deduction in proportion to the fair market value of each parcel at the time of the sale or disposition.[140]

Because section 1252 was not the main thrust of the TRA in dealing with farm shelters,[141] its effect may be preempted by the recapture provisions of section 1251.[142] Thus, if there is a gain on the sale or exchange of land, section 1251 limits recapture to the lesser of the gain or the sections 175 and 182 expenses allowable in the taxable year and the *four* preceding taxable years.[143] The amount recaptured is further limited by the balance of the excess deductions account.[144] Due to the five-year limitation and the other general restrictions of section 1251 discussed in the last section, recapture of land expense deductions under that section will occur less often than under section 1252.[145] To the extent 1251 is applicable, however, recapture is first accomplished against the EDA and any remaining amount is then recaptured under section 1252.[146]

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134. PROPOSED TREAS. REG. §1.1252-2(c), 36 Fed. Reg. 25,037 (1971).

135. PROPOSED TREAS. REG. §1.1252-2(b)(2), 36 Fed. Reg. 25,037 (1971), provides that in the case of a transfer at death the transferee's recapture potential is zero.

136. PROPOSED TREAS. REG. §1.1252-2(f), 36 Fed. Reg. 25,039 (1971).

137. INT. REV. CODE OF 1954, §170(e).

138. PROPOSED TREAS. REG. §1.1252-1(d)(3), 36 Fed. Reg. 25,036 (1971). This is the same method of treatment accorded installment sales under §1251.

139. PROPOSED TREAS. REG. §1.1252-1(a)(4), 36 Fed. Reg. 25,036 (1971).

140. *Id.*

141. "Although Section 1252 was a necessary part of the Senate's tax reform scheme, which did not utilize the excess deductions account approach, it should have been discarded when the House's approach to Section 1251 prevailed inasmuch as the enactment of both sections has provided much broader recapture potential for land than either the Senate or the House intended." Lewis, *supra* note 25, at 657. See text accompanying notes 75-76 *supra*.

142. See note 129 *supra*.

143. INT. REV. CODE OF 1954, §1251(c), (e)(5).

144. INT. REV. CODE OF 1954, §1251(c)(2)(A).

145. Recapture will occur only under §1252 if the land has been held for 5 to 9 years, if the seller has not been required to establish an EDA, or if the EDA balance is zero.

146. The overlap of the two sections presents a problem discussed in the text accompanying notes 210-212 *infra*.

In spite of the refinements added by the Proposed Regulations, the general operation of section 1252 remains relatively simple, as illustrated by the following example: On February 15, 1975, Taxpayer sells a parcel of farmland for $100,000, which he had purchased on January 1, 1969. The adjusted basis of the property was $71,000 and Taxpayer had deducted $30,000 of sections 175 and 182 expenses with respect to the property: $10,000 in 1969 and $20,000 in 1970. Because there have been no land expense deductions in the previous four taxable years, section 1251 is inapplicable and any recapture is limited to section 1252. The applicable percentage is 60 per cent,[147] which is applied to the aggregated $20,000 in land expense deductions allowed after 1969, resulting in a recapture potential of $12,000. This is less than the $29,000 realized gain on the property and therefore the amount of gain recognized as ordinary income under section 1252(a)(1) is limited to the recapture potential of $12,000. The remaining $17,000 may be treated as gain from the sale of section 1231 property. On the other hand, if the realized gain on the property had been only $10,000, the entire $10,000 gain would have been recognized as ordinary income, for the "applicable percentage" is applied only to the aggregate deduction.[148]

A FURTHER "SOLUTION" — THE SHOTGUN APPROACH

Just as section 1252 was aimed at a particular farm tax loophole, the TRA also included several other reforms directed at specific abuses of the existing agricultural tax provisions. As these reforms are an integral part of the congressional "solution" to the problem of farm tax shelters, it is necessary to examine each of them before the defects of the total reform effort may be considered.

Livestock Depreciation Recapture

One of the provisions most likely to have a greater impact on the farm investor than the true farmer was a simple amendment to section 1245, which removed the exclusion for livestock from the definition of section 1245 property.[149] Any livestock depreciation allowed after December 31, 1969, is now subject to recapture upon the subsequent sale of the animal.[150]

The provision is of little consequence to the true farmer, as he normally has raised his herd and it therefore has no depreciable basis. It does have an impact on the shelters because one of their major deductions is depreciation of the purchase cost of the herd. If the farm investor has purchased his herd

147. This is the percentage required when property is disposed of within the seventh year after it was acquired. INT. REV. CODE OF 1954, §1252(a)(3).

148. See text accompanying notes 126-127 *supra.*

149. INT. REV. CODE OF 1954, §1245(a)(3).

150. This provision applies to post-1969 depreciation on livestock even if acquired prior to 1970. The amount recaptured will generally be the excess of the amount realized over the adjusted basis. If the amount realized exceeds the original cost, recapture is limited to the excess of that cost over the adjusted basis. *Id.*

as a long-term investment, however, the effects of depreciation recapture become less important, for the proportion of the purchased herd to the total herd decreases substantially over a period of several years. As a result, most of the herd will have no basis,[151] and sales of the brood animals will probably produce only capital gains unaffected by section 1245 recapture. Although the amendment corrects the anomaly of treating livestock in a manner different from other section 1231 property, a problem was created by the adoption of the EDA approach in conjunction with the section 1245 amendment. Neither provision specifically states the effect of 1245 recapture on the taxpayer's EDA, thus raising the possibility of a double recapture.[152] Moreover, some farmers may change accounting methods to avoid the effect of section 1251,[153] thereby expanding the scope of the amended section. While most will probably remain on the cash method,[154] those that do change will establish a depreciable basis for their entire herd. In that event, any subsequent sale will be subject to 1245 recapture.

Restrictions on Like-Kind Exchanges

In a normal breeding operation, most bull calves are not retained for breeding purposes but are either exchanged for heifers, sold to others for breeding, or in the majority of instances, castrated and sold as steers. Some taxpayers who followed the first course prior to 1969 claimed the transaction was an exchange of like-kind property and therefore not subject to tax.[155] This position was contested by the Service but upheld by several courts.[156] Although the House supported the Treasury's interpretation and did not deem clarification necessary,[157] the final bill accepted the Senate's proposal and enacted section 1031(e) to force recognition of gain on such exchanges.[158] Unlike other reforms, this section is applicable to all 1954 Code years.[159]

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151. This assumes that the investor is on the cash basis, as is normally the case. If he is on the accrual basis, the entire herd would have a depreciable basis and would be subject to §1245 recapture.

152. See text accompanying notes 213-221 *infra*.

153. This election is permitted by INT. REV. CODE OF 1954, §1251(b)(4).

154. Griffith & Joy, *supra* note 1, at 500; Lewis, *supra* note 25, at 641. *But cf.*, Pinney, *Agricultural Tax Problems, Including the "Prepaid Feed" Controversy*, U. SO. CAL. 1973 TAX INST. 477, 495-96 (1973).

155. Section 1031 provides that gain realized on like-kind exchanges is recognized only to the extent of the value of any "boot" received in the exchange. INT. REV. CODE OF 1954, §1031.

156. Wylie v. Commissioner, 281 F. Supp. 180, 21 A.F.T.R.2d 972 (N.D. Tex. 1968); Leo Woodbury, 49 T.C. 180 (1967).

157. H.R. REP. No. 91-413, 91st Cong., 1st Sess., pt. 1, 66 (1969).

158. The amendment simply provides that "for purposes of this section [§1031], livestock of different sexes are not property of a like kind." INT. REV. CODE OF 1954, §1031(e).

159. S. REP. No. 91-552, 91st Cong., 1st Sess. 102 (1969). One loophole remains, however, for as one commentator observes: "[E]ven though a breeding heifer cannot be exchanged for a breeding bull, the section does not proscribe tax-free treatment on the exchange of a bull for a stallion." Lewis, *supra* note 25, at 659.

Extended Holding Period for Cattle and Horses

Prior to the TRA, some taxpayers accorded capital gain treatment to the proceeds from the sale of bull calves or steers, a treatment subject to attack on the ground that such stock was held primarily for sale and therefore could not be section 1231 property.[160] Nevertheless, capital gain treatment could properly be accorded the sale of "culls"[161] from the brood herd and, upon the sale of an entire herd, of all calves more than 12 months old.[162]

A restrictive amendment, enacted to simplify the process for determining whether an animal was held for sale or qualified for section 1231 treatment, extends the holding period for horses and cattle to 24 months.[163] Although the amended section still excludes poultry from the definition of livestock qualifying for section 1231 treatment,[164] the definition was expanded to include sporting animals,[165] thereby preventing them from qualifying for section 1231 treatment after only a six-month holding period.[166] In addition to restricting the treatment of race horses and other sporting animals as section 1231 property, the extended holding period will result in most "culls" being taxed at ordinary rates, as they are normally sold within 24 months. Perhaps of more importance in reducing the benefits of breeding operations as shelters, the new holding period will require ordinary income treatment for a larger percentage of the gross sale proceeds upon a disposition of the entire breeding herd. As a result, at least one commentator has observed that the section 1231 amendment, as well as those of section 1031 and 1245, appears to be more effective in reducing the shelters' attractiveness than the more widely noted enactment of section 1251.[167]

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160. *See* TREAS. REGS. §§1.1231-2(b) & (c)(2).

161. Lewis, *supra* note 25, at 660-61. "Culls" are "animals held for breeding but which lack the required characteristics the breeder is seeking to develop, or which are 'culled' from the herd because of age, inferior quality, or to maintain the herd at a given size." *Id.* Whether the sale of culls was accorded capital gain treatment seemingly depended on the taxpayer's method of culling. *Compare* McDonald v. Commissioner, 214 F.2d 341, 45 A.F.T.R. 1733 (2d Cir. 1954) (capital gain treatment allowed), *with* Gotfredson v. United States, 303 F.2d 464, 9 A.F.T.R.2d 1689 (6th Cir. 1962), *and* Gotfredson v. Commissioner, 217 F.2d 673, 46 A.F.T.R. 1373 (6th Cir. 1954) (capital gain treatment denied).

162. *Cf.* TREAS. REG. §1.1231-2(b)(2), ex. (2).

163. The amendment was applied only to horses and cattle because other animals may breed and produce at less than two years of age. Hjorth, *supra* note 80, at 588 n.17.

164. INT. REV. CODE OF 1954, §1231(b)(3).

165. This new language provides some uncertainties concerning what animals will be considered sporting. "[P]resumably [the definition] includes all uses that involve 'sport' to a user or spectator. If the animal provides 'sport' only to the owner, it probably is not used in a trade or business and would be an ordinary capital asset subject only to the 'more than six months' holding period." O'Byrne, *New Law Greatly Limits the Tax Shelter Formerly Provided by Farming Operations,* 32 J. TAXATION 298, 299 (1970).

166. Prior to this amendment, a racehorse held for more than six months qualified for capital gain treatment. McKinley Kirk, 47 T.C. 177 (1966), *acquiesced in,* 1967-2 CUM. BULL. 2. If the animal were held solely for breeding purposes, however, a twelve-month holding period was required. Anderson Fowler, 37 T.C. 1124 (1962).

167. Lewis, *supra* note 25, at 658.

Citrus Development Costs and Insurance Proceeds

As a result of a section proposed by Florida's late Senator Holland,[168] the planting and development costs of citrus groves must now be capitalized for the first four years after planting.[169] Prior to this amendment, the citrus investor could deduct annually the development costs of his grove, even though no income would be realized for several years. While development costs do not include costs incurred in planting, but only those that promote the growing process,[170] the deferral benefit resulting from their yearly deduction was still attractive enough to make citrus investment a desirable shelter.[171] Indeed, the shelter had become so popular that Senator Holland's main stimulus in introducing the amendment was the over-cultivation of Florida citrus caused at least in part by these shelters.[172]

As adopted in the TRA, section 278 requires the capitalization of all expenditures "attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove . . . [which are] incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted . . . ."[173] Once this period is determined, any subsequent buyer of the grove must continue capitalizing the costs until the end of the fourth year.[174] Thus, the section cannot be averted by the simple expedient of having the managing company plant the trees and then sell them to the investor. Nevertheless, the section was given only prospective effect[175] and provides an exclusion for costs incurred in replanting a grove damaged by specified casualties.[176] While such losses would obviously not be planned by the investor,[177] the effect of the exclusion may result in a double deduction in the year of any

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168. 115 CONG. REC. S15,951 (1969).

169. INT. REV. CODE OF 1954, §278. As noted earlier, prior to this enactment a cash basis taxpayer could fully deduct these costs in the year incurred without waiting until the productive stage of the grove was reached. See text accompanying notes 46-49 *supra*. For a fuller discussion of this treatment, see Hewitt, Froehlich, Greaves, Kane, O'Byrne, Thomas & West, *Tax Planning for the Professional—Ramifications and Ruminations*, U. So. CAL. 1970 TAX INST. 27, 186-87 (1970).

170. Maple v. Commissioner, 440 F.2d 1055, 1057, 27 A.F.T.R.2d 71-1144, 71-1145 (9th Cir. 1971), *aff'g* 27 CCH Tax Ct. Mem. 944 (1968); Estate of Richard Wilbur, 43 T.C. 322 (1964).

171. Griffith & Joy, *supra* note 1, at 505.

172. 115 CONG. REC. S15,954 (1969). A similar bill, H.R. 9454, 89th Cong., 1st Sess. (1965), had earlier been introduced by Rep. William Haley, also of Florida, which would lead to the conclusion that at least the Florida citrus lobby was concerned with the impact of the shelters on production. *See* O'Byrne, *supra* note 165, at 298-99. The new section, however, may well establish a precedent for requiring all farmers to capitalize such costs and maintain inventories. *Id.*

173. INT. REV. CODE OF 1954, §278(a).

174. TREAS. REG. §1.278-1(a)(3).

175. INT. REV. CODE OF 1954, §278(b)(2).

176. INT. REV. CODE OF 1954, §278(b).

177. *But see* Griffith & Joy, *supra* note 1, who suggest that "hereafter, few trees will die a natural death." *Id.* at 505.

loss, as the loss itself will also be deductible to the extent of the capitalized costs.[178]

Perhaps to reduce the sting of section 278, Congress also provided some aid to the crop grower by allowing him the election of reporting crop insurance proceeds in the year after receipt.[179] Although applying to all taxpayers with investment in crops, the section was undoubtedly included as a measure to aid the actual farmer.[180] In order to qualify for the election the taxpayer must establish that he uses the cash method and that he would normally report the income from the destroyed crops in the following taxable year.[181]

Hobby Losses

A provision of the TRA not limited to the farming industry, but of prime importance to the agricultural investor, repealed section 270 and promulgated section 183 in its place. Both provisions concern the deduction of so-called "hobby losses." By limiting the deduction of these expenses instead of the previously required recomputation of taxable income,[182] the new section shifts the emphasis of the congressional attack. Unfortunately, the new approach is very similar to and perhaps more lenient than that of the old Regulations.[183] Basically, section 183 greatly restricts the deductions attributable to "activities not engaged in for profit,"[184] but then raises a presumption in favor of the taxpayer that an activity is engaged in for profit if the gross income therefrom exceeds deductions for at least two of five consecutive years ending with the taxable year.[185] Again agriculture is singled out for preferred treatment because an activity consisting primarily of the "breeding, training, showing, or racing of horses"[186] is presumed to be engaged in for profit if net income is realized in two of seven consecutive years.[187]

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178. Davenport, *supra* note 4, at 333 n.57.

179. INT. REV. CODE OF 1954, §451(d).

180. Prior to the change, the cash basis farmer who received such proceeds normally had a doubling of income because he also realized the proceeds of the previous year's crop sale in the current year. Griffith & Joy, *supra* note 1, at 507.

181. INT. REV. CODE OF 1954, §451(d).

182. Section 270, repealed by the TRA, required a recomputation of income if the losses from a trade or business exceeded $50,000 for five consecutive years.

183. TREAS. REG. §§1.162-12, 1.165-6(a)(3). See text accompanying note 51 *supra*.

184. This term is defined as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212." INT. REV. CODE OF 1954, §183(c).

185. INT. REV. CODE OF 1954, §183(d). Under the House Bill the Treasury would have been aided by a presumption that an activity was not engaged in for profit if it realized losses in excess of $25,000 in three out of five years. H.R. REP. No. 91-413, 91st Cong., 1st Sess. pt. 1, at 71 (1969). The Senate reversed the presumption, S. REP. No. 552, 91st Cong., 1st Sess. 104-05 (1969), and this version was adopted in the final bill.

186. INT. REV. CODE OF 1954, §183(d).

187. This preferential treatment is disparaged by one commentator, who believes the racing industry does not "appear to have either a high social or economic claim for special treatment." Davenport, *supra* note 4, at 331.

Even if the activity is not engaged in for profit, certain deductions are still allowed under the new section. Expenditures that are normally deductible even though personal in nature (such as interest, taxes, and casualty losses) remain so regardless of whether the activity was engaged in for profit.[188] Any other expenses are treated much the same as wagering losses[189] and are deductible to the extent that gross income from the activity exceeds the amount of the personal deductions.[190]

This disallowance approach to hobby losses appears to inhibit the deferral or reduction benefit generally available to agricultural investors. Were this in fact the case, it would certainly be an improvement over the provisions of section 270, which allowed the taxpayer to shelter at least $50,000 during four out of five years.[191] Unfortunately for the Treasury, however, it is doubtful that the section will be very beneficial in curtailing hobby loss deductions.[192] By utilizing the farmer's cash method of accounting,[193] most farm investors will be able to shift income and expenses in order to realize a net income in two out of five years.[194] Not only will taxpayers who accomplish this be aided by the statutory presumption, but even if they fail, their deductions are not necessarily disallowed.[195] Thus, the same issue of intent that caused so much litigation prior to the TRA remains[196] although, as has been suggested, "the requirement of a reasonable expectation of profit imposed by some courts is eliminated and the taxpayer has been given a new opportunity to shift the burden of proof to the Commission by realizing a profit in two of five years."[197]

DEFECTS IN THE "SOLUTION"

Drafting Inadequacies

Section 1251 and 1252 are comittee compromises dictated by the need for farm tax reform and the final result suffers from both error and obscurity. Two

188. INT. REV. CODE OF 1954, §183(b)(1).

189. INT. REV. CODE OF 1954, §165(d).

190. INT. REV. CODE OF 1954, §183(b)(2).

191. Section 270 was applicable only if the activity had losses in excess of $50,000 for five consecutive years. Thus, if a taxpayer lost more than this amount for four years, but something less in the fifth year, there would be no recomputation of income under the section.

192. "While the Treasury previously had been largely unsuccessful in winning the hobby loss cases, this new tool will impose an even heavier burden upon it. Few taxpayers . . . in the farming business . . . will fail to show at least one dollar of net income in 40 per cent of their years. Furthermore, so long as the cash method of accounting is permitted for farm income and expenses, the taxpayer can defer the expenses or the income of one year to a later year and get a doubling-up effect." Davenport, *supra* note 4, at 331-32.

193. See text accompanying notes 7-13 *supra*.

194. *See* Davenport, *supra* note 4, at 331-32.

195. Although he would not be aided by a presumption, the taxpayer could still deduct the losses if he could show that the activity was engaged in for profit — that is, that he expected to realize a profit — regardless of whether the expectation was reasonable. *See* S. REP. No. 91-552, 91st Cong., 1st Sess. 103 (1969).

196. See text accompanying notes 52-56 *supra*.

197. Lewis, *supra* note 25, at 670.

deficiencies in the statutes have already been mentioned: the Subchapter S corporation loophole in the original section 1251,[198] and the omission of an applicable percentage for the tenth year in section 1252.[199]

The Subchapter S loophole was closed by a 1971 amendment,[200] but the amendment has left a problem for the farmer who had previously elected the small business corporation as a means of raising capital. As the financing shareholders are likely to have nonfarm income in excess of $50,000, the corporation will be required to maintain an EDA if its farm losses exceed $25,000.[201] Or, if one of the shareholders has any other farm net losses, or stock in another Subchapter S corporation with farm net losses, the corporation must maintain an EDA if it realizes farm net losses in any amount.[202] Thus, although an investor is properly prevented from using such corporations to avoid the operation of the statute, a farmer's choice of organization may deny him the benefits of the $25,000 annual exclusion even though he was not the intended target of the statute. This unintended result could have been avoided and the loophole closed by simply treating the corporation as a conduit for the purposes of section 1251, passing the farm losses through to the shareholders in their proportionate amounts and applying the section to them only as individuals.[203]

A close reading of section 1251 reveals two other shortcomings in the statute: an incomplete definition of "trade or business of farming,"[204] and the incongruous possibility that gain recognized by the involuntary conversion of land will be subject to a greater recapture than would an ordinary sale.[205] The uncertainty created by the ineffectual definition[206] is resolved in the Proposed Regulations, which define the term as:[207]

> [A]ny trade or business with respect to which the taxpayer may compute gross income under §1.61-4 [referring to gross income of farmers], expenses under §1.162-12 [expenses of farmers], make an election under section 175, 180, 182 or use an inventory method referred to in §1.471-6 [inventories of livestock raisers and other farmers].

The second problem arose due to inappropriate statutory language; the limitation on farmland recapture expressly applies only to sales or exchanges, which taken literally would exclude involuntary conversions from the general treatment of farmland that limits recapture to the amount of the land's potential

198. See text accompanying notes 80-82 *supra.*
199. See text accompanying notes 122-24 *supra.*
200. Revenue Act of 1971, §305.
201. INT. REV. CODE OF 1954, §1251(b)(2)(B).
202. *Id.*
203. Such an amendment was proposed by one commentator, citing as precedent the similar approaches of §§58(d) and 163(d)(4)(C). Hjorth, *supra* note 80, at 595.
204. Section 1251(e)(4) merely provides that horse racing shall be included in the term and that if a taxpayer is engaged in more than one farming enterprise, all such businesses shall be treated as one entity for the purposes of the section.
205. Griffith & Joy, *supra* note 1, at 498-99; Lewis, *supra* note 25, at 646.
206. See note 204 *supra.*
207. PROPOSED TREAS. REG. §1.1251-3(e)(1), 36 Fed. Reg. 25,030 (1971).

gain.[208] The treatment by the Treasury in the Proposed Regulations, however, eliminated the congressional omission by ignoring the statutory language and extending the special rule for farmland to any disposition.[209]

Possible Traps

Although sections 1251 and 1252 were enacted to reduce the possibilities of abuse incident to nonfarmer investments in agriculture, they pose several traps for the true farmer. Some of these traps result from the ambiguous relationships between section 1251 and sections 1245 and 1252.

As sections 1251 and 1252 did not emerge from a single comprehensive legislative plan, their compatibility is in doubt.[210] Indeed, there is a possibility of double recapture upon the disposition of farmland if sections 185 and 182 deductions were taken more than four years before the current year. Assuming a taxpayer otherwise met the requirements for establishing an EDA, the deductions would be reflected in its current balance; because they are over four years old, however, they will not be recaptured under section 1251. If the taxpayer has held the land for more than five, but less than nine years, the deductions will be recaptured to the extent of the applicable percentage under section 1252, but this recapture will not reduce the balance of the EDA because it is a disposition of section 1231 property.[211] Therefore, later sales of other farm property will be subject to further recapture under section 1251 in the amount of the same deductions already recaptured under section 1252.[212]

Similarly, there is a possibility of double recapture by the joint operation of section 1245 and the farm recapture sections. Again assuming the taxpayer is otherwise required to maintain an EDA, depreciation of section 1245 property will be reflected in the balance of the EDA account. Gain on a sale of the depreciated property would not reduce the EDA, for it is farm recapture property and, therefore, is specifically excluded from the determination of income or loss.[213] Nor would treatment of the gain as ordinary income under section 1245 reduce the EDA because the only other reduction allowed for an EDA is for an amount treated as ordinary income "solely by operation of this [1251] section."[214] Thus, an amount subject to section 1245 recapture also remains subject to potential recapture under section 1251.[215] Happily, there is no similar problem under section 1250, because such property is specifically excluded from the definition of farm recapture property, and the gain derived from its sale will reduce the EDA balance.[216]

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208. INT. REV. CODE OF 1954, §1251(c)(2)(C). See note 205 *supra*.

209. PROPOSED TREAS. REG. §1.1251-1(b)(2), 36 Fed. Reg. 25,018 (1971). This is obviously the result intended by Congress, for the section is entitled "Special Rule for *Disposition* of Land." INT. REV. CODE OF 1954, §1251(c)(2)(C) (emphasis added).

210. See note 141 *supra*.

211. INT. REV. CODE OF 1954, §1251(e)(2).

212. Lewis, *supra* note 25, at 657.

213. INT. REV. CODE OF 1954, §1251(e)(2).

214. INT. REV. CODE OF 1954, §1251(b)(3)(B).

215. Vaughan, *Depreciation and the Farm-Loss Recapture Provisions of Section 1251,* 50 TAXES 660, 661 (1972).

216. INT. REV. CODE OF 1954, §1251(e)(1)-(2).

The Proposed Regulations appear to remove the possibility of double recapture by allowing any gain subjected to 1245 recapture to be included in farm net income,[217] thus reducing the EDA. Unfortunately, as one commentator has observed, this interpretation is unlikely to prevail.[218] One reason is that it would allow pre-1970 depreciation, recaptured through section 1245, to reduce the EDA balance even though only post-1969 depreciation could increase the account.[219] Additionally, this treatment seems to be in direct conflict with the statute.[220] Under these circumstances, a change in the Proposed Regulations seems likely. To avoid the resulting double recapture, therefore, Congress should amend the section, allowing section 1245 recapture to reduce the EDA, but only to the extent attributable to post-1969 depreciation.[221]

Another result of several of the TRA's reform provisions is that the timing of transactions has been accorded an unrealistic importance. Due to changes in the treatment of long-term capital losses, any taxpayer may have an additional $1,000 in taxable income as a result of improvident timing of his losses from year to year.[222] Under section 1251, however, a farmer may find that failure or inability to time farm losses correctly results in a far greater penalty, as no negative EDA is recognized.[223] This is especally true if he experiences erratic changes in farm income and loss as is shown in the following example: *A's* farming operations have produced an aggregate net income from 1970 to 1973 of $75,000. But due to major fluctuations between income and loss he may have an EDA balance at the end of 1973 of $75,000:

YEAR	NET INCOME (LOSS)	EDA BALANCE (LOSS LESS $25,000 EXCLUSION)
1970	$ 50,000	—0—
1971	(25,000)	—0—
1972	150,000	—0—
1973	(100,000)	$75,000
Totals	$ 75,000	$75,000

217. PROPOSED TREAS. REG. §1.1251-3(b)(2), 36 Fed. Reg. 25,030 (1971).

218. Vaughan, *supra* note 215, at 664-65.

219. *Id.*

220. Section 1251(e)(2) specifically states: "Gains and losses on the disposition of farm recapture property referred to in section 1231(a) (determined without regard to this section or section 1245(a)) shall not be taken into account." INT. REV. CODE OF 1954, §1251(e)(2).

221. Vaughan, *supra* note 215, at 665.

222. *See* INT. REV. CODE OF 1954, §1211(b). For example, if a taxpayer has $2,000 of net long-term capital losses in Year 1 and $1,000 of short-term gains in Year 2, the effect on ordinary income is negated over the two-year period. He is able to offset $1,000 of ordinary income in Year 1 but it has "cost" him the entire $2,000 of long-term losses. Therefore, he has no capital loss carryover in Year 2 to offset his short-term gain and the entire gain must be added to his ordinary income. On the other hand, if he had the same net amount of gains and losses, but timed them differently, he would be able to offset ordinary income in the first year without an increase in the following year. This would occur, for instance, if he had an additional $1,000 of net short-term losses in Year 1 and a total of $2,000 of short-term gains in Year 2.

223. Lewis, *supra* note 25, at 645.

He is thus subject to a potential recapture of $75,000 upon the sale of any farm recapture property in 1973 or later. Compare this with *B*, who has had net losses of $75,000 over the same period, but whose EDA balance at the end of 1973 is zero:

YEAR	NET INCOME (LOSS)	EDA BALANCE (LOSS LESS $25,000 EXCLUSION)
1970	$(125,000)	$100,000
1971	100,000	—0—
1972	(25,000)	—0—
1973	(25,000)	—0—
Totals	$ (75,000)	—0—

Over the four-year period, *B* has been able to shelter $75,000 of his nonfarm income, while *A's* taxable income has been increased by the same amount. *B* is also able to gain the reduction benefit on any sale of farm recapture property in 1971 or later, while *A* is subject to potential recapture of $75,000. The possibility that *A* may realize $75,000 in farm net income in 1974, thereby eliminating the EDA balance, does not render the timing factor any less important, as the applicability of section 1251 to a sale of farm recapture property is not determined until the close of the tax year. Thus, he could have sold such property at a gain in 1973, thinking that it would be accorded section 1231 treatment, only to discover that he is subject to recapture due to the sudden establishment of an EDA. Unless a farmer can be assured that he will qualify for exclusion from the provisions of section 1251,[224] any sale of farm recapture property during the year runs the risk of recapture at the end of that year.

A similar uncertainty exists with respect to the provisions concerning transfers by gift, which require the donee, in certain instances, to assume a portion of the donor's EDA.[225] While this requirement was obviously included to reduce a possible loophole,[226] it may pose an unnecessary trap for the farmer. For instance, if he receives a gift of farm recapture property, and in the same year has already sold other farm property at a gain, the prior sale may be subjected to 1251 recapture if the potential gain of the gift exceeded 25 per cent of the donor's total potential gain on farm recapture property.[227] The same result could occur even if the gift represented less than 25 per cent of the donor's potential gain. Thus, if the donor later in the same year gave other farm property that, when aggregated with the original gift, exceeded the 25 per cent limitation, the gain on the prior sale would again be converted into

224. See text accompanying notes 77-83 *supra*.

225. INT. REV. CODE OF 1954, §1251(b)(5)(B). See text accompanying notes 97-99 *supra*.

226. Without this provision a taxpayer and his successor could completely avoid the effects of the section by transferring all his farm recapture property by gift. This result may still be possible to a limited degree. See text accompanying notes 239-41 *infra*.

227. Griffith & Joy, *supra* note 1, at 502. This would occur if the donor had a current EDA balance.

ordinary income.[228] Both of these results could have been easily avoided without creating a loophole by simply subjecting the donee to recapture only upon subsequent sale of the gift property itself.[229]

As mentioned earlier,[230] farmers who have formed a Subchapter S corporation to raise capital may find themselves subject to the provisions of the section even though they would not otherwise meet its requirements. If a partnership is formed for the same purpose, however, an even worse result may follow, because a section 721[231] transfer is accorded different treatment by section 1251 from that prescribed by the other recapture sections.[232] Although neither section 1245 nor section 1250 provides for recapture in this situation unless gain is otherwise recognized,[233] section 1251 does require recognition of the EDA balance or the amount by which the fair market value of the transferred property exceeds the value of the transferor's partnership interest attributable to such property.[234] An unwary farmer may transfer all his farm property to the partnership, with the other partner contributing an equal value in cash. As the farmer now has a 50 per cent interest in both types of property, he may have to recognize ordinary income of as much as 50 per cent of the value of the transferred property, assuming his EDA and potential gain in the property are that great.[235] If the draftsman of the partnership agreement is aware of this provision, he can avoid these consequences on formation of the partnership by simply providing that any gain on the sale of the transferred property will be allocated to the farmer.[236]

Remaining Loopholes

If the recapture approach effectively eliminated the shelter effects available to farm investors as intended, perhaps the preceding difficulties posed to the true farmer could be tolerated. Such an approach, however, is incapable of eliminating the potential for abuse inherent in the agricultural tax laws. The agricultural investor experiencing a high income year may still profit from the deferral benefit by investing in a short-term farm shelter, such as a cattle feed-

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228. INT. REV. CODE OF 1954, §1251(b)(5)(B).

229. In this way there would never be any unexpected recapture, as discussed above. The donor would only be subjected to recapture when and if he sold the gift property itself. Perhaps another method of avoiding the possible trap for the unwary donee would be to allow recapture upon the sale of any property in a year *subsequent* to the year of the gift, thereby precluding the possibility of a sale of farm recapture property prior to the gift being subjected to recapture after the fact.

230. See text accompanying notes 200-203 *supra*.

231. This section provides: "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership . . . ." INT. REV. CODE OF 1954, §721.

232. Lewis, *supra* note 25, at 653.

233. INT. REV. CODE OF 1954, §§1245(b)(3), 1250(d)(3).

234. INT. REV. CODE OF 1954, §1251(d)(5)(B).

235. *Id.*

236. *Id.* This allocation provision can be an artificial one, designed solely to comply with the tax requirements of §1251, and need not have any economic effect. *See* INT. REV. CODE OF 1954, §704(c)(2).

ing program. The prepaid expenses of the program would reduce nonfarm income, in effect providing the investor with an interest-free loan from the Government that would not be repaid until the following tax year.[237] Even if his expenses exceed $25,000, none of the recapture provisions will prevent their deduction and the resultant deferral benefit because income in the following year would be characterized as ordinary in any event. There would simply be nothing for the provisions to recapture.

Furthermore, the farm investor may still realize the advantages of the reduction benefit to a certain extent. The limitations placed on section 1251 allow the "Wall-Street Cowboy" to continue sheltering up to $25,000 a year because there will be no addition to the EDA until farm losses exceed this amount. For a taxpayer with an annual income of $75,000 to $100,000 a farm shelter offering this benefit remains highly desirable.[238]

Even if an investor is required to establish an EDA, the gift provisions allow him to dispose of much of his potential farm recapture property over a period of several years without tax liability and without a transfer of the EDA. Thus, by giving 25 per cent of his property to members of his family each year,[239] he can dispose of over 75 per cent of the farm recapture property in five years,[240] completely avoiding the effects of section 1251 for both himself and his transferees.[241]

CONCLUSION

Although Congress was cognizant of the tax abuses existing in agricultural investment prior to the TRA,[242] its "solution" failed to eliminate them. Be-

237. Halperin, *supra* note 68, at 390. It should be noted, however, that the importance of this form of "self-averaging" was reduced by the liberalization of the Code's income averaging provisions. See note 45 *supra* and accompanying text.

238. Whether it will be a desirable investment, however, will depend on many other factors such as the experience of the managers, size of the operation, and the initial cost to the investor.

239. If he filed a joint return there would be no benefit in giving the property to his wife, because a joint EDA would be required. PROPOSED TREAS. REG. §1.1251-2(f)(1), 36 Fed. Reg. 25,029 (1971), *citing* TREAS. REG. §1.1245-4(a). This would appear to be statutory restriction on this method. *See* PROPOSED TREAS. REG. §1.1251-4(a)(1), 36 Fed. Reg. 25,031 (1971), *citing* TREAS. REG. §1.1245-4(a).

240. This may be accomplished as follows:

YEAR	FARM RECAPTURE PROPERTY HELD AT BEGINNING OF YEAR (%)	YEARLY GIFT (25% OF REMAINING PROPERTY)	PROPERTY HELD AT END OF YEAR
1	100.00	25.00	75.00
2	75.00	18.75	56.25
3	56.25	14.06	42.19
4	42.19	10.55	31.64
5	31.64	7.91	23.73

241. *See* INT. REV. CODE OF 1954, §1251(b)(5)(B); J. O'BYRNE, *supra* note 119, at 563.

242. See note 58 *supra*.

cause the problem centers around the farmer's ability to utilize special cash methods of reporting income,[243] an apparent solution would be the restriction of this preference. Indeed, initial steps in this direction were taken first with respect to citrus and later with respect to almond operations.[244] Nevertheless, many of the original reasons for the preference would still seem applicable to the majority of farmers today.[245]

The problem, therefore, is to propose a method of eliminating the benefits for the nonfarmer, while allowing the true farmer to continue to realize them. As demonstrated, the EDA approach fails to meet this requirement. On the other hand, the Metcalf Bill would have prevented farm operations from sheltering nonfarm income[246] while allowing an investor to realize farm income without incurring tax liability. Certainly it would have been a more effective solution than the EDA provision for it would have affected all farm investors. At the time the EDA was adopted, on the other hand, it was estimated that only 3,000 farm investors would be affected.[247]

As a result, the simple amendments to sections 1031, 1231, and 1245 appear to be more effective in reducing the amount of sheltered income than either of the farm recapture provisions.[248] Nevertheless, because many true farmers have nonfarm income it is possible that the recapture provisions will effectively discourage them from continued investment in nonfarm areas.[249] Even if this does not occur, the provisions pose far too many traps for the unwary farmer. Congress should take a second look at the problem and discard the recapture approach in favor of one that will better solve the problem without adversely affecting the nation's farmers.[250]

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243. See text accompanying notes 7-35 *supra.*

244. See text accompanying notes 168-178 *supra.*

245. See note 12 *supra.* Although farm conditions have changed notably since the 1920's, and the advent of the computer and modern accounting methods would now reduce the problems of instituting an inventory method of accounting, the average farm operation is still unable to afford the cost of such techniques. To impose such a burden would most likely hasten the trend toward large corporate operations. As other methods are available for curtailing the abuses in farm taxation, this would seem too high a price to pay.

246. See text accompanying notes 66-68, 105-111 *supra.*

247. *Senate Hearings, supra* note 65, at 3530.

248. Lewis, *supra* note 25, at 658.

249. Pinney, *supra* note 154, at 494.

250. Shortly before this note went to press, the House Ways and Means Committee proposed major reforms in the Internal Revenue Code. Incorporated within these changes are several of the recommendations of this note, including the repeal of §1251. Section 134, *House Ways and Means Committee Print No. 1 of Tentative Draft of Title 1, Changes Primarily Affecting Individuals, of Tax Reform Bill,* appearing in BNA DAILY REPORT FOR EXECUTIVES, Sept. 11, 1974. Essentially, the proposed changes would require the taxable farm income of corporations (or limited partnerships with a corporation as a general partner) to be computed on an accrual method of accounting. §133, *proposing* INT. REV. CODE OF 1954, §447(a), *id.* Individuals or electing small business corporations, on the other hand, would not be allowed to deduct, *inter alia,* farm expenses in excess of farm income. The excess expenses would be placed in a deferred deduction account to be deducted in any subsequent year in which farm income exceeds expenses. Section 132, *proposing* INT. REV. CODE OF 1954, §464, *id.* Among the deductions so restricted would be preproductive period expenses (other than

taxes, depreciation, or casualty losses) and prepaid expenses for supplies. *Id.* These provisions would not apply to taxpayers with less than $20,000 in annual nonfarm adjusted gross income and would have only limited application to those with nonfarm income between $20,000 to $40,000 a year, §132, *proposing* INT. REV. CODE OF 1954, §464(f), *id.,* in keeping with the concept of the Metcalf Bill. See text accompanying notes 66-68 and 105-111 *supra.* As observed, this approach is much more effective in eliminating the tax shelters and has the added benefit of greatly reducing any undesirable effects to the true farmer. For these reasons, it is hoped that Congress will adopt the committee approach and thereby eliminate the unnecessary complexity of §1251.