Cleveland State Law Review

Volume 27 | Issue 1

Note

1978

Farm Tax Advantages after the Tax Reform Act of 1976: Congress Finds the Needle but Misses the Haystack

Daniel A. Minkler

Recommended Citation

Note, Farm Tax Advantages after the Tax Reform Act of 1976: Congress Finds the Needle but Misses the Haystack, 27 Clev. St. L. Rev. 85 (1978)

NOTES

FARM TAX ADVANTAGES AFTER THE TAX REFORM ACT OF 1976: CONGRESS FINDS THE NEEDLE BUT MISSES THE HAYSTACK

The United States Office of Management and Budget has estimated the total tax expenditure[1] to agriculture in fiscal year 1979 to be $910 million.[2] Special farm accounting rules that have been in existence since 1915[3] are responsible for this resulting reduction of the internal revenue. Approximately sixty percent of the expenditure may be attributed to the expensing of amounts normally chargeable to capital account, while capital gains treatment of certain ordinary income is responsible for the balance of the agricultural tax subsidy.[4]

This Note will first explain the source and operation of the benefits that may be derived from the utilization of the farm tax rules. Additionally, the ability of taxpayers to use farm losses to offset nonfarm income through sheltered investments will be examined. Next, the Note will review the attempt of Congress to reform the farm tax laws through the Tax Reform Act of 1969,[5] including the attempted elimination of sheltered farm investments. Part III of the Note will explore the mechanics of those provisions of the Tax Reform Act of 1976[6] which were designed to curtail the use of the special farm tax rules by taxpayers other than ordinary farmers. Finally, the approach of Congress in attacking the farm shelter investment rather than requiring farmers to conform to accepted business accounting methods will be analyzed with respect to the relative equities and effects of the sizeable tax expenditure to the agricultural community.

I. The Sources of Farm Tax Advantages Prior to the 1976 Tax Reform Act

A. *Farm Accounting Rules*

Special accounting rules offer those individuals engaged in the business of

---

[1] A tax expenditure may be briefly defined as a government subsidy made through the tax system in the form of reduced revenue. The subsidy usually will have some economic or social objective. For a complete discussion of the concept of tax expenditures, see S. Surrey, Pathways to Tax Reform (1973).

[2] U. S. Office of Management and Budget, Special Analyses, The Budget of the United States Government: Fiscal Year 1979, at 158 (1978) (Special Analysis G) [hereinafter cited as Special Analysis G].

[3] T.D. 2153, 17 Treas. Dec. Int. Rev. 101 (1915), as amended by T.D. 2665, 20 Treas. Dec. Int. Rev. 45 (1918).

[4] Special Analysis G, *supra* note 2.

[5] Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969). *See* the discussion at notes 45-66 *infra* and accompanying text.

[6] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

farming opportunities to achieve savings through tax deferral.[7] These opportunities arise through provisions that allow farmers to depart from traditional accounting procedures in the computation of their taxable income.

The Income Tax Regulations provide that the method of accounting utilized by a taxpayer in computing his taxable income must, in the opinion of the Commissioner, clearly reflect income.[8] In ordinary business practice inventories are required in every case where the production, purchase, or sale of merchandise is an income-producing factor.[9] When the taxpayer is required to use inventories in his tax computations, the accrual method of accounting must be used with regard to purchases and sales.[10] However, farmers may elect to use the cash receipts and disbursements method of accounting,[11] even though the production, purchase, or sale of farm merchandise might be a material factor of their gross income This special option afforded farmers to select their method of accounting dates back to a 1915 decision by the Commisioner of Internal Revenue allowing farmers to report their taxable income on either the accrual or cash method of accounting.[12] The rationale consistently offered in support of providing farmers special treatment under the accounting rules is that the bookkeeping requirements of inventory accounting would place an undue burden on farmers.[13] The

[7] For example, suppose Payer, in a 50% tax bracket, incurs $100 costs in year 1 for the production of an item which is sold in year 2 for $100, thus no economic gain or loss. Assuming that a special tax provision permits Payer to deduct the production costs in year 1, rather than match the expense with the income it produces in year 2, then Payer has a $50 tax savings in year 1. In year 2 when the item is sold for $100 Payer will have to pay an additional $50 tax, but in the meantime he has had the interest-free use of the money. If the $50 had been invested in 7% interest free bonds for the one year deferral period, then Payer would have a $3.50 net gain.

Deferral may also be achieved through accelerated depreciation deductions in recovering the cost of a capital asset over the period of its useful life.

[8] Treas. Reg. § 1.446-1(a)(2) (1957).

[9] Treas. Reg. § 1.471-1 (1958). Farmers using the accrual method of accounting must also use inventories to determine gross income. Treas. Reg. § 1.61-4(b) (1957).

[10] Treas. Reg. § 1.446-1(c)(2) (1957). Under the accrual method of accounting income is reported when all events have occurred which fix the right to receive that income and the amount thereof can be determined with reasonable accuracy. Deductions under this method are allowable for the taxable year when all events have occurred which establish the fact of liability and the amount thereof can be determined with reasonable accuracy. Treas. Regs. §§ 1.451-1(a) (1957), 1.446-1(c)(1)(ii) (1957). Thus, a farmer using an accrual method would include income for the year in which it was earned and deduct expenses for the year in which they were incurred, regardless of when payment was received or made. INTERNAL REVENUE SERVICE, PUB. NO. 225, FARMERS TAX GUIDE 20 (1978) [hereinafter cited as FARMERS TAX GUIDE].

[11] Treas. Reg. § 1.471-6 (1958). Under the cash receipts and disbursements method of accounting, a taxpayer includes in gross income for the taxable year all items which are actually or constructively received in that year. Expenses are deductible in the taxable year in which they are actually paid. Treas. Reg. § 1.446-1(c)(1)(i) (1957). In addition to the accrual and cash methods of accounting, certain hybrid accounting systems may be acceptable if clearly reflective of income. I.R.C. § 446(c)(4). For a discussion of hybrid accounting methods in farm taxation, see J. O'BYRNE, FARM INCOME TAX MANUAL § 121 (5th ed. 1977) [hereinafter cited as TAX MANUAL].

[12] *See* note 3 *supra*. The selection of an accounting method, once made, is binding for all subsequent years unless the Commissioner approves a change. I.R.C. § 446(e). But typically over 97% of the tax returns showing farm operations report on the cash method of accounting. *Panel Discussions Before the House Comm. on Ways and Means on the Subject of General Tax Reform*, 93d Cong., 1st Sess., pt. 5, at 657 (1973) (statement of Claude Maer) [hereinafter cited as 1973 *Panel Discussions*].

[13] *See* note 154 *infra* and accompanying text.

simplistic cash method of accounting eliminates the need for farmers to allocate costs among different operations and further allocate costs within each operation. "The sacrifice in accounting accuracy under the cash method represents an historical concession by the Secretary and the Commissioner to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure."[14]

In order to reap the benefits of the special farm accounting rules an individual must be a farmer operating his farm for profit. Every individual, partnership, or corporation that cultivates, operates, or manages a farm, including stock, dairy, poultry, fruit and truck farms, and land used for farming operations, whether as an owner or tenant may be classified as a farmer.[15] A determination as to whether or not an individual is engaged in farming for a profit depends on a consideration of all the attendant facts and circumstances.[16] A farming activity will be presumed to be engaged in for profit if the gross income derived from that activity for two or more years of a five year period of consecutive taxable years, or seven consecutive years if the farming activity involves the breeding, training, showing, or racing of horses, is greater than the deductions attributable to the farming activity.[17]

1. Inventory and Capital Account Expenses

Businesses which incur costs in the production of inventory or development of capital assets are required to match these expenses with the taxable period in which the inventory item or capital asset is sold.[18] The Regulations, however, permit farmers to take a current deduction from gross income for, among other farm expenses, the purchase of feed and other costs associated with raising livestock.[19] Unless the farmer computes his income upon the crop method,[20] he may currently deduct the cost of seeds and young plants which are acquired for the purpose of development and cultivation prior to their sale in later years, so long as this is a consistent practice of the taxpayer.[21]

---

[14] United States v. Catto, 384 U.S. 102, 116 (1966).

[15] Treas. Reg. § 1.61-4(d) (1957). However, once the taxpayer is classified as a farmer, it is still necessary to avoid the "hobby loss" provisions of section 183.

[16] Treas. Reg. § 1.183-2(b) (1972). The Ninth Circuit has even held that continuous losses are mere evidence of an activity that is not engaged in for profit, and an activity is a trade or business if the taxpayer has a good faith expectation of profit regardless of the objective reasonableness of that expectation. Mercer v. Comm'r 376 F.2d 708 (9th Cir. 1967).

[17] I.R.C. § 183(d).

[18] *See, e.g.*, United States v. Catto, 384 U.S. 102, 109 (1966).

[19] Treas. Reg. § 1.162-12(a) (1958). But certain other costs, such as amounts expended in purchasing farm machinery, work, dairy, breeding, or sporting animals must be capitalized. Livestock purchased for work, dairy, or breeding purposes may be included in inventory. Treas. Reg. § 1.471-6(g) (1958).

[20] Under the crop method, which may be employed with the consent of the Commissioner when a farmer does not finish harvesting his crops in the taxable year they were planted, the total cost of producing the crop, including the cost of seeds and young plants, must be deferred and deducted in the later taxable year when the crop is sold. FARMERS TAX GUIDE, *supra* note 10.

[21] Treas. Reg. § 1.162-12(a) (1958). A farmer, though, may not similarly deduct the cost of

The effect of this provision is to postpone the farmer's tax liability by ignoring year end inventories and deductions, thereby creating a zero basis in the item for the purpose of its subsequent sale. If instead the farmer uses the accrual method of accounting, his current deductions for business expenses will be offset by an amount equal to the annual incremental increase in the inventory of livestock, crops, or other farm merchandise on hand at the close of the taxable year.[22] In this manner income is increased by additions to inventory valuation; consequently, the smaller the incremental increase in inventory valuation the greater the current deduction.[23]

2. Deduction of Development Costs

Amounts spent in the development of farms, orchards, and ranches during their preproductive period may, at the taxpayer's discretion, be treated as current deductions.[24] Additionally, sections 175, 180 and 182 provide the farmer with an opportunity to deduct as current expenses amounts which would otherwise be considered as capital expenditures.

Soil and water conservation expenditures for land used in farming may be deducted under section 175, with certain limitations,[25] by taxpayers engaged in the business of farming. The apparent rationale for including section 175 in the Internal Revenue Code of 1954 was to provide farmers with an incentive for adopting accepted conservation techniques.[26]

---

livestock which is intended for sale as beef. Treas. Reg. § 1.61-4(a) (1960). Also, this provision is not applicable to the cost of seeds and young plants in timber operations. See I.R.C. § 611.

[22] Treas. Reg. § 1.61-4(b) (1957). Gross income is determined by adding the sales price of farm products held for sale and sold during the year to the closing inventory value of the farm products plus gross income from all other sources, including miscellaneous items of income such as rental receipts and breeding fees, then subtracting the value of the beginning inventory of the farm products together with the amount of purchases of farm products during the taxable year.

[23] Four inventory valuation methods are available to farmers: cost, lower of cost or market, farm-price and unit-livestock price, if the enterprise involves the raising of livestock. Treas. Regs. §§ 1.471-2(c) (1958), 1.471-6(c) (1958). The effect each inventory valuation method has on computation of gross income largely depends on the nature of the farm operation and the surrounding circumstances. For an explanation of the inventory techniques, see Muir, *Tax Advantages in Farming*, 1 N.M.L. Rev. 147, 152-53 (1971) [hereinafter cited as *Tax Advantages*]; Tax Manual, *supra* note 11 at § 120; Farmers Tax Guide, *supra* note 10, at 27. For a summary comparison of the effect each inventory valuation method has on gross income and the relative advantages and disadvantages of each method, see Tax Manual, *supra* note 11 at § 120; Hawkinson, *Farm Expenses and General Accounting Principles*, 22 Tax L. Rev. 237, 248-49 (1966); and [1978] Fed. Tax Coordinator 2d (RIA) ¶ ¶ N 1108-16.

[24] Treas. Reg. § 1.162-12(a) (1958). However, amounts expended in purchasing work, breeding, dairy, or sporting animals are treated as investments of capital and must be depreciated unless included in inventory.

[25] The amount allowed as a deduction under section 175 may not exceed 25% of the gross income from farming during the taxable year. I.R.C. § 175(b). Deductible expenditures include payments made for leveling, terracing, contour furrowing, other earth moving operations and for the "construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds, the eradication of brush, and the planting of windbreaks." Items that are deductible under other code sections and items which are subject to the depreciation allowance of section 167 may not be deducted as soil and water conservation expenditures. I.R.C. § 175(c)(1). See Treas. Reg. § 1.175-2 (1957) for further elaboration of qualifying deductions and Treas. Regs. §§ 1.175-3 (1961), 1.175-4 (1957) for the prerequisites to the availability of the deduction.

[26] H.R. Rep. No. 1337, 83d Cong., 2d Sess. 832-33, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4017, 4054.

Expenditures for fertilizer, lime, or "other materials to enrich, neutralize, or condition land used in farming" at the election of the taxpaying farmer may be deducted currently under section 180. Since section 180 deductions apply only for land used in farming, costs of initial preparation of land do not qualify for section 180 treatment. This provision was seemingly added to the Internal Revenue Code of 1954 in recognition of the then existing universal practice of farmers.[27]

A farmer may also elect under section 182 to deduct land clearing expenditures in the taxable year when incurred. The land clearing must be for the purpose of making the land suitable for farming, and the deduction of such expenses is limited to the lower of $5,000 or twenty-five percent of the *taxable income* from farming in the taxable year.[28] Section 182 was added to the Code because Congress felt that land clearing expenditures were so closely associated with the trade or business of farming as to require treatment similar to that given soil and water conservation expenditurers.[29]

B. *Capital Gains Treatment*

Another tax saving device is the ability to convert ordinary income into capital gain which then will be taxed at the preferential capital gains rate. Depreciation is an example of how conversion operates. During the useful life of a capital asset a taxpayer may offset his ordinary income with depreciation deductions. The basis of the asset will be reduced by an amount equal to the total of the depreciation deductions, such that when the capital asset is sold at an amount greater than the reduced basis, that amount will represent both the capital gain on the sale and the amount of ordinary income offset in past years which has now been converted.[30] Congress has attempted in certain cases to negate the conversion effect by employing a "recapture" technique which treats those percentages of gains on the sale of the asset attributable to accelerated depreciation deductions or all depreciation deductions in the case of personal property as ordinary income.[31]

Farm property used in the trade or business which may benefit from

---

[27] S. REP. No. 1767, 86th Cong., 2d Sess., *reprinted in* 1960-2 C.B. 829, 837.

[28] I.R.C. §§ 182(a), 182(b). Clearing of land may include bulldozing, blasting, cutting, burning, plowing or other suitable methods employed for the removal of trees, stumps and rocks, as well as earth moving operations made for the purpose of preparing the land for farming. Treas. Reg. § 1.182-3(a) (1965). Deductions are not permitted for expenditures in respect of depreciable items which are of such a character as to be subject to the depreciation allowance under section 167. *Id.* subsection (c).

[29] S. REP. No. 1881, 87th Cong., 2d Sess. 126-27, *reprinted in* [1962] U.S. CODE CONG. & AD. NEWS 3304, 3430.

[30] For example, assume that Payer purchases an asset to be used in his business for $10,000. Using the straight-line depreciation method and assuming that the asset has a ten year useful life with no salvage value, Payer will have a $1,000 depreciation deduction in each of 10 years to be applied against his ordinary income. Assuming further that Payer sells the asset after 5 years for $6,000, his capital gain will be $1,000 ($6,000 sales price less $5,000 adjusted basis) and 20% ($1,000 capital gain divided by $5,000 ordinary income that was offset through the deduction x 100) of the ordinary income which had been offset through the depreciation deduction will have been converted into capital gain and thus qualify for preferential tax treatment.

[31] For a recapture approach to the deduction of certain expenses, *see* notes 45-51 *infra* and accompanying text.

capital gains treatment under section 1231 includes farm real property, timber, livestock held for draft, breeding, dairy, or sporting purposes, and unharvested crops.[32] The combination of capital gains treatment for real property used in the farming trade with the deferral advantages offered by section 175 soil and water conservation expenses, section 180 fertilizer expenses, and section 182 pre-productive period development costs provides the farmer with significant tax saving opportunities.[33] An even more common example of conversion of ordinary income in the farm business occurs on the sale of livestock held for draft, breeding, dairy, or sporting purposes.[34] Unharvested crops when sold with farm land used in the trade or business are also section 1231 "property used in the trade or business" if held for more than six months [nine months and twelve months for taxable years beginning in 1977 and after December 31, 1977 respectively].[35]

C. *The Operation of Farm Tax Shelters*

Losses sustained in the operation of a farm business may be used by a taxpayer to offset nonfarm gross income.[36] Therefore, an opportunity exists for high bracket taxpayers to take advantage of the special farm accounting rules to achieve tax savings with regard to their nonfarm income.

The typical tax sheltered investment would employ a limited partnership vehicle and nonrecourse financing. Under such a scheme a loan would be made to the partnership under an arrangement whereby only the partnership's assets, and not those of the individual investor, would be subject to liability for the loan amount. Prior to the Tax Reform Act of 1976, section 704(d) of the Code and Income Tax Regulation section 1.752-1(e) permitted a limited

---

[32] Section 1231 of the Internal Revenue Code provides that "gains on sales or exchanges of property used in the trade or business" and from the involuntary conversion of capital assets held for more than 6 months [9 and 12 months for taxable years beginning in 1977 and after December 31, 1977 respectively] shall be treated as long-term capital gains if the total gains are greater than the total losses. I.R.C. § 1231(a).

[33] *See* notes 36-37 *infra* and accompanying text for a discussion of the utilization of this combination in the farm tax shelter area.

[34] Livestock is given a broad definition by the Income Tax Regulations and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. Treas. Reg. § 1.1231-2(b)(3) (1957). Again, the test of whether or not the livestock is held for a draft, breeding, dairy, or sporting purpose depends on the attendant circumstances. Actual use of the animal is strongly indicative of its intended purpose.

Immediately after the addition of section 151(b) of the Revenue Act of 1942 to the 1939 Code (section 1231(b)(3) of the 1954 code), controversy ensued over the tax treatment to be accorded culls (animals separated from the breeding herd as feeder or slaughter animals) removed from the herd prior to the termination of their useful life. The Commissioner's position advocating the inapplicability of section 1231 to such animals was rejected in a number of cases. *See, e.g.*, Albright v. United States, 173 F.2d 339 (8th Cir. 1949). Congress acted to remove the ambiguity in this area by adding a 12-month holding period requirement to the definition of livestock, later increased in the Tax Reform Act of 1969, Pub. L. No. 91-172, § 212(b)(3) (amending I.R.C. § 1231(b)(3)) to 24 months in the case of cattle and horses held for draft, breeding, dairy, or sporting purposes.

[35] I.R.C. § 1231(b)(4). Under these circumstances, in computing taxable income section 268 of the Code disallows any deductions attributable to the production of the unharvested crop sold with the farm land, but section 1016(a)(11) allows an adjustment of the basis of such unharvested crops. Of course, such crops are eligible for section 1231 treatment if involuntarily converted. I.R.C. § 1231(a).

[36] Treas. Reg. § 1.165-6(a)(2) (1960).

partner to deduct losses to the extent of the adjusted basis of his proportionate share of the partnership, and this proportionate share could be increased through the application to the partnership interest of loan funds upon which the partner had no personal liability.[37]

In some cases the attractive features of the farm tax laws were packaged and sold through public offerings.[38] Such an offering might make use of a management contract wherein the management company as a partner would, for example, purchase breeding livestock and arrange for their feeding, care and other maintenance requirements while the investor remained completely passive.[39] Deferral shelters, those that merely utilize the farm accounting rules to avoid matching the taxable periods of income and expenses that were responsible for generating that income, usually arose with regard to winter vegetables, shell eggs, and cattle feeding operations.[40]

The most attractive farm tax shelters make combined use of deferral and conversion techniques. The operation of this type of tax shelter involves the taxpayer taking current deductions from ordinary income for section 1231 developmental costs of real property or livestock used for breeding, dairy, draft, or sporting purposes plus deductions for section 175 soil and water conservation expenditures, section 180 fertilizer costs, and section 182 preproductive period expenses, then selling the assets after the expiration of the required holding period for the corresponding application of preferential capital gains treatment. In this manner a "negative income tax" benefit may be achieved.[41] Deferral and conversion shelters in the farm area have included horse operations, orchards, groves and vineyards, timber and Christmas tree enterprises, ranchland leases and cattle breeding ventures.[42]

---

[37] *See* notes 126-30 *infra* and accompanying text wherein the 1976 "at risk" provisions are discussed.

[38] *See, e.g.*, Davenport, *Farm Losses Under the Tax Reform Act of 1969: Keepin' 'Em Happy Down on the Farm*, 12 B. C. INDUS. & COM. L. REV. 319, 321, n. 10 (1971) [hereinafter cited as *Tax Reform Act of 1969*].

[39] The management contract may be employed equally as well on an individual basis exclusive of a partnership arrangement. For the importance of this approach to investors seeking tax savings through farm investments after the Tax Reform Act of 1976, *see* note 88 *infra* and accompanying text. It should be noted, however, that the limited partnership offers the investor the important advantage of limited liability for the debts of or claims against the partnership, while at the same time allowing the deductible losses to flow through to the investor.

[40] STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1st SESS., TAX SHELTERS: FARM OPERATIONS 10-13 (Comm. Print 1975) [hereinafter cited as TAX SHELTERS: FARM OPERATIONS].

Egg shelters offered the greatest advantage prior to the Tax Reform Act of 1976. All amounts invested in the egg operation could be deducted in the first year. The costs of egg-laying hens used in the enterprise for only one year could also be currently deducted. Rev. Rul. 60-191, 1960-1 C. B. 78. In winter vegetable and other plant shelters, deductible expenses included the cost of seeds, seedlings, planting and cultivation expenses. See TAX SHELTERS: FARM OPERATIONS, *supra*, at 11 for a model of a typical cattle feeding investment shelter.

[41] A negative income tax results when a taxpayer's after-tax rate of profit on a business venture exceeds his before-tax rate of profit on that venture. For an example of this effect in operation, see Surrey, *The Tax Reform Act of 1969-Tax Deferral and Tax Shelters*, 12 B. C. INDUS. & COM. L. REV. 307, 312 n.6 (1971).

[42] TAX SHELTERS: FARM OPERATIONS, *supra* note 40, at 13-22. The report contains a detailed example of the operation of a cattle breeding program over a six year period. The example illustrates the combination of deducting prepaid expenses and depreciation expenses with the sales of animals culled from the breeding herd, and details the tax benefits gained from deferral and conversion showing the cumulative tax advantage over the period.

II. Attempted Reform: The Tax Reform Act of 1969

From an examination of the 1969 hearings on the subject of tax reform before the House Ways and Means Committee and Senate Committee on Finance and the final reform provisions of Subtitle B of Title II of the Tax Reform Act of 1969, it is readily apparent that the concern of Congress and the Treasury was directed at the use of the special farm tax provisions by high bracket taxpayers interested in offsetting nonfarm income and not with the special tax treatment afforded genuine farmers.[43] Because Congress attempted to selectively remove the farm tax shelters from the operation of the Internal Revenue Code, rather than directly attack the problem of special farm accounting rules, the 1969 reform provisions were in part unduly complex, unworkable, and largely ineffective.[44] This selective approach by Congress is reflected again in the reform provisions of the Tax Reform Act of 1976, discussed in Part III.

A. *Recapture Provisions of the 1969 Act*

The most notable and most complex farm tax reform measure adopted by Congress in 1969 was the addition of section 1251 to the 1954 Code establishing an excess deduction account (EDA) for farm losses that are used to offset nonfarm income.[45] Section 1251 operated on the theory of recapture and required that gains realized from the sale or disposition of "farm recapture property"[46] used in the business of farming be treated as ordinary income if and to the extent that farm losses have previously been used to offset nonfarm income. The impact of the recapture provision would depend on the amount existing in the EDA for the taxable year.[47]

The major weakness of section 1251 arose under an exception to the

---

[43] *Hearings on Tax Reform Before the House Ways and Means Comm.*, 91st Cong., 1st Sess. 5059 (1969) (statement of Edwin S. Cohen, Assistant Sec. of the Treas. for Tax Policy).

[44] *See* the discussion of the excess deductions account at note 50 *infra* and accompanying text.

[45] 1969 Tax Reform Act, Pub. L. No. 91-172, § 211(a) (codified at I.R.C. § 1251).

[46] Farm recapture property is defined in section 1251(e) as land and depreciable property, other than property to which section 1250 applies, used in the business of farming and held for longer than 6 months [9 and 12 months for taxable years beginning in 1977 and after December 31, 1977 respectively]; section 1231(b) property relating to livestock and unharvested crops which is or has been used in the business of farming; and property acquired in an exchange the basis of which is determined "with reference to the adjusted basis of property which was farm recapture property in the hands of the taxpayer," as described in the preceding categories. I.R.C. § 1251(e).

[47] Every taxpayer who sustained a farm net loss for the taxable year, defined in section 1251(e)(2) as the amount by which the deductions attributable to the business of farming exceed the gross income derived from that business (excluding gains and losses from the disposition of section 1231(a) recapture property as determined without regard to either section 1245(a) or section 1251), was required to establish an EDA. The EDA was designed to reflect the amounts of farm losses which had been used in previous taxable years to offset nonfarm income. Additions were to be made to the EDA in sums equal to the farm net loss for each taxable year. The EDA then could be reduced by subtracting from the total in the account at the close of the taxable period "an amount equal to the net farm income for such year, plus the amount (determined as provided in regulations prescribed by the Secretary) necessary to adjust the account for deductions" which had not been used to reduce tax liability. I.R.C. § 1251(b)(3). A more elaborate discussion of the operation of the EDA may be found at: Bravenac, 42 J. Tax. 312 (1975); *Tax Advantages, supra* note 23, at 166-79; *Tax Reform Act of 1969, supra* note 38, at 334-44.

general rule requiring additions to the EDA. An individual was not required to make additions to the EDA in a taxable year if his nonfarm adjusted gross income for that year did not exceed $50,000.[48] In the event the taxpayer's nonfarm income did exceed the $50,000 limit, the addition to the EDA was to be made only for the amount by which the taxpayer's farm net loss for the taxable year was greater than $25,000.[49] Although farmers were burdened with the requirement of establishing an EDA if they sustained any farm net loss in the taxable year, the $50,000 nonfarm adjusted gross income exception in the case of ordinary farmers made actual additions to the account a rare occurrence. In the three taxable years immediately following the effective date of section 1251, the number of tax returns that showed both nonfarm adjusted gross income in excess of $50,000 and farm net loss greater than $25,000 was less than one percent of all tax returns which reported any nonfarm income and farm net losses.[50] In terms of dollar amounts, the returns which reflected nonfarm adjusted gross income in excess of $50,000 and farm net loss of more than $25,000 constituted on the average less than eight percent of the total dollar amount of farm losses from all returns. These figures, submitted by the United States Treasury Department in 1975 to the House Committee on Ways and Means, indicate that not only was Congress successful in protecting the ordinary farmers from the adverse impact of section 1251, but also that through the arbitrary dollar amounts chosen for the EDA additions exception, Congress created an opportunity for the wealthy taxpayer to plan his tax shelter investments in such a manner as to also avoid the adverse impacts of section 1251. "During the five and one-half years between January 1, 1970, and July 1, 1975, the dollar amount of tax shelter offerings in partnership form registered with the National Association of Securities Dealers was $942,424,000 in cattle feeding and breeding ventures and $166,575,625 in vintage and other farming shelters."[51]

The fact that additions had to be made to the EDA only under conditions which fit a small minority of taxpayers, especially in light of the ability of many wealthy taxpayers to shape their financial activities to meet the exception, was only one of the drawbacks to section 1231. The recapture premise of the EDA completely ignored the tax advantage of deferral and was instead aimed at eliminating the conversion aspect of a tax savings package. Notwithstanding the limited impact of the provision on farm tax shelters, section 1251 did not restrict the ability of taxpayers to defer tax liability by offsetting ordinary income with current deductions allowable under the liberal farm accounting rules.[52]

---

[48] The exception does not apply to trusts but is available for 1371(b) electing small business corporations, so long as none of the shareholders are individuals with a farm net loss for the taxable year within which the taxable year of the corporation ends. I.R.C. § 1251 (b)(2)(B). The possibility of tax loopholes created by placing electing small business corporations within the exception was soon noticed. *See, e.g.*, Griffith & Joy, *What the Act Does to the Farmer: Farm Parity or Class Discrimination?*, 23 TAX LAW. 495, 501 (1970).

[49] I.R.C. § 1251(b)(2)(B).

[50] *See* TAX SHELTERS: FARM OPERATIONS, *supra* note 40, at 8-9.

[51] *Id.* These dollar amounts do not include figures for those public and private syndications not required to be registered with the National Association of Securities Dealers.

[52] Additionally, one may wonder if there exists a rational basis for discriminating against trust

Another recapture rule added by the 1969 Reform Act is codified in section 1252 of the Code and relates to gains realized from the disposition of farm land. Under this provision the applicable percentages[53] of the total post-1969 deductions allowed by section 175 for soil and water conservation expenses and section 182 for land clearing expenses will be recaptured as ordinary income[54] if the farm land for which these expenses were incurred is held for less than ten years and is disposed of after December 31, 1969.[55] The rationale for enactment of section 1252 was to prevent high-bracket taxpayers from taking advantage of the conversion possibilities under section 1231 when there exists no motivation to retain the farmland for other than a short period of time.[56] It is interesting to note, however, that nothing in the statute makes allowance for those farmers who make section 175 and section 182 expenditures with the intent of gaining long term use of the improved farmland but are then forced to sell the land for reasons wholly unmotivated by the tax consequences of the disposition. In such a situation it is difficult to reconcile the policy of encouraging soil and water conservation and land clearing through allowance of current deductions with a provision designed to later recapture the benefits earlier granted.

B. *Other Reform Measures of the 1969 Act*

Section 278 of the Code, added by section 216 of the 1969 Reform Act, requires expenditures relating to the planting, cultivation, maintenance, or development of any citrus or almond grove to be charged to capital account if incurred within four years after the trees were planted. This approach properly recognizes and eliminates the tax advantages which arise by allowing taxpayers to take current deductions for expenses normally chargeable to capital account. At first it appears that the citrus industry and almond growers have been given unfair treatment, but in fact the addition of section 216 to the 1969 Reform Act was a defensive measure sought by the citrus industry. Recognizing the adverse economic effects that might arise from the growing investments of high-bracket taxpayers, such as an increase

---

and corporate farmers by not including them within the exception to the EDA. In this respect a small corporate farmer is at an economic disadvantage when compared, for instance, to a subchapter S corporation which keeps its farm net loss below the $25,000 limit. This discriminatory approach will be seen again under the Tax Reform Act of 1976. *See* note 124 *infra* and accompanying text.

[53] The applicable percentages are set forth in I.R.C. § 1252(3) and range from 100% if the farm land is disposed of within 5 years after the date of its acquisition to 0% if the land is held for a minimum of 10 years.

[54] The 1976 Tax Reform Act amendments, Pub. L. No. 94-455 § 1901(b)(3)(K), substituted "ordinary income" for the original language contained in section 214 of the 1969 act: "gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231."

[55] I.R.C. § 1252(a)(1). The amount recaptured as ordinary income is not to exceed the excess of the amount realized (or fair market value of the farm land in the case of dispositions not involving sales, exchanges, or involuntary conversions) over the adjusted basis of the land. Also, section 1252 does not apply to the extent such gain is subject to the section 1251 EDA.

[56] S. Rep. No. 91-552, 91st Cong., 1st Sess. 105, *reprinted in* [1969] U.S. Code Cong. & Ad. News 2027, 2135.

in goods available for sale and corresponding drop in prices, the citrus industry actually urged the passage of the amendment.[57]

The exclusion of livestock from the operation of Code section 1245 depreciation recapture was terminated by section 212(a) of the 1969 Reform Act.[58] However, this reform measure is of little consequence to the cash basis farmer who is able to take current deductions for the expenses of raising his livestock. Only accrual basis taxpayers and those who purchased livestock are affected.

Even though the Internal Revenue Code provided for alleviating the harshness of bunched income[59] Congress believed it to be necessary to make special provision for cash basis farmers receiving crop insurance proceeds. Section 451(d) of the Code, added by section 215(a) of the 1969 Reform Act, permits cash basis farmers who receive insurance proceeds as a result of crop damage to elect to report that income for the taxable year following the taxable year of the damage if pursuant to his customary practice the income from the disposition of the crops would have been reported in a following taxable year.[60]

The required holding period to qualify section 1231 livestock[61] for capital gains treatment was increased by section 212(b) of the 1969 Reform Act from twelve months to twenty-four months.[62] This amendment represented an attempt by Congress to strengthen the distinction between animals used in the trade or business and these that are held merely for sale.[63]

The 1969 Tax Reform Act also added section 183 to the Code, relating to activities not engaged in for profit,[64] and section 1031(e) dealing with like-kind exchanges.[65]

---

[57] *See, e.g.*, the remarks of Senator Holland of Florida who introduced the amendment, 115 CONG. REC. 515954 (daily ed. Dec. 6, 1969). *See also* Woods, *Tax-Loss Farming*, 34 AG. FIN. REV. 24, 28 (1973): "A year later, at the request of almond growers, these . . . requirements were extended to almonds."

Section 278(a) does not apply to other types of fruit or nuts or to vineyards. The selective treatment of 278(a) is highlighted by Treas. Reg. § 1.278-1(a)(2)(i) (1971), wherein a "citrus grove" is defined as "one or more trees of the rue family, often thorny and bearing large fruit with hard, usually thick peel, and pulpy flesh, such as the orange, grapefruit, lemon, lime, citron, tangelo, and tangerine."

An "almond grove" is "one or more trees of the species *Prunus amygdalus*." Treas. Reg. §1.278-1(a)(2)(ii)(1971).

[58] Section 1245 recaptures depreciation deductions as ordinary income when property, as defined in Section 1245(3) , is disposed of at a gain.

[59] *See* I.R.C. §§ 1301-1304.

[60] I.R.C. § 451(d).

[61] The change made was wholly with respect to cattle and horses held for draft, breeding, dairy, or sporting purposes.

[62] I.R.C. § 1231(b)(3)(A).

[63] *See* note 34 *supra* and accompanying text.

[64] The relevant provisions of Section 183 are discussed at notes 16-17 *supra* and accompanying text. The full impact of the addition of Section 183 to the Code is beyond the scope of this Note.

[65] To prevent a tax free rapid growth of a breeding herd through trading male calves for female calves (rather than selling the steers for ordinary income), Congress added section 1031(e), which states that livestock of different sexes are not property of a like kind for the nonrecognition of gain treatment offered by section 1031(a).

The farm tax advantages described in Part I of this Note have largely survived the 1969 Tax Reform Act. Despite the reform measures added to the Code by the 1969 Reform Act the number and size of publicly offered farm tax shelters increased drastically in the years following its passage.[66] By attempting to selectively attack the high-bracket, tax-motivated farm investor Congress missed the mark of genuine reform. The Recapture statutes still permit the underlying avoidance device of deferral to continue. Essentially, the 1969 Farm Tax Reform package, except in the case of citrus and almond growers, failed to treat the underlying source of farm tax advantages, the practice of permitting farmers to depart from accepted business accounting practices.

III. Further Reform, The Tax Reform Act of 1976

In 1976 the focal point of farm tax reform was again the availability of the special farm tax rules to high-bracket taxpayers who used the farm deductions to offset nonfarm income. The belief was maintained that the advantageous accounting rules should be continued for most full-time farmers.[67]

A. *The House Approach*

House Bill 10612 originally contained a provision placing a limitation on artificial losses (LAL) sustained in farm operations. The provision would have required that "accelerated deductions" could not exceed a taxpayer's net income from related sources in the taxable year in which the deductions were incurred.[68] To the extent such deductions exceeded the net income from

[66] *See* note 51 *supra* and accompanying text.

[67] For the legislative consideration of farm tax reform in 1975, see House Comm. on Ways and Means, 94th Cong., 1st Sess., Press Release Announcing Panel Discussions, Testimony From the Interested Public on Tax Reform 5 (Comm. Print 1975); Tax Shelters: Farm Operations, *supra* note 40; H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 37-54, 92-93, 106-07 (1975); *Hearings on Tax Reform Before the House Comm. on Ways and Means*, 94th Cong., 1st Sess. 1360-402 (1975).

In addition to the House alternative for farm tax reform and the approach taken in the Tax Reform Act of 1969, other measures have been suggested. For a discussion of several reform measures that have been introduced in years prior to the Tax Reform Act of 1976, see *Tax Reform Act of 1969*, *supra* note 38, at 321 n. 11.

The most straightforward solution to genuine reform in farm taxation would be to revoke the right of farmers to make use of the cash receipts and disbursements method of accounting and to further revoke the ability to currently deduct expenditures normally chargeable to capital account. Professor Davenport has been the most ardent advocate of this approach. *See, e.g.*, 1973 *Panel Discussions*, *supra* note 12, at 618-32 (statement of Professor Charles Davenport).

[68] H.R.Rep. No. 94-658, 94th Cong., 2d Sess. 44-45, *reprinted in* [1976] U.S. Code Cong. & Ad. News 2897, 2938-39 [hereinafter cited as House Report].

Accelerated deductions are defined as amounts attributable to preproductive period expenses, prepaid expenses, and the accelerated portion of depreciation occurring during the productive period of the farming business. The House Report further indicates that preproductive period expenses are amounts "attributable to crops, animals (other than certain livestock), trees, or to other property having a crop or yield, during the preproductive period of such property and which is allowable as a deduction for the taxable year but for the application of LAL." Also included are section 175 soil and water conservation expenditures and section 182 land clearing expenditures if the amounts are spent during the preproductive period of the farming activity. The term does not include taxes, interest, and casualty related expenses. Prepaid expenses "include any amount paid for feed, seed, fertilizer, or other supplies which are on hand at the close of the taxable year." Accelerated depreciation "includes all depreciation allowances which exceed those that would be made if the property were depreciated on a straight

related sources,[69] they were to be deferred and recorded in a deferred deduction account. The expenses could then have been used to offset net related income in future taxable years or offset the proceeds from the disposition of the property that was the source of the expenditures.

LAL was to apply to all farming activities undertaken by individuals, trusts, estates, and corporations. However, LAL would not have applied to taxpayers who used the accrual method of accounting and capitalized farm preproductive period expenses. The inapplicability of LAL to such taxpayers was in recognition of the fact that accrual accounting already corrected distortions of income that arise from the mismatching of expenses and revenues and therefore accrual method taxpayers were not likely to have significant accelerated deductions.

LAL would have limited the use of accelerated deductions resulting from farming operations to application against farm income only. Individuals would not have been permitted to offset nonfarm income with losses generated through accelerated deductions from farming activities; thus, the incentive for high-bracket taxpayers to invest in farming ventures would have been largely eliminated. An exception to this rule was created to accomodate those members of the farming community who find it necessary to supplement their farm income.

> In recognition of the fact that many persons whose principal occupation is farming also supplement their farm income with income from nonfarm sources, the bill permits a farm loss produced by accelerated deductions to be deducted currently (without regard to the LAL limitations) against the taxpayer's non-farm income up to $20,000.[70]

For example, an individual who sustained a net farm loss of $20,000 but received income of $20,000 (the source of the income being unrelated to a farming activity) during the taxable year would have been allowed to currently offset the entire amount of his nonfarm income with the farm loss. If the individual's nonfarm income exceeded $20,000, then the amount of the farm loss resulting from accelerated deductions which could have been used as a current deduction would have been reduced by $1.00 for each $1.00 of

---

line method for each taxable year of its useful life for which the taxpayer holds the property." *Id.* at 48-50, 2944.

[69] Net related income means generally the excess of the gross income from "LAL farm property" over the amount of deductions attributable to such property, but not including the accelerated deductions incurred with respect to that property.

> "LAL farm property," includes all property which is used or held for use in the trade or business of farming and all property which is held in connection with the trade or business of farming and which is either stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business of farming.

Id. at 46,2940. For taxpayers other than farming syndicates all farm income is net related income. Farming syndicates (for a definition and explanation of the term "farming syndicate," *see* notes 81-85 *infra* and accompanying text) must identify each distinct farm activity conducted as a separate class of LAL farm property. For a complete discussion of the intricacies of the concept of "net related income," see HOUSE REPORT, *supra* note 68, at 50-54.

[70] HOUSE REPORT, *supra* note 68, at 45.

nonfarm income in excess of $20,000.[71] As a result of this limitation an individual who received nonfarm income of $40,000 or more would have been forced to place his farm-accelerated deductions in a deferred deduction account.

LAL would have been much more effective in eliminating the farm tax shelters and inequitable distribution of farm tax advantages than the EDA.[72] As a consequence of the genuine reform that LAL would have instituted, the lobbying against the provision was strong.[73] The objections to LAL as applied to farmers focused on its complexity and similarity to the EDA.[74] The primary concern of the National Livestock Feeders Association was that LAL would "undoubtedly draw into its web a number of bona fide day-to-day smaller and medium-sized operations."[75] As was the case with the EDA, complicated record keeping would have been required of all farmers because the possibility that the taxpayer's nonfarm income might exceed the $20,000 level, thus triggering the application of LAL, would have always existed. The Senate was persuaded by these arguments and abandoned the LAL approach to farm tax reform. Admittedly, LAL was an indirect solution to the farm taxation problem, but it would have had a greater impact on the tax expenditure to agriculture than any other proposal seriously considered by Congress.

B. *The 1976 Farm Tax Reform Provisions: Eliminating the Shelter*

1. Farming Syndicates

New sections 278 and 464 of the Code, added by sections 207(a) and 207(b) of the 1976 Reform Act, represent the Senate's alternative to the House LAL proposal in H.R. 10612.[76]

a. Section 464

Section 464 places limitations on the amount of deductions allowed

---

[71] *Id.* Thus, an individual with $20,001 of nonfarm taxable income would have been permitted to offset that income by a maximum of $19,999 of farm losses attributable to accelerated deductions. If an individual received $30,000 of nonfarm income in a taxable year, the maximum amount of farm losses which he would have been permitted to use to offset that income would have been $10,000.

[72] It was estimated that LAL would have resulted in a revenue increase of $100 million for calendar year 1976. This amount represents over a 10 percent decrease in the total tax expenditure to agriculture in fiscal year 1976. *See* U. S. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, THE BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1977, 125 (1976) (Special Analysis F) [hereinafter cited as 1976 Special Analysis F]; *see also* the analysis of the effects of the Tax Reform Act of 1976 in Part IV of this Note.

[73] LAL was also offered as a solution to other tax shelter areas such as real estate and oil and consequently received much resistance when it reached the Senate. *See, e.g.*, Surrey, *Reflections on the Tax Reform Act of 1976*, 25 CLEV. ST. L. REV. 303, 311 (1976).

[74] *See Hearings Before the Comm. on Finance United States Senate*, 94th Cong., 2d Sess. 399 (1976) (statement of Claude Maer) [hereinafter cited as *Finance Hearings*].

[75] *Id.* at 400 (statement of Bill Jones).

[76] H.R. CONF. REP. No. 94-1515, 94th Cong., 2d Sess. 413-16, *reprinted in* [1976] U.S. CODE CONG. & A.D. NEWS 4124-27 [hereinafter cited as CONFERENCE REPORT].

farming syndicates. The provision requires that farming syndicates shall be allowed to take deductions for amounts paid for feed, seed, fertilizer, or other similar farm supplies only in the taxable year when such items are actually used or consumed.[77] An exception to this requirement arises when the farm supplies have not been used or consumed due to disease, drought, fire, storm, flood, or other casualty, or when the amounts expended for such farm supplies are required to be charged to capital account under section 278.[78] The section also places limits on the deductibility of certain poultry expenses. Farming syndicates must now capitalize the cost of poultry bought for a business or trade use and deduct such expenses pro rata over a period of twelve months or the useful life of the poultry, whichever is shorter.[79] If the poultry is bought for resale, the cost of the poultry must be deducted in the taxable year in which it is sold.[80]

A farming[81] syndicate is defined as a partnership or other enterprise engaged in the trade or business of farming if interests in the partnership or enterprise have at any time "been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale."[82] Also included as farm syndicates, for the

---

[77] I.R.C. § 464(a). Deductions for feed, seed, fertilizer, and other similar expenses may be taken in a taxable year later than the taxable year when the items are used if such a deduction would be allowable without regard to section 464. The effect of this subsection is not to require accrual basis accounting for farming syndicates but merely to deny deductions for prepaid feed and other farm supplies. *But see* discussion of new section 447 at note 104 *infra* and accompanying text, indicating that a farming syndicate may otherwise be forced to adopt the accrual method of accounting.

[78] I.R.C. § 464(d). *See* the discussion of section 278 at note 98 *infra* and accompanying text.

[79] I.R.C. § 464(b). Poultry is defined within the subsection to include baby chicks and egg-laying hens.

[80] I.R.C. § 464(b)(2). The sections limiting deductions for poultry expenses apply only to farming syndicates. The rationale supporting the allowance of current deductions for poultry expenses — that poultry bought for resale have a low cost and poultry bought for use in the business such as egg-laying hens typically have a useful life of less than one year — will continue to operate in favor of other farm operations, unless they are subject to the section 447 mandatory accrual requirements. *See, e.g.*, Rev. Rul. 60-191, 1960-1 C.B. 78.

[81] The term "farming" is defined as "the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals." I.R.C. § 464(e)(1). Trees, except for trees bearing fruit or nuts, are specifically excluded from the definition of farming. However, timber is again afforded favorable treatment under section 447 through exclusion from the mandatory accrual requirements of that section, discussed *infra* in text accompanying notes 104-27. The forest industry presented a detailed account of the economics of timber production to support their position that disallowance of current deductions would inhibit needed forest investment. A timber venture requires a long term capital investment and continuing maintenance costs while providing a low financial return compounded by the risks of casualty. The United States Forest Service, in fact, had been urging timber growers to incur preproductive expenses for expansion to help avert a national timber shortage. *Finance Hearings, supra* note 74, at 453-56 (statement of Edward Knapp, Forest Industries Commission on Timber Valuation and Taxation).

The exception from section 464 for timber production signifies Congressional willingness to permit current deductions for expenses normally chargeable to capital account when the nature of the farm operation is such that tax incentives are necessary to promote investment. The import of this Congressional reasoning will be discussed with respect to the tax expenditure aspect of the farm laws in Part IV of this Note. It is interesting to note that this exception is not dependent on the size or character of the timber operation. Large corporations as well as small sole proprietorships will continue to benefit from allowance of current deductions.

[82] I.R.C. § 464(c)(1)(A). One author has noted that the "reference to Federal or state registration and regulation will result in disparate treatment of farming enterprises throughout

purposes of section 464, are partnerships or other enterprises engaged in the business of farming, "if more than thirty-five percent of the losses during any period are allocable to limited partners or limited entrepreneurs."[83] This definition includes subchapter S corporations but not other corporations because tax losses in such other corporations cannot be passed on to the shareholders.[84] Farm enterprises in the organizational form of general and limited partnerships, trusts, interests in subchapter S corporations, and agency relationships created by management contracts are within the ambit of the farming syndicate definition.[85]

Five exceptions to the farming syndicate definition and concomitant operation of section 464(a) are created for farm interests involving active management of the farm enterprise. However, these exceptions apply only to those partnerships or other enterprises considered to be farming syndicates because more than thirty-five percent of the farm losses during any period are allocable to limited partners or limited entrepreneurs.[86] The five exceptions outline those situations where an individual's farm interest will not be considered a limited partnership or limited entrepreneur interest in the application of the thirty-five percent loss allocation rule of section 464(c)(1)(B).

Excluded from the coverage of section 464(c)(1)(B) is any individual who, for a period of not less than five years, has actively participated in the management of a farming business.[87] Similarly excluded are partnership interests and interests in any other enterprise which are attributable to an active participation in the management of a farming business. The new section does not define active participation; however, the Senate Report accompanying H.R. 10612 is useful in determining what is meant by the term.

> The determination whether a person actively participates in the operation or management of a farm depends upon the facts and circumstances. Factors which tend to indicate active participation include participation in the day-to-day decisions in the operation or management of the farm, actually working on the farm, living on the farm, and engaging in the hiring and discharging of employees as compared to only the farm manager. Factors which tend to indicate

---

the U.S." Bravenac & Olsen, *How to Plan Agricultural Transactions in Light of the Tax Reform Act of 1976*, 46 J. TAX. 164, 166 (1977) [hereinafter cited as *Agricultural Transactions*].

[83] I.R.C. § 464(c)(1)(B). The original version of the Senate amendment to H. R. 10612 required an allocation of more than 50 percent of the losses during any period. S. REP. No. 94-938, 94th Cong., 2d Sess. 58-59, *reprinted in* [1976] U. S. CODE CONG. AD. NEWS 3439, 3494-95 [hereinafter cited as SENATE REPORT]. Bravenac and Olsen have suggested that the argument may be raised that "during any period" as opposed to "at any time" (used in section 464(c)(1)(A) with respect to public offerings) indicates that a determination of whether the partnership or enterprise surpasses the 35% loss allocation limit and thus becomes a farming syndicate for the purposes of section 464 must be made for each taxable year. *Agricultural Transactions, supra* note 82, at 166.

[84] STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG. 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 46 (Comm. Print 1976) [hereinafter cited as GENERAL EXPLANATION].

[85] SENATE REPORT, *supra* note 83, at 59.

[86] I.R.C. § 464(c)(2). A limited entrepreneur is an individual who "has an interest in an enterprise other than as a limited partner," and who fails to actively participate in the management of the farm enterprise. I.R.C. § 464(e)(2).

[87] I.R.C. § 464(c)(2)(A).

> a passive person similar to a limited partner include lack of control of the management and operations of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, not owning the farmland in fee, and having limited liability for farm losses.[88]

Another exception applies to individuals who have an interest in any farming enterprise if their "principal business activity involves active participation in the management" of some other farm business.[89] This exception may well leave the "tax shelter" door open to individuals who have farm operations which generate income slightly in excess of nonfarm income.[90] By actively participating in their own farm operation, taxpayers will have the option to invest in unrelated farm ventures without being subject to the provisions of section 464.

If the farm is the principal place of residence of the individual, then "any partnership or other enterprise engaged in the trade or business of farming" of that farm will also not be considered a farming syndicate under section 464(c)(1)(B).[91] In addition, an individual's interest in a livestock processing operation will be excluded from the thirty-five percent loss allocation rule if the livestock were raised in a farming business in which the individual actively participated in its management.[92]

The fifth exception pertains to the family[93] of an individual who qualified under any of the other four exceptions if the interest of the family member is derived from the active participation of the qualifying individual.[94]

The rationale for all of these exceptions to the definition of farming syndicate with respect to the thirty-five percent loss allocation rule of section 464(c)(1)(B) may be traced to the Congressional concern for legitimate farmers and ranchers, who, it was felt, should not be subject to the impact of section 464.[95] This approach is in accord with the theme of the entire farm tax

---

[88] SENATE REPORT, *supra* note 83, at 59 n. 12.

[89] I.R.C. § 464(c)(2)(D).

[90] The taxpayer must be able to demonstrate that farming is his principal business activity. Thus, the tax advantages in most instances would not be available, for example, to doctors or lawyers seeking tax sheltered investments. The tax advantages would exist, however, for those who are 50.1% farmers and derive substantial amounts of income from nonfarm sources. The advantage is also inequitable. As the size of the farm operation increases, freedom from the scope of section 464 when investing in other farm operations also increases.

[91] I.R.C. § 464(c)(2)(B).

[92] I.R.C. § 464(c)(2)(C).

[93] For the purpose of this exception, "family" is defined with respect to the grandparents of the individual who actively participated in the farming business. I.R.C. § 464(c)(2)(E). The family includes the "brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendents" of such grandparents. I.R.C. § 267(c)(4).

[94] I.R.C. § 264(c)(2)(E). The Senate Report provides an example:

> [I]f A, an individual who has owned and operated a farm for more than five years, wishes to retire and forms the AB limited partnership with B, an unrelated individual, and more than 50 percent of the losses are allocated to A [35 percent under the section as enacted], the limited partner, the AB partnership will not be treated as a farming syndicate . . . . Similarly, if A later dies and the partnership is continued by B and C, A's son, the BC partnership will not be treated as a farming syndicate.

SENATE REPORT, *supra* note 83, at 59-60.

[95] SENATE REPORT, *supra* note 83, at 60.

reform package of the 1976 Act: the selective removal of the components of farm tax shelters while at the same time preserving for "real" farmers the tax advantages inherent in the special farm accounting rules. The efficacy of this approach will be examined in Part IV of this Note.

The Senate Report indicates that the thirty-five percent loss allocation rule of section 464(c)(1)(B) should further be limited to farm operations in which an individual has only "limited risk."[96] The report suggests that, except for the specific five exceptions noted above, the determination of whether an operation is a farming syndicate under the thirty-five percent loss allocation rule should not turn upon the degree of the investor's active participation in the management of the enterprise but instead on whether the investor is at "limited risk." Because new section 465(a)[97] deals directly with the problem of deductions exceeding the amount at which a taxpayer is at risk in a farming venture, it is not clear what degree of reliance should be placed on the Senate Report's "limited risk" test for the definition of a farming syndicate. In view of the language of section 464(c)(1)(B) and the specific exceptions thereto, perhaps the safest approach for farm investors seeking tax advantages would be to participate frequently in management decisions.

b. Section 278

Section 207(b)(1) of the 1976 Reform Act added new section 278(b) to the Code, requiring farming syndicates, as defined in section 464(c), to capitalize amounts which would otherwise be deductible as amounts attributable to the planting, cultivating, maintaining, or developing a grove, orchard, or vineyard in which fruit or nuts are grown. These expenses must be charged to capital account only to the extent they are incurred "in a taxable year before the first taxable year in which such grove, orchard, or vineyard bears a crop or yield in commercial quantities."[98] Under prior law only those amounts attributable to planting, cultivating, maintaining, or developing citrus or almond groves were required to be charged to capital account.[99] The new section provides an exception to the capitalization requirement in the case of amounts attributable to the replanting of a grove, orchard, or vineyard after casualty due to freezing temperatures, drought, disease, pests, or the like.[100]

---

[96] Whether or not an individual is at "limited risk" depends on the attendant circumstances. Factors which indicate "limited risk" include insulation from loss through nonrecourse financing, stop-loss orders, guarantees, fixed price repurchase agreements, insurance, or other similar arrangements. *Id.*

[97] *See* notes 126-30 *infra* and accompanying text for a complete discussion of the "at risk" provision.

[98] I.R.C. § 278(b)(3). The expenditures can be recovered subsequently by depreciation of the grove, orchard, or vineyard. See *Agricultural Transactions, supra* note 82, at 167, where the authors indicate that amounts capitalized pursuant to section 278(b) qualify as progress expenditures under section 46(d). Therefore, an investment credit can be taken during the preproductive period of the grove, orchard, or vineyard.

[99] I.R.C. § 278(a). Section 278(a) continues in operation after the 1976 Reform Act amendments and differs from section 278(b) primarily in the period of time for which capitalization is required. With respect to citrus and almond groves, the additions to the capital account terminate at the close of the fourth taxable year after the taxable year in which the trees were planted.

[100] I.R.C. § 278(c).

As yet, Regulations have not been issued for new section 278(b). One potential source of confusion which should receive treatment in the new Regulations is the meaning that should be given the terms grove, orchard, vineyard, fruit, and nuts. In the botanical sense fruit is the ripened ovary of a flower and includes such entities as stringbeans, cucumbers, and grains of corn, oats, and wheat.[101] It is doubtful that Congress intended such a broad application of section 278(b).

When the section 278(b) rules apply to a situation that also is subject to section 278(a) (which requires capitalization of certain expenses incurred with respect to citrus and almond groves), the capitalization rules relating to a farming syndicate take precedence over the four year grace period provided for in section 278(a). Also, amounts expended for prepaid supplies and subject to the section 464 rules shall nonetheless be subject to the capitalization requirements of section 278(b).[102]

Both sections 464 and 278 reflect the belief of Congress that the special farm accounting rules should be continued for farmers who are legitimately attempting to make a profit. The prohibitions applicable to farming syndicates take aim at the passive farm investor who acts under a tax motivation with the purpose of sheltering nonfarm income. Congress further believed that removing the tax incentives for investors who were not particularly interested in making the farm profitable would improve the economic position of full-time farmers who must compete in the market place.[103]

2. Method of Accounting for Farming Corporations

New Code section 447 added by section 207(c)(1)(A) of the 1976 Reform Act changed the method of accounting to be employed by corporations or partnerships (if a corporation is a partner in the partnership) engaged in the trade or business of farming.[104] A corporation's taxable income from farming must "be computed on an accrual method of accounting and with the capitalization of preproductive expenses."[105] However, the accrual accounting requirement does not extend to nurseries or to timber operations.[106] Also,

---

[101] T. Weir, C. Stocking & M. Barbour, Botany: An Introduction to Plant Biology 285 (5th ed. 1974). If groves and orchards were limited in meaning and vineyards were limited to grapevines, the confusion could be largely dispelled.

[102] Senate Report, *supra* note 83, at 62. For example, although section 464(c) would allow a deduction for the cost of fertilizer, when it is used, section 278(b) would govern and the farming syndicate would therefore be required to charge the fertilizer expense to capital account.

[103] General Explanation, *supra* note 84, at 46.

[104] I.R.C. § 447(a). The House Ways and Means Committee Report accompanying H. R. 10612 defined farming for the purpose of section 447 as it is so defined in section 464(e), with the exception that the House definition would have included timber operations as farming. House Report, *supra* note 68, at 95. This definition was not included in section 447 as enacted.

[105] I.R.C. § 447(a).

[106] *Id.* Although not in the original House proposal, the Conference Committee adopted Senate Amendment Number 7 to H. R. 10612, creating an exception for nurseries and timber operations. Conference Report, *supra* note 76. The nurserymen and timber growers lobbied extensively before the Senate Finance Committee. *Finance Hearings*, *supra* note 74, at 432-37 (statement of Robert F. Lederer, Am. Assoc. of Nurserymen), and at 453-56 (statement of Edward Knapp, Forest Industries Commission on Timber Valuation and Taxation).

income that is received from "the personal services of employees who are engaged in the operation of machinery used in connection with farming activities is not income from the trade or business of farming."[107] For example, corporations engaged in contract harvesting operations are not required to report the taxable income derived therefrom on the accrual method of accounting.

The capitalization requirement of section 447 applies as well to preproductive expenses. A preproductive period expense is defined as any amount incurred with respect to crops, animals, or other property which produces crops or yields during the preproductive period of that property.[108] An exception has been created for taxes, interest, and amounts attributable to certain casualties.[109]

A corporation will not be subject to the mandatory accrual and capitalization requirements of section 447(a) if it falls within the classification of an electing small business corporation (subchapter S corporations),[110] a family corporation,[111] or a corporation with gross receipts of $1 million or less.[112]

The Conference Agreement on H.R. 10612 added the exception to cover corporations with gross receipts of $1 million or less. Since the primary justification for permitting the use of the cash receipts and disbursements method of accounting in farming is that small farm operations should not be burdened with the bookkeeping required by the accrual method of accounting, Congress decided small corporations should be excepted from the section 447(a) rules.[113] A corporation fits the exception if it (and any predecessor corporation) did not have gross receipts exceeding $1 million for each prior year beginning after December 31, 1975.[114] If a corporation's gross

---

[107] HOUSE REPORT, *supra* note 68, at 95.

[108] I.R.C. § 447(b) " 'Productive period' means in the case of property having a useful life of more than 1 year which will have more than 1 crop or yield, the period before the disposition of the first such marketable crop or yield, or in the case of any other property, the period before such property is disposed of." I.R.C. §§ 447(b)(3)(A), 447(b)(3)(B). For a comparison of the section 447 term "marketable crop" and section 278(b) term "commercial quantities" see *Agricultural Transactions, supra* note 82, at 167.

[109] I.R.C. § 447(b)(2).

[110] *See* I.R.C. § 1371(b). Because subchapter S corporations are excepted from the new rules for corporations engaged in farming, any corporation that is eligible to elect subchapter S status may do so and be exempt from the mandatory accrual accounting requirement. GENERAL EXPLANATION, *supra* note 84, at 53.

[111] A corporation may be considered a family corporation if 50 percent of the voting power and 50 percent of the outstanding shares of stock of the corporation are owned by members of the same family. I.R.C. § 447(c)(2). Members of the same family include an individual's "brothers and sisters, the brothers and sisters of such individual's parents and grandparents, the ancestors and lineal descendants of any of the foregoing, a spouse of any of the foregoing, and the estate of any of the foregoing." I.R.C. § 447(d)(1). In determining percent of stock ownership, provision is made for proportionate attribution through partnerships, trusts, and corporations.

The present exception for family corporations is much broader than originally conceived in the House bill. The Conference Committee on H. R. 10612 lowered the percentage of stock ownership from 66⅔ to 50 percent. It was felt that the lowering of the percentage would make unnecessary two special rules in the House bill relating to "two-family" ownership and existing stockholdings of certain employees.

[112] I.R.C. § 447(c).

[113] CONFERENCE REPORT, *supra* note 76, at 416.

[114] I.R.C. § 447(e).

receipts exceed the $1 million limitation in a taxable year ending after 1975, it must then and for all subsequent taxable years adopt the accrual method of accounting. One possible area of difficulty in the application of this exception is the definition to be given "gross receipts."[115] Generally, gross receipts will include gross sales without a subtraction for cost of goods sold. Tax planners should be aware that for the purpose of section 447(e) the gross receipts of a corporation are not limited to those derived solely from farming operations. Notwithstanding the narrow application of section 447(a) to farm taxable income, the gross receipts of a corporation from all sources should be taken into consideration in determining the applicability of the gross receipts exception. However, receipts from the sale of farmland and improvements, farm machinery, and equipment should probably be excluded from a gross receipts calculation under section 447(e).[116]

The harsh effects that may result to a taxpayer who is required by section 447 to change to an accrual accounting method are mitigated by a provision for a ten year adjustment period.[117] To coordinate section 481 with the change in accounting method, the Commissioner must prescribe Regulations taking into account the net amount of adjustments required by section 481(a) in each of ten taxable years, commencing with the year in which the change occurred.[118] Corporations which have used an annual accrual method of accounting[119] for ten taxable years ending with the first taxable year that began on or after January 1, 1976, are not even required to make the change in accounting if the corporation continuously employed such method of accounting, and its crops are harvested within one year of planting.[120]

Section 447 became effective for taxable years beginning after December 31, 1976, but section 404 of the Tax Reduction and Simplification Act of 1977 postponed the effective date for certain corporations. In the case of any farm corporation in which either two families own at least 65 percent of the stock or three families own at least 50 percent of the stock, and substantially all of the other stock is owned by employees, employees' families, or exempt retirement trusts established for the benefit of the employees; accrual accounting under section 447 shall be required for taxable years beginning after December 31, 1977.[121]

Through the mandatory accrual requirements of section 447, Congress has

---

[115] For a discussion of an interpretative basis for "gross receipts," see *Agricultural Transactions, supra* note 82, at 165.

[116] GENERAL EXPLANATION, *supra* note 84, at 54 n.22.

[117] I.R.C. § 447(f).

[118] Furthermore, the "change shall be treated as having been made with the consent of the Secretary, and for purposes of section 481(a)(2), such change shall be treated as a change not initiated by the taxpayer." *Id.*

[119] Under an annual accrual method of accounting "revenues, costs and expenses are computed on an accrual method of accounting and the preproductive expenses incurred during the taxable year are charged to harvested crops or deducted in determining the taxable income for such years." I.R.C. § 447(g)(2).

[120] I.R.C. § 447(g)(1). The advantage to corporations fulfilling the condition to this exception lies in the ability to avoid inventorying the cost of crops remaining unharvested at the end of the taxable year and instead taking a current deduction for the taxable year in which the expenses were incurred. *Agricultural Transactions, supra* note 82, at 165.

[121] Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 404, 91 Stat. 126 (1977).

taken a direct and theoretically correct approach to eliminate the tax advantages inherent in the farm tax accounting rules. Yet, the reform has been limited to large corporations, due to the prevailing congressional attitude that only "large farm businesses . . . have ready access to the skilled accounting assistance often required to identify specific farm costs."[122] Partnerships in which a corporation is a partner are included in the mandatory accrual provision; otherwise, corporations could avoid section 447 by becoming a partner in a partnership entitled to use the cash receipts and disbursements method of accounting.[123] The exceptions created for subchapter S corporations, family corporations, and corporations with gross receipts of $1 million or less again reflect the desire of Congress to preserve simplified accounting methods, and thus tax advantages, for the so-called "real" farmers, while attempting to remove the tax incentives for high-income investors seeking tax shelters. This categorical selective treatment creates inequities in the farm tax system. President Carter, although accepting the premise that simplified bookkeeping techniques should be permitted of small farmers, recognized in his Message to the 95th Congress Transmitting Proposals for Tax Reduction and Reform that tax inequities presently exist in section 447.[124] The distinction between family and nonfamily corporations bears no rational relationship to the concept that small farmers need an elementary accounting device in computing taxable income. Family corporations may be equal in size with nonfamily corporations and thus have equal access to sophisticated accounting assistance. In order to remove this competitive imbalance, President Carter has recommended that the reach of section 447 be expanded to include *all* corporations with gross receipts in excess of $1 million, including all farm syndicates.[125] While such a proposal represents further movement in the direction of true reform in the farm tax area, it falls short of erasing the source of unfair farm tax advantages.

3. Deductions Limited to the Amount at Risk

New section 465 added by section 204(a) of the 1976 Reform Act is aimed directly at tax shelter leveraging through the use of non-recourse indebtedness, stop-loss orders, guarantees, and other risk limitation devices.[126] The

---

[122] HOUSE REPORT, *supra* note 68, at 94.

[123] Section 447 does not impose additional burdens on partnerships that are farming syndicates under sections 278 and 464. Amounts attributable to poultry, orchards, groves, and vineyards that must be capitalized under the farm syndicate rules are also preproductive expenses that must be capitalized under section 447(a). Similarly, amounts paid for feed, seed, fertilizer, or other farm supplies that may only be deducted when such supplies are consumed under section 464 are also items which must be inventoried under section 447.

[124] MESSAGE FROM THE PRESIDENT OF THE UNITED STATES TRANSMITTING PROPOSALS FOR TAX REDUCTION AND REFORM, H. R. DOC. No. 95-283, 95th Cong., 2d Sess. 14 (1978).

[125] *Id.*

[126] Notwithstanding a certain degree of overlap with the new farm syndication rules, section 465 is necessary to reach those farming operations to which sections 278 and 464 do not apply. Such is the case with respect to winter vegetables, rose bushes, and other nursery plants to which the farming syndicate rules are inapplicable. Section 465 does not apply to a corporation unless that corporation is an electing small business corporation as defined in section 1371(b) or a personal holding company as defined in section 542.

new rule essentially provides that a taxpayer engaged in the business of farming, as defined in section 464(e), may deduct the amount of a loss from that activity "only to the extent of the aggregate amount with respect to which the taxpayer is at risk" in each farming activity at the close of the taxable year.[127] The amount a taxpayer is at risk includes the amount of cash and adjusted basis of other property invested in the activity by the taxpayer plus any amounts borrowed for the activity if the taxpayer is personally liable or has pledged property as security for such borrowed amounts.[128] Any losses which, as a result of being in excess of the taxpayer's amount at risk, are not allowed to be currently deducted shall be allowed as a deduction in the next and subsequent taxable years to the extent the taxpayer is at risk for the activity.

If an individual is engaged in more than one farming activity, the at risk provision applies separately to each such activity.[129] A determination of whether the taxpayer is indeed engaged in more than one farming activity must be gathered from the attendant facts and circumstances. The Senate Report suggests that in making such a determination the following be considered: "the degree of organizational and economic interrelationship of various activities in which the taxpayer is engaged, the business purpose which is (or might be) served by carrying on the various activities separately or together, and the similarity of the various activities."[130]

4. Prepaid Interest

Prior to the addition of new section 461(g) to the Code, cash-basis taxpayers were able to achieve tax savings through prepaid interest deductions. Unless the interest prepayment was for a period extending beyond twelve months after the end of the current taxable year, a cash-basis taxpayer would be permitted to deduct the interest expenses currently so long as income was not materially distorted.[131]

The reasons for a change in the law, as set forth in the House Report accompanying H.R. 10612, describe the benefits of prepaid interest deductions for tax motivated farm investors.

> The deduction for prepaid interest has become highly important to investors seeking year-end artificial losses who acquire their interest in a property . . . , or in a partnership which will own the proper-

---

[127] I.R.C. § 465(a).

[128] I.R.C. § 465(b). Generally, property used in the farm activity may not be pledged. Additionally, borrowed amounts will be excluded from the total amount at which the taxpayer is at risk if those amounts are borrowed from a person who either has an interest in the activity or who bears a relationship to the taxpayer as defined in section 267(b).

[129] SENATE REPORT, *supra* note 83, at 63. However, this rule is not meant to apply to activities engaged in by a partnership or subchapter S corporation. *Id.*

[130] *Id.*

[131] Rev. Rul. 68-643, 1968-2 C. B. 76, 77 (1968). Factors such as ". . . the amount of [the taxpayer's] income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason for the prepayment, and the existence of a varying rate of interest over the term of the loan" should be considered in determining whether the deduction creates a material distortion of income.

> ty, toward the end of the calendar year. In such cases, the investors will not be able to operate the property long enough in that taxable year to generate either income or a large amount of ordinary and necessary business expenses. Therefore, deductions arising from prepaying as much of the financing costs as possible have been central to the creation of year-end tax losses. If the investors have income from other sources, the interest deductions can be used to offset this other income (rather than offsetting income from the property itself, which will be realized in a later year.)[132]

Section 461(g) eliminates the tax deferral advantage described in the House Report. Taxpayers using the cash receipts and disbursements method of accounting to compute taxable income must now allocate interest prepayments to the period for which that portion of the interest represents a cost of using the borrowed money. If that period is after the close of the taxable year in which the interest is prepaid, then such allocable portion of the interest must be charged to capital account.[133]

5. Termination of Additions to the EDA

Section 206(a) of the 1976 Reform Act added section 1251(b)(2)(E) to the Code which calls for the termination of additions to the EDA for any taxable year beginning after December 31, 1975. However, the recapture rules of section 1251 will continue to apply to farm recapture property, as defined at section 1251(e)(1), that is disposed of after December 31, 1975, but only with respect to an EDA that was created prior to December 31, 1975.[134]

The EDA was terminated due to its complexity, limited applicability, and the belief of Congress that the farm syndicate and at risk limitation rules deal more directly with the farm tax shelter problem.[135]

IV. Enough Reform?

A. *Minimal Effect on Farm Tax Advantages*

The effectiveness and propriety of the farm tax reform provisions of the Tax Reform Act of 1976 should be measured by the impact they will have on the existence of farm tax advantages and inequities. Such an analysis should begin with an examination of the change in the agricultural tax expenditure

---

[132] House Report, *supra* note 68, at 98.

[133] I.R.C. § 461(g).

[134] House Report, *supra* note 68, at 93.

[135] A few other provisions of the 1976 Reform Act have an effect on the tax rules applicable to farmers. These changes include: (1) an amendment to section 183 providing that taxpayers no longer have to waive the statute of limitations with respect to items in their return that are unrelated to farming in order to take advantage of the profit presumption; (2) an amendment to section 451(d) providing that payments received under the Agricultural Act of 1949 shall be treated as insurance proceeds if received as a result of casualty damage to crops or the inability to plant crops because of a natural disaster; (3) the creation of new section 451(e) which allows taxpayers on the cash basis of accounting to elect to include income from the disposition of livestock brought about as a consequence of drought in the taxable year after such disposition. For a more detailed treatment of the above listed changes, see *Agricultural Transactions, supra* note 82, at 168-69.

brought about by the reform provisions. Although a well delineated relationship between the reform provisions and the change in the tax expenditure to agriculture is not available, it is helpful to compare the United States Office of Management and Budget tax expenditure estimates made for fiscal years before and after the effective dates of the reform provisions.[136] These tax expenditure estimates reflect the revenue loss resulting from the two major special farm tax rules: (1) the expensing of certain items normally chargeable to capital account, and (2) capital gains treatment of certain ordinary income. Table 1 presents the agricultural tax expenditure estimates of the United States Office of Management and Budget from years 1976, 1977, and 1978. The estimates in the table for fiscal years 1977, 1973, and 1979 are based upon the Internal Revenue Code as amended by the 1976 farm tax reform provisions, while the estimate for fiscal year 1976 presents the revenue loss under the Code prior to the reform measures.

TABLE 1[137]

TAX EXPENDITURE ESTIMATE: AGRICULTURE
(In Millions of Dollars)

Source of revenue loss	1976 estimate for fiscal year 1976	1977 estimate for fiscal year 1977	1978 estimate for fiscal year 1978	1978 estimate for fiscal year 1979
Corporations:				
Expensing of certain capital outlays	105	80	70	75
Capital gains treatment of certain ordinary income	30	10	10	10
Total attributable to corporations	135	90	80	85
Individuals:				
Expensing of certain capital outlays	355	370	445	460
Capital gains treatment of certain ordinary income	490	330	350	365
Total attributable to individuals	845	700	795	825
Total Expenditure	980	790	875	910

[136] The tax expenditure estimates of the United States Office of Management and Budget were intended by the Congressional Budget Act of 1974 to provide a means for Congress to evaluate the effects that certain legislation might have on the budget. The estimates enable Congress to compare the revenue effects of prior law with newly enacted law. For a brief discussion of the usefulness of tax expenditure estimates in the formulation of tax policy, see McDaniel, *Tax Expenditures In The Second Stage: Federal Tax Subsidies For Farm Operations*, 49 S. CAL. L. REV. 1277, 1277-80 (1976) [hereinafter cited as *Tax Subsidies For Farm Operations*].

[137] Source: the estimates for fiscal years 1978 and 1979 are taken from Special Analysis G, *supra* note 2, at 158, and are based on the Internal Revenue Code as of December 31, 1977; for fiscal year

Table 1 indicates that the 1976 farm tax reform provisions will have a minimal effect on the total tax expenditure to agriculture. Initially, the reform measures were estimated to achieve only a twenty percent decline in the agricultural tax expenditure between fiscal years 1976 and 1977. Later estimates reveal that the overall impact of the farm tax reform provisions on the revenue loss will be even less. By fiscal year 1979, the agricultural tax expenditure resulting from special farm tax rules will be only seven percent less than the total expenditure prior to the 1976 farm tax reform attempts.[138] Over seventy percent of this slight reduction in the tax expenditure is attributable to the reform provisions' effects on farming corporations. This result may be expected from the operation of new section 447 which requires accrual accounting of certain corporations engaged in farming. The balance of the reduction in the tax expenditure may be assumed to occur as a result of individual taxpayers receiving fewer farming partnership losses. This assumption rests on the fact that the sole proprietor remains unaffected by the farming syndicate rules of new section 465 and largely unaffected by the other 1976 farm tax reform measures.

The reason for such a negligible impact on the agricultural tax expenditure may be attributed to the narrow approach chosen by Congress in attempting to eliminate special farm tax advantages. The attention of Congress was focused upon use of the syndicated farming partnership interests by tax-motivated individuals seeking to take advantage of the favorable farm tax rules. Congress also focused upon tax advantages accruing to large farm corporations that were able to employ the tax saving cash receipts and disbursements method of accounting.

The limited goal of Congress to eliminate these two major abuses of the special farm tax rules while preserving such rules for the ordinary farmer has been achieved to a great extent. The ability to make use of the tax shelter deferral mechanism, upon which syndicated farming partnerships have typically relied for achieving tax savings, has been largely eliminated by new sections 464 and 465.[139] It should be noted, however, that section 464 does not

---

1977 the estimate is taken from U.S. Office of Budget, Special Analyses, The Budget of the United States Government: Fiscal Year 1978, at 128 (1977) (Special Analysis F) and is based upon the Code as of December 31, 1976; for fiscal year 1976 the estimates were taken from 1976 Special Analysis F, *supra* note 72, at 125, and are based upon the Code as of December 31, 1975.

[138] This minor reduction in the total tax expenditure to agriculture would not be surprising to the Congressional committee responsible for the farm tax reform provisions of the 1976 Reform Act. Prior to enactment the estimated revenue effect of new section 447 (mandatory accrual accounting for certain farm corporations) was to increase corporate tax liability by $30 million annually. House Report, *supra* note 68, at 97. New sections 278 and 464 (the farming syndicate rules) were estimated to increase federal budget receipts by $31 million in fiscal year 1978. Senate Report, *supra* note 83, at 62. The other farm tax reform provisions were estimated to have a negligible effect on the internal revenue. The combined effect of these revenue estimates would be to reduce the 1976 agricultural tax expenditure by 6.3 percent, a reduction that is not significantly different from the 1978 estimates of the United States Office of Management and Budget shown in Table 1, *supra*, p. 109.

[139] *See* the text accompanying notes 40-42 *supra*. It will be recalled that section 464 limits the deduction for certain farm expenses, including poultry expenses, to the taxable year in which the item for which the expense was incurred is actually used or consumed. Thus, the prepayment method of achieving tax deferral by generating current farm losses to offset nonfarm income loses its vitality. However, sole proprietors engaged in the trade of farming as well as other forms of doing business that fit within the farming syndicate exceptions in section 464 may still be permitted to use the cash method and take current deductions for certain prepaid farm supplies.

prevent farming partnerships from using the cash method of accounting and therefore does not eliminate all tax deferral possibilities. Instead, the provision merely eliminates the convenient device of achieving end-of-the-year tax losses through the prepayment mechanism. The narrow operating range of the statute is further highlighted by the exception to the thirty-five percent loss allocation rule created for individuals who actively participate in the management of the farm enterprise.[140]

The most effective means of eradicating the farm tax advantages would be to require accrual accounting of all farms in which the production, purchase, or sale of merchandise is an income-producing factor. This technique was utilized by Congress in a questionable manner against certain farm corporations.[141] It is difficult to understand why the corporate form of conducting a farm business should be denied the beneficial treatment of the farm tax rules while such treatment is continued for sole proprietorships, partnerships, and the corporations specifically excepted under section 447, even though these business entities may be much larger and have greater access to skilled

---

The criteria for whether a current deduction will be allowed for prepaid feed are set forth in Rev. Rul. 75-152, 1975-1 C. B. 144 (1975). This ruling requires that the feed expense be a payment and not a mere deposit, that the prepayment be made for a business purpose, and that the reporting of the expense as a current deduction not create a material distortion of income. Payment has been defined by the Eighth Circuit as a nonrefundable transfer of the consideration for the prepaid item. Mann v. Comm'r, 483 F.2d 673 (8th Cir. 1973). *See* De La Cruz v. Comm'r, CCH Dec. 34, 909(m), T.C. Memo 1978-8.

Recently, some doubt has been cast on the ability of even cash method taxpayers to take advantage of prepaid expense deductions. In Clement v. United States, No. 131-75 (Ct. Cl. July 14, 1978), the taxpayers, limited partners in a cattle-feeding partnership, were held to be not entitled under the law as effective in 1968 to deduct the cost of cattle feed purchased in one year and consumed in subsequent years. The taxpayers were initially successful in the Trial Division of the Court of Claims in their refund suit against the government. Trial Judge Schwartz, applying the tests set forth in Rev. Rul. 75-152, found that the prepayment was made for a business purpose and that the prepayment would indeed result in a material distortion of income. Notwithstanding the material distortion of income determination, Judge Schwartz held that the taxpayers were entitled as farmers to deduct the prepayment in the year of purchase. The basis for his decision was that farmers are expressly exempted from having to use the inventory method of accounting and that to hold otherwise would be to "require the farmer-taxpayer to engage in disapproved ad hoc and hybrid accounting instead of his regular and consistent method." Clement v. United States, 77-2 U.S.T.C. ¶ 9600 [1977]. The appellate Division of the Court of Claims dismissed the taxpayer's petition and held that the Commissioner's refusal to allow deduction of the entire prepayment was consistent with the cash method of accounting as defined by the regulations. The regulation cited by the court which prescribes the taxable year of deduction for taxpayers using the cash method provides, "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made." Treas. Reg. § 1.461-1(a)(1)(1957). The feed deduction must therefore be taken in the year that the particular asset is used or consumed. The court reasoned that under this scheme the taxpayer is not forced to adopt an inventory method of accounting but only that "period costs" must be recognized and integrated into the over-all cash accounting method. By way of footnote, the court distinguished period costs, those which arise with respect to time intervals, from product costs which are instead incurred in producing a product. Thus, the farmer need not wait until the livestock is sold to account for the feed deduction but rather may claim such deduction when the livestock consumes the feed.

This reasoning may well be applied to all cash method farmers who attempt to currently deduct prepaid costs. The question remains unanswered to what extent the Commissioner will be able to utilize the material distortion of income test in requiring farmers to adapt their cash accounting scheme to account for period costs.

[140] *See* note 86 *supra* and accompanying text.

[141] *See* the discussion of new section 447 at notes 104-25 *supra* and accompanying text.

accounting assistance. Certainly, if size is the determinant of a farming operation's ability to adopt accrual accounting techniques, then the form of doing business should be irrelevant to the imposition of mandatory accrual accounting.

B. *Who Receives the Benefits from the Agricultural Tax Expenditure?*

The ownership and size of farm assets together with the financial integrity of farms are significantly affected by federal tax policy.[142] In this regard it has been suggested that the agricultural tax expenditure be viewed as a federal loan program to farmers.[143] The effects of this loan program should be carefully evaluated when considering the desirability of the current farm tax laws. This view is consistent with a major objective of the Congressional Budget Act of 1974, that it should be a goal of Congress to evaluate in terms of direct spending programs those tax provisions which cause a revenue loss and thus create tax expenditures to certain sectors of the economy.[144] Since an understanding of the economic effects of a $910 million subsidy to agriculture is of importance to a proper assessment of the propriety of the farm tax laws, it is necessary to identify the beneficiaries of the tax expenditure.

Excluding from consideration corporations and partnerships engaged in farming, it has been shown that farm losses become more frequent as individual gross income increases.[145] Special tabulations prepared by the Internal Revenue Service for taxable year 1970[146] indicated the following with respect to sole proprietors engaged in the trade or business of farming:[147]

---

[142] *See, e.g.*, Woods, *Tax Policy as a Research Issue*, 37 AG. FIN. REV. 37 (1976) [hereinafter cited as Woods]. Mr. Woods, who is a Public Policy Specialist with the Extension Service in Washington, D.C., emphasizes that:

> [T]he effects of tax deductions and concessions are highly selective as to which groups benefit and which groups suffer. Such tax benefits raise serious questions of equity. And because the selective consequences affect the ability to survive, they work indirectly to influence who is going to control U. S. agriculture in the future.

Id. at 40.

[143] *See Tax Subsidies For Farm Operations, supra* note 136. The loan, which is interest free and unsecured, arises from the mechanism of tax deferral. *See* note 7 *supra* and accompanying text. Often the loan may be totally forgiven through a conversion device. *See* notes 32-35 *supra* and accompanying text.

[144] S. REP. No. 93-688, 93d Cong., 2d Sess. 1, *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 3504, 3504.

[145] Carlin and Woods, *Tax Loss Farming*, ERS-546, U.S. Dept. Ag. 8-9 (1974) [hereinafter cited as ERS-546].

[146] The results of the special tabulations are taken from the United States Department of Agriculture Economic Research Service Report. *Id.* at 9.

[147] *See id.* at 8-12. Although the tabulations reflect income statistics prior to the 1976 farm tax reform provisions, they may be relied upon for the purpose of this discussion. The 1970 taxable year tabulations are based only upon farm sole proprietorships. Amounts of farm losses that may be attributed to partnerships and corporations were excluded from the compilations. Admittedly, other economic factors may cause change in the distribution of farm losses among income classifications, but for the purpose of evaluating the farm tax laws as applied to the sole proprietor, these other factors may be ignored. The sole proprietor farm tax laws have not changed significantly since 1970, and these laws are the major focus of inquiry.

For further support for the conclusions drawn from the 1970 tabulations referred to in the text, see *Tax Subsidies For Farm Operations, supra* note 136, at 1302.

(1) More than seventeen percent of the reported farm losses were attributed to proprietors with gross incomes in excess of $24,999. This group, however, comprised only five percent of the total proprietors reporting farm losses but in dollar amounts paid fifty-six percent of the income taxes incurred by the entire farm loss group of taxpayers.

(2) The majority of reported farm losses were less than $5,000 per return and relatively low income taxpayers sustained the greatest proportion of farm losses.

(3) One income group in particular reported a disproportionately high percentage of returns with large farm losses. Of that group of individuals with basic incomes of $50,000 or more, nearly five percent of those filing returns reported farm losses of $50,000 or more.

These findings reveal that the benefits from the farm tax laws are accruing to the higher income bracket sole proprietors in substantial proportions. Of special significance is the fact that none of the farm returns used in the tabulation relied on a tax shelter mechanism to take advantage of the special farm tax rules.

The above tabulations do indicate that the greatest proportion of farm losses (approximately forty percent) were sustained by proprietors with less than $5,000 gross income, but this fact should not be construed to mean that the present farm tax rules yield substantial benefits to lower income taxpayers. In fact, the opposite is true. Consider, for example, the relative benefits of the agricultural expenditure "loan program" to the following four hypothetical taxpayers. Taxpayers A, B, C and D each sustain a $1,000 net farm loss for the taxable year.[148] As a result of nonfarm income taxpayer A is in a seventy percent marginal tax bracket, taxpayer B is in a fifty percent marginal tax bracket, and taxpayer C is in a twenty percent marginal tax bracket. Taxpayer D has only $1,000 of nonfarm income and therefore has no taxable income. The federal "interest free loan" to each taxpayer, made available through use of the special farm accounting rules and by offsetting $1,000 of nonfarm income with the farm loss, is as follows: A receives $700, B receives $500, C receives $200, and D receives no loan. Thus, as a taxpayer's marginal tax rate increases so does his potential for receiving the benefits of the agricultural tax expenditure. In short, the benefits are fewest for low income taxpayers involved in farming operations.[149]

The effects of the distribution of benefits under the farm tax laws are not completely clear.[150] It is certain, however, that taxpayers who receive the

---

[148] The loss is assumed to be attributable to the expensing of amounts normally chargeable to capital account. The example will work equally well if the assumption is that the taxpayers, as farm sole proprietors using the cash method of accounting, have no net farm loss but instead have farm deductions for the taxable year totalling $1,000, which they are entitled to take as current deductions through the special farm accounting rules. The distribution benefits from the agricultural tax expenditure will be identical to that explained in the text.

[149] This effect is completely out of line with the direct federal subsidy programs to agriculture. In the direct cash payments programs the after-tax benefits are the greatest for low income farmers. See *Tax Subsidies For Farm Operations*, *supra* note 136, at 1301.

[150] Several authors have focused upon the problem of analyzing the impact of the current tax laws on the farm economy. *See, e.g.*, *Tax Subsidies For Farm Operations*, *supra* note 136; Woods, *supra* note 142; and ERS-546, *supra* note 145.

greater benefits will have a competitive advantage in the market place. Furthermore, it is clear that Congress did not consider the possible economic effects of a $910 million subsidy to agriculture when legislating the 1976 farm tax reform provisions. The rationale for limiting the reform measures to certain corporations and farming syndicates was to eliminate the farm tax shelter while maintaining favorable tax rules for the ordinary farmer.[151] One indication is that the favorable tax rules were left intact for ordinary farmers in order to preserve a simple method of accounting for such taxpayers.[152] Not to be overlooked, though, is a statement in the House Report accompanying H. R. 10612 which indicates that Congress was aware that the liberal farm tax rules were intended to provide an incentive to some group of taxpayers.[153] Unfortunately, nowhere in the legislative materials accompanying H.R. 10612 is the group to be benefitted identified, nor the objectives and anticipated consequences of the benefits analyzed.

C. *Requiring Accrual Accounting of All Farmers*

The arguments typically presented in favor of retaining the cash method of accounting for legitimate farmers include: (1) the simplicity of the bookkeeping requirements under the cash method; (2) the practical difficulties that would be involved if inventories were required; (3) lack of managerial sophistication and accounting expertise; and (4) the tendency of the present accounting rules to mitigate the effects of uneven price changes from year-to-year.[154] The practical difficulties of inventory valuation were especially emphasized by the spokesman for the American Association of Nurserymen before the Senate Finance Committee hearings on H.R. 10612. It was urged that environmental plants grown in open fields present special problems of counting and valuation. For instance, the number of plants in a row diminish each year due to disease, insects, and other attrition factors. Additionally, variable growth rates prevent uniform valuation, and inclimate weather conditions often serve as a roadblock to taking an inventory. Finally, because the number of plants surviving from year-to-year is less than the number originally planted, it would be necessary to transfer costs from lost plants to those that survive.[155] At the time this and similar arguments were presented to the Senate Finance Committee, a 1922 determination of the Internal Revenue Service forbid farmers from inventorying growing crops "for the reason that the amount and value of such crops on hand at the beginning and end of the taxable year cannot be accurately determined."[156]

---

[151] *See* SENATE REPORT, *supra* note 83, at 58; CONFERENCE REPORT, *supra* note 76, at 416; and GENERAL EXPLANATION, *supra* note 84, at 46.

[152] *See* note 113 *supra* and accompanying text.

[153] HOUSE REPORT, *supra* note 68, at 44.

[154] These arguments may be found throughout the hearings before the Senate Finance Committee. *Finance Hearings, supra* note 74. Other arguments in favor of retaining the cash method of accounting for farmers have focused upon the economic advantages inherent in such a system.

[155] *Finance Hearings, supra* note 74, at 432-37 (statement of Robert F. Lederer). Mr. Lederer indicated that, "[d]espite constant efforts to develop a system, there is no existing standard cost accounting procedure available to nursery growers."

[156] I.T. 1368, I-1 C.B. 72 (1922).

For these reasons the accrual method of accounting was never seriously considered by Congress as a viable alternative for farm tax reform.

The 1922[157] and 1915[158] treasury decisions which lay the foundation for utilization of the cash method of accounting are of questionable relevance to the modern era of agriculture. In 1976, the Internal Revenue Service changed its position with respect to inventorying growing crops. Farmers, nursery operators, and florists who use the accrual method of accounting must, as of January 1, 1978, inventory growing crops and plants.[159] Such taxpayers must maintain adequate accounting records for the purposes of proper determination and verification of their inventories. The rationale for the change in position is that "it has been determined by the Service that growing crops, trees, and plants are capable of being inventoried."[160] It was not suggested that this capability depended upon the size or form of the farming operation. As early as 1973, one commentator pointed out that the accounting literature and availability of many different techniques indicated that the problems of inventory valuation and cost capitalization were not as difficult as portrayed by the proponents of the cash method.[161]

The notion that farmers are incapable of maintaining their books on the accrual method of accounting with full capitalization of costs, or that it would be a greater burden to farmers than to other businessmen to report their income in such a manner, does not comport with the modern status of the agricultural industry. Requiring all farmers who receive income from the production, purchase, or sale of merchandise to utilize the accrual method of accounting and capitalize their costs should be considered a viable reform alternative.[162]

V. Conclusion

The provisions of the Tax Reform Act of 1976 relating to farm taxation represent only partial reform. By selectively attacking the farm tax shelter

---

[157] *Id.*

[158] *See* note 12 *supra* and the accompanying text.

[159] Rev. Rul. 76-242, 1976-26 I.R.B. 9; amplified by Rev. Rul. 77-64, 1977-13 I.R.B. 12. Taxpayers using the crop method are excepted from the requirements of this Ruling. The inventory methods available to farmers were briefly mentioned at note 23 *supra*. These inventory techniques have been discussed elsewhere and it is beyond the scope of this Note to present a detailed account of the operation of such techniques. For a complete discussion of the inventory methods available to farmers see the authorities cited at note 23 *supra*.

[160] Rev. Rul. 76-242, 1976-26 I.R.B. 9. No other explanation was offered.

[161] 1973 *Panel Discussions*, *supra* note 12 (statement of Professor Charles Davenport). Professor Davenport also pointed out the paradox that "most farmers keep two sets of books, one for their bankers, . . . and another one for the Federal Government." The credit needs of a farmer mandate that he "be able to present all relevant data to his banker and such relevant data includes complete capitalization and the inventorying of costs."

[162] This alternative should not be rejected on the basis that harsh results would occur in the taxable year in which the new rule would become effective. It would be possible to mitigate this harshness by utilizing a ten year transition rule such as that provided for in new Code section 447(f). In this manner the adjustments required under section 481 could be spread over a ten year period or in a manner prescribed by the Commissioner through regulations. *See* the text accompanying notes 117-18 *supra*.

and large farming corporations, Congress has maintained for most farmers the tax advantages inherent in the farm accounting rules.

The new farming syndicate and "at risk" provisions removed the foundation upon which the farm tax shelter rested. No longer can tax-motivated investors make use of the liberal farm accounting rules through leveraging and prepayment of expenses. Additionally, farming syndicates must now charge certain development costs to capital account, thus losing the previously existing deferral advantage available through expensing such items.

Farming corporations with gross receipts in excess of $1 million, except for subchapter S corporations and family corporations, have been singled out as enterprises capable of utilizing the accrual method of accounting and capitalizing costs. There is no sound rationale for the discriminatory treatment of these corporate forms of doing business. As indicated in President Carter's 1978 farm tax reform proposal, family corporations, subchapter S corporations, and farming syndicates that have gross receipts in excess of $1 million should be equally capable of maintaining their books on the accrual method and therefore should be required to do so.

While President Carter's proposal would achieve further reform, it falls short of eliminating the inequitable operation of the farm tax advantages. Sole proprietors and farmers who can structure their operations to fit within one of the many exceptions to the new rules continue to take advantage of the liberal farm accounting rules after the Tax Reform Act of 1976. This advantage will amount to a $910 million tax expenditure in fiscal year 1979. The amount of benefits accruing to an individual under this tax subsidy is proportional to that individual's income bracket. Such a result is contrary to the effects of direct agricultural spending programs in which the after-tax benefits are greater at the low income levels.[163] In short, the present farm tax laws operate inequitably in favor of the wealthier farmer and in contraposition to the economic objectives of the United States Department of Agriculture.

Advancements in agricultural technology and the modernization of farms make it difficult to justify the undesirable effects of the present farm tax laws with a 1915 administrative disposition that farmers are too small and too unsophisticated to adopt the accrual method of accounting. To remove the present inequities in farm taxation and achieve genuine reform, Congress should require of all farmers full cost capitalization and accrual accounting with use of inventories.

DANIEL A. MINKLER

[163] *See generally*, *Tax Subsidies For Farm Operations*, *supra* note 136, at 1301-04.