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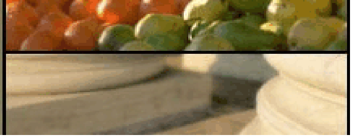

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Farming as a Tax Shelter

by

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FARMING AS A TAX SHELTER

By THOMAS B. ALLINGTON*

A tax shelter is almost any arrangement which qualifies for preferential tax treatment. Farming and ranching operations offer several opportunities for a tax sheltered investment. Most of the tax benefits of a farm investment stem from the special accounting methods which farmers are allowed to use in computing their taxable income, coupled in certain instances with favorable capital gains treatment. Generally speaking, the maximum benefits of such an investment will accrue to the individual taxpayer who has a substantial nonfarm source of income which puts him in a high tax bracket, for this is the taxpayer who will gain the most by deferring his tax liability or taking advantage of capital gains rates or tax credits to avoid some taxes altogether.

PRINCIPAL TAX BENEFITS OF FARMING

Current Deductions

General accounting principles ordinarily require deferral or capitalization of expenditures incurred in connection with products which will only produce income in later years.[1] But, in many instances farmers are allowed to accelerate the time when deductions may be taken from current income for income tax purposes. For example, Treasury Regulation 1.162-12 provides that farmers may deduct from gross income all necessary expenses incurred in raising crops or livestock, without regard to when these products might be sold. Since the cost of feed and supplies may normally be deducted in the year purchased,[2] the farmer has not only the opportunity to defer his tax liability by deducting such expenditures currently, but also the ability to determine to a certain extent the year of deduction by properly planning his purchases.[3]

In some cases farmers have the rather unique opportunity to elect between deducting or capitalizing certain expenditures that may benefit future years. The Internal Revenue Code specifically provides that expenditures by a farmer for fertilizer,[4] soil and water conservation,[5] and clearing land[6] may be deducted, with

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1. United States v. Catto, 384 U.S. 102, 109 (1966).
2. Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959); John Ernst, 32 T.C. 181 (1959).
3. Inventories do not have to be used by a cash basis farmer in computing gross income. *See* Treas. Reg. § 1.61-4(a). But a deduction may be denied where advance payments for feed and supplies are merely deposits for future purchases. Shippy v. United States, 308 F.2d 743 (8th Cir. 1962); Tim W. Lillie, 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562 (1966).
4. INT. REV. CODE of 1954, § 180.
5. INT. REV. CODE of 1954, § 175.
6. INT. REV. CODE of 1954, § 182.

certain limitations, or capitalized at the election of the taxpayer. In addition, the cost of raising livestock may be deducted if the taxpayer does not want to capitalize, even if the livestock is being raised for draft, breeding, or dairy puproses.[7]

One area where the election to deduct or capitalize can be most advantageous to the outside investor is in the development of a new farming operation. The cost of acquiring a farm must, of course, be capitalized, but ordinary and necessary expenses incurred after acquisition to bring the operation to a productive state may be deducted or capitalized at the taxpayer's option.[8] The election does not apply to expenditures which are inherently capital in nature, such as the cost of buildings or machinery.[9] But, ordinary maintenance expenses such as taxes, interest, and labor incurred during the pre-productive stage may be deducted instead of deferring them until income is realized from the operation.[10] Also included in this category are the cost of feed and other expenses of raising a breeding or dairy herd to maturity,[11] and so-called "cultural practices expenditures" for irrigation, cultivation, and spraying of orchards and other crops prior to maturity.[12]

Giving a taxpayer the option to deduct or capitalize these expenditures allows him to choose the better of two possible worlds. If he has a relatively high income from sources other than farming, he can elect to deduct the expenses in the year they are incurred, thereby deferring some of his tax liability. On the other hand, the taxpayer with a low income can capitalize development costs so that they will be available to offset income generated later during the productive stage. The Commissioner has even conceded that a farmer may elect to deduct some development expenses while capitalizing others, even within the same tax year.[13] Once an election is made for a particular year, however, it cannot be revoked.[14]

Net Operating Losses

Allowing farmers to accelerate their deductions often results in a net operating loss, especially in the early years of the investment. A loss is almost inevitable during the development stage of a livestock, timber, or orchard operation if the taxpayer elects to deduct maintenance expenses during that period. Since farming is a relatively risky business, some losses may occur during the

7. Treas. Reg. § 1.162-12. Amounts expended to purchase draft, breeding, or dairy animals are regarded as investments of capital.

8. Treas. Reg. § 1.162-12.

9. *See* INT. REV. CODE of 1954, § 263.

10. IRS PUB. NO. 225, FARMER'S TAX GUIDE 23 (1969 ed.) [hereinafter cited as FARMER'S TAX GUIDE (1969 ed.)].

11. Whitman v. United States, 248 F. Supp. 845 (W.D. La. 1965).

12. Robert L. Maple, 37 P-H Tax Ct. Mem. 1041 (1968); Estate of Richard R. Wilbur, 43 T.C. 322 (1964), *acquiesced in*, 1965-2 CUM. BULL. 7.

13. Estate of Richard R. Wilbur, 43 T.C. 322, 327 (1964).

14. *Id.* at 329-31.

productive period as well.

While investors are not prone to put their money into losing ventures, it is entirely possible that a farm investment could show a net loss for tax purposes in a particular year even though a profit can be expected from an economic standpoint. The taxpayer who has a relatively high income from another source can realize substantial tax savings by deducting these losses from his nonfarm income.[15] Tax liability is deferred and in many instances any gain on sale of the investment can qualify for capital gains treatment.

A prime example of the combined benefits of accelerated deductions and capital gains is an investment in livestock held for breeding purposes. A taxpayer in a high income tax bracket could purchase calves for a relatively small investment and elect to deduct all of the expenses of raising them to maturity. Since the operation would produce virtually no income during this period, deduction of the expenses would result in a net loss. If this loss can be deducted from other income, the taxpayer in, say, the 60% income tax bracket will save $60 in taxes for every $100 of deductible losses. Economically, the investment may actually show a profit because the appreciation in the value of the growing animals may exceed the cost of raising them. Combining this profit with the tax savings realized through deduction of the tax losses will result in an even greater total return on the investment.

Capital Gains

Often the acceleration of deductions only defers tax liability without eliminating or reducing it. But some taxes may be avoided altogether where the gain realized in later years can be taxed at lower rates. Such preferential treatment is assured if there is a long-term capital gain on disposition of the investment.[16]

When the cattle in the example above reach maturity, their basis will still be the original purchase price paid when they were calves,[17] although the value of the mature animals will normally be much greater. Assuming the cattle are held for breeding purposes for twelve months or more, any gain on disposition would qualify for long-term capital gains treatment under section 1231 (b) (3), or a maximum tax of 25%.[18] Thus, the investor in the 60% income tax bracket could potentially avoid 35% in taxes by deducting the cost of raising the livestock currently rather than capitalizing those expenditures.

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15. Farm losses and expenses are not deductible from other income if the farm is operated for recreation or pleasure and not as a trade or business for profit. Treas. Reg. §§ 1.162-12, 1.165-6(a) (3).

16. Net long-term capital gains are in effect taxed at one-half the normal rate or 25%, whichever is lower. INT. REV. CODE of 1954, §§ 1201-02.

17. INT. REV. CODE of 1954, § 1012. It is assumed that the taxpayer has not elected to inventory the livestock.

18. INT. REV. CODE of 1954, § 1201.

Similar capital gains benefits are available under section 1231 for: (1) livestock held for twelve months or more for draft, breeding, or dairy purposes;[19] (2) unharvested crops on land held for more than six months if the crops and land are sold at the same time to the same person;[20] and (3) timber for which the taxpayer elects capital gains treatment under section 631.[21] In addition to these specific categories, some farm property may fall within the general category of depreciable property used in a trade or business under section 1231(b)(1). In *McKinley Kirk*,[22] for example, the taxpayer was raising and training horses for the purpose of racing them. It was held that inferior horses culled from the herd and sold qualified as section 1231 property even though not held for draft, breeding, or dairy purposes.

Ordinary Losses

Under section 1231 the character of the gain or loss must be determined by combining all gains and losses during the year on section 1231 property. If the net result is a gain, then all gains and losses on such property are considered to be long-term capital gains and losses. But, if the netting process shows a loss, then all gains and losses are ordinary. For this reason, the investor in section 1231 property has a definite tax advantage. Even if there should be a loss on final disposition of his investment rather than the hoped-for gain, the loss will be fully deductible from ordinary income.

Section 1231 does not apply to property held primarily for sale to customers in the ordinary course of business[23] and any gain or loss on such property would be ordinary. This, too, can be helpful to the investor in livestock, orchards, or timber who may have some sales at a loss of property which does not qualify under section 1231. Even where livestock is being held for breeding or dairy purposes, the owner will typically have some animals which are held primarily for sale each year. Any loss on the sale of such animals is deductible as an ordinary loss regardless of the outcome of the section 1231 netting process.[24]

Depreciation

There is nothing particularly unique about depreciation deductions for farmers.[25] The various methods of accelerated de-

19. INT. REV. CODE of 1954, § 1231(b)(3).
20. INT. REV. CODE of 1954, § 1231(b)(4).
21. INT. REV. CODE of 1954, § 1231(b)(2). *See generally* Murray, *Current Capital Gains Problems: Timber and Cattle*, N.Y.U. 22D INST. ON FED. TAX 185, 188-91 (1964); Gibson, *Federal Income Taxation Relating to Timber*, 8 PRAC. LAW., April 1962, at 37.
22. 47 T.C. 177 (1966).
23. INT. REV. CODE of 1954, § 1231(b)(1)(B).
24. Wilson v. United States, 376 F.2d 280 (Ct. Cl. 1967).
25. *See* Treas. Reg. § 1.167(a)-6(b).

preciation[26] and the additional first-year depreciation allowance[27] are generally available as in other business ventures. However, farmers do have some special opportunities for avoiding recapture of depreciation as ordinary income when depreciable property is sold.[28]

Unlike most section 1231 property, depreciation of livestock is not subject to recapture on sale or other disposition.[29] Thus, even the farmer who capitalizes the cost of livestock can trade depreciation deductions from ordinary income for capital gains in a later year. Generally, any livestock used in a trade or business or held for the production of income may be depreciated if not included in inventory.[30] Once the animals have reached maturity, depreciation deductions may be taken to reflect the physical deterioration of the herd with age.[31] This includes livestock used in a business even though not held for breeding, dairy, or draft purposes.[32]

Certain types of depreciable real property may also escape the full effect of the recapture provisions. Depreciation on buildings and their structural components is subject to full recapture only if the property is held for a year or less before disposition.[33] After that, part of the depreciation in excess of the straight-line amount is recapturable until the property has been held for more than ten years.[34] In effect, the taxpayer can convert ordinary income into capital gains to the extent the property retains a value higher than its original basis less straight-line depreciation deductions. If the property is held longer than ten years or if it is depreciated on a straight-line basis, there is no recapture at all. Since a farming operation often involves a significant investment in depreciable real property, the urban investor may find yet another tax advantage in going into farming.

ACCOUNTING METHODS

Like most other business taxpayers, farmers have a choice of either the cash or accrual method of reporting income.[35] In some

26. *See* INT. REV. CODE of 1954, § 167(b).
27. *See* INT. REV. CODE of 1954, § 179.
28. Section 1245 provides generally that any gain on disposition of depreciable personal property must be reported as ordinary income to the extent of post-1961 depreciation deductions. Under § 1250, some of the depreciation taken on buildings or other real property not subject to § 1245 may have to be recaptured as ordinary income if the property is disposed of within ten years or depreciation has been deducted on a basis other than the straight-line method.
29. INT. REV. CODE of 1954, § 1245(a)(3).
30. Treas. Reg. § 1.167(a)-6(b).
31. *Cf.* Harry H. Kem, Jr., 51 T.C. 455 (1968).
32. *See* McKinley Kirk, 47 T.C. 177 (1966) (race horses).
33. INT. REV. CODE of 1954, § 1250(b).
34. INT. REV. CODE of 1954, § 1250(a).
35. A third method, called the crop method, may be used with the consent of the Commissioner for crops which require more than twelve months between planting and harvesting. The cost of growing the crop

operations the choice that is made will make little difference in the total amount of taxes paid. But the tax leverage available to the high income investor can vary dramatically under the various techniques for valuing inventories and determining net income. While no attempt will be made here to describe fully the details of tax accounting for farmers, a brief summary follows of those aspects which significantly affect the farm investment as a tax shelter.

Cash Method

Generally, the cash method of accounting is the most advantageous for farmers because it allows the most latitude in deferring tax liability. All expenses are deductible in the year when paid and inventories are not required to determine income.[36] Since the cost of raising crops and livestock does not have to be deferred until they are sold, the taxpayer has current deductions and postponed income.

In the case of livestock which qualifies as section 1231 property, the cash basis farmer will ordinarily obtain the maximum capital gains benefits as well. Because the cost of raising livestock may be deducted currently, the basis for such livestock is normally zero. If so, the entire net proceeds of sale will be taxed as long-term capital gains under section 1231, despite the fact that the cost of raising was previously deducted from ordinary income.

The cost of purchased livestock must be capitalized under any accounting method.[37] Section 1231 property can be depreciated, but the cost of livestock or other items purchased for resale must be offset against the proceeds in the year of sale.[38] Any gain or loss on purchased livestock is computed by deducting the unrecovered cost of the animals from the net selling price.[39] While the capital gains benefits are not as spectacular for section 1231 property which has been capitalized, there is still a considerable advantage in the fact that depreciation on livestock does not have to be recaptured as ordinary income.[40]

Accrual Method

A farmer who elects to use the accrual method of accounting must use inventories to determine his gross income.[41] While expenses of raising crops and livestock are deductible when incurred, these deductions will be partially or wholly offset by including the inventory value of products on hand at the end of the year in gross

is deferred until income is realized. Treas. Reg. § 1.162-12.
36. Treas. Reg. § 1.61-4(a).
37. Treas. Reg. § 1.162-12.
38. Treas. Reg. § 1.61-4(a).
39. *Id.*
40. INT. REV. CODE of 1954, § 1245(a)(3).
41. Treas. Reg. § 1.61-4(b).

income. Consequently, the opportunities for deferral of tax liability are greatly reduced for the accrual method farmer, and he may even experience an acceleration of tax liability in many instances.

In the case of livestock, the tax consequences may vary considerably depending on the method of valuation which is selected for inventory and whether section 1231 livestock is included. Farmers are entitled to capital gain-ordinary loss treatment for section 1231 livestock whether or not such property is included in inventory.[42] But the accrual basis taxpayer who elects to capitalize and depreciate the cost of section 1231 livestock will receive the most benefit from the capital gains provisions because gain or loss on a sale of such livestock is computed by deducting the adjusted basis of the animals from the net selling price.[43] If the livestock has been included in inventory, however, gain or loss is determined by deducting the last inventory value of the animals from the net selling price.[44] Since inventory livestock is not depreciable,[45] there is no opportunity for converting ordinary income into capital gains except to the extent the cost of raising the livestock may exceed the inventory value.

Farm inventories in general may be valued by using either a cost method[46] or the farm-price method.[47] Under the farm-price method, inventories are valued at market price less the direct cost of disposition. Section 1231 livestock, whether raised or purchased, may be either included in inventory or capitalized and depreciated, at the election of the taxpayer.[48] Since depreciation of livestock will produce current deductions from ordinary income and result in more capital gains benefits on final disposition, the farm investor will usually find it advantageous to exclude section 1231 livestock from inventory.

Livestock raisers may also select the unit-livestock-price method of valuing inventories.[49] Under this method the taxpayer groups his livestock according to kind and age, and assigns a standard unit price based on production costs to all animals within each class. The unit prices and classifications initially selected by the taxpayer are subject to the approval of the District Director, but once established no changes can be made without the consent of the Commissioner. Purchased livestock is included in inventory at actual cost plus the cost, if any, of raising the animals to maturity. Because inventory is being valued roughly at cost, the unit-livestock-price method generally cancels out any benefit from

42. Treas. Reg. § 1.1231-2.
43. FARMER'S TAX GUIDE 31 (1969 ed.).
44. Treas. Reg. § 1.61-4(b).
45. Treas. Reg. § 1.167(a)-6.
46. Treas. Reg. § 1.471-2 (including cost or market, whichever is lower).
47. Treas. Reg. § 1.471-6.
48. FARMER'S TAX GUIDE 24 (1969 ed.).
49. Treas. Reg. § 1.471-6.

accelerated deductions such as might be available to a cash basis farmer. On the other hand, income usually will not be accelerated either as it may be under the farm-price method where unrealized profits are reflected in the inventory value.

Despite the more lenient results of the unit-livestock-price method in terms of acceleration of income, this method of valuation has certain disadvantages where section 1231 livestock is involved. Unlike other inventory methods, the unit-livestock-price method requires that all livestock *raised* by the taxpayer, whether for sale or breeding purposes, must be included in inventory.[50] The taxpayer has no opportunity, therefore, to take depreciation deductions from ordinary income in exchange for capital gains later on. Only animals which are *purchased* for draft, breeding, or dairy purposes may, at the option of the taxpayer, be treated as capital assets subject to depreciation.[51] Despite the discrimination in favor of taxpayers who have not elected the unit-livestock-price method, the Supreme Court upheld this regulation in *United States v. Catto*,[52] where taxpayers using the unit-livestock-price method attempted to drop breeding livestock from inventory and account for them on a cash basis. The Court characterized this as a hybrid accounting method which the Commissioner had the discretion to reject.[53]

Because election of an accrual method of farm accounting is binding for subsequent years unless a change is authorized by the Commissioner,[54] most farm investors will probably want to avoid such an election altogether. This can be accomplished by simply accounting for receipts and expenditures on a cash basis and not using inventories to compute gross income. If an accrual method is selected for some reason, acceleration of income can be avoided by valuing inventories on the basis of cost or the lower of cost or market. Although the unit-livestock-price method is based on approximate costs, livestock raisers will usually want to select some other method of valuing inventory so that section 1231 livestock can be treated as a capital asset subject to depreciation. Unfortunately, farmers who value their inventories at cost may find that they have inadvertently elected the unit-livestock-price method. The regulations provide that use of a constant unit-price method of valuing inventories is in effect an election of the unit-livestock-price method.[55] In *Adolf J. Urbanovsky*,[56] the taxpayer contended that he had valued his inventory at market prices as required under the farm-price method. But since his records showed that he had used various unit values, unchanged from year

50. Treas. Reg. § 1.471-6(f).
51. Treas. Reg. § 1.471-6(g).
52. 384 U.S. 102 (1966).
53. *Id.* at 117.
54. Treas. Reg. § 1.471-6(a).
55. Treas. Reg. § 1.471-6(h).
56. 34 P-H Tax Ct. Mem. 1665 (1965).

to year, and classifications similar to those commonly used under the unit-livestock-price method, the Tax Court held that he could be considered as having adopted the latter method. As a result, livestock raised for breeding purposes had to be included in inventory.

An inadvertent election of the unit-livestock-price method can probably be avoided by keeping detailed records showing the determination of market price or cost for individual items in inventory. In the case of cost valuation, this may require rather sophisticated methods for allocating costs to specific items in inventory since merely estimating values for groups of similar items may constitute an election. But this may be a small price to pay for the additional tax benefits available for section 1231 livestock which does not have to be included in inventory.

SOME LIMITATIONS

Since farming may often result in a net loss in some years, either because deductions are accelerated for income tax purposes or because the operation is simply a losing venture economically, it is important to determine whether such losses are deductible from nonfarm income. Significant tax savings will accrue to high bracket taxpayers if other income may be reduced by the amount of the loss. Assuming the loss results from expenditures which do not have to be capitalized, the individual taxpayer may obtain a deduction if the loss is incurred in a trade or business or in a transaction entered into for profit.[57] This raises the general problem of determining whether the taxpayer had a business or profit-seeking motive.

Hobby Farms

The regulations provide that farm expenses and losses are not deductible from other income if the farm is operated for recreation or pleasure and not as a trade or business for profit.[58] This requirement has been the subject of a rather large number of cases over the years where the crucial factor was whether a farm was being operated with an expectation of profit.[59] While the courts

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57. INT. REV. CODE of 1954, § 165(c). Deduction of farm expenses themselves can also be asserted under § 162(a) (trade or business expenses) or § 212 (expenses paid for the production of income or the maintenance of income producing property). However, it might be argued that the advantageous accounting methods are only available to farmers under § 162. *See* Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAW. 275, 297 (1969).

58. Treas. Reg. §§ 1.162-12, 1.165-6(a)(3).

59. A farm loss deduction was denied in the following cases: Bessenyey v. Commissioner, 379 F.2d 252 (2d Cir.), *cert. denied*, 389 U.S. 931 (1967); Schley v. Commissioner, 375 F.2d 747 (2d Cir. 1967); Teitelbaum v. Commissioner, 346 F.2d 266 (7th Cir. 1965); Godfrey v. Commissioner, 335 F.2d 82 (6th Cir. 1964), *cert. denied*, 379 U.S. 966 (1966); Teitelbaum v. Commissioner, 294 F.2d 541 (7th Cir. 1961), *cert. denied*, 368 U.S. 987 (1962); Coffey v. Commissioner, 141 F.2d 204 (5th Cir. 1944); Union Trust

have generally agreed that an intent to make a profit is an essential

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Co. v. Commissioner, 54 F.2d 199 (6th Cir. 1931); Deering v. Blair, 23 F.2d 975 (D.C. Cir. 1928); Proebstle v. United States, 16 Am. Fed. Tax R.2d 5100 (S.D. Tex. 1965) (jury verdict); Thacher v. Lowe, 288 F. 994 (S.D.N.Y. 1922); Frank M. Austin, 38 P-H Tax Ct. Mem. 29 (1969); Robert E. Currie, 38 P-H Tax Ct. Mem. 13 (1969) (dogs and ponies); Billy V. Wann, 37 P-H Tax Ct. Mem. 1425 (1968); Curtis C. Smith, 36 P-H Tax Ct. Mem. 1339 (1967); Harold I. Snyder, 35 P-H Tax Ct. Mem. 1485 (1966); V.H. Monette & Co., 45 T.C. 15 (1965), *aff'd per curiam,* 374 F.2d 116 (4th Cir. 1967); Alfred M. Cox, 34 P-H Tax Ct. Mem. 25 (1965), *aff'd per curiam,* 354 F.2d 659 (3d Cir. 1966); Anthony Imbesi, 33 P-H Tax Ct. Mem. 1841 (1964), *vacated,* 361 F.2d 640 (3d Cir. 1966); Bertha R. Conyngham, 33 P-H Tax Ct. Mem. 1293 (1964); Riss & Co., 33 P-H Tax Ct. Mem. 1223 (1964); Edward T. Dicker, 32 P-H Tax Ct. Mem. 388 (1963); Edwin H. Miner, 31 P-H Tax Ct. Mem. 1293 (1962); Robert Y.H. Thomas, 31 P-H Tax Ct. Mem. 430 (1962), *vacated on other grounds,* 324 F.2d 798 (5th Cir. 1963); Ralph H. Pino, 31 P-H Tax Ct. Mem. 315 (1962); Hilton V. Carter, Sr., 29 P-H Tax Ct. Mem. 1213 (1960); George T. McLean, 29 P-H Tax Ct. Mem. 749 (1960), *aff'd per curiam,* 285 F.2d 756 (4th Cir. 1961); D.H. McGhee, 26 P-H Tax Ct. Mem. 971 (1957), *aff'd,* 264 F.2d 232 (6th Cir. 1959); R.E.L. Finley, 26 P-H Tax Ct. Mem. 67 (1957), *aff'd on other issues,* 265 F.2d 885 (10th Cir.), *cert. denied,* 361 U.S. 834 (1959); Jacqueline Finley O'Shea, 26 P-H Tax Ct. Mem. 64 (1957), *aff'd on other issues,* 265 F.2d 885 (10th Cir.), *cert. denied,* 361 U.S. 834 (1959); R.E.L. Finley, 27 T.C. 413 (1956), *aff'd on other issues,* 255 F.2d 128 (10th Cir. 1958); Jack R. Mavis, 24 P-H Tax Ct. Mem. 277 (1955); Frederick Baker, 23 P-H Tax Ct. Mem. 58 (1954); Edward M. Stout, 22 P-H Tax Ct. Mem. 83 (1953), *aff'd per curiam,* 210 F.2d 607 (6th Cir. 1954); John D. Scott, 21 P-H Tax Ct. Mem. 613 (1952); Adley W. Hemphill, 20 P-H Tax Ct. Mem. 996 (1951); C.C. Cooke, 20 P-H Tax Ct. Mem. 819 (1951), *modified on other issues,* 203 F.2d 258 (10th Cir.), *cert. denied,* 346 U.S. 815 (1953); John Randolph Hopkins, 15 T.C. 160 (1950); R.G. Bock, 19 P-H Tax Ct. Mem. 646 (1950); Jane Brady Moseley, 18 P-H Tax Ct. Mem. 143 (1949); Margaret Batts Tobin, 11 T.C. 928 (1948), *rev'd on other grounds,* 183 F.2d 919 (5th Cir.), *cert. denied,* 340 U.S. 904 (1950); W. Brown Morton, 17 P-H Tax Ct. Mem. 263 (1948), *aff'd,* 174 F.2d 302 (2d Cir.), *cert. denied,* 338 U.S. 828 (1949); Ezra Winter, 11 P-H Tax Ct. Mem. 1726 (1942); Harry C. Fisher, 29 B.T.A. 1041 (1934), *aff'd per curiam,* 74 F.2d 1014 (2d Cir. 1935); Louise Cheney, 22 B.T.A. 672 (1931); Union Trust Co., 1 P-H Tax Ct. Mem. 6 (1930); Frank C. Munson, 2 B.T.A. 174 (1925).

The following cases allowed farm losses to be deducted: Mercer v. Commissioner, 376 F.2d 708 (9th Cir. 1967); Tatt v. Commissioner, 166 F.2d 697 (5th Cir. 1948); Farish v. Commissioner, 103 F.2d 63 (5th Cir. 1939); Smith v. Commissioner, 78 F.2d 408 (3d Cir. 1935); Whitney v. Commissioner, 73 F.2d 589 (3d Cir. 1934); Commissioner v. Field, 67 F.2d 876 (2d Cir. 1933); Commissioner v. Widener, 33 F.2d 833 (3d Cir. 1929); Wilson v. Eisner, 282 F. 38 (2d Cir. 1922); Blackmon v. United States, 22 Am. Fed. Tax R.2d 5860 (N.D. Tex. 1968) (jury verdict); Lazonby v. Tomlinson, 272 F. Supp. 558 (N.D. Fla. 1967); Cenac v. United States, 20 Am. Fed. Tax R.2d 5228 (E.D. La. 1967) (jury verdict); Woodard v. United States, 19 Am. Fed. Tax R.2d 1657 (D.N.M. 1967); Worrell v. United States, 254 F. Supp. 992 (S.D. Tex. 1966); Graves v. United States, 19 Am. Fed. Tax R.2d 644 (D. Colo. 1966) (jury verdict); DuBose v. Ross, 18 Am. Fed. Tax R.2d 5708 (N.D. Ga. 1966) (jury verdict); Seven Sixty Ranch Co. v. Kennedy, 17 Am. Fed. Tax R.2d 587 (D. Wyo. 1966); Wright v. United States, 249 F. Supp. 508 (D. Nev. 1965); Whitman v. United States, 248 F. Supp. 845 (W.D. La. 1965); Clark v. United States, 17 Am. Fed. Tax R.2d 459 (D. Mass. 1965) (jury verdict), *vacated on other grounds,* 358 F.2d 892 (1st Cir.), *cert. denied,* 385 U.S. 817 (1966); Fabacher v. United States, 17 Am. Fed. Tax R.2d 401 (S.D. Miss. 1965); DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964); O'Neill v. Patterson, 15 Am. Fed. Tax R.2d 332 (N.D. Ala. 1964) (jury verdict); Thomas v. United States, 9 Am. Fed. Tax R.2d 866 (S.D. Fla. 1962) (jury verdict): Dickerson v. United States, 7 Am. Fed. Tax R.2d 698 (N.D. Tex. 1961); Bevelhymer v. United States, 14 Am. Fed. Tax R.2d 5167 (D. Kan. 1960) (jury verdict); *In re* Ward, 131 F. Supp. 387 (D. Colo. 1955); Elsas v. Edwards, 48 Am. Fed. Tax R. 1927 (M.D. Ga. 1955); Warr v. United States, 48 Am. Fed. Tax R. 1371 (W.D. Okla. 1953); Cooke v. Glenn, 78 F. Supp. 519 (W.D. Ky. 1948), *aff'd per curiam,* 177 F.2d 201 (6th Cir. 1949); DuPont v. United States, 28 F. Supp. 122 (D. Del. 1939); Plant v. Walsh, 280 F. 722 (D. Conn. 1922); Alden B. Starr, 38 P-H Tax Ct. Mem. 176 (1969); Robert E. Currie, 38 P-H Tax Ct.

element of a trade or business, there has been some disagreement over the nature of the expectation that is required.

The Profit Motive

One question that has arisen is whether the expectation of profit must be based on an objective standard of reasonableness or whether it is sufficient if the taxpayer merely has a subjective intent to make a profit. Most of the cases have proceeded on the basis that the expectation of profit need not be reasonable so long

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Mem. 13 (1969) (apple orchard); Everell E. Fisher, 37 P-H Tax Ct. Mem. 1154 (1968); Jean A. Lowenthal, 37 P-H Tax Ct. Mem. 433 (1968); Beverly J. Hill, 36 P-H Tax Ct. Mem. 1413 (1967); Estate of Lillian Solomon, 36 P-H Tax Ct. Mem. 1004 (1967); Charles B. Pennington, 36 P-H Tax Ct. Mem. 564 (1967); Ralph S. Prickett, 36 P-H Tax Ct. Mem. 5 (1967); Ralph A. Mauller, 35 P-H Tax Ct. Mem. 881 (1966); Eugene J. Davis, 35 P-H Tax Ct. Mem. 699 (1966); Herbert C. Sanderson, 33 P-H Tax Ct. Mem. 1894 (1964); William L. Brueck, Sr., 33 P-H Tax Ct. Mem. 1345 (1964); Rowe B. Metcalf, 32 P-H Tax Ct. Mem. 1587 (1963); Theodore Sabelis, 37 T.C. 1058 (1962), *acquiesced in*, 1962-2 Cum. Bull. 5; Alice D. Worcester, 31 P-H Tax Ct. Mem. 1253 (1962); John S. Ellsworth, 31 P-H Tax Ct. Mem. 170 (1962); Leonard P. Sasso, 30 P-H Tax Ct. Mem. 1169 (1961); Norma Mathews Lauer, 30 P-H Tax Ct. Mem. 1134 (1961); Robert Verta, 28 P-H Tax Ct. Mem. 551 (1959); D. Joseph St. Germain, 28 P-H Tax Ct. Mem. 309 (1959); Theron D. Stay, 27 P-H Tax Ct. Mem. 741 (1958); George M. Zeagler, 27 P-H Tax Ct. Mem. 391 (1958); Harvey S. Farrow, 26 P-H Tax Ct. Mem. 710 (1957); W. Brown Morton, 26 P-H Tax Ct. Mem. 356 (1957); W. Clark Wise, 26 P-H Tax Ct. Mem. 306 (1957), *aff'd per curiam*, 260 F.2d 354 (6th Cir. 1958); Bruce Sloan, 25 P-H Tax Ct. Mem. 142 (1956); Dean Babbitt, 23 T.C. 850 (1955), *acquiesced in*, 1955-2 Cum. Bull. 3; Murray W. Harmon, 24 P-H Tax Ct. Mem. 682 (1955); C.J. Anderson, 24 P-H Tax Ct. Mem. 123 (1955); Louis J. Best, 23 P-H Tax Ct. Mem. 883 (1954); Hedi Katz, 23 P-H Tax Ct. Mem. 232 (1954); Amos S. Bumgardner, 23 P-H Tax Ct. Mem. 184 (1954); Otis Beall Kent, 23 P-H Tax Ct. Mem. 39 (1954); Iri R. Cope, 22 P-H Tax Ct. Mem. 1117 (1953); Anne Klein Ansley, 22 P-H Tax Ct. Mem. 1008 (1953), *rev'd on other grounds*, 217 F.2d 252 (3d Cir. 1954); J.G. Stoller, 22 P-H Tax Ct. Mem. 959 (1953); Leland E. Rosemond, 20 P-H Tax Ct. Mem. 590 (1951); Dan R. Hanna, Jr., 20 P-H Tax Ct. Mem. 520 (1951); Frank R. Fageol, 20 P-H Tax Ct. Mem. 341 (1951); Vincent Treanor, 20 P-H Tax Ct. Mem. 303 (1951); Norton L. Smith, 9 T.C. 1150 (1947), *acquiesced in*, 1948-1 Cum. Bull. 3; George W. Cutting, 16 P-H Tax Ct. Mem. 1109 (1947); W.H. Osmundson, 15 P-H Tax Ct. Mem. 22 (1946); James L. Bryne, 14 P-H Tax Ct. Mem. 1222 (1945); Thomas Watson, 12 P-H Tax Ct. Mem. 1411 (1943); Barbara S. Kirkland, 11 P-H Tax Ct. Mem. 1566 (1942); Paul Butler, 11 P-H Tax Ct. Mem. 925 (1942); P.L. Reed, 11 P-H Tax Ct. Mem. 287 (1942); Shadybrook Farm, Inc., 11 P-H Tax Ct. Mem. 282 (1942); Lillie S. Wegeforth, 42 B.T.A. 633 (1940), *acquiesced in*, 1940-2 Cum. Bull. 8; Israel O. Blake, 38 B.T.A. 1457 (1938), *acquiesced in*, 1939-1 Cum. Bull. 4; Lucien H. Tyng, 36 B.T.A. 21 (1937); Laura M. Curtis, 28 B.T.A. 631 (1933), *acquiesced in*, XII-2 Cum. Bull. 4 (1933); Security First Nat'l Bank, 28 B.T.A. 289 (1933); James Clark, 24 B.T.A. 1235 (1931), *acquiesced in*, XI-1 Cum. Bull. 2 (1932); Irving C. Ackerman, 24 B.T.A. 512 (1931), *aff'd*, 71 F.2d 586 (9th Cir. 1934); Margaret E. Amory, 22 B.T.A. 1398 (1931), *acquiesced in*, X-2 Cum. Bull. 3 (1931); Edwin S. George, 22 B.T.A. 189 (1931), *acquiesced in*, X-2 Cum. Bull. 26 (1931); George B. Lester, 19 B.T.A. 549 (1930), *acquiesced in*, IX-2 Cum. Bull. 35 (1930); E.S. Hass, 13 B.T.A. 1352 (1928); Walter P. Temple, 10 B.T.A. 1238 (1928), *acquiesced in*, VII-2 Cum. Bull. 39 (1928); Hamilton F. Kean, 10 B.T.A. 97 (1928), *acquiesced in*, VII-1 Cum. Bull. 17 (1928); Rose P. Crane, 9 B.T.A. 437 (1927), *acquiesced in*, VII-1 Cum. Bull. 8 (1928); Moses Taylor, 7 B.T.A. 59 (1927), *acquiesced in*, VII-1 Cum. Bull. 31 (1928); August Merckens, 7 B.T.A. 32 (1927), *acquiesced in*, VI-2 Cum. Bull. 5 (1927); Samuel Riker, Jr., 6 B.T.A. 890 (1927), *acquiesced in*, VI-2 Cum. Bull. 3 (1927); Thomas F. Sheridan, 4 B.T.A. 1299 (1926), *acquiesced in*, VI-1 Cum Bull. 5 (1927); H.T. Cochran, 3 B.T.A. 215 (1925), *acquiesced in*, V-1 Cum. Bull. 2 (1926); Kansas Sav. & Trust Co., 2 B.T.A. 1253 (1925), *acquiesced in*, V-1 Cum. Bull. 3 (1926).

as the taxpayer has a genuine intent to make a profit.[60] However, both the Sixth Circuit[61] and two recent memorandum decisions of the Tax Court[62] have stated that the operation of a farm must be such that the taxpayer can reasonably expect to make a profit.[63]

Requiring a reasonable expectation of profit presumably means that deduction of losses will be disallowed as a matter of law if certain objective criteria are not met. Besides the problem of determining what these criteria are, there is the question of how such a standard would be applied to certain farming operations which are somewhat speculative in nature. Breeding a special strain of livestock or developing a stable of race horses can be extremely risky ventures, and while it may be possible to expect a profit, it might be considerably more difficult to establish that it is reasonable to expect one. Since all business ventures involve some degree of risk that a loss will occur, it would seem that a deduction should be allowed where the taxpayer has a genuine intent to make a profit without considering the probabilities of such a profit.

Of course, the fact that a profit is improbable may indicate that the taxpayer actually has other motives for farming. Several cases which have held that the subjective intent of the taxpayer is controlling have nevertheless allowed the reasonableness of the profit expectation to be considered in determining whether profit is the true motive for the operation.[64] Such an approach does introduce an element of objectivity into the determination of the taxpayer's intent without necessarily precluding him from undertaking speculative ventures or being just plain more optimistic than the average investor. The likelihood of a profit is then just one more item to consider along with other relevant factors in determining whether the taxpayer in good faith expects to make a profit.

As a practical matter, if it is found that a taxpayer could not reasonably expect to make a profit, the operation is likely to be characterized as a hobby rather than a business, especially if it appears that the taxpayer has been getting some personal satis-

60. *E.g.*, Worrell v. United States, 254 F. Supp. 992 (S.D. Tex. 1966); Wright v. United States, 249 F. Supp. 508 (D. Nev. 1965); Alden B. Starr, 38 P-H Tax Ct. Mem. 176 (1969); Robert E. Currie, 38 P-H Tax Ct. Mem. 13 (1969); Curtis C. Smith, 36 P-H Tax Ct. Mem. 1339 (1967); Charles B. Pennington, 36 P-H Tax Ct. Mem. 564 (1967); Margit Sigray Bessenyey, 45 T.C. 261 (1965), *aff'd*, 379 F.2d 252 (2d Cir.), *cert. denied*, 389 U.S. 931 (1967); Otis Beall Kent, 23 P-H Tax Ct. Mem. 39 (1954).

61. Godfrey v. Commissioner, 335 F.2d 82 (6th Cir. 1964).

62. Ellen R. Schley, 34 P-H Tax Ct. Mem. 646 (1965), *aff'd*, 375 F.2d 747 (2d Cir. 1967); Alfred M. Cox, 34 P-H Tax Ct. Mem. 25 (1965). *See also* Proebstle v. United States, 16 Am. Fed. Tax R.2d 5100 (S.D. Tex. 1965); Robert Y.H. Thomas, 31 P-H Tax Ct. Mem. 430 (1962); George T. McLean, 29 P-H Tax Ct. Mem. 749 (1960).

63. *See generally* Sharpe, *Has There Been a Swing to Stricter Tests for Farm Loss Deductions?*, 27 J. TAXATION 348 (1967).

64. *E.g.*, Cenac v. United States, 20 Am. Fed. Tax R.2d 5228 (E.D. La. 1967); Margit Sigray Bessenyey, 45 T.C. 261 (1965); V.H. Monette & Co., 45 T.C. 15 (1965); *cf.* Robert E. Currie, 38 P-H Tax Ct. Mem. 13 (1969).

faction from his farming activities. Most of the cases which have dealt with the problem of the taxpayer who may be farming for both fun and profit have declared that the intent to make a profit must be the dominant or primary purpose if a trade or business is to be found.[65] Assuming the subjective intent of the taxpayer is controlling, the danger exists that the reasonableness of the profit expectation will be given too much weight in determining the taxpayer's motive. Perhaps for this reason, the Ninth Circuit held in *Mercer v. Commissioner*[66] that the reasonableness of the taxpayer's expectation of profit was irrelevant if it otherwise appeared that he had a good faith intent to make a profit. It might be noted, however, that this case involved little possibility of other, personal motives since the taxpayer had purchased cattle, put them on his brother's ranch in Alaska, and devoted little of his own time to taking care of them.

While there is general agreement that an intent to make a profit is necessary to a trade or business, little is said in the regulations and cases about how this profit should be computed. Profits could be estimated by using one of the accounting methods available to farmers for tax purposes. This would mean that many deductions would be accelerated, especially under the cash method, and there would inevitably be a loss during the development stage of the operation. Under this method, the taxpayer would seldom be able to establish that he expected to make a profit if a tax loss actually occurs. The mere fact that the taxpayer seeks to deduct a loss would mean that his operation was not profitable from a tax accounting standpoint, and unless there is some other explanation as to why expected profits did not materialize, the taxpayer would not be able to show an intent to make a profit. Testing the profitability of a farming operation in this fashion would hardly be appropriate where the real issue is whether the taxpayer is engaged in a trade or business. The taxpayer who is attempting to establish that he is engaged in business for profit should not be required to use tax accounting methods which differ from generally accepted business practices in estimating profits and losses.

A better method of determining expected profits would be to simply use ordinary general accounting principles to estimate revenues and expenses. Preparatory and development expenditures would be capitalized or deferred in most cases, and there would generally be a better matching of income and deductions. If a profit could be expected on this basis, the taxpayer would be able

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65. *E.g.*, Godfrey v. Commissioner, 335 F.2d 82 (6th Cir. 1964); Blackmon v. United States, 22 Am. Fed. Tax R.2d 5860 (N.D. Tex. 1968); Cenac v. United States, 20 Am. Fed. Tax R.2d 5228 (E.D. La. 1967); Wright v. United States, 249 F. Supp. 508 (D. Nev. 1965); Frank M. Austin, 38 P-H Tax Ct. Mem. 29 (1969); Harold I. Snyder, 35 P-H Tax Ct. Mem. 1485 (1966); Alice D. Worcester, 31 P-H Tax Ct. Mem. 1253 (1962). *Contra*, DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964).

66. 376 F.2d 708 (9th Cir. 1967).

to deduct his tax losses whether they resulted from acceleration of deductions under a tax accounting method or for other reasons. The requisite intent to make a profit based on general accounting principles could exist even though a loss is sure to result from a tax accounting standpoint. This approach is better suited to determining the business nature of the taxpayer's operation because it is based on calculations ordinarily used by businessmen to determine their profits or losses.

Although the particular method used to estimate profits may not make much difference in many instances, some cases have apparently considered tax accounting losses in determining whether a profit motive exists.[67] It is often said that a series of past losses do not preclude the existence of a profit motive, but these may be considered as additional evidence bearing on the question of the taxpayer's intent.[68] Tax losses have sometimes been considered in this regard without inquiring into whether a loss would also exist if general accounting principles were used.[69] However, some cases have decided that a sufficient explanation for past tax losses exists so as to neutralize their impact as evidence of the taxpayer's motive if it appears that the losses are peculiar to the tax accounting method used.[70] Thus, during the formative years of a livestock, timber, or orchard operation tax losses may be a certainty although a profit may be expected eventually from the operation.

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67. *E.g.*, Bessenyey v. Commissioner, 379 F.2d 252 (2d Cir. 1967); Curtis C. Smith, 36 P-H Tax Ct. Mem. 1339 (1967); V.H. Monette & Co., 45 T.C. 15 (1965); Thacher v. Lowe, 288 F. 994 (S.D.N.Y. 1922).

68. Morton v. Commissioner, 174 F.2d 302 (2d Cir. 1949); Cenac v. United States, 20 Am. Fed. Tax R.2d 5228 (E.D. La. 1967); Graves v. United States, 19 Am. Fed. Tax R.2d 644 (D. Colo. 1966); Whitman v. United States, 248 F. Supp. 845 (W.D. La. 1965); DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964); O'Neill v. Patterson, 15 Am. Fed. Tax R.2d 332 (N.D. Ala. 1964); Thomas v. United States, 9 Am. Fed. Tax R.2d 866 (S.D. Fla. 1962); *In re* Ward, 131 F. Supp. 387 (D. Colo. 1955); Jean A. Lowenthal, 37 P-H Tax Ct. Mem. 433 (1968); Ralph A. Mauller, 35 P-H Tax Ct. Mem. 881 (1966); Herbert C. Sanderson, 33 P-H Tax Ct. Mem. 1894 (1964); Bertha R. Conyngham, 33 P-H Tax Ct. Mem. 1293 (1964); Rowe B. Metcalf, 32 P-H Tax Ct. Mem. 1587 (1963); John S. Ellsworth, 31 P-H Tax Ct. Mem. 170 (1962); Theron D. Stay, 27 P-H Tax Ct. Mem. 741 (1958); J.G. Stoller, 22 P-H Tax Ct. Mem. 959 (1953); Leland E. Rosemond, 20 P-H Tax Ct. Mem. 590 (1951); Lucien H. Tyng, 36 B.T.A. 21 (1937); Samuel Riker, Jr., 6 B.T.A. 890 (1927).

69. *See* Bessenyey v. Commissioner, 379 F.2d 252 (2d Cir. 1967); Coffey v. Commissioner, 141 F.2d 204 (5th Cir. 1944); Curtis C. Smith, 36 P-H Tax Ct. Mem. 1339 (1967); V.H. Monette & Co., 45 T.C. 15 (1965); Edward T. Dicker, 32 P-H Tax Ct. Mem. 388 (1963).

70. *See* Farish v. Commissioner, 103 F.2d 63 (5th Cir. 1939); Commissioner v. Field, 67 F.2d 876 (2d Cir. 1933); Cenac v. United States, 20 Am. Fed. Tax R.2d 5228 (E.D. La. 1967); Worrell v. United States, 254 F. Supp. 992 (S.D. Tex. 1966); Thomas v. United States, 9 Am. Fed. Tax R.2d 866 (S.D. Fla. 1962); Dickerson v. United States, 7 Am. Fed. Tax R.2d 698 (N.D. Tex. 1961); Plant v. Walsh, 280 F. 722 (D. Conn. 1922); Alden B. Starr, 38 P-H Tax Ct. Mem. 176 (1969); Everell E. Fisher, 37 P-H Tax Ct. Mem. 1154 (1968); Estate of Lillian Solomon, 36 P-H Tax Ct. Mem. 1004 (1967); Theodore Sabelis, 37 T.C. 1058 (1962); George M. Zeagler, 27 P-H Tax Ct. Mem. 391 (1958); Barbara S. Kirkland, 11 P-H Tax Ct. Mem. 1566 (1942); Lucien H. Tyng, 36 B.T.A. 21 (1937); *cf.* Mercer v. Commissioner, 376 F.2d 708 (9th Cir. 1967); Whitman v. United States, 248 F. Supp. 845 (W.D. La. 1965).

Even the prospect of a loss under general accounting principles should not necessarily be equated with lack of a profit motive because unrealized appreciation in the value of property may indicate that a net gain can be expected in the future. Since the basic issue is whether a trade or business exists, the prospect of an economic profit should be considered even though the realization concept may prevent that profit from being recognized under either general or tax accounting procedures. A few cases have apparently recognized this by taking into account unrealized appreciation of such things as land and livestock.[71]

Tax Avoidance

A more difficult problem may arise where outside investors stand to gain significant tax savings by deducting farm losses from other income. The quesion arises whether these tax benefits may be considered in determining the profitability of the farm, assuming that a profit could not otherwise be expected. For example, suppose a taxpayer in the 60% income tax bracket buys livestock to hold for breeding purposes. The cost of maintaining the herd and raising the offspring may be deducted currently, and this, combined with depreciation deductions, may give rise to tax losses in the first few years of the operation. If the taxpayer is able to deduct losses of, say, $20,000, he could save $12,000 in taxes on his other income. Assume the herd is then sold for a $16,000 capital gain, which is taxed at 25%, or $4,000. This leaves the taxpayer with an overall net loss, ignoring taxes, of $4,000. However, the net tax savings would be $8,000. Economically, the investment was a losing venture, but because of the tax savings the taxpayer is actually $4,000 better off than if he had not made the investment.

The question of tax savings as a motive has arisen in other areas of the income tax and the law is somewhat confusing on this point.[72] The statement has often been made that a taxpayer has the right to decrease his taxes or avoid them altogether,[73] but this does not help solve the problem of whether he is engaged in a trade or business. At least one recent case dealing with the interest deduction has denied a deduction where it appeared that interest was being paid on indebtedness for the sole purpose of saving taxes. In *Goldstein v. Commissioner*[74] it was held that no interest deduction should be allowed on indebtedness incurred in a trans-

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71. Worrell v. United States, 254 F. Supp. 992 (S.D. Tex. 1966); DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964); Estate of Lillian Solomon, 36 P-H Tax Ct. Mem. 1004 (1967); Herbert C. Sanderson, 33 P-H Tax Ct. Mem. 1894 (1964); Israel O. Blake, 38 B.T.A. 1457 (1938).

72. *See generally* Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAW. 275 (1969).

73. *E.g.*, Gregory v. Helvering, 293 U.S. 465, 469 (1935).

74. 364 F.2d 734 (2d Cir. 1966); *cf.* Amor F. Pierce, 38 P-H Tax Ct. Mem. 1 (1969).

action where the taxpayer could not objectively expect an economic profit aside from the tax benefits of the interest deduction. The court reasoned that to allow the deduction would only encourage transactions that have no economic utility and that would not even be undertaken except for the income tax advantages. It was felt that this would frustrate the purpose of Congress in allowing an interest deduction in the first place.

If this line of reasoning is applied to farm losses, no deduction would be allowed there either. Although the issue in this case is whether a business purpose exists, a desire for tax savings hardly establishes that purpose. Consequently, arrangements for investing in farming or ranching operations which are of no economic substance other than as a vehicle for tax avoidance should not give rise to deductions from nonfarm income. The recent decision of the Tax Court in *Billy V. Wann*[75] illustrates this point. There, taxpayers with gross income from other sources of only about $13,000 per year rented a twenty-five acre farm and moved there to live. They claimed annual losses ranging up to approximately $6,500 for a cattle operation on the farm. Since the cattle operation was terminated when the Internal Revenue Service questioned these deductions, the court concluded that the motive for the operation was anticipated tax savings and benefits rather than expected profits, and no deduction was allowed.

The effect of tax avoidance as a motive becomes more complex if it is assumed that the operation would be, strictly speaking, economically profitable, but not reasonably so without adding on the tax benefits. Suppose the taxpayer could expect to make a small economic profit on his total investment, but not as much as he could make by investing his money elsewhere. Assume that this expected profit represents only a two or three percent return on his investment while a higher rate of return would be more reasonable when viewed strictly from an investment standpoint. The two or three percent return would be unacceptable, but the total return on the investment might approach a more reasonable level if tax savings resulting from the deduction of tax losses from other income are included in the calculation. Although allowing deduction of the tax losses in this situation will also encourage transactions which might not take place if the tax savings were not available, the reasoning of *Goldstein* would not prevent the deduction. The most that can be said is that the taxpayer has mixed motives for the investment, one of which is saving some taxes. But the tax avoidance motive cannot, by itself, preclude a finding that a business purpose exists so long as some economic profit, however small, can be expected. A fortiori, the taxpayer who can expect to realize a reasonable return on his investment without tax savings could be engaged in a trade or business even

75. 37 P-H Tax Ct. Mem. 1425 (1968).

though the tax benefits gained by deducting farm losses will give him an even greater total return.

Although an intent to avoid taxes does not automatically preclude a profit motive where an economic profit can otherwise be anticipated, it may indicate that the taxpayer has other, nonbusiness reasons for making the investment. This is especially true for taxpayers who are not in a very high tax bracket because without a great deal of tax savings a farm may be a poor investment when compared with other alternatives. Thus, even if the taxpayer in *Wann* could have established an expectation of a small economic profit in the future, his tax avoidance motive would indicate that profit might not have been the dominant purpose for the investment. When this factor is combined with other personal benefits that could accrue to the taxpayer, the conclusion may be that he is not engaged in a trade or business.

Other Factors

Since the question of the taxpayer's intent is basically a factual one, any number of circumstances may be considered in determining whether he is primarily motivated by a business purpose.[76] The fact that a particular operation has not been profitable in the past may be an indication that a profit seeking motive does not exist. However, the importance of past losses may be considerably diminished if there is some explanation of them which indicates that they could not reasonably have been anticipated. Drought,[77] disease,[78] or even an unexpected decline in market prices[79] may have caused losses in what would otherwise have been a profitable operation. If so, the taxpayer would not necessarily have been without a profit motive merely because losses did actually occur.

The overall financial position of the taxpayer is sometimes relevant. Lack of other substantial wealth or income may indicate that a farming operation is a potential source of additional income rather than a hobby.[80] Conversely, a wealthy individual

76. *See generally* 5 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 28.73 (1963 rev.); Sharpe, *What the Taxpayer Should Do to Have the Courts Recognize his Farm as a Business,* 28 J. TAXATION 48 (1968).
77. Seven Sixty Ranch Co. v. Kennedy, 17 Am. Fed. Tax R.2d 587 (D. Wyo. 1966); Dickerson v. United States, 7 Am. Fed. Tax R.2d 698 (N.D. Tex. 1961); Jean A. Lowenthal, 37 P-H Tax Ct. Mem. 433 (1968).
78. DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964); Jean A. Lowenthal, 37 P-H Tax Ct. Mem. 433 (1968); Theron D. Stay, 27 P-H Tax Ct. Mem. 741 (1958); Hamilton F. Kean, 10 B.T.A. 97 (1928); Rose P. Crane, 9 B.T.A. 437 (1927); *cf.* Worrell v. United States, 254 F. Supp. 992 (S.D. Tex. 1966).
79. Seven Sixty Ranch Co. v. Kennedy, 17 Am. Fed. Tax R.2d 587 (D. Wyo. 1966); Dickerson v. United States, 7 Am. Fed. Tax R.2d 698 (N.D. Tex. 1961); *In re* Ward, 131 F. Supp. 387 (D. Colo. 1955); John S. Ellsworth, 31 P-H Tax Ct. Mem. 170 (1962); George M. Zeagler, 27 P-H Tax Ct. Mem. 391 (1958); Thomas Watson, 12 P-H Tax Ct. Mem. 1411 (1943); Lucien H. Tyng, 36 B.T.A. 21 (1937); H.T. Cochran, 3 B.T.A. 215 (1925).
80. *See* Mercer v. Commissioner, 376 F.2d 708 (9th Cir. 1967); Whit-

with a large income from other sources could find it more difficult to prove an intent to make a profit because of his ability to absorb substantial losses with equanimity.[81] In addition, since high bracket taxpayers stand to gain the most in tax savings from the deduction of farm losses, a tax avoidance motive may also be present. However, taxpayers can sometimes turn their substantial wealth into a factor which is favorable to finding a business purpose. There is some support for the proposition that an enterprise which appears to be unprofitable when judged from past experience is nevertheless a trade or business if the taxpayer has tried different methods or otherwise shown a plan to try to reduce his losses and make a profit.[82] A wealthy taxpayer may actually be in a better position to show that he can make the necessary investment to recoup his early losses and eventually make a profit from the operation than one who has less capital. This is especially true of highly speculative enterprises, such as horse racing, or operations which can give rise to substantial losses in the early formative years, such as breeding a special strain of livestock.

Proper management techniques are also generally necessary to a business purpose.[83] If the taxpayer is truly engaged in a trade or business, he should be able to show that the operation has been conducted in a businesslike manner utilizing adequate records and modern technology. In some cases, the degree of participation by the taxpayer himself in the management of the operation may

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man v. United States, 248 F. Supp. 845 (W.D. La. 1965); Estate of Lillian Solomon, 36 P-H Tax Ct. Mem. 1004 (1967); Ralph S. Prickett, 36 P-H Tax Ct. Mem. 5 (1967); Ralph A. Mauller, 35 P-H Tax Ct. Mem. 881 (1966); Eugene J. Davis, 35 P-H Tax Ct. Mem. 699 (1966); Hedi Katz, 23 P-H Tax Ct. Mem. 232 (1954); Anne Klein Ansley, 22 P-H Tax Ct. Mem. 1008 (1953); James L. Bryne, 14 P-H Tax Ct. Mem. 1222 (1945).

81. *See* Bessenyey v. Commissioner, 379 F.2d 252 (2d Cir. 1967); Schley v. Commissioner, 375 F.2d 747 (2d Cir. 1967); Teitelbaum v. Commissioner, 294 F.2d 541 (7th Cir. 1961); Coffey v. Commissioner, 141 F.2d 204 (5th Cir. 1944); Wright v. Commissioner, 249 F. Supp. 508 (D. Nev. 1965); Proebstle v. United States, 16 Am. Fed. Tax R.2d 5100 (S.D. Tex. 1965); O'Neill v. Patterson, 15 Am. Fed. Tax R.2d 332 (N.D. Ala. 1964); Frank M. Austin, 38 P-H Tax Ct. Mem. 29 (1969); Estate of Lillian Solomon, 36 P-H Tax Ct. Mem. 1004 (1967); Edward R. Godfrey, 32 P-H Tax Ct. Mem. 1 (1963); Robert Y.H. Thomas, 31 P-H Tax Ct. Mem. 430 (1962); John S. Ellsworth, 31 P-H Tax Ct. Mem. 170 (1962); Jane Brady Moseley, 18 P-H Tax Ct. Mem. 143 (1949); Lucien H. Tyng, 36 B.T.A. 21 (1937).

82. *See* Tatt v. Commissioner, 166 F.2d 697 (5th Cir. 1948); Graves v. United States, 19 Am. Fed. Tax R.2d 644 (D. Colo. 1966); Fabacher v. United States, 17 Am. Fed. Tax R.2d 401 (S.D. Miss. 1965); DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964); Thomas v. United States, 9 Am. Fed. Tax R.2d 866 (S.D. Fla. 1962); *In re* Ward, 131 F. Supp. 387 (D. Colo. 1955); Jean A. Lowenthal, 37 P-H Tax Ct. Mem. 433 (1968); Eugene J. Davis, 35 P-H Tax Ct. Mem. 699 (1966); William L. Brueck, Sr., 33 P-H Tax Ct. Mem. 1345 (1964); Rowe B. Metcalf, 32 P-H Tax Ct. Mem. 1587 (1963); Alice D. Worcester, 31 P-H Tax Ct. Mem. 1253 (1962); Dean Babbitt, 23 T.C. 850 (1955); Amos S. Bumgardner, 23 P-H Tax Ct. Mem. 184 (1954); Iri R. Cope, 22 P-H Tax Ct. Mem. 1117 (1953); J.G. Stoller, 22 P-H Tax Ct. Mem. 959 (1953); Dan R. Hanna, Jr., 20 P-H Tax Ct. Mem. 520 (1951); Frank R. Fageol, 20 P-H Tax Ct. Mem. 341 (1951); Norton L. Smith, 9 T.C. 1150 (1947); P.L. Reed, 11 P-H Tax Ct. Mem. 287 (1942); Shadybrook Farm, Inc., 11 P-H Tax Ct. Mem. 282 (1942); Rose P. Crane, 9 B.T.A. 437 (1927).

83. *See* Amos S. Bumgardner, 23 P-H Tax Ct. Mem. 184 (1954).

give rise to different inferences depending on whether he is experienced in farming and whether he appears to be deriving some personal benefit. It is generally not necessary that the taxpayer actively participate in the management of the business and his doing so may actually give rise to an inference that he is engaged in a hobby if he is inexperienced and does not consult with experts in farm techniques and management.[84] The fact that the taxpayer leaves the day-to-day management to others could mean that he views the operation strictly as an investment for profit with no personal benefits to himself.[85] On the other hand, a taxpayer who is experienced in farming but engaged in another occupation now, may be required to establish that he is not participating in the operation of his farm primarily because of the personal satisfaction of working with livestock or maintaining a country estate as a showplace.[86]

It is a well known fact that the average size of farms has generally become larger in recent years because many small operations are not able to take advantage of technological advances which require a large investment in equipment and other capital assets.[87] For this reason, the size of the operation may give some indication of whether a farming investment is a business. If the taxpayer who is not relying primarily on farming for his livelihood has not made a sufficient capital investment to put the enterprise on a profitable basis, a hobby may be inferred.[88] However, if the taxpayer once establishes that he is engaged in a trade or business, a court may be reluctant to find that the operation has become a hobby even if it has diminished in size. In *Beverly J. Hill*,[89] for example, the taxpayer had been engaged in the horse racing business but the operation had dwindled to only one horse which did not even race during the year. Finding nothing else to indicate that what had concededly been a business in prior years had now become only a hobby or social activity, the court allowed deduction of training expenses for the horse.

Although it is often said that the taxpayer's intent when he started the operation is the dominant factor in determining whether

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84. *See* Cenac v. United States, 20 Am. Fed. Tax R.2d 5228 (E.D. La. 1967); O'Neill v. Patterson, 15 Am. Fed. Tax R.2d 332 (N.D. Ala. 1964).

85. *See* Mercer v. Commissioner, 376 F.2d 708 (9th Cir. 1967); Dickerson v. United States, 7 Am. Fed. Tax R.2d 698 (N.D. Tex. 1961); Dean Babbitt, 23 T.C. 850 (1955).

86. *See* Schley v. Commissioner, 375 F.2d 747 (2d Cir. 1967); DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964); Thomas v. United States, 9 Am. Fed. Tax R.2d 866 (S.D. Fla. 1962); Margit Sigray Bessenyey, 45 T.C. 261 (1965); Robert Y.H. Thomas, 31 P-H Tax Ct. Mem. 430 (1962); John S. Ellsworth, 31 P-H Tax Ct. Mem. 170 (1962); W. Clark Wise, 26 P-H Tax Ct. Mem. 306 (1957); Hamilton F. Kean, 10 B.T.A. 97 (1928).

87. The average size of farms in the United States increased from 147 acres in 1920 to 359 acres in 1967. U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 605 (1967).

88. *See* Jane Brady Moseley, 18 P-H Tax Ct. Mem. 143 (1949).

89. 36 P-H Tax Ct. Mem. 1413 (1967).

a profit motive exists,[90] this does not mean that what is admittedly a hobby cannot later become a business under the proper circumstances. Each year should stand by itself and the question should be whether the taxpayer had a business purpose during that particular year.[91] If a farm is operated for recreation or pleasure and not for profit, and if a loss is incurred, the regulations provide that the entire receipts from the sale of farm products may be excluded from income.[92] Any expenses, being regarded as personal expenses, would not be deductible.[93] But, if a hobby farm produces a profit one year, it is not clear whether the Commissioner could tax gross receipts while disallowing any deduction for expenses on the ground that they are not business expenses.[94] As a practical matter, however, the taxpayer whose farm actually does show a profit would probably not have too much difficulty establishing a business purpose for that year.

Statutory Limitations

Even if the taxpayer succeeds in establishing that his operation is a trade or business, section 270 of the Internal Revenue Code provides that he cannot deduct more than $50,000 per year from other income if the business results in losses of $50,000 or more each year for five consecutive years. While this places an upper limit on the tax benefits to be derived from the deduction of farm losses, the statute is generous enough to permit the realization of substantial tax savings. In addition, certain "specially treated" deductions may be excluded in computing the losses under section 270 which further increases the tax shelter potential of farming. Among these are farm losses "which are directly attributable to drought, the net operating loss deduction allowed by section 172, and expenditures as to which taxpayers are given the option, under law or regulations, either (1) to deduct as expenses or (2) to defer or capitalize."[95] This latter category would presumably include development expenses of farms, ranches, and orchards prior to the productive stage.[96]

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90. Tatt v. Commissioner, 166 F.2d 697, 698 (5th Cir. 1948); Farish v. Commissioner, 103 F.2d 63, 65 (5th Cir. 1939); Whitman v. United States, 248 F. Supp. 845, 851 (W.D. La. 1965); Jane Brady Moseley, 18 P-H Tax Ct. Mem. 143, 145 (1949).

91. *See* O'Neill v. Patterson, 15 Am. Fed. Tax R.2d 332 (N.D. Ala. 1964); Thomas v. Commissioner, 324 F.2d 798 (5th Cir. 1963); Thomas v. United States, 9 Am. Fed. Tax R.2d 866 (S.D. Fla. 1962); DuPont v. United States, 28 F. Supp. 122 (D. Del. 1939); Everell E. Fisher, 37 P-H Tax Ct. Mem. 1154 (1968); Bertha R. Conyngham, 33 P-H Tax Ct. Mem. 1293 (1964); Robert Y.H. Thomas, 31 P-H Tax Ct. Mem. 430 (1962); Norma Mathews Lauer, 30 P-H Tax Ct. Mem. 1134 (1961).

92. Treas. Reg. § 1.162-12; *see* Bertha R. Conyngham, 33 P-H Tax Ct. Mem. 1293 (1964).

93. INT. REV. CODE of 1954, § 262; Treas. Reg. § 1.162-12.

94. *See* Treas. Reg. § 1.212-1(c).

95. INT. REV. CODE of 1954, § 270(b).

96. Sonnabend v. Commissioner, 377 F.2d 42 (1st Cir. 1967); *see* Treas. Reg. § 1.162-12.

Because high bracket taxpayers can avoid substantial amounts of taxes through the deduction of tax losses where a business purpose exists, several bills have been introduced in Congress in recent years to further limit the deduction of farm losses from other income.[97] Some proposals would eliminate such deductions entirely[98] while others would permit up to $15,000 in losses to be deducted in any one year.[99] In some cases, the limitation on deductions would apply only to farmers using the cash method of accounting while those electing an accrual method would be exempted.[100] If one of these bills is eventually enacted, it would, of course, significantly reduce the tax shelter benefits of investments in farming. Whether such a limitation on the deduction of farm losses is the best method of reducing tax avoidance by high bracket taxpayers is another matter.

Capitalization of Expenditures

Many farm losses, and therefore many farming tax shelters, could be reduced or eliminated if more expenditures were deferred or capitalized as required by general accounting principles, rather than being deducted currently as allowed by present accounting methods for farmers. Capitalization of the cost of raising crops and livestock, for example, would achieve a better matching of revenue and expenses and would eliminate the deferral of tax liability which occurs when such costs are deducted currently. Since the tax accounting methods available to farmers are almost exclusively a product of the regulations, it would seem at first blush that changes requiring more capitalization could be made administratively by simply amending the regulations. However, this appears to be easier said than done due to the long history of the regulations[101] and their apparent acceptance by Congress over the years.[102] In fact, the Treasury Department itself has

97. *E.g.*, S. 1560, 91st Cong., 1st Sess. (1969); S. 500, 91st Cong., 1st Sess. (1969); S. 4059, 90th Cong., 2d Sess. (1968); S. 3443, 90th Cong., 2d Sess. (1968); S. 2613, 90th Cong., 1st Sess. (1967); H.R. 9270, 91st Cong., 1st Sess. (1969); H.R. 8982, 91st Cong., 1st Sess. (1969); H.R. 8952, 91st Cong., 1st Sess. (1969); H.R. 8640, 91st Cong., 1st Sess. (1969); H.R. 8374, 91st Cong., 1st Sess. (1969); H.R. 8157, 91st Cong., 1st Sess. (1969); H.R. 7789, 91st Cong., 1st Sess. (1969); H.R. 7617, 91st Cong., 1st Sess. (1969); H.R. 7575, 91st Cong., 1st Sess. (1969); H.R. 7336, 91st Cong., 1st Sess. (1969); H.R. 4257, 91st Cong., 1st Sess. (1969); H.R. 19916, 90th Cong., 2d Sess. (1968); H.R. 19182, 90th Cong., 2d Sess. (1968); H.R. 17478, 90th Cong., 2d Sess. (1968); H.R. 17255, 90th Cong., 2d Sess. (1968); H.R. 14218, 90th Cong., 1st Sess. (1967).

98. *E.g.*, S. 2613, 90th Cong., 1st Sess. (1967).

99. *E.g.*, S. 500, 91st Cong., 1st Sess. (1969).

100. *E.g.*, S. 500, 91st Cong., 1st Sess. (1969); H.R. 19916, 90th Cong., 2d Sess. (1968).

101. The regulation permitting current deduction of the cost of raising crops and livestock dates back at least to 1919. United States v. Catto, 384 U.S. 102, 110 n.13 (1966). *See also* T.D. 2153, 17 TREAS. DEC. INT. REV. 101 (1915).

102. In the Revenue Act of 1951, 65 Stat. 452, 501, Congress amended the predecessor to § 1231 to specifically provide capital gains treatment for the sale of livestock held for draft, breeding, or dairy purposes. INT. REV. CODE of 1954, § 1231(b)(3). The committee reports of both the Senate

maintained that these provisions have the force of law and can only be changed through legislation.[103]

Despite this position, there seems to be increasing disenchantment among the courts with what are essentially inaccurate methods of determining income for farmers. In *United States v. Catto*,[104] the Supreme Court observed that:

> The general and long-standing rule for all taxpayers, whether they use the cash or accrual method of accounting, is that costs incurred in the acquisition, production, or development of capital assets, inventory, and other property used in the trade or business may not be currently deducted, but must be deferred until the year of sale, when the accumulated costs may be set off against the proceeds of sale. Under general principles of accounting, therefore, it would be expected that expenses incurred by ranchers in raising breeding livestock should be charged to capital account, even though the ranchers employed the cash method of accounting.[105]

With respect to the Treasury Department's position that acceleration of deductions by cash method ranchers coupled with capital gains benefits on sale could not be attacked administratively, the Court said:

> We need not here determine the correctness of the Secretary's interpretation of the legislative history, since no question is presented in this case concerning the vulnerability of the position of cash-method ranchers to action by the Secretary.[106]

A statement such as this seems to be virtually an invitation to the Treasury to tighten up the regulations permitting the deduction of the cost of raising breeding animals.[107]

That the Treasury may have some support for doing this is also indicated by the recent decision of the Tax Court in *George L.*

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and House of Representatives stated that such gains from the sale of livestock should be computed in accordance with the tax accounting methods "presently recognized by the Bureau of Internal Revenue." S. REP. No. 781, 82d Cong., 1st Sess. 42 (1951); H.R. REP. No. 586, 82d Cong., 1st Sess. 32 (1951). The following year legislation was recommended by the Treasury Department to require capitalization of the cost of raising livestock for draft, breeding, or dairy purposes. Special Letter from the Secretary of the Treasury to the Chairman of the Senate Finance Comm., June 27, 1952, 98 CONG. REC. 8307 (1952). No action was taken by Congress.

103. United States v. Catto, 384 U.S. 102, 115 (1966); Special Letter from the Secretary of the Treasury to the Chairman of the Senate Finance Comm., June 27, 1952, 98 CONG. REC. 8307 (1952); *see Hearings on the President's 1963 Tax Message Before the Comm. on Ways and Means, House of Representatives*, 88th Cong., 1st Sess., pt. 1, at 144-46 (1963); Hawkinson, *Farm Expenses and General Accounting Principles*, 22 TAX L. REV. 237 (1967).

104. 384 U.S. 102 (1966).

105. *Id.* at 109-10.

106. *Id.* at 115 n.23.

107. *See* O'Byrne, *Supreme Court Restricts Capital Gain on Breeding Animals Under Unit-Livestock-Price Method*, 24 J. TAXATION 376 (1966).

Schultz.[108] In that case, the taxpayer was a wealthy investor who purchased raw whiskey in bulk to hold for the normal aging period of four years at which time it could be bottled and sold for consumption. The court found that his purpose was to acquire four-year-old bourbon, a product which would be more valuable than the raw whiskey originally purchased because of the passage of time and a chemical change occurring during the aging process. Therefore, amounts expended for insurance and storage costs had to be capitalized as the cost of obtaining four-year-old whiskey rather than being deducted currently. In response to the taxpayer's argument concerning the regulations applying to farmers, the court said:

> We are not unmindful, as petitioner points out, that a cash basis cattle owner or crop grower is permitted to expense the cost of raising his livestock or crop even though he may be entitled to capital gain treatment on the profit from the sale thereof. But the fact that respondent conceivably may have painted himself into a corner in these areas does not require us to put him in the same position in other areas, where the underlying considerations are quite different.[109]

Taking the *Catto* and *Schultz* cases together, it would seem that the Treasury would have a substantial basis for requiring more capitalization in farming situations. In *Catto*, taxpayers using the unit-livestock-price method of valuing inventories were required to include in inventory all livestock raised, whether for sale or breeding purposes. This has the same effect as capitalizing the cost of raising the animals because their inventory value, when added to gross income, would approximately offset the deductible expenses of raising them. It would be only a short step from this to requiring all farmers, whether on the cash or accrual basis, to capitalize the cost of raising breeding animals. *Schultz* would also lend support to capitalization in this case because the expenses are being incurred to obtain a different asset (breeding animals) than the original property (immature animals).

One reason that the Treasury has not changed its regulations in this regard may be because it would be extremely burdensome to require all farmers to keep the detailed records and accounts that would be necessary to allocate costs to raised crops and livestock. Indeed, this was the principal reason for allowing cash method farmers to deduct such expenses currently in the first place.[110] It seems questionable, however, whether this consideration applies with equal force to the average farmer and the wealthy investor who seeks a tax shelter for other income in a farming operation. The latter is often a successful businessman in his

108. 50 T.C. 688 (1968).
109. *Id.* at —.
110. United States v. Catto, 384 U.S. 110-11 & n.15 (1966).

own right to whom modern cost accounting methods, although complicated, would not be particularly onerous.

In addition, the Commissioner is authorized under section 446 (b) to require that all taxpayers use a method of accounting which clearly reflects income. Present tax accounting methods for farmers, although differing from ordinary accounting procedures, do not unreasonably distort the income of the average farmer who has been in business for a period of years and who relies primarily on farming for his livelihood. But this is hardly true of the wealthy taxpayer who combines farming with other sources of income, especially during the development stage of the enterprise.

For these reasons, the Treasury Department should be able to require that a more accurate system of reporting income and deductions be used by farmers with substantial income from other sources, including capitalization of the cost of raising crops and livestock which are not sold during the year. If this were done, many of the tax losses which such taxpayers have to deduct from nonfarm income would be eliminated without disturbing the simplified accounting procedures available to bona fide farmers. The result would be a more accurate reflection of the overall income of these wealthy taxpayers.

Even within the context of the present regulations, there appears to be some room for requiring more capitalization of expenditures to reduce the acceleration of deductions. There is general agreement that the cost of acquiring property must be capitalized[111] and in many instances farm costs may be more accurately characterized as acquisition expenditures rather than deductible expenses. The Commissioner has had some success with this argument as evidenced by the decision in *Herbert K. Stevens*.[112] In that case the taxpayer was the owner and operator of a thoroughbred stable and farm, and it was conceded that he was engaged in the business of racing horses for profit. The taxpayer and another individual purchased some horses jointly under an agreement whereby the other individual paid the entire purchase price and the taxpayer paid all of the boarding and training expenses. Winnings and sale proceeds were to be divided equally. When the taxpayer sought to deduct all of the maintenance and training expenses of the horses, the court held that one-half of these costs had to be capitalized as the cost of acquiring a half interest in the horses.

The theory of *Schultz* could also be applied to characterize such expenses as acquisition costs. Like the investor in raw whiskey who seeks to acquire four-year-old bourbon, the investor in

111. *See* INT. REV. CODE of 1954, § 263; Treas. Reg. § 1.162-12.

112. 46 T.C. 492 (1966); *cf.* D. Joseph St. Germain, 28 P-H Tax Ct. Mem. 309 (1959). *But see* Whitman v. United States, 248 F. Supp. 845 (W.D. La. 1965).

immature breeding animals, untrained race horses, or seedling trees is actually seeking to acquire the mature product which will then begin producing income for him. Therefore, the cost of maintaining such property until maturity should properly be capitalized as part of the cost of acquiring the desired asset. This is not to say, however, that all expenses incurred during the early stages of a business should necessarily be capitalized. A rancher who owns a mature herd of breeding livestock may still be in the development stage of the business in the sense that his ultimate goal is to build up a herd over a period of time with special characteristics or bloodlines. But, this does not mean that the expense of maintaining the herd could not be deducted except for the cost of raising young animals as replacements.

Much the same result as capitalization of acquisition costs can be reached by disallowing deduction of expenses on the ground that they were incurred in preparing to enter a business rather than in the actual conduct of one. If the business has not actually commenced, the expenses, and any resulting losses, cannot be deducted because they were not actually incurred in a trade or business.[113] Several cases have denied the deduction of farm losses where the court felt that the operation was merely in the preparatory stage.[114] Usually, this involves a situation where the taxpayer has acquired a small operation, a few breeding animals for instance, with a view to building up a profitable business through natural increases. Until the operation reaches a size where a profit can be expected, no trade or business actually exists even though some gross income may be produced. Any expenses incurred during this period are merely part of the cost of acquiring a business as opposed to the cost of running one.

Such a test can eliminate the acceleration of deductions in the preparatory stage, but after that it will be no threat because a business purpose would then be present. Once the operation reaches a profitable state, expenses would be deductible without regard to whether they were being incurred to build the business up even further or to replace assets the cost of which has already been capitalized. Therefore, if deductions are to be disallowed for any expenses during this period, it would have to be done on the theory that they should be capitalized as the cost of acquiring new capital assets.

CONCLUSION

If legislation is to be adopted limiting the potential of farming as a tax shelter for nonfarm income, it would be better to change

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113. *See* INT. REV. CODE of 1954, §§ 162(a), 165(c).

114. Williams v. United States, 22 Am. Fed. Tax R.2d 5924 (D. Wyo. 1968); Harold I. Snyder, 35 P-H Tax Ct. Mem. 1485 (1966); Edward R. Godfrey, 32 P-H Tax Ct. Mem. 1 (1963), *aff'd*, 335 F.2d 82 (6th Cir. 1964), *cert. denied*, 379 U.S. 966 (1966); Edwin H. Miner, 31 P-H Tax Ct. Mem. 1293 (1962); George C. Westervelt, 8 T.C. 1248 (1947).

the accounting procedures which give rise to tax losses through acceleration of deductions rather than merely limiting the deduction of farm losses without regard to how they are computed. This could be done for taxpayers who have substantial amounts of other income without eliminating current deductions by farmers whose income is not significantly distorted thereby because farming is their principal business activity. Even without action by Congress, there appears to be a sound basis for amending the regulations to restrict the option to either deduct development expenses or capitalize them where it is being used to avoid substantial amounts of taxes.

Further limitation of tax avoidance by farmers could be obtained by providing for the recapture of depreciation as ordinary income, at least with respect to section 1231 livestock. This would prevent the swapping of depreciation deductions from ordinary income for capital gains in later years. Legislation would undoubtedly be necessary here, however, because livestock is presently excluded from the recapture provisions of section 1245.

Characterization of gain on all section 1231 property as ordinary income to the extent of prior deductions for such property could be another method of cutting down on the tax shelter benefits of farming. The recapture theory would have to be extended beyond depreciation to other expense deductions to accomplish this, but there is already some precedent for doing so.[115] However, characterization of sale proceeds as ordinary income in this manner would not limit the tax shelter potential of farming as much as requiring capitalization of production costs would. Tax avoidance would be reduced because the gain would have to be reported as ordinary income to the extent prior deductions have been used to offset ordinary income. But, tax liability could still be deferred from the time the deductions are taken until the property is sold.

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115. Hallcraft Homes, Inc. v. Commissioner, 336 F.2d 701 (9th Cir. 1964); Merchants Nat'l Bank v. Commissioner, 199 F.2d 657 (5th Cir. 1952); First Nat'l Bank, 16 T.C. 147 (1951).