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A BOUNTIFUL TAX HARVEST

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Professor Davenport traces the development of the "farm loss" inequity and analyzes the possible remedies. He meticulously examines the proposed solutions now before Congress, explains why he favors Senator Metcalf's Bill, and expresses his fear that division within the ranks will defeat reform.

I. INTRODUCTION

The nation's income tax law takes its form from its various architects. Congress has the initial chance to structure it. Then the Treasury promulgates regulations. These sources are subsequently interpreted by the courts in deciding cases and by the Internal Revenue Service in many administrative proceedings. Each institution is undoubtedly reacting to a peculiar set of pressures and to special arguments being exerted at the moment. As a consequence, the law at any time may be something that just happened. It is not surprising that a system growing like Topsey may sometimes reach a topsy-turvy result.

At this writing, several industries, notably oil and gas, real estate, perhaps timber, and some farming, offer this opportunity. This paper, however, is limited to the "farm loss" problem, but it seems likely that the conclusions and analytic techniques set forth are equally applicable in any case in which premature deductions are allowed for the cost of assets, while also conferring capital gain treatment on the sales proceeds to the extent they exceed any basis the property may have. Thus the conclusions and techniques discussed herein might just as easily apply to depreciation on real estate unless this deduction is sharply reduced by the current tax reform proposals.

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The "farm loss" problem arises from the deduction of capital costs while allowing sales proceeds to be treated as capital gain. We shall first trace briefly the development of the tax law in agriculture to ascertain just how we got where we are. Then we shall turn to a demonstration of the benefits afforded by the tax law. Thereafter the areas of principal application shall be outlined, and finally some solutions currently proposed will be evaluated.

II. Growth of the Tax Harvest

A. A Seed Is Planted

One root of the farm problem lies in a number of administrative decisions made very early in the game. A Treasury Decision[1] in 1915 and regulations issued under the Revenue Act of 1916[2] provided that the farmers could report their income on either the cash or accrual method of accounting. More importantly, the same authority gave the farmers permission to dispense with accounting practices employed by other businesses and permitted them to deduct livestock-raising costs even though they were capital expenditures.

This decision seems to have been prompted by several considerations. First, since the identification of specific costs attributable to particular animals on hand at year's end would have been very difficult, the easy answer was to ignore such costs. Furthermore, the accounting principles of the time appear to have been unsophisticated and unprepared to deal with the problem of segregating and capitalizing costs associated with livestock. Finally, there was undoubtedly some notion that the average farm did not represent the type of investment or financial acumen usually found in other business operations. To ask that expensive accounting techniques be employed would not only have overburdened the investment, but would also have overtaxed the farmer's financial management capacity.[3] In a sense, farms were just not considered businesses.

These early regulations also addressed themselves to the amounts incurred in the development of orchards and ranches. Contrary to the rule for livestock, the initial regulations required these costs to be capitalized.[4] Presumably, the inconsistency of allowing livestock

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1 T.D. 2153, 17 Treas. Dec. Int. Rev. 101 (1915), *as amended*, T.D. 2665, 20 Treas. Dec. Int. Rev. 45 (1918).

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

3 United States v. Catto, 384 U.S. 102, 110 (1966).

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

farmers an immediate writeoff while requiring capitalization of development costs of orchards and ranches was raised, and the issue was resolved for deductibility of both kinds of expenses when the next regulations were issued in 1919.[5] Case law stemming from this era indicates that, left to its own devices, the judiciary would have reached contrary results for those development costs.[6]

When these liberal rules, the expensing of raising and developing costs, were formulated, they had but one effect on tax liabilities. The deductions were premature and created artificial tax losses, which would not have arisen had the costs been properly capitalized. These artificial tax losses offset income from other sources and permitted a deferral of tax liabilities on other income until the farm assets were sold. This gross mismatching of income and expense could be tolerated when tax rates were relatively low. They became quite another matter when, as later explained, they combined with very high ordinary income rates and lower capital gains rates on many farm assets.

The point of recounting the historical is that these liberal accounting rules were developed by an administrative agency under a statute requiring that income be properly reflected. While expediency might be their chief justification, there is nothing to indicate that their impact as a stimulant for investment in farm assets was ever considered. Indeed, that consideration would have been improper. Furthermore, it is doubted that they originally had any such effect; instead, they dealt with difficult accounting problems.

B. The Flower Blooms

Congress discovered capital assets in the Revenue Act of 1921. It did not see fit, however, to include within that category depreciable property used in the trade or business. We were later told that this property had been excluded in order to assure full deductibility of losses.[7]

Whatever the reason for excluding these assets from the preferred treatment, World War II brought forth a rash of condemnations, destructions, and sales of depreciable property that had appreciated substantially. To prevent virtual confiscation of such ap-

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[5] Treas. Reg. 45, art. 110 (1919).

[6] *See* Ribbon Cliff Fruit Co., 12 B.T.A. 13 (1928); Harry B. Hooper, 8 B.T.A. 397 (1927).

[7] H.R. REP. NO. 2333, 77th Cong., 2d Sess. 53-54 (1942). *See* Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 NAT'L TAX J. 12, 31-32 (1949).

preciation by high wartime rates, Congress conferred capital gain on depreciable property used in the trade or business but preserved full deduction of losses realized on this property.[8] While the House specifically excluded real estate from the preferred dual treatment, the Senate added real estate and its improvements—largely to assure that losses on sales of plants and the like would be fully deductible.[9]

Although the Commissioner of Internal Revenue sought on several occasions[10] to compel a contrary result, farmers considered their breeding animals to be property used in the trade or business and applied the new rules to their own benefit. The ensuing controversy was settled in favor of the taxpayers in *Albright v. United States*,[11] when the court found that all the culls[12] from a dairy herd were property used in the trade or business and that sales proceeds therefrom qualified for capital gain treatment.

Even with this victory, the livestock interests were concerned that administrative practice might not be so lenient as the cases and in 1950 urged the Senate to legislate on the subject. These efforts failed,[13] but a renewed fight in 1951 moved Congress to clear up any uncertainties by enacting the predecessor of the Internal Revenue Code of 1954 section 1231(b)(3) in the Revenue Act of 1951.[14] The explanation of the Act also made clear that the animals' basis for gain was to be determined under the taxpayers' method of accounting.[15] That is, a cash basis taxpayer would have no basis for raised animals, and the entire sales proceeds would be capital gain. A taxpayer who capitalized or inventoried costs would use this basis and have gain only to the extent proceeds exceeded his basis.

The adverse effects of this legislation were noted in a letter from

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8 Wells, *supra* note 7, at 32.

9 S. REP. No. 1631, 77th Cong., 2d Sess. 49-50 (1942).

10 I.T. 3666, 1944-1 CUM. BULL. 270. I.T. 3712, 1945-1 CUM. BULL. 176; Mim. 6660, 1951-2 CUM. BULL. 60; Special Ruling by the Commissioner of Internal Revenue, CCH 1948 STAND. FED. TAX REP. ¶ 6091 (Aug. 4, 1947).

11 173 F.2d 339 (8th Cir. 1949).

12 In a livestock operation, there is an annual crop of young animals. Since few farmers have either the capacity or the desire to increase their operation by the full amount of each crop, some part of the livestock must be sold. Normally those animals least fitted for the operation are sold. The process of selecting the animals to be sold is referred to as "culling," and the animals so selected are "culls."

13 H.R. REP. No. 3124, 81st Cong., 2d Sess. 28 (1950) makes clear that Senate Amendment No. 82 was rejected largely because it was limited to cattle. It also expressed hope that the Treasury would administer the law in accordance with the *Albright* decision.

14 Revenue Act of 1951, § 324. The Act stated that livestock held more than 12 months regardless of age and held for draft, breeding, or dairy purposes would be treated as property used in the trade or business for the purpose of § 117(j) of the Internal Revenue Code of 1939, now § 1231 of the Internal Revenue Code of 1954.

15 S. REP. No. 781, 82d Cong., 1st Sess. 41 (1951).

Secretary of the Treasury Snyder to the Chairman of the Senate Finance Committee on June 27, 1952.[16] This is the first statement of the taxable income distortions that occur from permitting capital costs to be deducted while permitting proceeds to be treated as capital gain. As has often been the case, the mechanics of creating a tax loss that offsets income otherwise taxable at ordinary rates were accurately described, but the full tax consequences were not sharply delineated.

Again, recounting the legislative history of the capital gain aspects of the problem has a purpose beyond the historical. That purpose is to lay to rest the notion that the provision had any design other than to limit the tax on sales proceeds. There is nothing to suggest the limited tax rate was to produce the effect described in the next section of this paper. Furthermore, the farm industry wanted treatment equal[17] to that accorded other industries. The industry argued that the aged cow was the equivalent of machinery scrapped by the manufacturer. Both were claimed to be entitled to capital gains on sale. There is nothing in this history to suggest that Congress was purposefully subsidizing, in a rather haphazard manner, certain segments of the farm industry. Congress intended only to give farmers relief generally granted others.

With this historical note we can turn to demonstration of the negative tax impact.

III. How the Principle Operates

The problems in the farm tax loss area are described in various ways. The Treasury may point to the offsetting of farm losses against other income or to the creating of tax profits when there are no economic profits. Others write about "hobby farming."[18] These descriptions are not satisfactory, and the scope of this paper is not so narrow.

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[16] The letter pointed out that the deduction of livestock raising costs from ordinary income while allowing capital gains treatment for the sale of breeding livestock distorted income downward by $275,000,000 a year and gave a windfall to those farmers and ranchers then using cash basis accounting. Letter from Secretary of Treasury Snyder to the Chairman of the Senate Finance Committee, 98 CONG. REC. 8307, 8308 (1952), also reported in CCH 1952 STAND. FED. TAX REP. ¶ 6239 (June 27, 1952).

[17] *See* notes 13, 14 & 15 *supra*.

[18] *See* HOUSE COMM. ON WAYS AND MEANS and SENATE COMM. ON FINANCE, TAX REFORM STUDIES AND PROPOSALS OF THE U.S. TREASURY DEPARTMENT, 91st Cong., 1st Sess. 151, 154 (1969) [hereinafter cited as TREASURY STUDIES]; HOUSE COMM. ON WAYS AND MEANS, THE PRESIDENT'S 1963 TAX MESSAGE, 88th Cong., 1st Sess. 144-45 (1963) [hereinafter cited as 1963 TAX MESSAGE]; letter from Secretary Snyder, *supra* note 16. For a discussion of "hobby farming" see Sweeney, *The Farm Loss Deduction*, 53 A.B.A.J. 447 (1967), and Dickinson, *The Farm Loss Deduction: A Reply*, 53 A.B.A.J. 1111 (1967).

Rather, this paper is concerned largely, but not solely, with the negative tax rate that may be applied to farm *profits*.

What is a negative tax rate? A positive income tax rate takes a part of a taxpayer's profits and puts them in the Treasury. A negative tax rate, on the other hand, takes dollars from the Treasury and puts them in the hands of citizens, just as a spending program does. In the analysis that follows, this latter process is shown to flow from the conferring of capital gain treatment on the sales "proceeds" of assets, "proceeds" that are created by expenses, which may be fully deducted when paid.

The negative tax effect may be fully demonstrated by the following five cases. In each case, the asset sold is assumed to have no basis because its costs have been fully deducted, and as a consequence, the entire sales proceeds are given capital gain treatment. The cases are:

Case No. 1. An economic loss is incurred.
Case No. 2. An economic breakeven is reached.
Case No. 3. An economic profit is realized, but the profit margin is less than 100 percent of cost.
Case No. 4. An economic profit is realized, and cost is 50 percent of the selling price.
Case No. 5. The same as Case No. 4 except cost is less than 50 percent of sales proceeds.

The economic and tax reporting of these cases would be as follows:

CHART A

	Economic Reporting			Tax Reporting		
	Sales Price	Cost	Economic Profit or (Loss)	Ordinary Loss[19]	Taxable[20] one-half of Capital Gain[21]	Profit or (Loss)
Case No. 1	80	100	(20)	100	40	(60)
Case No. 2	100	100	0	100	50	(50)
Case No. 3	120	100	20	100	60	(40)
Case No. 4	200	100	100	100	100	0
Case No. 5	250	100	150	100	125	25

[19] Reported on Schedule F, Internal Revenue Service Form 1040, and which would offset other fully taxable income.

[20] This is the taxable portion of the capital gain, which is reached by reducing the entire gain by the deduction allowed by Internal Revenue Code of 1954, § 1202 so that the taxable portion is only 50% of the gain. This one-half of the gain is taxed either at the taxpayer's marginal tax rate or at a 50% rate, whichever is lower. In cases in which the 50% rate (resulting in a tax of 25% on the gain) is lower, the taxpayer pays the *alternative tax on capital gains*. This additional rate limitation on long term capital gain (in practical effect of benefit only to those taxpayers having sufficient income to be in a tax bracket above 50%) would be removed by § 511 of H.R. 13270, 91st Cong., 1st Sess. (1969) (passed

In each case, the ordinary tax loss may be fully offset against other nonfarm income while only one-half of capital gain is subject to tax. The result is that if the taxpayer has other income against which the loss may be deducted, taxes on this other income will be reduced by the amount of the loss multiplied by the taxpayer's marginal tax rate. The taxpayer will, however, incur a tax on the gain that may never exceed more than 25 percent of the entire capital gain.

The consequences of this reporting may best be illustrated by reference to four taxpayers having the different marginal tax brackets of 0 percent, 30 percent, 50 percent, and 70 percent. The assumption of a 0 percent bracket is valid only if the taxpayer has no other taxable income. Except in the case of the 0 percent taxpayer, the tax on the gain is less than the benefit of deducting the loss from other income. The net benefit or payment from the Treasury to the taxpayer is the difference in the value of the loss and the liability for the capital gain tax.[22] Specifically, the size of the payment or reduction of other taxes after giving effect to the capital gains liability is in each case as follows:

CHART B

	Effective Tax Rate on Additional Income			
	0%	30%	50%	70%[23]
Case No. 1	0	18	30	50
Case No. 2	0	15	25	45
Case No. 3	0	12	20	40
Case No. 4	0	0	0	20
Case No. 5	24	(7.50)	(12.50)	7.50

by the House and referred to the Senate Finance Committee on August 7, 1969). Conclusions herein, which assume the alternative tax computation, must be considered in light of this possible change in the law. The Treasury Department has announced opposition to the elimination of the alternative tax. *See Hearings on Tax Reform Act of 1969 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess. 6 (interim manuscript) (Statement of David M. Kennedy on Sept. 4, 1969).

The foregoing analysis applies to individuals only. Corporations receive substantially the same benefit under a slightly different statutory framework. Section 461 of H.R. 13270 would raise the corporate alternative tax rate to 30%. While the farm loss problem is largely related to individuals, the rate of corporate expansion into farming in the last several years has grown. *See Hearings Before the Subcomm. on Monopoly of the Select Comm. on Small Business*, 90th Cong., 2d Sess. 2 (1968). *See also* Thomas, *Corporate Sodbusters*, Barron's, Aug. 5, 1968, at 3, col. 1; Thomas, *Lure of the Land*, Barron's, Aug. 19, 1968, at 3, col. 1.

21 Reported on Schedule D, Internal Revenue Service Form 1040, as a sale of a capital asset.

22 This usually will be the taxpayer's effective tax rate multiplied by the difference between the loss and the taxable one-half of capital gains. When the taxpayer uses the alternative tax on capital gains, the benefit is greater.

23 These results are proportionately greater because the tax rate on the taxable one-half of capital gains is limited to 50%, while the loss is fully deductible against ordinary income taxed at more than the 50% rate. Also note that the top tax rate of 70% would be reduced to 65% by H.R. 13270, 91st Cong., 1st Sess. (1969).

24 The parentheses indicate that a positive tax is paid by the taxpayer. For the 0%

Chart B is the net tax benefit to each taxpayer. This amount should be added to the economic net return to ascertain the overall dollar gain for each taxpayer. When this is done, the total after-tax dollar profit in each case to taxpayers in various tax brackets would be:

CHART C

	0%	30%	50%	70%
Case No. 1	(20)	(2)	10	30
Case No. 2	0	15	25	45
Case No. 3	20	32	40	60
Case No. 4	100	100	100	120
Case No. 5	150[25]	142.50	137.50	157.50

These charts permit a number of observations.

(1) There is no taxable income until the economic profit is at least as much as the cost, (See Chart A, Case No. 4). Any profit beyond that is taxed at no more than the applicable capital gain rate (See Chart B, Case No. 5, 50 percent taxpayer).

(2) If there is no other income, the tax rate is never less than zero; in other words, the taxpayer receives no refund or abatement of taxes on other income (See Chart B, 0 percent taxpayer column).

(3) If there is other taxable income,[26] the interplay of ordinary deductions and capital gain produces a negative tax rate until the profit is as great as cost (See Chart B, Cases No. 1, 2, and 3, 30 percent and 50 percent taxpayers).

(4) The taxpayer who pays the alternative tax on capital gains continues to receive a negative tax benefit even though profit exceeds cost. This negative tax benefit does not disappear until the ratio of sales price to cost exceeds the ratio of the marginal ordinary income tax rate to the capital gain rate (See Chart B, Cases No. 4 and 5, 70 percent taxpayer).

(5) To a taxpayer without other income, his tax rate is the same regardless of profit margins until his sales price is twice his cost (See Chart B, Case No. 5, for 0 percent taxpayer).

While the foregoing appears generous in the extreme, one other

taxpayer, the taxable income would be taxed at the lowest rate if the income was not eliminated by itemized deductions and personal exemptions. For the 30% and 50% taxpayer, the profit for tax purposes is subjected to capital gain rates. The 70% taxpayer continues to show a net payment from the Treasury.

25 Since no amount of tax for this taxpayer is shown in Chart B, the total economic profit has not been reduced by any tax. The tax would be $25 multiplied by the effective tax rate.

26 The income might be realized in another year because the loss may become a net operating loss deduction in another year.

potential benefit has not been mentioned. It arises when the costs are incurred and deducted in years before the sales proceeds are realized. For example, in Case No. 3, the 50 percent taxpayer who deducts the $100 of costs in the first year reduces his taxes on other income by $50. If the income is not realized until later years, this $50 is an interest-free loan from the federal government to the taxpayer, which is wholly or partially repaid when the income is realized and subjected to tax. This benefit exists apart from any differential in tax rates. Even if the sales proceeds are fully taxed as ordinary income in a later year, the taxpayer has had a substantial benefit from the premature deduction of capital costs.

This note on deferral completes the analysis, and for the purposes of this discussion, we can now specify that the progeny of fully deductible costs and capital gain income are three in number. First, is the opportunity to defer taxes on other income by deducting costs before realization of the income produced by them. This is the *deferral* benefit. Second, in some circumstances, an economic profit bears no tax at all. This occurs when the sales proceeds, fully reported as capital gain, are not more than twice the amount of the deducted costs. This is the *exemption* benefit. Third, in some cases the tax saving resulting from the deduction of the costs is greater than the tax paid on the sales proceeds at capital gain rates. This occurs in all cases in which (1) there is other income, noncapital gain income, to absorb the deducted costs, and (2) the ratio of the sales proceeds (taxed only at capital gain rates) to the costs does not exceed the ratio of the marginal ordinary income tax rate to the capital gain tax rate. This is the majority of cases. The difference between the tax saving produced by the deduction and the tax paid on the sales proceeds is, in effect, a *payment from the Treasury* to the taxpayer. This payment varies in proportion to the taxpayer's tax rate. It is thus a kind of a *negative income tax*. It can be argued that the negative income tax is just an extension of the exemption benefit. That is, the deducted costs exempt not only the income produced by them but other income as well. While there is some merit to this argument, the division between the exemption benefit and the negative income tax will become more meaningful in the discussion of pending legislative proposals.

It seems appropriate now to narrow the area of our discussion by considering the cases in which the opportunity to realize these benefits arises.

IV. The Greenest Pastures

While there are other avenues of abuse[27] in the farm field, the investment literature suggests that the potential for artificial farm tax

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[27] There are basically six areas in which the farm loss problem may arise. In addition to those discussed in the text, they are:

(a) The do-it-yourself averager, who shifts income and expense from year to year through the use of cash accounting. For example, a taxpayer, who desires to reduce taxes in a particular year, might purchase a large amount of supplies that would not be consumed until the following year. The deduction would be claimed in the year of purchase, and no adjustment would be made for the goods on hand at year's end. Similarly, a taxpayer might sell products and defer payments until the following year. The income would be reported by a cash basis taxpayer only in the following year. The extent of the premature deductions, which may be taken, is not clear. Recent cases indicate that the taxpayer faces increasing judicial resistance to this tax limiting approach. For cases concerning supplies see Lillie v. Commissioner, 370 F.2d 560 (9th Cir. 1967), *aff'g per curiam*, 45 T.C. 54 (1966); Shippey v. United States, 308 F.2d 743 (8th Cir. 1962); Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959); Harry W. Williamson, 37 T.C. 910 (1962); John Ernest, 32 T.C. 181 (1959), *acquiesced in*, 1959-2 Cum. Bull. 4. *See also* Pauley v. United States, 63-1 U.S. Tax Cas. ¶ 9280 (S.D. Cal. 1963); Rev. Rul. 170, 1953-2 Cum. Bull. 141 (intangible drilling expenses); Rev. Rul. 58-53, 1958-1 Cum. Bull. 152 (personal services under § 212). Prepaid alimony is not deductible. George R. Joslyn, 23 T.C. 126 (1954), *rev'd and rem'd in part and aff'd in part on other grounds*, 230 F.2d 871 (7th Cir. 1956). Nor are prepaid medical expenses deductible. Robert S. Bassett, 26 T.C. 619 (1956). Deduction of prepaid interest, long considered a somewhat special case, is also now subject to severe limitations. *See* Rev. Rul. 68-643, 1968-2 Cum. Bull. 76. While Lillian Bacon Glasswell, 12 T.C. 232 (1949), *acquiesced in*, 1949-2 Cum. Bull. 2, and Estate of Aaron Lowenstein, 12 T.C. 694 (1949), *acquiesced in*, 1949-2 Cum. Bull. 2, permit deduction of taxes on current income even though paid prior to the time the taxes became due, these cases clearly rely on a lack of distortion in income. Indeed, they represent cases in which income is perfectly matched against the taxes imposed upon it. This liberality in timing income and expenses seriously weakens § 270 as well.

(b) The hobby farmers, who are engaged in activity which they refer to as farming but for whom the profit motive is not the inducing factor. This presents the question of subjective intent, which is usually litigated by the Internal Revenue Service. For excellent summaries of the hobby loss cases see 18 Section of Taxation, ABA, Annual Report, No. 4, at 275 (1965); 19, No. 4, at 149 (1966); 20, No. 4, at 143 (1967); 21, No. 4, at 768 (1968). This problem is not one unique to the field of agriculture, and legislation designed specifically for it should not be confined to agriculture. Any solution to the other farming problems should be applicable equally to hobby farming. Thus solutions of the farming problem need not be tailored to deal with the hobby problem.

(c) The statutory provisions, which allow farmers to deduct expense which all would concede to be capital. These are § 175 (soil and water conservation expenditures), § 180 (expenditures for fertilizer), and § 182 (expenditures for land clearing). The last section is limited to 25% of *taxable income*. Section 175 is limited to 25% of *gross income* from farming with an unlimited carryover. The charge is often made that § 175 permits the purchase of rundown farm land, which produces gross income but little or no net income, and the rebuilding of it by deductible expenditures. In many cases, the land is then alleged to be held for subdivision and not for farming purposes. This aspect is merely another facet of deducting capital expenditures and perhaps should not be placed in a separate category. It, however, is not as widespread as the problems discussed in text and is relegated to a footnote to concentrate the text on the two major aspects of the farm problem.

(d) The abuser of accelerated depreciation, who purchases animals at a very high price, claims accelerated depreciation on them, and sells well before the end of the depreciable life is reached. Since the animals will be treated as breeding animals and since there is no recapture of depreciation on livestock, the gain may be reported as capital gain. Solving this abuse would seem to be largely a matter of enforcing the present law. Depreciation below a realistic salvage value is not permitted. Salvage value must be established by reference to the expected useful life of animals to the taxpayer. This would seem to be an avenue unsuccessfully traveled by Hertz Corporation v. Commissioner, 364 U.S. 122 (1960). *See* Massey Motors, Inc. v. United States, 364 U.S. 92 (1960). This problem is also

losses arises largely in two areas: (1) the growing of trees, vines, and other plants having a relatively long life and producing annual crops, and (2) the raising of livestock. The purpose in both cases is the deduction of capital costs followed by sale at capital gain rates. There are differences in the two operations, but in each, the virtual impossibility of turning a tax profit is the same.

A. Development Costs of Plants

A number of crops, principally fruit and nuts, are produced by trees or vines only after a substantial development period.[28] The cost of planting them must be capitalized. Under the Treasury's regulations,[29] however, all of the costs thereafter incurred prior to the time that the plant is a commercial producer may be deducted currently. Since the planting costs are relatively insignificant,[30] the major portion of all costs incurred in the preoperation stage may be deducted and may create losses, which can offset ordinary income from other endeavors. When the commercial bearing state is reached, a wise taxpayer may sell out, and his gain will ordinarily be treated as capital gain because the property will be considered as property used in the trade or business. It should be noted that this results from the general language of Code section 1231(b)(1) and not from the special provision added for livestock in 1951.

For example, a taxpayer may purchase ten acres of land and plant it with orange trees. The cost of the land and planting may be assumed to be $12,000. The orange trees will not bear fruit until the seventh year, but during the development period, annual costs of perhaps $1,500 may be incurred for irrigation, cultivation, pruning, spraying, and other care of the trees. By the end of the sixth year, the taxpayer will have incurred "cultural practices expenditures"[31] of $9,000. These expenditures may be currently deducted against other income. To a taxpayer in the 70 percent bracket, the deductions

another facet of deducting capital expenditures. The difference is that the excessive deduction may be spread over a number of years rather than solely in the year when incurred. Again, this problem is also relegated to this footnote to avoid digression from the two major areas of abuse.

28 These crops include citrus, peaches, apricots, cherries, grapes, and nuts. There are undoubtedly others. The foregoing, however, indicates the widespread nature of the area in which these costs are incurred.

29 Treas. Reg. § 1.162-12 (1961).

30 In Robert L. Maple, 27 CCH Tax Ct. Mem. 943 (1968), the cost of raising orange trees to a stage when they could be planted in the grove was $2.75 per tree. Of this amount only $.42 was required to be capitalized. After planting in the grove, the trees may take from four to eight years to bear commercial quantities of fruit. Costs during that period are also deductible.

31 For use of this terminology see Estate of Richard R. Wilbur, 43 T.C. 322 (1965).

over the years will have reduced his taxes on other income by $6,300. If the grove is sold early in the seventh year at an economic profit of 10 percent, the taxpayer will realize $23,100. His basis, however, will be only $12,000, and he must pay a capital gains tax on the difference between his basis and the sales price, amounting to $2,775.[32]

The net economic profit is $2,100 [$23,100 sales price, less $21,000 of costs ($12,000 land and planting costs, plus $9,000 cultural practice expenditures)]. But the taxpayer also realizes an additional *tax profit.* The tax benefit from deduction of cultural practices expenditures was $6,300, and the tax cost of the sale was $2,775. The taxpayer thus has a *tax profit* (money paid to him by the Treasury's reducing taxes on other income) of $3,525. There is an overall profit of $5,625, consisting of an economic profit of $2,100 and a *tax profit* or subsidy of $3,525.

B. *Livestock*

Livestock also presents an opportunity to realize substantial tax profits from an economically profitable operation. Raising costs also qualify for current deduction.[33] If, however, the livestock are breeding,

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[32] In the year of sale, the taxpayer will report:

Proceeds of sale of § 1231 assets	$23,100
Basis	12,000
Gain	$11,100
Tax at 25% rate	$ 2,775

[33] Treas. Reg. § 1.162-12 (1961) permits farmers to deduct livestock raising costs and makes no reference to the taxpayer's method of accounting. Certainly the option to deduct these expenses is available to the cash basis taxpayer. As to accrual basis taxpayers who must use inventories, the answer is not so clear. The option is not available to a taxpayer who uses the unit livestock method because he must include raised livestock in his inventory even though held for draft, breeding, or dairy purposes. *See* Treas. Reg. § 1.471-6(f) (1964). This requirement was upheld in United States v. Catto, 348 U.S. 102 (1966). Taxpayers using other methods of inventory valuation are not required to include raised animals in inventory. This has led at least one author to argue that the option to expense raising costs is available to these taxpayers. *See* Hawkinson, *Farm Expenses and General Accounting,* 22 TAX L. REV. 237, 257 (1967). He adds that *United States v. Catto* throws doubt on this conclusion. Since *Catto* merely upheld longstanding regulations, it seems doubtful that it would support a requirement that all taxpayers, even though not specifically mentioned in the regulations, must inventory the cost of raising draft, breeding, and dairy animals. Thus it is likely that only the taxpayer using the unit livestock method must inventory these costs, and if they are inventoried, they are deducted unless capitalized. Whether these costs must be capitalized, if not inventoried, by the accrual basis taxpayer is not clear. Treas. Reg. § 1.61-4 (1963), dealing generally with reporting by cash and accrual basis farmers, might be argued to require capitalization of these costs by accrual basis farmers. Treas. Reg. § 1.61-4(b) (1963), applicable only to accrual basis farmers, states that draft, breeding, or dairy livestock "may be included in inventory . . . instead of being treated as capital assets subject to depreciation." This language may imply that livestock raising costs must be capitalized if not inventoried. The Internal Revenue Service seems never to have so construed this provision. Thus it seems likely, but not clear, that an accrual taxpayer using some method other than the unit livestock method may choose to deduct livestock raising costs, to include the costs in inventory, or to capitalize such costs. Presumably, once the farmer makes a choice, he must continue with that method.

draft, or dairy animals, they qualify for capital gain treatment if held for more than twelve months.[34]

Since "culls" from a breeding herd are characterized as breeding animals, they are also entitled to capital gain.[35] A large part of the farm product may fall into this category with the result that a very significant portion of the total receipts from the operation is reported as capital gain.

While many animals are classified as livestock,[36] cattle appear to offer the widest avenue to escape taxes. For example, a taxpayer may have a herd of ten cows. They have produced ten calves (average would be about eight and one-half or nine) for several years, one-half of which are bull calves. The cost of keeping an animal for a one-year period is $100, so that expenses for the ten cows are $1,000. The five bull calves are sold soon after birth for $40 each, and the proceeds are reported as ordinary income. The five heifers are retained for breeding purposes. The herd will therefore increase unless five of the cows are sold. If the taxpayer has been in business several years, he may have old cows or he may have young heifers of the prior years. In either event, he can cull five animals from his breeding herd and sell them at capital gain rates. Assume that the culls sell for a total of $900. Thus the economic profit for the year is $100, a 10 percent profit margin. If this is all that occurs and if we ignore the alternative tax, the taxpayer will report the following:

Proceeds from culls (reported as capital gain)	$ 900
Less § 1202 deduction (capital gains)	450
	450
Add proceeds from bull calves	200
Total adjusted gross farm income	$ 650
Farm expenses	1,000
Farm tax loss	$ 350

Since there is a crop each year, the same pattern may be repeated year after year.[37] In a properly operated breeding operation, a tax profit

34 INT. REV. CODE of 1954, § 1231(b)(3). Race horses qualify under the more general language of section 1231(b)(1) and need only be held more than six months.

35 The case law dealing with culls is extensive. *See* McDonald v. Commissioner, 214 F.2d 341 (2d Cir. 1954), *on remand*, 23 T.C. 1091 (1955), *acquiesced in*, 1956-1 CUM. BULL. 4. *See also* C.A. Smith's Estate, 23 T.C. 690 (1955), *acquiesced in*, 1956-1 CUM. BULL. 5.

36 Included as livestock are sheep, goats, dogs, foxes, minks, and other exotic little creatures such as chinchillas, Treas. Reg. § 1.1231-2(a) (1965). *See* William W. Greer, 17 T.C. 965 (1951), *acquiesced in*, 1951-1 CUM. BULL. 4. *See also*, U.S. TREASURY DEPARTMENT, FARMER'S TAX GUIDE 24 (ed. 1969).

37 An excellent illustration of the artificial losses and their effect on taxes on income from other sources may be found in a letter from the National Livestock Tax Committee to Chairman Wilbur Mills of the House Ways and Means Committee, Mar. 28, 1969, for

will never be reported. In addition, a taxpayer in the 50 percent bracket who has dividend income to absorb this $350 loss will be relieved of $175 in taxes on the dividend income. It is this benefit that is his negative income tax.

In these selected areas of agriculture, the problem of the "farm loss" is confronted in its most extreme. Quite clearly, the problem is neither one of hobby losses nor of the gentleman farmer, both of which have received extensive treatment. The problem is not so subtle. Rather it is one of combining the deduction of capital costs with capital gain on sale. Even though the activity produces an economic profit, there is almost no prospect that it will produce a profit for tax purposes because a profit is not reported for tax purposes until the economic profit is as great as cost. The results are (a) a deferral of taxes, (b) an exemption of profits from tax, and (c) a negative income tax.

These results are irrational in a system designed to impose a tax on profits. Congress is not likely to have intended them. But neither the irrationality nor the lack of design assure its removal, a matter to which we now turn.

V. The Ideal Solution—Accrual Accounting and Full Cost Capitalization

The farm loss problem has received much attention in recent years, and a number of solutions have been proposed.[38] In this author's view

inclusion in the hearings record of the recent tax reform hearings before the Committee. House Comm. on Ways and Means, Tax Reform, 1969, 91st Cong., 1st Sess. 2056, 2059-60 (1969) [hereinafter cited as Tax Reform 1969]. *See also* Pitcairn & Chandler, *Tax Advantages of Cattle Operations*, 1 P-H Tax Ideas ¶ 17,013, (1968).

[38] In addition to solutions discussed in text see, *e.g.*, Sweeney, *The Farm Loss Deduction*, 53 A.B.A.J. 447 (1967), which advocated amending § 165 to disallow a farm loss unless there was a reasonable expectation of profit, and five consecutive loss years would have been considered as proof that the expectation was not reasonable in absence of clear and convincing evidence. This solution is technically deficient since there is no statutory definition of a farm "loss," and the "loss" arises usually because § 162 deductions (not § 165) exceed ordinary income. It is premised also on the belief that the farm loss problem may be one of "hobby losses." The suggestion is properly rejected in a reply article. Dickinson, *The Farm Loss Deduction: A Reply*, 53 A.B.A.J. 1111 (1967). *See also* Hjorth, *Cattle Congress and the Code—The Dangers of Tax Incentives*, 1968 Wis. L. Rev. 644, 670, in which the author proposes a § 1245 recapture and denial of § 1231 treatment in absence of a failure to capitalize growing costs. This is a good proposal but does not reach citrus groves, although it could be so broadened. It, however, does raise the accounting problems discussed in text. *See also* Tax Reform 1969, at 2056 (letter from the National Livestock Tax Committee), which suggests a § 1245 recapture and lengthening of lives for an asset to qualify under § 1231. As is demonstrated in attachments to this letter suggesting this approach, considerable tax subsidy remains. Thus this proposal must be adjudged largely ineffective.

See also S. 1560, 91st Cong., 1st Sess. (1969), introduced by Senator Miller. This bill would limit farm deductions of nonfarmers to farm income except in the case of an individual whose principal residence is on a farm. In such case, the limit on farm deduc-

only three present even feasible approaches. One goes directly to the problem and recommends accrual accounting and full cost capitalization. It may be the ideal solution. The other two appear to have as their purpose an elimination or reduction of the negative tax on total farm profits while not entirely doing away with cash accounting or capital gain, at least for "real" farmers.

The accrual accounting and full cost capitalization suggestion has much appeal and has been discussed at length,[39] but a few further words may be in order here. Its rationale is that the farm problem arises from the overly simplified accounting rules, and the solution would be outright revocation of the authority for farmers to deduct raising and development costs. In the primary areas of abuse, this solution would require that livestock raising costs either be "inventoried" or "capitalized" (interchangeable terms for our purposes). For growing plants, the dispensation to expense cultural practices expenditures would be revoked. They would be capitalized, as apparently would have been required if the matter had been left to case law.[40] While this suggestion appears to be the proper tax treatment, there are at least two barriers to its adoption. The first is a practical one; the other is a political one. While the first undoubtedly could be reduced to nonobjectionable levels, there is great doubt that the second can be overcome.

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tions would be the total of (a) farm income, (b) wages and salaries, (c) timber income, and (d) royalties derived from property. A farmer would be entitled to claim all his deductions. A farmer is defined as a taxpayer whose net income from farming for the three preceding years equals two-thirds of the total net income for these years. For this purpose net farm income includes the full amount of gain on the sale or exchange of assets. Total income, however, excludes all those gains except those incurred on farm assets. Certain deductions are not disallowed even though attributable to the farm. They are deductions arising from (a) general casualty and weather conditions, (b) experimental farming, and (c) egg or broiler operations. Also, farms (a) acquired from decedents, (b) acquired by foreclosure, or (c) operated by an estate are excepted for limited periods. Provisions are made to consolidate sole proprietorships with partnerships and Subchapter S farm income and losses.

S. 1560 has many weaknesses. First, it raises difficult definitional problems. What is a principal residence? What is a farm on which the principal residence must be located? This differs radically from the problem of defining farm income and expense—a feature common to many proposals. Second, a farmer may continue to offset nonfarm income, *e.g.*, wages, by farm losses. Additionally, a nonfarmer may do so if he lives on a farm. There would appear to be no policy supporting this exception. Third, the sponsor concedes the definition of "net farm income" and "total income" are designed to prevent, at least to some extent, application of the Bill to livestock—probably the worst abuse. Fourth, the definition of a farmer depends on a new concept of farm income that is not the same as that set out for filing of a declaration of estimate tax. Thus a new category of farmers would be created. Fifth, this approach is not directed toward either of the causes of the problem, *i.e.* capital gain and simplified accounting rules. Its effect would thus be difficult to predict.

As to some other approaches, some redefinition of assets qualifying for § 1231 might also be attempted. This does not appear fruitful so long as their costs can be fully deducted.

[39] *See* Hawkinson, *supra* note 33.

[40] *See* cases cited note 6 *supra*.

Although the greatest abuses of the present scheme rarely arise in very diversified operations, the farmer engaged in multiple farming endeavors is always cited to illustrate the practical problem. For example, a farmer may be engaged in growing grain crops and livestock. Some of the grain may be fed to his livestock and some may be sold. Labor will be divided between these activities, and accurate separation of labor and other costs as between the various operations may be difficult. The allocation of costs between products on hand and products sold raises another accounting problem. These allocation problems suggest that a shortcut method of tracing costs must be devised if farming operations are not required to adopt cost accounting procedures,[41] which are sometimes claimed to be too sophisticated for the so-called family farm.

While inventories using some simplified valuation technique may fill the gap left by cost accounting,[42] their use is not a path without some obstacles. First, the products must be counted, and then they must be valued. Each process presents some problem.

Counting of the product on hand must occur at the end of the year. Since most tax years end on December 31, a livestock raiser might be forced into winter's blizzards to obtain a count of cattle. Substantial numbers of calves may also be in gestation at that time. These and other special problems might be overcome by delaying inventory until roundup time, assuming this time was approximately the same each year, but administration of this lenience could impose a burden on the Commissioner, who would have to decide in each case whether the special dispensation would be available. Another alternative might be the use of a fiscal year that would end at a time when the difficulties mentioned would be least present.

While these practices would permit the counting of animals, the measurement of grain crops and other feed such as hay might not be susceptible of more than a fair estimate without expensive measuring

41 Full cost accounting is used by some farmers for financial reporting purposes even though not for tax purposes. Lenders may also require that financial statements be prepared on at least a modified accrual basis. Thus techniques are available and in use. If, as suggested later in the text, more simplified inventory methods are developed, one might question whether they should be available to taxpayers who now employ better procedures for nontax purposes while reporting taxable income on the special farm accounting rules. Yet denial of these simplified methods could create a competitive edge that does not now exist.

42 Under Treas. Reg. § 1.471-8 (1958), taxpayers engaged in selling at retail may establish an inventory by reducing selling prices in accordance with an established formula to reach approximate costs. While agricultural products normally would not have standard markups, a similar procedure might be used by reducing market value by a reasonable profit margin.

and movement while in storage. Assuming that this burden would not be imposed, a reasonably accurate estimate is better than no count at all.

Although these and other techniques structured to ease the counting problems would grant a taxpayer some latitude and perhaps stretch his conscience, they seem to offer permissible, reasonable approximations, and they would reduce the counting problem to manageable proportions. They also appear likely to reflect income more accurately than the present accounting rules do.

Once the product is counted, its valuation remains, and the inventory method must be selected. At present, four methods are authorized: (a) cost; (b) lower of cost or market; (c) the farm price method; and (d) for livestock, the unit livestock method. Each has at least one feature suggesting either that the method is not feasible or that the method must be modified.

The use of cost suffers from the allocation difficulties just mentioned—the accounting art perhaps has not been sufficiently perfected to permit its use without excessive cost. Rejection of cost also leads to a rejection of cost or market, whichever is lower. If cost cannot feasibly be ascertained, certainly no determination of whether cost or market value is lower can be made. The alternative might be the use of market value. This method has never been acceptable, but its use might be considered. The major criticism of it would be the recognition of potential profit before realization by sale in those cases in which market exceeds cost.[43]

The farm price method is similar to market valuation. It values the product at current selling prices but permits the estimated direct cost of disposition to be deducted from the value. This method also suffers from the criticism that it would force a recognition of profit before realization.

We come then to the unit livestock method, which is, of course, not applicable to grain crops. It requires a classification of livestock by age and kind with a standard valuation, based on approximate costs when the inventory was first established, being given each unit. This unit value may not, however, be changed from year to year.[44] Thus it has some of the characteristics of the LIFO method but is more closely aligned to the base price method, a wholly impermissible

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43 One might also consider the constitutional implications of forcing recognition of profit before there is a realization. *See, e.g.*, Eisner v. Macomber, 252 U.S. 189 (1920).

44 Treas. Reg. § 1.471-6(f) (1958).

method of accounting.[45] It fails to recognize price increases and thus permits a premature deduction of costs when costs are rising.[46]

While the use of inventories does offer a means of estimating costs, each of the methods now in use carries with it at least one infirmity, which suggests that new methods or adaptation of old ones should be considered when applied to farming. Ideally, a method akin to the present retail price method might solve most of the problems by permitting valuation at current market less a reasonable profit margin, so as to prevent the premature recognition of income that now occurs under the farm price method.

But even adaptation of inventory methods would not prevent a number of transitional problems. Costs written off in earlier years might become a part of the opening inventory and become an adjustment for the purposes of section 481, which prescribes rules for handling accounting problems arising out of a change of method. In some cases these adjustments would convert what is capital gain when sold under present law to ordinary income when placed in opening inventory in the year of change. While other problems could also arise, they should soon disappear as all existing operations shifted to proper accounting and as new enterprises commenced business using proper methods. The practical problems thus could be overcome.

This brings us to the political problem. While there may be considerable sentiment in Congress to deal with the farm problem,[47] it does not seem to be premised on the belief that the cash method should be eliminated for farmers. Indeed, the very foundation of the present bills is to preserve the cash method for "farmers" while dealing with the abuses arising from its use by nonfarmers. This political problem appears insuperable at the moment.

In concluding this discussion, the denial of cash accounting and full capitalization of costs would eliminate a large part of the farm loss problem, *i.e.*, the deferral of taxes resulting from premature deduction, the complete exemption of farm profits from tax, and the negative income tax. While arguably ideal,[48] this solution does raise the

45 Treas. Reg. § 1.471-2(f)(4) (1958). "LIFO" is a shorthand designation for the Last-In-First-Out method of inventory valuation.

46 Senator Jack Miller of Iowa realizes that unit livestock valuations are unrealistic and would not close off the farm loss problem in the livestock area. TAX REFORM 1969, at 2001, 2003 (statement of Senator Miller).

47 *See* S. 1560, 91st Cong., 1st Sess. (1969); S. 500, 91st Cong., 1st Sess. (1969); H.R. 5250, 91st Cong., 1st Sess. (1969); H.R. 4257, 91st Cong., 1st Sess. (1969).

48 Even ideal solutions may not entirely handle the problem. Under a system requiring that all costs be capitalized, there would remain a problem of reporting gain on some assets as capital gain, even though the assets are held for sale to customers in the ordinary

previously discussed technical and practical problems. The problems are not sufficiently grave as to cast doubt on the correctness of this approach. Their superficial complexity lends support to the conclusion that whatever the Congressional mood, it is not to prescribe theoretically correct accounting rules applicable for all farmers. We turn, therefore, to other solutions.

VI. OTHER SOLUTIONS

Since elimination of the farmer's cash accounting may engender political opposition from quarters now espousing some change in the farm tax rules, those desiring improvement must move on to consider other approaches. Two are now pending before Congress. One is a modified version of the excess deductions account proposed by President Kennedy in 1963.[49] The other is now embodied in a bill authored by Senator Metcalf of Montana.[50] The excess deductions account may be described as a recapture proposal[51] while Senator Metcalf's Bill is a disallowance proposal.

A. Recapture

This discussion begins with the Treasury's proposals to Congress on April 21, 1969.[52] It consisted of an excess deductions account re-

course of business. For example, breeding livestock produce a crop each year. Some part of the crop may be retained for breeding purposes, and some part, usually the vast majority of it, will be sold in the ordinary course of business. At the birth of the animal, a taxpayer does not know into which category particular animals fall, and the purpose for which they are held is ambiguous. This ambiguity is resolved under present law by requiring that each animal be held at least twelve months for long-term capital gain treatment to be allowed. That period is unsatisfactory because the ambiguity of purpose is generally not resolved during the twelve months. Similarly, questions could arise concerning the cost of maintaining female animals during the period of gestation. These costs would seem to be capital costs of the young animals. But if the mother also had some other utility such as use as a dairy cow, the taxpayers would likely argue that the costs were deductible as costs of producing milk.

49 1963 TAX MESSAGE 144. The newer version was presented in TAX REFORM 1969, at 5047 (the President's 1969 Tax Message).

50 S. 500, 91st Cong., 1st Sess. (1969). Its genesis was S. 2613, 90th Cong., 1st Sess. (1967). The 1967 Bill was revised in accordance with a Treasury report on S. 2613, 114 CONG. REC. 8782 (daily ed. July 17, 1968), and reintroduced, S. 4059, 90th Cong., 2d Sess. (1968). It was further revised before introduction in 1969.

51 The theory undoubtedly is the same as that embodied in two other statutory recaptures, § 1245 and § 1250. There have been excessive deductions against ordinary income. When income is realized, it should be treated as the excessive deductions and taxed at ordinary income rates. This notion of merging two transactions is familiar to the case law. *Compare* Arrowsmith v. Commissioner, 344 U.S. 6 (1952), *with* William L. Mitchell, 52 T.C. No. 21 (Apr. 30, 1969). *See also* United States v. Skelly Oil Co., 394 U.S. 678 (1969).

52 The House Committee on Ways and Means tentatively adopted the excess deductions account in roughly the form described in text. *See* HOUSE COMM. ON WAYS AND MEANS, PRESS RELEASE ANNOUNCING TENTATIVE DECISION ON TAX REFORM SUBJECTS BY CHAIRMAN MILLS (May 27, 1969). Changes from the Treasury's proposals are for present purposes unimportant. The House also incorporated a version of it in H.R. 13270, 91st

ferred to as an EDA. In the case of corporations, any excess of ordinary farm deductions over ordinary farm income would be required to be entered into the EDA. All other taxpayers would add this excess only to the extent that it exceeded $5,000. The amount in the EDA is reduced in any subsequent year[53] by any net farm income in the subsequent year. The $5,000 floor has the purpose of exempting the small "legitimate" farmer from the operation of the EDA.[54] Apparently, it is not granted for a corporation in order to preclude a taxpayer separating his farming operation into several Subchapter S corporations and securing the benefit of several floors on the EDA.

Gain on the disposition of farm property that may now be reported as capital gain would be reported as ordinary income to the extent of any amount in the EDA, computed at the year's end after giving effect to operations for the year.[55] The amount in the account would be reduced by the amount of capital gain converted to ordinary income. Increases in land values would be exempted from this conversion of capital gain to ordinary income except to the extent there had been prior deduction of clear capital expenditures such as soil and water conservation expenses, fertilizer costs, and land clearing costs, under sections 175, 180, and 182, with respect to the parcel sold. No amount of farm loss is disallowed, and a taxpayer using a full cost absorption inventory method of accounting and capitalizing capital expenditures would not be required to keep the EDA.[56]

Cong., 1st Sess. (1969). The Treasury Department presented yet a third model when Assistant Secretary Cohen testified before the Senate Finance Committee on September 4, 1969. *See Hearings on Tax Reform Act of 1969 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess. 39-42 (interim manuscript) (statement of Edwin S. Cohen on Sept. 4, 1969). This House version is discussed later in the text. There were also other parts to the Treasury farm proposals including a § 1245 recapture of excessive depreciation on livestock, an extension of lives for draft, breeding, and dairy animals and race horses to qualify under § 1231(b) and vast and complex changes to § 270. These appear mainly to have been designed to sew up the loose edges left after application of the excess deductions account. The need for these other provisions is discussed along with the proposals. TAX REFORM 1969, at 5414.

[53] One difficulty with this approach arises when considerable farm income is realized before there is a loss. If the income followed the loss, it would reduce the amount in the EDA but apparently not if it precedes the loss, unless there is to be a negative EDA. As a result, timing of income will have a substantial impact.

[54] TAX REFORM 1969, at 5495 (statement of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy).

[55] TAX REFORM 1969, at 5178. As discussed later in the text, the gain mentioned by the Treasury's Technical Explanation probably includes the excess of fair market value over basis if the disposition is one that is not taxable under present law. If not, there is substantial room for avoidance by transferring § 1231 property to a related taxpayer who would have no EDA. As finally adopted by the House in H.R. 13270, 91st Cong., 1st Sess. (1969), the rules for transfers are complex. They do not close the possibility of tax avoidance through transfers but may represent a reasonable approach to a difficult problem inherent in the recapture concept.

[56] Under the tentative decision of the Committee on Ways and Means, gain on

As already noted, the current proposal is similar to one proposed in 1963, but there are several differences. Under the 1963 EDA, additions to the account would be made only in years in which the taxpayer's nonfarm income exceeded $15,000. The purpose of this feature appears to be the same as the $5,000 floor in the current proposal. The 1963 proposal, however, focused more sharply on the use of farm losses to reduce taxes on nonfarm income. The 1963 proposal defined a farmer as one not having nonfarm income in excess of $15,000. The present proposal defines the farmer as one not having losses greater than $5,000. Both concede the propriety of deducting livestock losses against other farm income such as grain crops without penalty.

The 1963 recommendation also excluded certain expenses in computing the excess of income over deductions. These excluded expenses were taxes and interest and losses and expenses from casualties and drought. It did not, however, contain an exception for gains due to increases in land values.

The theory underlying the excess deductions account must be that the economic reality of the farm tax loss may not be determined when the loss is incurred. Since it may be an economic loss, it should be fully allowable against other income. The loss, however, arises in an industry in which the accounting rules and definition of capital assets are so loose that later capital gain must be presumed to have been created by the loss. Since the loss was an ordinary income deduction, the gain must be treated as ordinary income. Thus the EDA attacks the problem of converting ordinary income to capital gain. It does not, however, question the validity of the loss that permits an improper deferral of taxes if the loss is not an economic loss.

B. S. 500, Senator Metcalf's Bill

The initial analysis of the farm loss problem demonstrated that even the generous farm tax rules could not do more than exempt farm profits from tax, if the farmer had no outside income. This Bill apparently attempts to reach somewhat the same result by treating taxpayers having large nonfarm income as if their farm operations were carried on apart from their other activities. By eliminating or at least reducing the spillover of artificial "farm losses" against income pro-

buildings would be excepted. Gain on farm land would be subject to recapture only to the extent of § 175 and § 182 expenses (soil and water conservation expenses and land clearing expenses that would be capitalized absent these provisions but not including § 180 fertilizer costs, which would also be capitalized absent § 180) incurred within five years before the sale with respect to the property sold. *See* PRESS RELEASE BY CHAIRMAN MILLS, *supra* note 52.

duced by other activity, farmers having large nonfarm income would be brought nearly to a parity with farmers who do not have substantial nonfarm income.

On the other hand, tax losses resulting from true economic losses from farming are not to be treated less favorably than losses sustained in nonfarming businesses. An economic loss can be determined by proper accounting, and the limitations of the Bill would not apply if the taxpayer elected to forego the special farm accounting rules. Instead, if accounting rules applicable to business generally—and to farming itself apart from taxation—were adopted to insure that tax losses were real and not simply the result of accounting distortions, a taxpayer would be excepted from the Bill. To fall under the alternative, a taxpayer would have to elect to use inventories when they were a significant factor and also elect to capitalize all capital expenditures, including development costs incurred prior to the time when the productive stage is reached in farm operations.

Absent the election, a taxpayer could not deduct in any one year more than $15,000 of a farm loss against income from sources other than farming, and even the first $15,000 of deductible loss is decreased by one dollar for each dollar of nonfarm adjusted gross income in excess of $15,000. Thus at $30,000 of nonfarm adjusted gross income, no farm loss would be allowed. Apparently, the first $15,000 of loss is allowed to prevent application of the Bill to farmers who may have to supplement their income with part-time employment or with employment during the off season. The Bill assumes that if a taxpayer has no more than $15,000 of nonfarm income, he is the type of farmer for whom the special accounting rules were devised. As his nonfarm income progresses upward from this figure, he becomes less like such a farmer with each dollar of nonfarm income, until his income reaches $30,000 at which time he must choose between proper accounting and use of farm losses against other income.

A farm loss would be defined generally as the difference between the total of a taxpayer's farm expenses and his farm income. Farm income would include only the one-half of farm capital gains that is included in adjusted gross income. It could also include the income of an operation related to and conducted on an integrated basis with the farm operation. If the difference between expenses and income is more than $15,000, only the first $15,000 of the loss could be deducted. The disallowed portion would first be reduced by the excluded one-half of farm capital gains. Thereafter any balance could be carried forward

and backward as a deduction against net farm income of other years (including the taxable one-half of capital gains) to avoid imposing hardships when the taxpayer incurs a large isolated loss in one year.

Certain deductions are excluded from the farm loss computation. The result is that they are thereby allowed even though the loss may exceed the $15,000 limit. These deductions are (1) taxes and interest, (2) casualty, drought, and abandonment losses and expenses, and (3) losses on the sale of "farm assets,"[57] which as defined in the Bill includes any property used in the trade or business of farming under section 1231(b)(1), (3), or (4). The first category consists of items generally deductible whether or not they are attributable to the carrying on of a trade or business. The second consists of items not in the taxpayer's control, and disallowance of them might create an undue hardship to the taxpayer. Notably, these same expenses and losses are excluded from the operation of present section 270. The third category is losses incurred on the sale or other disposition of section 1231 assets or property used in the farming business. These losses generally represent real economic losses and not artificial "tax losses" created by the special farm tax accounting rules. It must be noted that the unlimited deduction of all the above items would be in lieu of the $15,000 limitation.

When the farming activity is carried on by a partnership or a Subchapter S corporation, the farm nature of the income and expense would be carried over to the individual partners or shareholders who would aggregate the income and expense with all of their other farm operations. The $15,000 limitation would then apply to any loss computed on this individual aggregate basis unless each of the entities from which the individual derived farm income or deductions had made the election described above.

The obvious design of this Bill is to treat farming as a special industry and confine the tax benefits of the farm tax rules to farm income. It is apparently premised on the notion that the farm accounting rules are so generous that farming is a special business, which should be isolated. The effect is to build a wall around farming and to allow all of the special rules to apply only within the walled territory. Only by foreswearing the special accounting rules and electing to apply nor-

[57] At the hearings on the farm loss problem, Representative Byrnes expressed concern about the effect of the Bill on a feed lot operation when there was a sudden drop in price. TAX REFORM 1969, at 2149. If the category of assets were expanded to include ordinary income assets, the change would handle the situation by allowing the loss. Another answer may be that feeder operations may not be farming. Moody-Warren Commercial Co., 29 B.T.A. 887 (1934).

mal accounting can a taxpayer destroy the wall insulating the tax aspects of his farm from his other income. This general theory is breached somewhat in allowing some loss, the first $15,000 if other adjusted gross income does not exceed $15,000, to be deducted. This allowance, however, arises only in an effort to define a farmer, and thus its benefits are limited to farmers.

By isolating farm income, the Bill is designed to preserve the capital gain treatment accorded farm assets and the farm accounting rules, while limiting their effect to farm income. It proceeds on the assumption that the use of the farm loss against other income is the practice to be curbed.

The question to which we now turn is whether this isolation is preferable to the continued allowance of losses but conversion of some capital gain to ordinary income as occurs under a recapture proposal such as the EDA.

VII. Evaluation of the EDA and the Metcalf Bill

The theoretical underpinnings of the EDA and the loss disallowance proposals are quite different. The first apparently concedes the propriety of the loss and argues that the resulting creation of capital gain is improper. The second proceeds from a belief that the abuse lies in the current use of the farm loss against other income but sanctifies capital gain treatment of certain assets. The question of which is better might be answered on just these theoretical distinctions. More appropriately, one may inquire into the practical differences in operation. This is done below first by analyzing the general theory of each and then by taking account of the special wrinkles each offers in its published form.

A. The Recurring Loss

Assume a hypothetical case, with a consistent pattern year to year, in which the net operating costs[58] each year of $100 produce animals that may be sold at $110. Since the animals do not qualify for capital gain treatment until they have been held more than twelve months, there are no sales the first year even though the cost is incurred. Thus costs in the first year of operations are $100, and the product would,

58 In this context, we may assume that a part of each animal crop is sold and reported as ordinary income but that the proceeds of such sales are $100 less than the costs of the entire farm operation. In the following year, culls from the prior year's crop will be sold at $110.

under present law, become $110 of capital gains on sale in the second year.

The EDA would permit the $100 "loss" in the first year to be deducted against income from other activities. To a taxpayer having an effective marginal tax rate of 60 percent, the loss produces a tax savings of $60 on other income. These foregone taxes become an interest-free loan, which is not repaid for a substantial period. The loss, however, is added to the EDA, which is $100 when the second year starts. The second years also results in net costs of $100, which will produce a $110 gain in the third year. The loss of $100 in the second year is added to the EDA, and at year's end, it stands at $200. As a consequence, the entire sales proceeds of $110 in that year are converted to ordinary income, giving a net ordinary income of $10 when combined with the $100 "loss." The full amount of the sales proceeds would be subtracted from the EDA. The balance in the EDA is then only $90. This balance is increased by the third year costs of $100, and the account totals $190 at that year's end. In the third year, the entire sales proceeds of $110 are converted to ordinary income, and the same amount is subtracted from the excess deductions account. The amount in the EDA to be carried to the fourth year is then reduced to $80. The pattern is repeated until at the end of the eleventh year, the amount in the EDA account would be reduced to zero. Thereafter, the taxpayer would report a $100 loss each year, which would convert $100 of the sales proceeds into ordinary income, resulting in neither ordinary income nor loss. The additional sales proceeds of $10 would be reported as capital gain.

From this a rule may be derived—assuming an operation consistently producing the same amount of costs and sales proceeds. The rule is that the tax-free loan produced by the first year loss will be repaid in equal annual installments over a number of years, which is derived by dividing the profit margin into one. Thus, if the profit margin is only 2 percent, the period of the loan is 50 years; if 4 percent, the period is 25 years; if 10 percent, the period is 10 years.

In comparison, the Metcalf Bill would not allow any loss in the first year, but the taxpayer would have a farm loss carryover of $100 to be used against farm income of the second year. Under that Bill, the farm income of the second year would be only $55 (the taxed portion of the capital gain of $110), and the loss of the second year would entirely absorb this income. The excluded one-half of the capital gain, however, would absorb the balance of the second year's loss as well as

$10 of the carryover. The carryover to the third year would be only $90; to the fourth year, $80. By the end of the eleventh year, the carryover would have disappeared, but no tax liability would have been incurred in any of the years. Nor would operations thereafter incur any tax liability because the taxable one-half of capital gain would always be less than the deductions available to offset it. The carryover would disappear, and if the operation were terminated in the thirteenth year, there would be a capital gains tax on the full sales proceeds.

Again, a rule may be derived. The farm loss carryover disappears at the same time that the taxpayer has repaid the tax-free loan under the EDA. Even after the carryover disappears no amount of tax will be paid unless sales proceeds are more than twice costs. This is the very nature of capital gain income. But no loss has offset any income earned outside the farming operation.

The foregoing analysis assumes that the farming operation commences after the EDA or the Metcalf Bill is enacted into law. Their effect on existing operations would differ slightly. Under the EDA, sales in the year of enactment would be denied capital gains to the extent of current excess deductions. There would be no deferral of taxes on current expenses. But prior years' expenses would continue to be deferred, and assuming no change in operations, prior years' deferral would not be recaptured at capital gain rates until the operation terminated. If the operation were diminishing, the deferral of prior years' expenses would be returned at capital gain rates each year in an amount in proportion to the diminution. A diminishing operation, therefore, is just a termination occurring over a number of years. If the operation were expanded, however, the expenses of the expansion in that year would shelter an equal amount of outside income and permit the tax to be deferred on the sheltered income in the described pattern.

The ability to increase the amount on which taxes have been deferred merely by increasing the size of the operation may be the weakest point in the EDA. When this potential is combined with the continuance of special accounting rules, the estate planning possibilities begin to be apparent. Since losses are fully deductible with no penalty prior to transfer, the EDA will encourage the shifting and prepaying of expenses of the expanding operation with a minimum of sales. If this can be continued a sufficient number of years, the taxpayer may leave a very bountiful estate to his bereaved, and they will take it at a new basis without any excess deductions account.

Under Senator Metcalf's Bill, prior years' expenses are in essence merely forgotten. The chances are that they will never have any effect on future tax liability and, in distinction to the EDA, will never be recaptured at all. There is, however, no loss deduction against other income and hence no potential for an increasing deferral. Similarly, the Bill is neutral on decreasing operations. The Bill should not present an incentive either for expansion or for diminution of operations.

B. The One-Time Development Loss

Having analyzed an operation having a recurring pattern, we should now turn to an operation such as a citrus grove in which losses resulting from development costs are reported for a substantial period before sale at capital gains rates occurs. For example, assume that an orchard has a cost of $100 and a four year development period, during which the deductible expenses are $100 each year. At the start of the fifth year the grove is sold for an economic profit of $200 or at a $700 sales price.

Under the EDA, the annual loss of $100 could offset otherwise fully taxable income each year. A cumulative total of $400 in losses would be reported, and on the sale, $400 of ordinary income and $200 of capital gain would be realized. The result may be argued to be very close to a forced capitalization of costs except for the deferral of taxes on current income. If the ordinary income in the year of sale is viewed to just equalize the prior deductions, the EDA reaches the result on sale that would flow from proper capitalization of costs. But in the meantime, the cost has been currently deducted against other income with a consequent deferral of taxes on that other income.

Under Senator Metcalf's Bill, no losses would be allowed, but the $400 carryover would insulate the entire $600 gain from tax because it would exceed the one-half of the gain reported for tax purposes. There would then be a complete exemption of the gain from tax. Indeed, the farm loss carryover could exempt from tax another $200 of farm capital gain or $100 of ordinary farm income. This result follows from the language of the Bill in its present form, but as will be noted later, the Bill could be strengthened to avoid this result by causing the farm loss to be absorbed against the untaxed as well as the taxed portion of capital gains.

The immediate reaction to the foregoing is that the EDA is greatly superior to the Metcalf Bill because the latter continues to permit sub-

stantial income to be untaxed. This ready answer may not, however, withstand analysis and some effort to quantify the benefit of the deferral of taxes granted by the EDA. We turn now to that task.

If EDA is applied to the above example, a taxpayer in the 60 percent bracket would realize a tax savings of $60 in each of the four years in which $100 of costs were incurred. If his rate is the same in the year of sale, the only effect is to loan the taxpayer $60 for four years, an additional $60 for three years, an additional $60 for two years, and finally an additional $60 for one year. In the fifth year when the grove is sold, these loans are repaid by converting $400 of the gain to ordinary income. In addition, the taxpayer would pay a capital gains tax on the economic profit. If a taxpayer could borrow at rate of 7.5 percent[59] per annum, these loans would have had a value of $36 (that is, a savings in interest expense if the funds were borrowed) to the taxpayer. The capital gains tax he would incur would be $50. Therefore, there is a net tax detriment of $14 to the taxpayer. If either the interest rate or the period of deferral are increased, however, the odds in favor of the taxpayer increase. For example, if the borrowing rate is 10 percent, there is a virtual standoff, or if the development period is extended two years, the taxpayer's interest-free loan more than exceeds the value of the capital gains tax. On the other hand, if the profit margin is greater, the taxpayer will pay a greater tax.

This analysis suggests that the ability to defer taxes, which must ultimately be paid, even at ordinary rates, can be just as valuable as complete exemption from tax, particularly capital gains tax. The conclusion as to the efficacy of the EDA as compared to the Metcalf Bill then depends on a number of factors that may vary from taxpayer to taxpayer, from year to year, and from farm to farm. We shall return to this question later.

C. Lock In v. Force Out

The preceding discussion raises one other difference in the approaches; one would conclude that under the EDA the longer the period of deferral, the bigger the reward to the taxpayer. Since the deferral period exists until there are sales, the EDA might be said to discourage sales and thereby to "lock an investor in" to his farm investment. On the other hand, Mr. Metcalf grants a carryover, which

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59 Some might argue that the evil is the foregone revenue to the Government and that to measure the Bill's effectiveness from the Government's viewpoint, its borrowing rate should be used. While the choice may not be clear, the value to the taxpayer is our concern here, and that is at his borrowing rate.

expires at the end of five years. If his Bill is to be utilized to its optimum, the taxpayer must sell sufficiently often to absorb the carryover. The Bill then may be argued to "force out" a taxpayer at least once every six years.

An argument can be made that this difference would not exist in practice because lengthy deferral under the EDA could lead to a serious bunching of income. Bunching would present a problem by raising the marginal tax rate in a year of sale sufficiently to eliminate the deferral benefit. Thus the argument runs that bunching would tend to force sales to smooth out the income pattern. To the extent the realization pattern has large bulges, they may be somewhat ameliorated by the averaging provisions of the Code.[60] Certainly, this is no time or place to delve into the mysteries of averaging, but if it operates perfectly, it can tend to cause a realization of income at least once every five years to gain the full benefit of averaging. The bunching and the spread out obtained under averaging may be argued to undo the "lock in" effect and create its own "force out."[61] But all of this assumes that the increase in tax rates resulting from the bulge in income cannot be handled in any other way and also that the benefit of averaging is substantially reduced by exceeding the five year period. There is doubt that either of these assumptions would be true in the majority of cases. There would then be little reason to bring the deferral period to an end.

D. *The Preferred Status of Other Farm Income*

Both approaches grant a preferred status to ordinary farm income. While farm losses may be currently used to shelter any other income under the EDA, a farm loss may ultimately result in farm capital gain being converted to ordinary income. If the farm loss in one endeavor can be used against other ordinary farm income, there will be no EDA to convert later farm capital gains into ordinary income. For example, if other farm income can be found to equal excess livestock deductions, full capital gain treatment will be preserved on the livestock sales.

The Metcalf Bill might give an even greater impetus to diversify farm operations because the farm loss cannot be used against any other

[60] INT. REV. CODE of 1954, §§ 1301-04.

[61] On this analysis, a four-year development followed by sale in the fifth year would achieve the greatest tax savings, all other factors remaining the same. There would be four years of deferral, but income would be spread over five years. As suggested in the text, however, the benefits of averaging may not be significantly reduced by running beyond the five-year averaging period.

income. It therefore has no value whatsoever unless there is other farm income, while the EDA still permits use of the loss against other income. If a taxpayer could produce other ordinary farm income equal to livestock deductions, the livestock deductions could entirely exempt this other farm income from tax under the Metcalf Bill while the livestock gain would be subjected only to capital gain rates.

E. A Quirk in the Metcalf Bill

One further aspect of ordinary farm income under the Metcalf Bill should be noted. If we return to a simple case in which $100 of costs in the first year produces $110 of capital gain in the following year, the carryover rules have a strange effect. After deducting one-half of the capital gain in the second year, the farm income is $55. Under the Bill, the farm loss carryover of $100 from the first year would, in the second year, shelter an additional $45 of ordinary farm income from tax.

If the sales of livestock had been spread over the two years, the results would differ, however. If the taxpayer had realized $20 of ordinary farm income and $80 of livestock capital gains in the first year, the farm income would have been $60 ($20 of ordinary income plus $40, the included one-half of the livestock capital gains), and none of it would have been taxable because the farm loss of $100 would offset the farm income. There would be no farm loss carryover to the second year, however, because the farm loss ($40, which results from $100 of costs reduced by $60 of farm income) available for a carryover would be reduced by the one-half of the livestock capital gains deducted under section 1202. This amount is just equal to the farm loss, and there would be no carryover. The capital gains in the second year would be $30 ($110 less the $80 of sales in the first year), which would be reduced to $15 of taxable income by the section 1202 deduction. There would not be any farm loss carryover to reduce the taxable income further. The result is that the farm loss would have offset only the $20 of ordinary income realized in the first year and none of the capital gain or ordinary income in the second year. The explanation for this result is that the farm loss is not reduced by the amount deducted for capital gains under section 1202 for the purposes of determining how much farm income it can offset in the year of the gain, but is so reduced for the purpose of determining how much is available to carry over to later years. In this case, that amount eliminated the carryover.

While this result may appear strange, it is consistent with the Code's present treatment of net operating loss carryovers, which must be reduced by the section 1202 deduction in the year the loss is incurred. The moral would appear to be to avoid capital gains in years of ordinary losses. The result is one that puts the taxpayer who is unable to avoid capital gains in loss years at a disadvantage, unless he can also realize other ordinary farm income. It is, however, consistent with the view that only economic losses should be the subject of carryovers. To fail to make this adjustment would put farm losses on a higher level than other carryovers—certainly not an aim of this Bill—because they could be carried over for use against other farm income in greater amounts than other loss carryovers. This result then treats farm loss carryovers like other carryovers except in so far as it limits their use to farm income and is consistent with the theory of isolating and segregating farm operations from other operations unless proper accounting rules are followed.

F. The Small Farmer Exception

The Treasury EDA is not increased in any year in which the loss does not exceed $5,000. If operations are fairly consistent, this provision, in effect, would permit an annual loss deduction of $5,000 offset by capital gains of $5,000, which would not be converted to ordinary income. It could be exploited to the extent of $2,250 in tax savings each year.[62] This is the maximum benefit that may be derived from this exception.

The EDA floor might, however, be objectionable to some farmers who apparently are the type of taxpayers intended to benefit from simplified accounting. The $5,000 figure is relatively low and is not softened by excluding any deductions from the EDA. As a consequence the so-called "legitimate" farmers could lose some of the benefit of capital gain treatment.

The Metcalf Bill instead would allow a farm loss in the amount of $15,000 each year. This annual loss allowance may be the most serious defect of the Bill, although as later explained it may to some extent be remedied by other features of the Bill. The problem may perhaps best be shown by taking a citrus grove as an example. Assume

[62] This is $5,000 multiplied by the difference between the top tax bracket of 70% and the top capital gain rate of 25%. This benefit would be less under H.R. 13270, 91st Cong., 1st Sess. (1969), which would reduce the top ordinary rate to 65% and eliminate the alternative tax so that the top capital gain rate would be 32.5%. Under that Bill, the $2,250 would be reduced to $1,625.

that the land and planting cost is $10,000; that cultural practice expenditures of $15,000 are incurred annually; that the grove reaches the productive stage in the seventh year of its life; and that it is then sold for $135,000, an economic profit of $20,000.

Under the excess deductions account, the taxpayer would claim his $15,000 loss each year and add $10,000 to the EDA. The account would total $70,000 at the end of the seventh year, and the balance would convert $70,000 of the sale proceeds to ordinary income. In addition, there would be a capital gain of $55,000, which would reduce to $27,500 of taxable income. This has two effects: (1) There has been a deferral of taxes on $15,000 of income each year for six years to total $90,000. (2) There is a bunching of ordinary income in the year of sale. While this aspect may appear to create a serious problem, the penalty arising from bunching undoubtedly would be greatly eased by income averaging under sections 1301-04. In addition, there has been a gross mismatching of income and expense.

On the other hand, the Metcalf Bill permits $15,000 loss to be deducted annually if the taxpayer has no more than $15,000 nonfarm adjusted gross income. Thus there is deferral of taxes on the income sheltered by the loss. The taxpayer in this example would have sheltered $90,000 of nonfarm income from tax over the first six years. Upon sale, there would be a capital gain of $125,000 (sales price of $135,000 less land and planting costs of $10,000). After the section 1202 deduction, this would be reduced to $62,500, which would become $47,500 of taxable income after reduction by the $15,000 of cultural practices expenditures in the year of sale. Thus the annual loss allowance, which was designed to define a farmer, has the effect of allowing uneconomic losses to offset other income and defer taxes on other income to the extent of $15,000 per year. When this loss is recaptured on sale, it is taxed at no more than capital gain rates. The continuance of this potential to shelter other income might induce investors to seek investments that limit the loss to $15,000 per year were there not other features of the Bill that should prevent much exploitation of the annual loss allowance.

While the Bill thus appears to have these drawbacks, it also reduces the annual loss allowance by one dollar for each dollar of nonfarm adjusted gross income in excess of $15,000. At $30,000 of nonfarm adjusted gross income the annual allowance disappears. In the majority of cases, it is doubtful that one having nonfarm adjusted gross income at this level will have funds to invest to produce a $15,000 annual

loss. Also the tax rate on a joint return at those income levels is less than 40 percent, and the tax savings, arising by permitting capital gain treatment on the sale, is not great because the difference in the ordinary income rate and the rate that would apply to bunched capital gains may not be great. Even so, a taxpayer having nonfarm adjusted gross income of less than $30,000 has some opportunity (but one, which declines as income increases) to exploit a farm loss and need only answer the question whether the play in tax rates is worth the risks and investment inconvenience. Even with this criticism, the Bill significantly reduces the tax benefits of farm losses. *This problem does point out that without the phaseout, the Bill would be a far less effective tool.*

G. The Integrated and Related Exception

The Metcalf Bill also provides that if a taxpayer is engaged in farming and one or more businesses, which are directly related to his farming and conducted on an integrated basis with his farming, the taxpayer may elect to treat all these businesses as a single business engaged in farming. The obvious purpose is to permit a taxpayer to treat a nonfarm business, producing net income, as a part of his farming operation, to reduce the farm loss and thereby reduce the amount to which the Bill applies.

The provision also raises a definitional problem in determining whether the two operations are related on an integrated basis. This problem could be cured by providing that a business would not be considered as related and conducted on an integrated basis with the farming operation, unless it consisted of the processing of a product raised in the farming operation. Such an exception should apply only if the sale of such processed produce produces a substantial portion of the total receipts of the overall operation.

Even with this modification, the provision raises the spectre that the Bill might fail to achieve its goal by permitting the offsetting of some "farm losses," arising from the farm tax accounting rules, against income earned in other business. For example, a taxpayer might be engaged in processing frozen orange concentrate from an orange grove on which large expenditures and consequent "farm losses" were incurred because a part of the grove had not yet reached full production. The grove, as a whole, presumably would be related to and conducted on an integrated basis with the concentrating business, and the special benefit of deducting "farm losses" against income from the concen-

trating business would be continued. Primarily, this provision would benefit those taxpayers who have the capital and resources to engage in a business related and integrated with their farming operations. With respect to these taxpayers the Bill would not accomplish its basic objectives, even though these taxpayers would not appear to be the type of taxpayer for whom the special farm accounting rules were devised.

Thus, even if modified as suggested, the Bill might not accomplish its basic purpose. The treating of separate businesses as a single operation departs from the usual practice in administering the tax law and may raise problems neither foreseen nor foreseeable at this time. There is little to be said for the provision, and it should be eliminated.

The EDA has a similar exception, which is not explicitly stated. Since the EDA converts capital gain to ordinary income only on a sale, it would never be actuated in many industries. For example, the frozen orange juice concentrator just mentioned might never sell the grove. If he did not, the EDA would have nothing on which to operate. The EDA would thus continue to permit the offsetting of farm losses against income from other sources for which the taxpayer would pay no penalty.[63]

H. Specially Treated Deductions Exception

The Metcalf Bill permits a taxpayer to choose between the $15,000 annual loss allowance and the total of certain so-called specially treated deductions. These deductions are taxes and interest, losses and expenses arising from abandonment, casualty, or drought, and recognized losses under section 1231. The theory seems to be that these losses are indeed economic losses and should not be subject to the disallowance rule. There is considerable appeal to this position, and it probably reaches a proper result.

In contrast, the Treasury's EDA makes no exception for such expenses. It should be noted that the EDA never disallows a loss. Rather, it is the measure of later capital gain that will be converted to ordinary income. A failure to exempt these expenses from the EDA must rest on the premise that either (1) the $5,000 annual exception will

[63] Interestingly, the racing industry is not satisfied even with this unstated exception. Under the tentative decisions of the House Committee on Ways and Means, horseracing and horse breeding would be treated as a combined operation. *See* PRESS RELEASE BY CHAIRMAN MILLS, *supra* note 52. Section 211 of H.R. 13270, 91st Cong., 1st Sess. (1969), also embodied this concept. This will permit tax losses from breeding operations to be offset against racetrack winnings.

account for them, or (2) the capital gain provisions are so generous that any loss, whether economic or not, should be used as a means of recapturing ordinary income deductions. In either case, the reasoning seems to be a little thin, and it seems likely that exclusions of some sort will be made.

I. Both Approaches Involve Certain Assumptions Regarding Causes and Effects of Losses

Both the EDA and the Metcalf Bill may be characterized as being arbitrary. The EDA operates on the premise that a farm loss creates capital gain. Perhaps a fairly valid assumption, but it may not be true when the loss results from casualty.

Similarly, the Metcalf Bill's denial of a loss is not explicitly limited to artificial losses created by the special farm accounting rules. The specially treated deductions exception may have virtually that effect, particularly if modified as hereinafter suggested. Its assumption that any remaining loss is created by the special farm accounting rules is on balance probably a fairer assumption than the asumption underlying the EDA.

Criticism of either proposal on this ground is not serious, and both underlying assumptions could be argued to be valid in a sufficiently large majority of cases to provide a basis for legislative action.

J. A Final Note on the Metcalf Bill

As previously noted, limiting the amount of a farm loss deductible against the amount of other farm income will ordinarily remove the so-called negative income tax effect. When farm income is only the included one-half of capital gains on which the tax rate is limited to 25 percent, however, deduction against ordinary income by a taxpayer having a tax rate in excess of 50 percent will continue to result in the negative tax effect. That is, one having a tax bracket greater than 50 percent will be able to achieve an effective tax of less than 0 percent on his overall farm profits because the tax saving from the loss deduction, although the deductible loss is limited to the taxable portion of capital, is greater than the tax on the capital gain.

The fact that the negative income tax effect is not entirely removed is not attributable, however, to either the cash method or the deduction of one-half of capital gains. Rather, it is solely attributable to the alternative 25 percent tax on capital gains. If rates on capital gains were not so limited but allowed to progress up to one-half of

the ordinary rate, the negative tax on farm profits would be fully remedied by this proposal.[64] The EDA does not suffer from this disability.

K. A Final Note on the EDA

As presented in 1963 and as under the current proposal, the EDA is a matter personal to the taxpayer. Apparently, the 1963 proposal would have applied upon any disposition of property while the current Technical Explanation deals only with "sales." Presumably, sales will be transformed into dispositions when the statutory language is drafted. If it is not, a number of transfers could permit the taxpayer to have had the advantage of the deduction while shifting the capital gain asset to another taxpayer. These transfers would include gifts, charitable contributions,[65] transfers to corporations under section 351, reorganization transfers, transfers to partnerships under section 721, transfers to trusts, corporate liquidations, transfers to or distributions by an estate or trust, and like exchanges and involuntary conversions.

The difficulty with imposing a tax on these transfers is that the taxpayer has not received any cash providing the wherewithal for paying the tax. In addition, the recapture provisions under section 1245 and section 1250 provide special treatment for these transfers (other than taxable corporate liquidations and distributions by estates and trusts), and the Treasury may be hard pressed to make a case for taxing transfers under the EDA, which are not now taxed under these recapture provisions. It is submitted that such a case can be made, however.

Except for a few industries such as the leasing of automobiles, most depreciable property subject to section 1245 does not by its very operation constantly produce merchandise for transfer, even though the merchandise so produced has also been used in the trade or business. The process of culling the livestock crop does produce this merchandise. The very nature of the business makes it inevitable that there will be substantial property that must be transferred. In most section 1245 cases, the property is either abandoned or transferred at nominal value. It may be argued that recapture is satisfactory in these

64 If the minimum tax discussed in TREASURY STUDIES, *supra* note 18, at 132 were adopted, the rates on capital gain would be fully progressive when it applied. *See* note 21 *supra*, which points out that H.R. 13270 would similarly eliminate the alternative tax.

65 Under the Administration's program presented on April 21, 1969, a charitable contributions deduction would be denied to the extent of unrealized gain on any property, which if sold would yield ordinary income. TAX REFORM 1969, at 5152, 5492. *See also* TREASURY STUDIES, *supra* note 18, at 178.

cases but that it is unsatisfactory when transfers are inevitable and each transfer presents a substantial tax avoidance opportunity. Thus the abuse possibilities are worse in this case, and recapture just is not adequate to handle the problem.

If the tax is not imposed at the time of disposition, a substantial avoidance problem can arise, although it might be possible to have the EDA carryover to the transferee.[66] Even with a carryover, there would still be the possibility of shifting substantial amounts of income from a high bracket taxpayer to a low bracket taxpayer.

L. Making the Choice

Since the foregoing may not have made the choice between the Treasury's proposal and the Metcalf Bill clear, perhaps we should return to our early discussion in which the benefits of expensing capital expenditures while reporting sales proceeds as capital gain were first specified as (a) a deferral of taxes on an amount of other income equal to the prematurely deducted capital expenditures, (b) the complete exemption of profitable operations from any tax until the ratio of sales proceeds to costs exceeds the ratio of the ordinary tax rate to the capital gain rate, and (c) the negative tax effect that results, even though the operation is profitable, if the deferred taxes under (a) are greater than the taxes paid on sale. Since none of these advantages generally is available to other businesses, we should test any solution in light of the extent to which these benefits would be eliminated. In view of this criterion and based on the assumption that profit margins in farming are low,[67] there would seem to be little doubt but that the Metcalf Bill is superior to the EDA in the prime areas of abuse; (a) development costs of plants, and (b) livestock. In addition, as later explained, the Metcalf Bill may reach some of the other areas of abuse.[68]

First, as to the matter of deferral, the Metcalf Bill begins to cut off this benefit when the taxpayer's nonfarm income exceeds $15,000, and at $30,000, the interest-free loan from the Government is no longer

[66] If the EDA is carried over to the transferee, it presumably would reduce the EDA in the hands of the transferor. Thus a transfer to a lower bracket taxpayer may present an opportunity to reduce the ordinary income potential to the transferor.

[67] *See* 1963 TAX MESSAGE 1541, in which returns of two or three percent of livestock are estimated. There is little reason to think that returns have improved. *See Hearings on Tax Reform Act of 1969 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess. 32 (interim manuscript) (statement of Claude M. Maer, Jr. on behalf of the National Livestock Tax Comm. on Sept. 22, 1969).

[68] *See* note 27 *supra*.

available. In comparison, the EDA does not disallow any loss. It has no effect on the deferral feature of deducting capital expenditures.

Second, the EDA seems to eliminate the prospect that a profitable operation will be completely exempt from tax. As we have seen, the Metcalf Bill permits this exemption to continue. This aspect of the Metcalf Bill could be remedied, however, by requiring that the full amount of farm capital gains be reduced by the "farm loss" before reducing the farm capital gains by the deduction under section 1202. The farm loss carryback or carryforward would be similarly limited. As a result, net farm gains would be taxed at least at capital gains rates.

But even without this change, it appears that the choice between the EDA and the Metcalf Bill remains the same because when profit margins are low, the deferral is much more advantageous than exemption from tax. This results because deferral is an interest-free loan on the marginal tax rate multiplied by the entire cost while exemption is an exemption from a capital gains tax on profit, which is low in relation to the cost. Thus, under the EDA, the interest-free loan from the Government is repaid rather slowly. For example, if costs consistently run $100 while sales are at a 5 percent profit margin or $5, the EDA permits a taxpayer to make no sales until the second year and to obtain the benefit of having deferred the tax on $100 over the following 20 years. If we assume a 70 percent taxpayer having in today's market a 7 percent borrowing rate, the annual benefit realized by the deferral is $4.90. In return for this benefit, he pays $1.25 of tax each year as the cattle are sold. The net benefit thus is $3.65, which reduces by 5 percent each year.

This savings may be compared to the exemption from tax of the net annual capital gain of $5, which is $1.25. This exemption would be achieved under the Metcalf Bill, but it has less value than deferral when profit margins are low.

When an asset such as a citrus grove is developed, the deferral aspect of the EDA may have substantially more benefit than exemption from tax. For example, if a $1,000 loss is incurred each year for a five-year period, a 70 percent taxpayer having a borrowing rate of 7 percent will be able to reduce his overall capital cost by 17.5 percent of the total cost just by the benefit of the deferred taxes. To obtain the same benefit in exemption from capital gains tax, the grove would have to be sold at an economic profit of 70 percent. If the grove is sold, the EDA will result in a bunching of ordinary income in the year of sale when the EDA is actuated and recaptures the prior deduc-

tions. While bunching might offset some of the benefit of deferral, if the taxpayer is not consistently in the top bracket, the averaging provisions of the Code may spread the bunched income over the deferral period thus lessening the bunching, but the benefit of deferral would remain.

In addition to the value of deferral resulting from the Government's loan for the amount of the deductions multiplied by the taxpayer's marginal tax rate, it also cuts the federal government in on the loss side of the transaction well before either the taxpayer or the Government can know whether the venture will ultimately be a success. The value of this risk shifting is probably far more than the interest-free loan.

This brings us to the third standard: to what extent is the negative tax eliminated? Under the EDA, the negative tax may occur if the sales proceeds are recaptured at a lower tax rate than the rate in effect when the expenses were deducted. Thus, if the taxpayer can await retirement, a lower income, death, or achieve a transfer to a lower bracket taxpayer,[69] the taxpayer not only has the benefit of deferring taxes on other income by currently deducting his farm costs, but a negative tax can be effected.

The Metcalf Bill does not completely foreclose the possibility of a negative tax subsidy. This potential is, however, preserved only (a) when the abuse may at least be said not to be great (taxpayers who have less than $30,000 of nonfarm adjusted gross income),[70] and (b) to those

[69] Nontaxable transfers of capital gain property may offer substantial opportunity to avoid the EDA. There would appear to be some roadblocks to the transferee's achieving a capital gain rate. First, in the case of livestock, it must be either draft, breeding, or dairy livestock in the hands of the transferee. The fact that the livestock had such character in the hands of the transferor would not establish the same character for the transferee. Second, an immediate sale by the transferee might be viewed as a sham with the sale proceeds being attributed to the transferor. Third, the transferee may himself have an EDA, especially if he retains the transferred property any substantial time in an effort to overcome the first two problems. In these cases, both the transferor and the transferee would incur raising costs, and in effect, the EDA would be divided between two taxpayers while only the transferee would make sales subject to the EDA. This technique could lessen the amount recaptured at ordinary rates. Even if the transferee lost the capital gain treatment on sales proceeds, however, if his tax rate is less than the transferor's the negative tax effect is achieved.

[70] If the farming operation is diversified and if these operations consist of a grain operation producing large ordinary income and a livestock operation producing large ordinary deductions and cattle capital gains, the Metcalf Bill arguably can produce a negative tax by insulating the grain ordinary income from tax while subjecting the livestock profits only to capital gains. This result can be argued to be exactly the same as using excess livestock deductions to offset salary income while reporting livestock capital gains. While the force of this argument cannot be denied, there are at least two pertinent comments. First, even this result does nothing more than exempt farm profits from tax. There is no spillover of benefits into endeavors other than farming. Second, those taxpayers, investing in farm assets solely for tax purposes, seem likely not to have diversified

taxpayers who have a marginal tax rate in excess of 50 percent. For example, in the latter case if a taxpayer in the 70 percent bracket has a $50 farm loss and $100 of farm capital gains, the farm income under the Bill just equals the farm loss that remains fully deductible against other ordinary income. The loss would produce a tax saving of $35, while the farm capital gains are subjected to only a $25 alternative tax for capital gains. This latter undesirable effect results from the alternative tax on capital gains, but it could be prevented by a slight modification in the Bill. If farm losses were required to offset farm capital gains *before* application of the alternative tax rate, there would have been no farm loss to use against ordinary income. In the example, the farm loss would have reduced the farm capital gain to $50 on which a tax of $12.50 would have been paid. Thus the Bill may be structured to handle this problem.

In addition to these fundamental questions, the Metcalf Bill also reaches the so-called do-it-yourself averager who, under the Bill, would not obtain any benefits by maximizing his loss in one year since it could not be used to insulate any income outside the farm assets. The EDA would have no effect on this device.

Also, the Metcalf Bill may have some salutary effect on the true hobby farmer who could deduct no loss unless he adopted a proper accounting method. If he did so, he could continue to deduct his hobby loss so long as he could prove it was more than a mere hobby. Adoption of proper accounting would seemingly reduce the amount of the annual loss, although it might not remove it. On the other hand, if there are few sales from the hobby operation, the EDA would have little impact.

To sum up, the EDA fails to close the door on deferral, does not eliminate the possibility of exempting farm profits from tax unless the amount subject to recapture is taxed at the same rates as the amounts deducted, and also opens wide the door of avoidance by transfers that will result in the negative tax effect. Neither does it reach the do-it-yourself averager. Its effect on the "hobby farmer" is unpredictable. On the other hand, the Metcalf Bill phases out deferral commencing at $15,000 of nonfarm adjusted gross income and completing the job at the $30,000 level. It does permit however, an exemption of some farm profits from tax, a matter to be discussed in the next section. It eliminates the negative tax for all but a few, but im-

farm operations. Whether enactment of the Bill would encourage diversification by "tax farmers" would depend on a number of considerations such as profit margins, interest rates, risks, alternative investments, and similar factors.

provements to be discussed will do away with this problem. It also reaches the do-it-yourself averager. It might also have some effect on the "hobby farmer." On most counts the Metcalf Bill is superior to the EDA. This conclusion suggests that recapture of any sort is a most ineffective tool.

M. Improvement in the Metcalf Bill

Having decided that the Metcalf Bill addresses the problem more directly, we should note that a number of changes could be made to the Bill that would improve it substantially. The following might be considered:

(1) Losses on ordinary assets (as distinguished from section 1231 assets) might be included in the category of specially treated deductions. These losses are true economic losses, and there is no reason to disallow them. The failure to include them would appear to be mere inadvertence. These losses probably would not occur in many cases, for most of the farm assets producing ordinary income either have no basis or are held in an inventory. In the former case, a loss could not be realized on the sale, and in the latter case, the taxpayer probably would not be subject to the Bill in any event because he would qualify under the provision excepting taxpayers using inventories and capitalizing capital expenditures.

(2) The Bill now allows an annual allowance of $15,000 if the taxpayer's nonfarm income does not exceed $15,000. For each dollar above $15,000 of nonfarm income, the loss allowance is decreased by one dollar. The obvious purpose is to exempt the so-called legitimate farmer who may have a small outside income. Without this very important feature of the Bill, it would be far less effective. The $15,000 figure may, however, be too high, and the Bill's author might consider adding an alternative phaseout so that two dollars of loss would be disallowed for each dollar of unearned investment nonfarm income of more than $5,000. The present phaseout should remain, and the one permitting the smallest loss would govern if there were any conflict between them.

(3) As previously noted, a number of taxpayers may purchase breeding herds, depreciate them for a short period, sell the herd, and realize substantial capital gains on the excessive depreciation. While this practice appears improper, there may be an enforcement problem arising from the inability of the Internal Revenue Service to audit

all taxpayers. The enforcement problem could be solved automatically by including livestock in the recapture provisions under section 1245. Logically, there is no reason to exempt livestock, and it would prohibit finagling with depreciation, even though the taxpayer elected accrual accounting in order to avoid application of the Bill.

(4) Under the Bill, the farm loss would be permitted to offset other farm income, and it may also be carried over to other years. In neither case does farm income include the untaxed portion of capital gains. A loss of $50 may thus continue to offset $100 of capital gain income in either the year of loss or when used as a carryover. This difficulty could be removed by requiring the loss first to be applied against ordinary income, and any balance then could be applied against capital gain income before the section 1202 deduction or before application of the alternative capital gain rate. The same treatment would be prescribed for carryovers. Thus, in the case in which the farm capital gain in the current year is $100 and the farm loss is $50, the capital gain would be reduced to $50 on which a tax would be paid. If there were also ordinary farm income of $20, the farm loss would be reduced to $30, and the farm capital gain would be $70. Exactly the same treatment would be accorded carryovers. For example, if the current loss is $50 with no capital gain until the following year, when $100 of farm capital gains are realized, the $50 loss carryover would reduce the capital gain to $50 on which a tax would be paid.

An alternative to the suggested treatment would be to require that the farm loss to be an adjustment to the basis of assets. This would necessitate deciding whether to adjust the basis of ordinary income or capital gain assets. It could also raise administrative problems if depreciable property were involved by presenting a new depreciation base each year. If, however, the alternative of a basis adjustment were chosen, presumably the adjustment would not be permitted to create losses but only to reduce gains to zero.

VIII. In Defense of the Faith

We have spent much time discussing the present farm tax rules and considering solutions. While all of this should make the need for a remedy clear, we would be remiss if we did not grant the opposition an opportunity to be heard. We now turn to it.

The House Committee on Ways and Means has twice held hearings on the farm tax loss problem.[71] The interesting aspect of these

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71 1963 Tax Message 1537-97; Tax Reform 1969, at 2001-183. Since writing the text,

hearings is that even those opposed to any proposed changes in the law note that there are abuses of the present scheme. The definition of abuse,[72] however, appears to depend on the speaker. Some speakers defend the subsidy to certain agricultural activity, even though it benefits a taxpayer whose major distinguishing feature is a source of large income from nonagricultural income. The defenses offered by these speakers are to be discussed.

A. *The Proposed Solutions Discriminate Against Farming*[73]

One of the more frequent complaints is that directed toward the excess deductions account in 1963. The argument was made that it offered a special set of rules for farming. Similarly, the same argument was made at the hearings last March.

Undoubtedly, this argument states a truism. There is, however, a reason for this discriminatory treatment. Farming is an industry having a special dispensation from tax accounting provisions otherwise having general application. This dispensation is the use of cash accounting and the expensing of capital expenditures when these procedures do not properly reflect income. It seems proper that losses created by special rules should be treated specially. Under either the Treasury's EDA or the Metcalf Bill, the special treatment of losses may be avoided by giving up the benefit of the special accounting rules. The special treatment ends when the benefit of special accounting rules end. Real economic losses, determined under accounting practices generally applicable to industries other than farming, then would be treated exactly as real economic losses in other industries. They would be fully deductible.

B. *Present Law Is Adequate To Handle the Job*[74]

Opponents of change sometimes argue that section 270 of the Internal Revenue Code (which disallows business losses when they exceed

the Senate Committee on Finance on September 22, 1969, has received testimony on farm losses.

72 *See* 1963 TAX MESSAGE 144-45; 1963 TAX MESSAGE 1546 (statement of Stephen H. Hart); TREASURY STUDIES 16, all of which assert that the abuse lies in rewarding uneconomic, *i.e.* unprofitable, farm operations by granting tax profits. *See also* 1963 TAX MESSAGE 1581 (statement of Arthur Levitt), which focuses on the sale of livestock to investors at prices greater than fair market value.

73 *See* 1963 TAX MESSAGE 1574 (statement of Jacquin D. Bierman); 1963 TAX MESSAGE 1540 (statement of Stephen H. Hart); 1963 TAX MESSAGE 1559 (statement of Floyd L. Madden); 1963 TAX MESSAGE 1569 (statement of James Trimble); TAX REFORM 1969, at 2155 (statement of Herrick K. Lidstone); TAX REFORM 1969, at 2035 (statement of Claude Maer); TAX REFORM 1969, at 2152 (statement of George D. Webster).

74 1963 TAX MESSAGE 1574 (statement of Jacquin D. Bierman); TAX REFORM 1969, at 2035 (statement of Claude Maer); TAX REFORM 1969, at 2107 (statement of R.H. Matthiessen, Jr.).

$50,000, for 5 consecutive years) along with the hobby cases are adequate to deal with the "farm loss" problem.

The second of these assertions is obviously not true. Indeed the hobby loss was specifically excepted when we started our inquiry. We are dealing with cases in which there is a desire to make a profit, and a profit may well be made. Even so, there is a tax loss that results in a negative income tax result.

As to the other assertion, section 270 is not adequate for many reasons. First, even though not included in taxable income, the deducted one-half of capital gains may be added to farm income to determine whether the loss exceeds $50,000. Perhaps of even greater significance, however, is the exclusion of certain expenses from the expense side (thereby lessening the loss), for the purpose of ascertaining whether section 270 applies but not for the purpose of the tax computation. Any expense that a taxpayer has an option either to capitalize or to expense is excluded. Therefore, the very expenses that create the tax loss[75] do not enter into the computation, which determines whether the section will be applied.

While these liberalities would prevent application of the section to most taxpayers, a final escape hatch is offered by the cash accounting method, which to some extent permits the deferral of both income and expense while also offering the opportunity to anticipate both income and expenses. The combination of these deficiencies permits all but the hopelessly incompetent or blissfully unaware to avoid the application of section 270.

C. *Outside Capital Necessary to Agriculture*[76]

Another reason strongly stressed for no change in the present tax law is the need for "outside" capital in agriculture. History is cited to support this conclusion. The argument hinges on the plea that, without the tax benefits offered farming (notably livestock), the outside capital would not be attracted and presumably something disastrous to agriculture and to the American consumer would result.[77]

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[75] *See* Sonabend v. Commissioner, 377 F.2d 42 (1st Cir. 1967).

[76] *See* 1963 TAX MESSAGE 1587 (statement of Jay B. Dillingham); 1963 TAX MESSAGE 1566 (statement of William Greenough); 1963 TAX MESSAGE 1567 (statement of B. Earl Puckett). *See also* TAX REFORM 1969, at 2129 (statement of John Asay); TAX REFORM 1969, at 2125 (statement of George Hellyer); TAX REFORM 1969, at 2035 (statement of Claude Maer).

[77] *See* 1963 TAX MESSAGE 1588 (statement of Harold W. Humphreys), in which he claims that without the subsidy to livestock "the very necessary proteins would have been priced beyond the reach of millions of our consuming public." For an opposing view, expressed by one of the strongest advocates of the present tax subsidy, see Oppenheimer,

Because this author is not an economist, this article is certainly not a forum in which to argue the economic effect of our many tax provisions. Let me comment briefly, however, on the several facets of this argument as follows:

(1) As noted by one witness in 1963,[78] outside capital has been necessary to agriculture since as early as the Civil War. There was no income tax system then and no tax subsidy. Yet agriculture managed to attract the necessary capital.

(2) Demand for agricultural products, *i.e.*, the ability to sell, not a tax benefit, creates the need for farm capital. If that need continues and if farm prices are inadequate absent the tax subsidy, farm prices will increase to provide an adequate attraction.

(3) By eliminating the "tax farmers" who can survive with a lesser profit than one who does not have outside income, those who are largely devoted to farming may be attracted to stay rather than to be driven out.

(4) There is not likely to be any effect on prices.[79]

(5) If special incentives are needed, certainly Congress can work out a system that avoids the negative income tax and benefits all participants evenly across the board or in a more rational manner than the present scheme, which confers the greatest benefits on those having the greatest amounts of outside income.

D. The Rules Encourage Research Development[80]

Often the claim is made that development of purebred seedstock is dependent upon the present tax rules permitting deduction of those costs.

This claim seems to say that there must be a profligate waste of funds in order to secure some very remote benefits resulting from loss operations. If subsidies are needed for research, they can easily be provided without wasting funds on those merely in the business of producing meat. The question is whether we should continue to subsidize the many to benefit a few.

In addition, if these expenses are true research and development

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The Case For the Urban Investor, 24 FARM Q. 80 (1969); 115 CONG. REC. 2033 (daily ed. Feb. 25, 1969) (reprint of speech given by Brig. Gen. H.L. Oppenheimer at the National Farm Institute, Des Moines, Iowa, Feb. 14, 1969).

[78] *See* 1963 TAX MESSAGE 1566 (statement of William Greenough).

[79] *See* note 77 *supra*.

[80] *See* TAX REFORM 1969, at 2035 (statement of Claude Maer); TAX REFORM 1969, at 2107 (statement of R.H. Matthiessen, Jr.); TAX REFORM 1969, at 1567 (statement of B. Earl Puckett).

expenses, they may be deducted under section 177 merely by electing accrual accounting under the Metcalf Bill. A similar election will avoid the EDA.

This argument also presumes that the losses under discussion are true economic losses. That is highly doubtful. First, if the taxpayer has no other farm operation, he is not likely to be engaged in a consistently profitless research program. It undoubtedly would be structured to turn a profit some day. Under the Metcalf Bill, his losses may be carried forward to that day to offset against the gains. If he wants to use them today, he may elect accrual accounting. Under the EDA, the taxpayer's present use of the loss at ordinary income rates is recaptured at the same rate.

Finally, the claim that this is just like the research division of a corporation overlooks the fact that those divisions usually are a part of an integrated operation that produces profits. This differs from the cattle situation in which the tax losses are suffered by an operation not related to another division. In the cattle case, only the tax losses are reported. There are no ordinary income profits. This, of course, indicates that the losses are not economic losses.

E. The Present Scheme Does Not Produce a Revenue Loss[81]

The claim is often made that the negative tax effect costs the Treasury nothing. This claim must have either one of two meanings.

First, the economic activity supported by the subsidy increases the federal government's revenue because the subsidy dollars are spent with suppliers of agricultural goods who pay tax on their receipts. Under this view, most expenditure programs would have no cost to the Government. Obviously, it cannot be used as a measure of the revenue loss.

Second, the charge may be that cattle operators pay taxes. Indeed, one witness at the recent reform hearings pointed out[82] that in 1968 his clients had ordinary income of $15,000,000 and capital gains of $4,000,000. Also, his clients' inventories increased by $3,000,000.

One should not, however, conclude that these taxpayers paid any tax on their cattle operations because the witness also pointed out that

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[81] *See* 1963 TAX MESSAGE 1581 (statement of Arthur Levitt); Oppenheimer, *supra* note 77.

[82] TAX REFORM 1969, at 2132 (supplementary statement by Brig. Gen. H.L. Oppenheimer).

they spent $20,000,000.[83] An analysis of this example, however, again illustrates the problem in the farm area. Take the witness's figures:

Net expenditures	$20,000,000
Less ordinary income	15,000,000
Difference	$ 5,000,000
Less taxable one-half of capital gains	2,000,000
Net tax loss	$ 3,000,000

The farm loss of $3,000,000 applied against other income would certainly produce some tax savings. Thus there was a cost to the Treasury.

The comparison to other businesses is interesting. First, the $3,000,000 loss would be reduced by $3,000,000, which went into the inventory or products to be sold in the future. This would reduce the loss to zero. If the $4,000,000 reported as capital gain were fully taxable, however, as it would be in most other industries, there would be *net profits* of $2,000,000. Instead, the taxpayers in the cattle operations reported a *net loss* of $3,000,000.

F. *Any Change Would Force Many Farmers Onto Accrual Accounting, Which Is Just Not Possible*[84]

This claim is really two contentions. Both appear equally erroneous.

First, not many farmers would be affected by the Metcalf Bill. In 1966 there were 3,000,000 families living on the farm. Less than 4 percent of those families had $15,000 of *gross income from all sources.*[85] The Treasury Staff Studies[86] estimated that 14,000 taxpayers would be affected by its proposal. The Metcalf proposal would reach a larger group because of his phaseout of any deduction at the $30,000 nonfarm adjusted gross income level. In no event, however, could it reach more than 120,000 farmers (4 percent of 3,000,000 families). Thus certainly not a large part of the farm population would be affected. The EDA recommended by the Treasury in 1969 would reach no more than 80,000 farmers.[87]

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[83] The fair assumption is that all of this amount is deductible. The witness claimed that there was no revenue effect of the deduction because the payees would take the amounts into income.

[84] *See* TAX REFORM 1969, at 2035 (statement of Claude Maer); TAX REFORM 1969, at 2001 (statement of Jack Miller).

[85] U.S. DEP'T OF COMMERCE, CURRENT POPULATION REPORTS, CONSUMER INCOME, ser. P-60, No. 15, at 23 (Dec. 28, 1967).

[86] TREASURY STUDIES, *supra* note 18, at 158.

[87] U.S. TREASURY DEPARTMENT (unpublished tabulation of statistics of income).

The second claim that accrual accounting is just not possible also seems refutable. It is now used by some taxpayers. There are inventories that permit an approximation of the cost of raising animals. While they may have their problems, they at least may be employed and would more accurately reflect income than the present scheme, particularly if the changes discussed above were adopted.

G. *The Present Scheme Is a Deliberate Subsidy Carefully Designed by Congress*[88]

Many proclaim that the interplay of current deduction and capital gains is a well thought out subsidy. While there may be some superficial appeal to this argument, it will not withstand analysis.

The farm problem under discussion arises out of (1) deducting capital costs and (2) conferring capital gains on certain assets. As was traced in some detail above, the first aspect of this combination developed very early in the administration of the income tax law. It was also developed by an administrative agency, which had no authority to conceive and implement plans for the distribution of federal money. It does not seem likely that this portion of the present law had any deliberate conception as a subsidy.

The capital gain portion of the combination seems equally as accidental. The 1942 amendment, which first brought cattle into the capital gain arena, certainly makes no reference to the subsidy impact.

After doubt and controversy arose in the 1940's, the farm interests succeeded in getting legislation in 1951. But neither in 1950 nor 1951 was there any discussion of the subsidy effect of conferring capital gains on livestock. The plea rather seemed to rest on clearing up confusion and giving the treatment to farm assets that was accorded other businesses.

Not until 1952 was there any discussion of the tax policy effect of these provisions.[89] While the Treasury's presentation of the excess deductions account in 1963 and in 1969 focused on the two aspects at the heart of the farm loss problem, they do not put the problem in its proper posture. These aspects are (a) the use of farm losses to offset other income and (b) the production of a tax profit when there is an economic loss.

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[88] *See* 1963 TAX MESSAGE 1574 (statement of Jacquin Bierman); TAX REFORM 1969, at 2124 (statement of Jay B. Dillingham); TAX REFORM 1969, at 2107 (statement of R.H. Matthiessen, Jr.); TAX REFORM 1969, at 2120 (statement of Brig. Gen. H.L. Oppenheimer). *See also* Oppenheimer, *supra* note 77.

[89] *See* Letter from Secretary Snyder, *supra* note 16.

The second aspect was universally denounced by the witnesses who appeared before the Ways and Means Committee in 1963 and in 1969. It hardly seems likely that failure to take action condones a system achieving that result. Rather, in the words of Representative Watts,[90] there was difficulty in separating the sheep from the goats.

As to the first point, the Treasury seems content to show that the losses, artificially produced, are used to offset income of another endeavor. While that statement is accurate, it does not demonstrate that in fact a profitable operation is not only paying no tax but is indeed receiving a subsidy from the Treasury in the form of reduced taxes on other income. Certainly, the latter statement of the problem is hard to defend and truly illustrates what is happening. Short of a presentation in this fashion, it is doubtful that one can say that Congress has condoned it.

In 1952 only the Senate Finance Committee considered the matter, and in 1963 only the House Ways and Means Committee considered it. The failure of these committees to act on the basis of the not well directed testimony of the Treasury should hardly be construed as congressional approval of a subsidy system, particularly when that subsidy is not available to the individual engaged only in the activity, which, if the argument were accepted, Congress intended to subsidize. In 1969, the House took action by incorporating the EDA into H.R. 13270. While, as later discussed, the provision adopted would likely be largely ineffective, it does manifest a notion that this subsidy has difficulties, which require pruning, if not elimination.

IX. Conclusion

Our existing farm tax laws permit taxpayers having income from other sources to invest in farm assets to a large extent at the expense of the public fisc. While it has been argued to be a deliberate subsidy to farmers, this seems doubtful on the record. It also seems implausible that Congress intended a subsidy that has little or no value to one having only the kind of income that it intended to benefit. The argument would mean that one hand giveth while the other taketh, by inducing unfair competition from the "tax farmer" who because he has sources of other income can subsist on little or no economic profit. Thus, even if Congress did intend the present scheme as a subsidy, it should be recast in a more rational form.

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[90] 1963 Tax Message 1558.

This subsidy is a negative income tax because the tax savings resulting from the premature deduction of capital costs against ordinary income is greater than the capital gain tax incurred on the sale of the property. There are now pending several proposals that measurably improve the tax law. None of them attacks the problem directly. Rather, they attempt to preserve some part or all of the tax benefits for selected taxpayers. As a consequence, they are complex. Since the complexity arises from an effort to maintain simplicity for the vast majority of farm taxpayers, the burden of complexity will fall only on those who want to retain whatever benefits remain after enactment of the remedial legislation.

Of the proposals pending, the Metcalf Bill offers the best designed solution. It is directed to the current offsetting of artificial farm tax losses against nonfarm income. It does not concede the propriety of this offset and consequently need not seek to impose a penalty at some later date, when the capital nature of the earlier losses is finally revealed. It is well designed to limit its application to artificial losses. It does not present the estate planning possibilities of some of the other solutions, and it does seek to exempt many farmers.

Since the Metcalf Bill appears to offer a better solution, it is lamentable that the Treasury's 1969 proposals did not endorse it, as did the previous Administration. Rather, the Treasury opted to present a solution which *may* accomplish many of the objectives. But by rejecting the Metcalf Bill proposal and advancing its own, the Treasury will find that effort, which could have been expended on passage of a solution, will be directed to demonstrating the superiority of its solution. This may prove a difficult, if not impossible task, that will undoubtedly annoy many of the proponents of the Metcalf Bill. Therefore, the fight may degenerate to one between those who want some action rather than between that group and those who have prospered from and are interested in maintaining the *status quo*. One doubts that the principles, which led to rejecting the Metcalf Bill, could be worth the loss in solidarity. Indeed, the principles, which militated so strongly against the Metcalf Bill, are not clear.

Be that as it may, the House Committee on Ways and Means at one time tentatively adopted the EDA substantially as recommended by the Treasury.[91] While it might have achieved some needed reform, it undoubtedly would have presented the opportunity for the artful tax lawyer to plan around the EDA. But the Bill reported out by this Committee and passed by the House appears to be about as an ineffec-

[91] *See* PRESS RELEASE BY CHAIRMAN MILLS, *supra* note 52.

tive version of the Treasury's suggestions as could be envisioned. As passed by the House, taxpayers having nonfarm adjusted gross income of less than $50,000 would not be required to keep an EDA. Furthermore, farm losses would be entered into the account only to the extent that they exceeded $25,000.

In 1964 there were about 18,000 tax returns showing nonfarm adjusted gross income in excess of $50,000. About 3,000 of these taxpayers turned a farm profit with the balance reporting losses. Thus only about 15,000 farm returns showing farm losses meet the outside income test. Yet in the same year, there were about 1,109,000 farm returns (out of 3,000,000) showing a farm loss. As a consequence, the Bill would affect less than 0.5 percent of all farm returns and less than 1.5 percent of farm returns showing a tax loss.[92] This relatively insignificant impact will be even further reduced by the exception of any loss, or part thereof, that does not exceed $25,000. The fairest guess seems to be that the proposal might have some impact on as many as 4,000 or 5,000 tax returns.[93] The revenue estimate for the long run is $20 million.[94] This compares with a revenue estimate of $50 million for the Treasury's recommended EDA[95] and $205 million if the Metcalf Bill were enacted.[96] The Treasury's proposal might have reached as many as 75,000 returns in any year,[97] while the Metcalf Bill would have reached around 14,000 taxpayers,[98] about the number of returns which meet the nonfarm adjusted gross income test under the Bill, but with an impact over ten times as great when revenue estimates are considered. These comparisons strongly suggest that H.R. 13270 would reach only the visible portion of the iceberg.[99]

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92 *See* TAX REFORM 1969, at 5428, 5430 (Office of Secretary of the Treasury, Office of Tax Analysis, General Explanation of Farm Proposals, Tables 1 and 3).

93 U.S. TREASURY DEPARTMENT (unpublished tabulation of statistics on income).

94 H.R. REP. No. 91-413 (Part I), 91st Cong., 1st Sess. 16 (1969).

95 TAX REFORM 1969, at 5058.

96 115 CONG. REC. 9898 (daily ed. Aug. 13, 1969) (remarks of statistics of Senator Metcalf).

97 U.S. TREASURY DEPARTMENT (unpublished tabulation of statistics of income).

98 TREASURY STUDIES 158. The proposal put forth by the Treasury Department in this document should reach about the same number of taxpayers as the Metcalf Bill. The estimate is 14,000 returns.

99 The Treasury Department has estimated that the special accounting rules cost about $800 million annually. *Hearings on the 1969 Economic Report of the President Before the Joint Economic Comm.*, 91st Cong., 1st Sess. 36 (1969) (supplementary statement of Joseph W. Barr). If the revenue raised under these alternatives then is an index of effectiveness, the House Bill would be 2.5% effective; the Treasury's EDA would be 6.25% effective; and the Metcalf Bill would be just over 25% effective.

Several averages may be derived from 1964 figures published as Table 3 to the General Explanation of the Treasury's Farm Proposal. TAX REFORM 1969, at 5430. The raw data presented there are:

(a) All tax returns showing more than $50,000 nonfarm adjusted gross income with a farm loss numbered 14,325 with aggregate farm losses of $369,605,000, an average of $25,800. If we assume a 50% marginal tax bracket, the average farm loss has an average value of

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The amount of revenue raised and the number of taxpayers affected are not, of course, the important criteria by which to measure a provision dealing with the farm loss problem. The question is whether the proposal will significantly reduce the federal subsidy going to taxpayers having both (a) certain kinds of farm investments and (b) substantial nonfarm income while providing relatively insignificant benefits to those who do not have the nonfarm income. The overall purpose thus is to discourage some investments in farm assets by improving the equity of the tax structure. On this ground, the Bill passed by the House seems destined to fail. It will permit all comers to incur tax losses up to $25,000 each year. An investment of this size may have substantial capital gain possibility.

Finally, the purpose of restricting the operation of the Bill to those taxpayers having a coincidence of $50,000 in nonfarm adjusted gross income and a farm loss in excess of $25,000 is not clear. It seems unlikely that a "legitimate farmer" cannot be more precisely defined. Thus the high dollar limits seem not to have a definitional purpose. Nor is the abuse limited to taxpayers having this happy combination of circumstances. But even if it were, under the Bill, they are permitted to exclude from the EDA the first $25,000 of farm loss each year. Since the justification for these limits is not immediately apparent and since the Bill does not appear altogether effective, it seems likely that Senator Metcalf will continue to press his solution, and the issue will be joined in the Senate.[100]

$12,900. If ultimately there are capital gain sales equal to the average farm loss, the taxes paid would be $6,650 under the Bill while under present law the taxes would be $6,450. Thus the Bill on the average would remove but $200 of the tax subsidy. This amount of reduction would hardly discourage anyone because the tax subsidy is over thirty times the recaptured tax.

(b) The above figures could be broken down into nonfarm adjusted gross income categories as follows:

$50,000 to $100,000 nonfarm adjusted gross income:

10,036 returns showing an average loss of $16,487. On the *average* the Bill would have no effect.

$100,000 to $1,000,000 nonfarm adjusted gross income:

4,204 returns showing an average loss of $46,908. If we assume a 65% tax rate (maximum under the Bill), the loss would have a current value of $30,490 on the average. If there were ultimately capital gains equal to the loss, the taxes incurred giving effect to EDA would be $22,365 leaving a negative tax benefit of $8,125. Again this is hardly sufficient deterrent to be effective.

Over $1,000,000 nonfarm adjusted gross income:

85 returns showing an average loss of $81,576. Again assuming a maximum rate of 65%, the loss would have a current value of about $53,000. Ultimately taxes of nearly $45,000 would be paid if EDA were fully effective. Again there is something less than full recovery of the tax subsidy, and the deferral benefit remains.

100 115 CONG. REC. 4354 (daily ed. May, 1969) (remarks of Senator Metcalf). In a press release, dated October 17, 1969, the Senate Finance Committee announced that it

Regardless of the outcome, there would appear to be some learning here that may be applicable beyond the farm field. We noted at the beginning that other industries such as oil and gas, real estate, and timber may offer much the same opportunity for tax avoidance as does investment in some farm assets. The benefits in these areas are also predicated upon premature and excessive deductions, and repair of the tax law in these areas is badly needed.

The foregoing analysis is helpful in suggesting guidelines and means of testing those solutions that may be put forward for these other areas. The problem must be precisely identified to expose the source of the difficulty. At that juncture, two paths will be offered. The problem may be attacked frontally as, for example, proper cost capitalization attacks the farm loss problem. If that route is not chosen and if excessive deductions are the problem, there are two means of dealing with them. First, the deductions may be blessed when claimed with a recapture of them at a later time. The other is to operate directly on the deduction by limiting its benefit either to a specified group or in a specified amount. Either means is complex, but there would seem to be no question but that the former, a recapture of prior excessive deductions, is a most inappropriate way of dealing with excessive deductions. Thus, unless all other techniques are exhausted and rejected on some more fundamental ground, the concept of recapture should not be raised as a solution.

had decided to disallow one-half of the farm loss in excess of $25,000 in those cases in which the nonfarm adjusted gross income exceeded $50,000, and the farm loss exceeded $25,000. This approach is at best a very poor substitute for Senator Metcalf's Bill. While the press release is not entirely clear, apparently there is no effort to confine the disallowance to losses created by the special accounting rules. The income and loss limits are still excessive. It does, however, take a step in the right direction by disallowing losses. At this writing, estimates of revenue and the number of taxpayers affected are not available.