Tax Expenditures in the Second Stage: Federal Tax Subsidies for Farm Operations

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TAX EXPENDITURES IN THE SECOND STAGE: FEDERAL TAX SUBSIDIES FOR FARM OPERATIONS

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With the enactment of the Congressional Budget Act of 1974[1] (Budget Act), the tax expenditure concept has moved into a new stage of development. Formally introduced into the political process in 1968,[2] the concept has gained recognition and acceptance during the intervening years as a useful tool in evaluating both the equity of our federal income tax system and the efficiency and effectiveness of tax subsidies to achieve national economic and social priorities.[3]

The Budget Act was enacted to provide better congressional control of the budgetary process. Standing Committees on the Budget were established in the House and Senate, and a professional budget staff was authorized in the Congressional Budget Office.[4] The basic objective of the Budget Act was to create a mechanism whereby Congress could examine and evaluate the federal budget in a unified fashion, permitting it to determine the effects that a particular legislative action would, or

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1. Act of July 12, 1974, Pub. L. No. 93-344, tits. I-IX, 88 Stat. 297 (codified in scattered sections of 1, 2, and 31 U.S.C.).

2. *See* U.S. DEP'T OF THE TREASURY, ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES 322-40 (1969) (for the fiscal year ending June 30, 1968).

3. This Article assumes the reader is familiar with the tax expenditure concept. For the concept articulated in its most complete form by its developer, *see* S. SURREY, PATHWAYS TO TAX REFORM (1973). For a shorter description of the concept, *see* 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 239 (1972).

4. Congressional Budget Act of 1974, Pub. L. No. 93-344, tits. I-II, 88 Stat. 299-305.

should, have on other items on the budget. Under prior procedures, House and Senate committees acted on each appropriation and authorization bill independently, with little consideration given to the impact of a particular action on the overall federal budget.

From the standpoint of tax policy, however, the most important change effected by the Budget Act was to treat "tax expenditures" as a formal part of the budget to be submitted by the President each year.[5] Tax expenditures are included within the area of responsibility of the Committees on the Budget and the Congressional Budget Office. The Committees on the Budget and the Congressional Budget Office are directed to request and evaluate continuing studies of tax expenditures. They are also to coordinate tax expenditures with direct budget expenditures. Information with respect to tax expenditures so obtained is to be furnished to the committees of Congress that have legislative jurisdiction over areas covered by tax expenditures. In addition, each legislative committee is entitled to secure tax expenditure information with respect to any program area under its jurisdiction.[6] In summary, the Congressional Budget Act of 1974 contemplates a systematic and rational congressional oversight of tax expenditures and direct expenditures once the Budget Act is fully in effect.[7]

The new role of tax expenditure analysis is already in evidence. Each legislative committee of the House of Representatives is now empowered to conduct studies and investigations of the effects of tax policy on programs within the committee's jurisdiction in order to coordinate tax and nontax policy decisions relating to the same overall areas of national policy.[8] The House Committee on the Budget has

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5. *See id.* § 601, 31 U.S.C. § 11 (Supp. IV, 1974), *amending* § 201 of the Budget and Accounting Act, 1921, 31 U.S.C. § 11 (1970).

6. *Id.* §§ 102, 202, 301, 308, 801, 88 Stat. 300-02, 304-08, 313-14, 327-30.

7. Except for the addition of § 201(i) to the Budget and Accounting Act, 1921 (added by § 601 of the Budget Act, 31 U.S.C. § 11i (Supp. IV, 1974)), all of these provisions will be fully effective for the fiscal year commencing Oct. 1, 1976. *Id.* § 905, 88 Stat. 331-32. The remaining provision will become effective on Oct. 1, 1978. *Id.* § 905(d), 88 Stat. 331-32.

8. H.R. RES. 988, 93d Cong., 2d Sess. 23-24 (1974), *approved*, 120 CONG. REC. H. 10169 (daily ed. Oct. 8, 1974); H.R. REP. No. 93-916 93d Cong., 2d Sess., pt. 2, 65-69, 119 (1974). The operation of the new procedures is reflected in the following excerpt from the report of the House Committee on Ways and Means on the Tax Reduction Act of 1975:

> In compliance with subdivision (B) of clause 3 [of House of Representatives Rule XI], the committee states that the changes made by this bill involve no new budgetary authority. The bill provides no permanent changes in tax expenditures because the provisions make only temporary tax changes for 1975. The temporary direct effects of the provisions in the bill on tax expenditures

issued its first report listing and quantifying existing tax expenditures.[9] The House and Senate Committees on the Budget have each created task forces whose primary responsibility is oversight of tax expenditures.[10] An Assistant Director for Tax Policy has been appointed in the Congressional Budget Office with primary staff responsibility for tax expenditures.

The 1976 and 1977 budgets submitted by the President also reflect the new status of the tax expenditures concept. In the discussion of each of the major budget functions, the tax expenditures corresponding to the particular function are discussed.[11] In addition, one of the Special Analyses submitted with each budget is devoted to an identification and quantification of tax expenditures by budget function.[12]

These political developments do not mean that the conceptual task of identifying tax expenditures has come to an end. Examination of the definitional problems must continue for those items whose inclusion in the tax expenditure budget requires further research and analysis.[13] But

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are: (1) the excess of the percentage standard deduction over the minimum standard deduction (in terms of tax liabilities) is decreased by the bill with the result that tax expenditures are decreased by about $800 million in the calendar year 1975; (2) the earned income credit increases tax expenditures by $2,894 million in calendar year 1975 tax liabilities and by $275 million and $2,619 million, respectively, in fiscal year 1975 and 1976 revenues; (3) the investment credit changes increase tax expenditures in terms of calendar year tax liabilities by $2,372 million in 1975 and $1,500 million in 1976, and fiscal year revenues by $625 million in 1975; $2,147 million in 1976; and $1,139 [million] in 1977; and (4) the increased surtax exemption increases tax expenditures by $1,200 million on calendar year 1975 tax liability and fiscal year revenues by $360 million in 1975 and $840 million in 1976.

H.R. REP. No. 94-19, 94th Cong., 1st Sess. 81 (1975).

9. H.R. REP. No. 94-145, 94th Cong., 1st Sess. 53-55 (1975).

10. TAX NOTES, July 28, 1975, at 10.

11. U.S. OFFICE OF MANAGEMENT AND BUDGET, THE BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1976, at 63-160 (1975) [hereinafter cited as 1976 FEDERAL BUDGET]; U.S. OFFICE OF MANAGEMENT AND BUDGET, THE BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1977, at 53-165 (1976) [hereinafter cited as 1977 FEDERAL BUDGET].

12. U.S. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, THE BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1976, at 101-17 (1975) (Special Analysis F); U.S. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, THE BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1977, at 116-37 (1976) (Special Analysis F).

13. For example, considerable work remains to identify tax expenditures in provisions dealing with the tax treatment of exempt organizations. Professor Andrews, while accepting the validity of the tax expenditure concept, has attempted to demonstrate that the deductions for charitable contributions and medical expenses do not constitute tax expenditures. His analysis, however, is based on the role of those deductions in a *consumption* tax system (which he favors) rather than on their role in an *income* tax system. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309

it does seem clear that, for most of the items contained in the tax expenditure budget whose classification as tax expenditures is not seriously in question, a second stage has been reached. The primary task with respect to these tax expenditures is no longer identification in a conceptual framework. Attention must turn instead to evaluation of tax expenditures both in terms of their efficiency and equity and in terms of their relationship to direct expenditure programs. That is, Congress in its regular legislative processes must recast these tax expenditure programs as direct spending programs and evaluate them just as it does direct spending programs.

This Article undertakes such an analysis for the tax expenditures associated with one major budget function—agriculture. Selection of this topic is appropriate because there is apparently little dispute that preferential tax provisions for farm operations in fact constitute tax expenditure programs and because the tax rules applicable to farm operations have consistently been singled out as an area for examination in the continuing Congressional tax reform effort.[14]

I. A PERSPECTIVE ON TAX EXPENDITURES FOR FARM OPERATIONS

Present federal income tax rules provide an annual subsidy to those engaged in or investing in farm operations. In both fiscal years 1976 and 1977, this tax expenditure subsidy[15] will exceed $1 billion, making

(1972). For a response to Professor Andrews, *see* S. SURREY, PATHWAYS TO TAX REFORM 20-22, 287-89 (1973).

14. For the 1975 experience, *see* HOUSE COMM. ON WAYS AND MEANS, 94TH CONG., 1ST SESS., PRESS RELEASE ANNOUNCING PANEL DISCUSSIONS, TESTIMONY FROM THE ADMINISTRATION, AND TESTIMONY FROM THE INTERESTED PUBLIC ON TAX REFORM 5 (Comm. Print 1975); STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., TAX SHELTERS: FARM OPERATIONS (Comm. Print 1975); H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 37-54, 92-93, 106-07 (1975); *Hearings on Tax Reform Before the House Comm. on Ways and Means*, 94th Cong., 1st Sess., pt. 2, at 1360-402 (1975). For earlier years, *see* notes 17-19 *infra*.

15. The subsidy provided by the tax rules regarding farm operations has been identified as a tax expenditure by the Office of Management and Budget, the House Committee on the Budget, and the staffs of both the Treasury Department and the Joint Committee on Internal Revenue Taxation. U.S. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, THE BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1976, at 108 (1975) (Special Analysis F); U.S. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, THE BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1977, at 125 (1976) (Special Analysis F); H.R. REP. NO. 94-145, 94th Cong., 1st Sess. 53-55 (1975); STAFFS OF THE TREASURY DEP'T AND THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG. 1ST SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES 8 (1975) (prepared for the House Ways and Means Comm. and the Senate Finance Comm.).

it the largest single agricultural subsidy program of the United States Government. It will account for about one-third of the total amount of budgeted federal financial support for agriculture in each of these fiscal years.[16]

Not all of this subsidy goes to those actually engaged in farming. As with any tax-based benefit, the special tax rules for farmers have been converted into tax shelter arrangements for high-bracket investors—doctors, dentists, lawyers, investment bankers, corporate executives, and the like.

Many concerned with tax policy and tax reform have called for repeal of the special tax provisions for farm operations on the grounds that they result in tax inequities, distort the farm economy, and constitute a hidden and wasteful subsidy.[17] Other tax reformers have urged that, at a minimum, limits be placed on the use of special tax provisions so that the abuses created by farm-loss tax shelters may be curtailed.[18]

Understandably, most industry representatives have reacted sharply against suggestions that the farm sector be deprived of all or any significant part of the present $1 billion federal tax subsidy. Frequently, these industry representatives express support for curbing tax shelter operations, but not in any manner that will reduce the federal subsidy received by the "legitimate farmer."[19]

The present federal tax expenditure program is best understood as a federal loan program, providing interest-free, unsecured loans to those engaged in or investing in farm operations. The loan is granted by deferring taxes which would be due under tax rules ordinarily applied to determine net income. The loan is repaid in later years as higher taxes

16. *See* 1976 FEDERAL BUDGET, *supra* note 11, at 100-03; 1977 FEDERAL BUDGET, *supra* note 11, at 94-97.

17. *See, e.g., Panel Discussions Before the House Comm. on Ways and Means on the Subject of General Tax Reform*, 93d Cong., 1st Sess., pt. 5, at 615 (1973) (statement of Professor Charles Davenport) [hereinafter cited as *1973 Panel Discussions*].

18. *See id.* at 646 (statement of Professor Roland J. Hjorth).

19. *See id.* at 635 (statement of Herrick K. Lidstone); *id.* at 654 (statement of Claude M. Maer, Jr.). Other industry testimony appears in *Public Hearings Before the House Comm. on Ways and Means on the Subject of General Tax Reform*, 93d Cong., 1st Sess., pt. 3, at 1072-158 (1973); *id.* pt. 4, at 1503-31. Earlier industry testimony defending tax preferences for at least the "legitimate farmer" appears in *Hearings Before the House Comm. on Ways and Means on the Subject of Tax Reform*, 91st Cong., 1st Sess., pt. 6, at 2001-183 (1969) [hereinafter cited as *1969 Ways and Means Hearings*]; *Hearings on the Tax Reform Act of 1969 Before the Senate Finance Comm.*, 91st Cong., 1st Sess., pt. 4, at 2710-833, 2841-923, 3489-552 (1969); *id.* pt. 5, at 4104-38.

are incurred than would be due under proper tax rules. In a significant number of cases, part of the loan is forgiven and the taxpayer is required to pay back only a portion of his tax loan.[20]

The present special tax rules for farm operations present, in actuality, the question whether to continue, in whole or in part, the present $1 billion annual federal farm tax-loan program. This question can be best answered by Congress by its examining the present tax laws relating to farm operations as a *spending* program, the methodology used by tax expenditure analysis. The normal *tax* rules for farm operations are well known and readily available for adoption. But adoption of the normal rules involves the termination of the present farm tax-loan program. Whether that program should be terminated or limited can only be decided by considering its relationship to other direct federal programs for agriculture, its effectiveness in achieving its avowed objectives, its costs in relationship to its benefits, and its fairness in distributing its benefits.

This Article will examine the special tax rules for farm operations as a federal loan program. The tax-loan program will be analyzed on an overall basis and as it applies to different activities within the farm sector, *e.g.*, crops, cattle, orchards, etc. The loan program will be critiqued by testing the need for the program and its effectiveness in meeting that need, by assessing the efficiency of the program, and by examining its distributional effects. Finally, the various proposals that have been put forth to terminate or limit present special tax rules for farm operations will be evaluated in light of the analysis developed.

II. THE TAX EXPENDITURE PROVISIONS

A. The Basic Tax Rules

Special tax rules that deviate from proper tax treatment of receipts and expenditures from farm operations provide federal financial aid to agriculture through the farm tax-loan program. They are set forth briefly here to provide the framework within which to examine their function as a federal expenditure program.[21]

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20. The way in which current tax laws provide a loan to those investing in farm operations is described more fully in notes 21-41 and accompanying text *infra*.

21. The special tax rules which provide the basis for the tax-loan program are also described in *1973 Panel Discussion, supra* note 17, pt. 5, at 618-28 (statement of Professor Davenport). *See also* Davenport, *A Bountiful Tax Harvest*, 48 Texas L. Rev. 1 (1969).

1. *Accounting Rules*

a. *Right to use cash method of accounting*: Under ordinary accounting rules, a taxpayer may only deduct currently that portion of operating expenditures which relates to income produced in the same period. This result may generally be achieved under either the cash or the accrual method of accounting. Taxpayers engaged in or investing in farm operations, however, are entitled to use the cash method of accounting for their farm receipts and disbursements[22] even though this method may not accurately reflect income for the annual accounting period. Under the cash method, operating expenditures may be deducted in the year paid even though the income generated by the expenditures is not reported until a subsequent year. A mismatching of income and deductions is thus produced.

b. *Option to deduct currently expenditures that are capital in nature*: Farmers and farm investors are permitted to deduct currently certain development costs which, under normal tax and accounting rules, would be capitalized and recovered through depreciation or amortization or upon sale of the property to which the costs relate. Thus, preproduction costs for the development of orchards or vineyards which yield an annual crop may be deducted currently, as may the capital costs of raising livestock.[23] In addition, immediate deduction of certain capital expenditures for soil and water conservation purposes,[24] fertilizer,[25] and land clearing is permitted.[26] In all of these situations, expenditures that would otherwise be allocated to and deducted over several years (or recovered upon sale of the property to which they relate) can be accelerated for tax purposes and deducted in the years in which they are incurred. Again a mismatching of deductions and income results.

c. *Inventories*: Under ordinary tax rules, businesses in which inventories are a significant factor must in effect defer the costs of inventories for tax purposes and deduct these costs only in the year in which goods are sold.[27] But farmers and farm investors are exempted from this inventory requirement,[28] thus permitting them to deduct the cost of inventories in the year incurred but defer the reporting of income therefrom until the year of sale. Taxable income is thus understated in the year the inventory is acquired and overstated in the year it is sold.

22. Treas. Reg. § 1.471-6(a) (1960).
23. Treas. Reg. § 1.162-12 (1972).
24. INT. REV. CODE OF 1954, § 175.
25. *Id.* § 180.
26. *Id.* § 182.
27. Treas. Reg. §§ 1.446-1(a)(4)(i) (1973); *id.* § 1.471-1 (1960).
28. Treas. Reg. § 1.471-6(a) (1970).

2. *Capital Gains Treatment*

In addition to the benefits provided through the accounting rules, preferential capital gains treatment is accorded to the gain realized on the sale of certain farm assets—notably cattle, horses, and other livestock, and unharvested crops sold with the land.[29] Thus, upon the sale of qualifying assets, only one-half of the gain is subject to income tax.[30] If the assets are transferred at death, the entire gain is exempt from income tax.[31] However, the "recapture" provisions of the Internal Revenue Code limit to some extent the benefits conferred by the capital gains rules. Specifically, depreciation taken with respect to purchased livestock,[32] certain "excess deductions" attributable to farm operations,[33] and optional deductions permitted for soil and water conservation,[34] and land-clearing expenditures[35] are all recaptured as ordinary income.[36] All of these provisions limit only the capital gains aspect of the tax expenditure program; they have no impact on the deferral benefits derived from the cash method of accounting or from the inventory and capitalization rules for farmers.[37]

B. FARM-LOSS TAX SHELTER OPERATIONS

The tax rules described above and the advantageous utilization of nonrecourse financing provide the four ingredients essential to a successful tax shelter:

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29. INT. REV. CODE OF 1954, §§ 1231(a), (b)(3)-(4).

30. *Id.* § 1202. It should be noted that the special tax benefits that are made available to business generally also can be utilized by those involved in farm operations. For example, the investment tax credit was extended to livestock in 1971. *Id.* §§ 38, 48(a)(6). In addition, accelerated depreciation (*id.* §§ 167(b), (m); Treas. Reg. § 1.167(a)-11 (1974)), additional first-year depreciation (INT. REV. CODE OF 1954, § 179), and the various 5-year amortization provisions, such as for pollution control facilities (*id.* § 169), are available to farm businesses. These tax expenditures are provided to business generally and will not be analyzed in this Article where the concern is with those tax expenditure provisions specifically targeted to farm operations.

31. INT. REV. CODE OF 1954, § 1014.

32. *Id.* § 1245.

33. *Id.* § 1251.

34. *Id.* § 1252; *see id.* § 175.

35. *Id.* § 1252; *see id.* § 182.

36. For discussion of these provisions, *see* Davenport, *Farm Losses Under the Tax Reform Act of 1969: Keepin' Em Happy Down on the Farm*, 12 B.C. IND. & COM. L. REV. 319 (1971); Durham, *Farms and Farming*, N.Y.U. 29TH INST. ON FED. TAX. 1527 (1971).

37. *See 1973 Panel Discussions, supra* note 17, pt. 5, at 626 (statement of Prof. Davenport); Davenport, *Farm Losses Under the Tax Reform Act of 1969: Keepin' Em Happy Down on the Farm*, 12 B.C. IND. & COM. L. REV. 319, 331 (1971); Lewis, *Farm and Hobby Losses After Tax Reform*, U. SO. CAL. 1971 TAX INST. 627.

(1) *deferral* of income taxes by currently deducting costs that ordinarily would be deducted over time—in effect an interest-free loan from the government;

(2) the *shelter* of nonfarm income from tax by deducting net farm losses from nonfarm income;

(3) the use of *leverage*, which enables a nonfarm investor to obtain tax deductions for expenditures made with borrowed funds (and the investor may have no personal obligation to repay the loan);[38] and

(4) the availability of *capital gains* treatment upon the sale of certain farm assets, in effect requiring the taxpayer to repay only a portion of the federal loan.[39]

The net result of the above factors is to provide a very substantial dollar benefit to the person who can take advantage of the tax shelter. The most likely candidates are high-bracket taxpayers—doctors, dentists, corporate executives, and the like. But these investors are not farmers and may know nothing about the farming industry. How can they become "tax farmers" without having to become "real farmers"?

The answer is provided by syndicating the tax benefits for farmers and selling them to a large number of investors. The syndication of the farm-loss tax shelter is made possible by a long-standing Treasury Regulation applying to limited partnerships the rule developed in the context of individual income taxation. It provides that a taxpayer is entitled to include in his cost basis for deduction purposes the amount of a nonrecourse loan.[40] Application of this rule in the limited partnership context means that the syndicator is able to divide up and sell very large tax benefits for a very small equity outlay by the investor. Tax shelter offerings are now available to the high-bracket investor in virtually every type of farm operation—from cattle to chickens, from mink farms to vineyards, and from orchards to rose and azalea bushes.[41]

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38. For a further discussion of the principle of leverage, *see* text accompanying notes 64-67 *infra*.

39. These elements, which are common to a variety of tax shelter arrangements, are discussed in greater detail in S. SURREY, PATHWAYS TO TAX REFORM 92-125 (1973); McDaniel, *Tax Reform and the Revenue Act of 1971: Lesions, Lagniappes and Lessons*, 14 B.C. IND. & COM. L. REV. 813 (1973); McDaniel, *Tax Shelters and Tax Policy*, 26 NAT'L TAX J. 353 (1973).

40. Treas. Reg. § 1.752-1(e) (1960).

41. *See 1973 Panel Discussion, supra* note 3, pt. 5, at 620-22 (statement of Prof. Davenport).

The growth of farm tax shelter operations has had a decided impact on the farm economy. Examined below are findings by those who have studied the subject with respect to whether this impact is desirable or consistent with the country's overall national policy toward agriculture.

C. THE VIEWS OF TAX REFORMERS

For many years advocates of tax reform have urged the repeal, or substantial limitation, of the special tax rules for farm operations.

Those who advocate repeal of present preferential provisions do so to "restore equity to the tax system and to remove the unfair competitive advantage wealthy farm investors have over farmers . . . ."[42] Thus, the House Ways and Means Committee has recently been urged to require accrual acounting, capitalization of development costs, and the use of inventories by those engaged in farm operations. Although it was recognized that adoption of these proposals would result in a termination of the federal subsidy to farm operations provided by the present special tax rules, it was argued that any necessary federal agricultural subsidy should be structured by Congress in a way "which does not give the highest benefits to the people who need it the least: the highest bracket taxpayer[s]."[43]

This basic position is unassailable from the standpoint of *tax policy alone*. The present tax preferences for farm operations create easily identifiable inequities in our income tax structure: they result in two families with the same economic income paying different amounts of federal income tax; and they permit high-income taxpayers to pay the same, or lower, income taxes as do persons with much lower economic incomes. The case is compelling for a change in the tax rules for farm operations when the present situation is viewed from the standpoint of tax equity alone; the House of Representatives accepted this position in its 1975 Tax Reform Bill when it required certain corporations and partnerships to adopt ordinary tax accounting methods.[44]

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42. *See id.* at 618.

43. *Id.* at 617.

44. *See* H.R. 10612, 94th Cong., 1st Sess. § 204 (1975); H.R. REP. No. 94-658, 94th Cong., 1st Sess. 93-97 (1975). The Senate Finance Committee stripped the tax reform provisions from the bill, retaining only the provisions that extended the tax cuts effected by the Tax Reduction Act of 1975 (Pub. L. No. 94-12, 89 Stat. 26). The tax reduction extension was ultimately passed by Congress as the Revenue Adjustment Act of 1975 (Pub. L. No. 94-164, 89 Stat. 970). The tax reform provisions of H.R. 10612 thus remained in the Senate Finance Committee for action in the second session of the 94th Congress.

Others interested in tax reform admit the case for tax equity, but conclude that the federal financial assistance delivered through the tax system should be continued for those whom they refer to as "legitimate farmers." Proposals are thus advanced to exclude the nonfarm investor from, or limit his participation in, the tax subsidy program. Various mechanisms have been suggested to achieve this result: impose a minimum tax on farm tax preferences;[45] limit the deductibility of farm expenditures to farm income (or to farm income plus a specified dollar amount of nonfarm income);[46] or confine an investor's farm deductions to the amount of his investment actually "at risk."[47] All of these proposals agree that limits on federal financial aid should be imposed only on nonfarmers who seek to take advantage of the federal subsidies intended for full-time farm operations.

D. Industry Views

Some farm industry representatives have agreed with advocates of tax reform that the present tax rules for farm operations are not proper as tax rules. For example, some farm industry representatives have candidly admitted in testimony before the House Ways and Means Committee that the cash method of accounting "does not provide a precise measurement of income on an annual basis"[48] and, as a general proposition, the accrual method is favored.[49]

Although some farm industry representatives recognize the problems with the present rules *as tax rules*, they nonetheless defend the continuation of the present system of tax expenditures for farm operations on one or more of the following grounds:

(1) The cash method is "simple," "workable," and "low cost."

(2) Use of inventories is not feasible as a practical matter due to difficulties in taking actual inventories of farm products and in allocating costs among different types of farm operations.

(3) The cash method of accounting produces "cost savings" to

45. This procedure was adopted by the House Ways and Means Committee in the version of the minimum tax it adopted in 1969. *See* H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 2, at 56 (1969).

46. *See, e.g.*, H.R. 10612, 94th Cong., 1st Sess. § 101 (1975).

47. *Id.* § 207. This proposal would effectively eliminate the benefit of leverage.

48. *1973 Panel Discussions, supra* note 17, pt. 5, at 661-62; *Public Hearings Before the House Comm. on Ways and Means on the Subject of General Tax Reform*, 93d Cong., 1st Sess., pt. 3, at 1136 (1973).

49. *1973 Ways and Means Hearings, supra* note 19, pt. 6, at 2160.

farmers by allowing them to deduct purchases of feed at times when prices are low.

(4) Present tax rules generate cash flow during periods when farmers, for market reasons, hold crops off the market.

(5) Present tax rules moderate erratic price patterns that segments of the farm industry experience from year to year.

(6) Present tax rules generate needed capital for the industry.[50]

When carefully analyzed these propositions are arguments in favor of a certain kind of expenditure program. The last four arguments listed above favor the present tax expenditure system because it provides a steady and reliable cash flow and encouragement allegedly needed for capital investment. The first two arguments, although nominally concerned with a method of accounting, are better understood as supporting the perceived administrative simplicity of the tax spending programs.

The views of tax reformers and farm industry advocates are not necessarily incompatible. They are simply addressed to different objectives. The goal of tax reform proponents is a more equitable income tax system, but this objective is not inconsistent with providing a federal subsidy to farm operations. The goal of farm industry representatives is maintenance of the present $1 billion in annual federal financial support for farm operations, but this objective is not inconsistent with tax reform. The goals of both groups can be achieved, however, only by taking the present $1 billion farm subsidy out of the income tax system. Considerable evidence exists that such a step will improve not only tax equity, but also the equity, efficiency, and effectiveness of the agricultural subsidy program.

III. THE FARM TAX-LOAN PROGRAM

The present tax rules constitute a mechanism by which the federal government annually loans funds to farmers and farm investors. The loans are also repaid through the tax system, although to a significant extent the tax rules also provide for partial or total forgiveness of the indebtedness.

The farm tax-loan program should be evaluated by asking the same questions that are asked of a direct federal spending program:

(1) Does it fill a need that is not being met by free market mechanisms?

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50. The listed arguments appear throughout the testimony cited in note 19 *supra*.

(2) Is it effective in meeting that need?

(3) How do its costs compare to its benefits?

(4) Are the results of the program consistent with the goals of other programs providing financial support for agriculture?

(5) Are the financial benefits of the program equitably distributed among income groups?

Only when these questions are answered can the farm tax-loan program be evaluated properly. The answers will determine whether the program should be terminated in whole or in part or transformed into a direct subsidy program. This section reviews the data and analyses that are presently available to assist policymakers in evaluating the present farm tax-loan program.

A. Scope of the Program

In fiscal year 1977, the farm tax-loan program will provide over $1 billion of federal financial aid to the agricultural sector of the economy. This figure represents about one-third of the aggregate federal subsidies to agriculture that appear in the budget.[51] Federal aid to agriculture effected through the income tax system has for the past several years been consistently around the $1 billion level.[52] When the levels of tax

51. The tax expenditure budget does not distinguish between loan programs and outright aid programs. In this respect it does not mirror the budget itself, which includes only direct expenditure programs in the budget total and lists credit programs separately. U.S. Office of Management and Budget, Special Analyses, The Budget of the United States Government: Fiscal Year 1976, at 108 (1975) (Special Analysis F). Some budgetary experts argue that the present budget is deficient in failing accurately to reflect the impact of federal credit programs. *See, e.g.*, Weidenbaum, *Reducing the Inflationary Impact of the Federal Budget*, in National Tax Ass'n & Tax Institute of America, Proceedings of the Sixty-Seventh Annual Conference on Taxation 324 (1974). Under this view the tax expenditure budget is correct in including both loan and outright aid programs, although it would appear helpful to identify each program by type.

The $1 billion figure for fiscal 1977 includes $650 million representing loans forgiven.

52. The following table sets forth the historical levels of federal aid to agriculture that have been provided through the income tax system:

Fiscal Year	Federal Tax Subsidies (billions of dollars)
1977	$1.080
1976	.980
1975	1.095
1974	1.300
1973	1.075
1972	1.015
1971	1.000
1970	1.020
1969	1.000
1968	.930

subsidies and direct subsidies are compared to the total federal aid to agriculture during the past several years, it is apparent that tax subsidies have comprised a significant portion of the total:[53]

Fiscal Year	Budgeted Federal Subsidies (billions of dollars)	Tax Subsidies (billions of dollars)	Total Direct Budget and Tax Subsidies (billions of dollars)	Tax Subsidies as Percent of Total Subsidies
1977	$2.584	$1.080	$3.664	29.5%
1976	3.348	0.980	4.328	22.6
1975	2.107	1.095	3.202	34.2
1974	2.477	1.300	3.777	34.4

It is thus clear that the federal tax subsidies for agriculture represent a major component of the total United States agricultural program. Indeed, for fiscal 1976 the tax subsidy was budgeted to be the single largest agricultural subsidy.[54]

The data is compiled from various tax expenditure budgets that have been prepared by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation and by the Office of Management and Budget. For a complete listing of the tax expenditure budgets prepared for fiscal years 1968-1976, *see* 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 242 (1972); *id.* at 101 (Supp. 1975).

53. 1976 FEDERAL BUDGET, *supra* note 11, at 93, 100; 1977 FEDERAL BUDGET, *supra* note 11, at 85, 95. The figures listed include funds for agricultural conservation programs. It must be recognized that the above figures understate both the level of direct federal support for agriculture and the level of tax subsidies for agriculture. Direct federal aid to agriculture is provided in budget programs other than that of the Department of Agriculture and through credit programs that do not appear in the budget. *See* Woods & Carlin, *Utilization of Special Farm Tax Rules*, in Income Tax Rules and Agriculture, Dec. 1974, at 17, 19 (Special Report No. 172, Agricultural Experiment Station, University of Missouri—Columbia) [hereinafter cited as Income Tax Rules and Agriculture], which identifies some 18 separate programs for agriculture.

But it is also true that federal tax expenditures for agriculture are provided through programs benefiting businesses generally. For example, agriculture benefits from part of the federal tax expenditure programs effected through the investment tax credit. accelerated depreciation for machinery, equipment, and improved real estate, and 5-year amortization for pollution control facilities. While the above data are thus incomplete both as to direct and tax subsidies, it seems likely that the relative level of support effect through the two mechanisms is approximately as depicted above.

54.

Program	Amount (billions of dollars)
Tax subsidies	$.980
Farm income stabilization (price support, etc.)	.881
Agricultural research and services	.938
Agricultural conservation programs	.302
Commodity Credit Corporation (outlays for agriculture)	.693

1976 FEDERAL BUDGET, *supra* note 11, at 93, 100-03. In fact, because of large increases in the price support program, the farm income stabilization total for 1976 was estimated

Legislative jurisdiction over the largest single federal program for agriculture is the responsibility of the House Ways and Means Committee and the Senate Finance Committee because that program is run through the tax system. But the size and nature of the program make it imperative that the committees and Congress understand and evaluate the tax direct subsidy programs in the same fashion that direct programs are understood and evaluated by the congressional Agricultural Committees.

B. The Operation of the Loan Program

Although the federal tax-loan program works somewhat differently in each segment of the agricultural sector, the basic mechanics are the same in each instance. This section will describe the elements of the loan program that are common to all types of agricultural operations. Specific operations in the farm sector also will be examined to see how the loan program varies somewhat for different types of agricultural activity.

1. *Making the Loan*

The federal government makes its tax loans to farmers and farm investors through those tax rules that defer payment of taxes that otherwise would be due if normal tax rules were in effect. As noted above, three different tax rules that deviate from ordinary tax accounting provide this deferral: the cash method of accounting, the failure to require use of inventories, and the option to deduct currently costs that are capital in nature.[55] The effect of deferral of income taxes is the same as if the government had collected the taxes and then made a loan to the farmer or farm investor in the same amount. This loan is interest free and is unsecured.

2. *Eligibility for the Loan*

Any farmer or farm investor is eligible for the farm tax loans. He is not required to establish either that he has a good credit rating or, in the case of low-income farmers, that he is unable to secure the loan through commercial credit sources. No loan committee approves the loans; they are automatically made available to every farmer or farm investor who files a federal income tax return. However, the taxpayer's return must

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to reach $1.896 billion and thus proved to be larger than the tax expenditure program. 1977 Federal Budget, *supra* note 11, at 95.

55. See text accompanying notes 21-28 *supra*.

show some gross taxable income in order to benefit from the tax-loan program since the loans are made in the form of special deductions from gross income.[56]

These eligibility requirements exclude those farmers who have no otherwise taxable income (because, for example, they have experienced net economic losses) as well as farmers with incomes below the poverty level. In the latter case, eligibility is precluded because poverty-level families neither have taxable income nor are they required to file federal income tax returns. In the case of a farmer with an actual net economic loss, the existence of further special tax losses is of no assistance, so that he too is effectively excluded from the tax-loan program for the current year.[57]

3. *The Amount of the Loan*

The amount of the federal farm tax loan is determined by the farmer's or investor's federal income tax bracket. The higher the tax bracket, the larger the loan that the federal goverment will make. For example, suppose that a farmer in the 20 percent tax bracket wants to make a farm expenditure in 1976 of $1,000. Assume that special tax rules for farmers permit full deduction of the $1,000 in 1976, although normal tax rules would require that the deduction be deferred until 1977, the year in which the income to which the costs relate will be made. Under the tax-loan system the farmer receives in 1976 a federal loan of $200 (20 percent of $1,000). In other words, the farmer has present use of the $200 which he would have had to pay in taxes had the $1,000 expenditure not been currently deductible. But if a farmer or farm investor in the 50 percent income tax bracket made the same $1,000 expenditure, the government will grant him a $500 loan. A 70 percent bracket taxpayer will receive a $700 federal loan for the same $1,000 expenditure.

In other words, the federal government says to the 20 percent bracket farmer, "If you can come up with $800 of your own funds, we will loan you $200." But it says to the 50 percent bracket taxpayer, "If you come up with $500 of your own money, we will loan you another

56. Of course, the gross income against which the special deductions are taken need not be from farming; the income could also be derived from the taxpayer's dental practice, etc.

57. The benefit of the tax loan may be realized currently if a net operating loss carryback can be utilized, or in the future through the net operating loss carryforward. INT. REV. CODE OF 1954, § 172(b).

$500." And to the most favored borrower of all, the 70 percent bracket taxpayer, the government states, "If you will invest only $300 of your funds, we will give you a $700 loan." Of course, as noted above, the poverty-level farmer or a farmer who has suffered a net economic loss during the tax year and has no taxable income from which to deduct the $1,000 expenditure is told: "If you want to put $1,000 into farming, you must come up with the entire amount yourself; there is no federal loan money for you."

4. *The Term of the Loan*

The time within which the original farm tax loan must be repaid varies according to the particular tax rule that is employed to effect the loan. In the case of farms which have reached the productive stage for annual crops, and in the case of prepayments for feed, the original term of the loan is generally 1 year. In most of these situations, use of the cash method of accounting and the failure to employ inventories defer tax liability from one taxable year to the next.

In those situations where the taxpayer is given the option to deduct currently what would otherwise be capital costs, the period of the original loan will vary with the type of agricultural operation involved. Thus, in the case of currently deductible expenditures that are related to an asset with a determinable useful life, the loan is repaid over the useful life. An immediately deductible expenditure attributable to an asset with a 40-year life is obviously more valuable to the taxpayer than one attributable to an asset with only a 15-year useful life because an interest-free loan repayable over 40 years has a greater present value than an interest-free loan in the same amount repayable over 15 years.

On the other hand, if the deductible capital cost relates to land, and hence is not depreciable or amortizable, the period of time over which the loan is repaid, and hence the rate of repayment, is variable, since only a sale of the land will produce the final loan settlement with the government. The special deductions for soil and water conservation expenditures, fertilizer, and land clearing costs are examples of this latter type of loan arrangement.[58]

In all of these situations, the farm tax loan can be renewed beyond the original period by making new deductible capital expenditures in the years in which the loan would otherwise have to be repaid in whole or in part. Thus a farmer who had deducted prepaid chicken feed expenses

58. *Id.* §§ 175, 180, 182.

in the fall of 1975 and realized income on the sale of chickens in 1976 can extend the 1975 loan by purchasing more feed in the fall of 1976. The same is true of tax loans for cattle, orchards, and vineyards although the timing of the new expenditure is different in each case.

5. *Repayment of the Loan*

The farm tax loan is repaid to the government in years subsequent to the deferral year by paying federal income taxes in those years that are larger in amount than would otherwise have been due had proper tax rules been in effect. A simple example will illustrate the repayment mechanism. Suppose a farmer has $10,000 of income each year. In 1975, he incurs a farm expenditure of $1,000 which, under present tax rules, he can deduct in that year. Assume ordinary tax accounting rules would allocate $500 of the expenditure to 1975 and $500 to 1976. No similar expenditure is made in 1976. Under present farm tax-loan rules, he has the following tax results:

	1975	1976
Income	$10,000	$10,000
Deductible Expenditure	1,000	0
Net Income	9,000	10,000
Tax Liability	$ 1,840	$ 2,090

Under the tax rules which apply to ordinary, nonfarm income, the results would have been:

	1975	1976
Income	$10,000	$10,000
Deductible Expenditure	500	500
Net Income	9,500	9,500
Tax Liability	$ 1,965	$ 1,965

The above example makes clear that in 1975 the farmer received a farm tax loan of $125 ($1,965 - $1,840) which he repaid in 1976 by paying $125 ($2,090 - $1,965) more in federal taxes than he would have under regular tax rules.

If, in the above example, the farmer incurred another $1,000 in deductible expenditures in 1976, his $125 loan from 1975 is in effect extended for another year. And if he continues each year for 20 years to make the same $1,000 expenditure, the loan is automatically extended for the full 20-year term. Because this automatically renewable loan

is interest free, the economic benefit can be very substantial indeed, especially to a taxpayer who otherwise would be required to pay 10 percent or more (with substantial security) for a commercial loan. If the farmer in the above example wished to increase his federal farm tax loan in 1976, he could do so by increasing the amount of his deductible expenditure in that year.

The preceding discussion assumed that present tax rules would require repayment of the loan in full. But this is not always the case. Gain on the sale of some livestock and farm products is taxed at preferential capital gain rates.[59] Since these rates are 50 percent of normal tax rates, the capital gain provisions result in the forgiveness of 50 percent of the farm tax loan. Suppose, in the example above, that $1,000 expenditure in 1975 was attributable to a breeding cow that was sold in 1976 for $500. Present rules produce the following results:

	1975	1976
Income	$10,000	$10,000
Deductible Expenditure	1,000	0
Excluded one-half of capital gain	0	250
Taxable Income	9,000	9,750
Tax Liability	$ 1,840	$ 2,027.50

Where capital gain rules were not involved, the tax liability in 1976 was $2,090, or $125 greater than the tax bill would have been under ordinary tax accounting rules. Hence the 1975 tax loan of $125 was repaid in full. But introduction of the capital gain preference for 1976 produced a tax bill of only $2,027.50, or $62.50 above the regular tax liability. The deductible expenditure in 1975 produced a $125 loan; the capital gain rules effected a loan foregiveness of one-half the outstanding farm tax loan in 1976.[60]

As in the case of the basic loan, the higher the farmer's or investor's tax bracket, the larger the farm tax loan the government forgives.

59. *Id.* § 1231(b).

60. The example assumes a sale at an economic loss. If the sale price had been $1,000, a profit would have been realized by the farmer by virtue of the interaction of the deduction against ordinary income and the capital gains treatment. That is, not only would the tax loan have been forgiven, but a positive cash payment would have been generated for the taxpayer. This is the "negative income tax" effect of present rules described by Professor Davenport in *1973 Panel Discussions, supra* note 17, and Halperin, *Capital Gains and Ordinary Deductions: Negative Income Tax for the Wealthy*, 12 B.C. IND. & COM. L. REV. 387 (1971).

6. *Farm Tax Loans to Investors in Farm Tax Shelters*

Although the farm tax-loan program described above was presumably intended for persons whose principal occupation is farming, its benefits are not too circumscribed. This is because the Internal Revenue Service definition of a "farmer" is far more expansive than the normal use of the term. Not only does the IRS definition include those engaged in farming in the "ordinary accepted sense," but it also includes anyone who operates a farm through a manager or agent, thus permitting the owner to be a "farmer" even if he does not actively participate in the farm operations.[61] More critically, one is a farmer if he is a member of a partnership that is engaged in "farming" activities.[62] This last rule permits doctors, dentists, entertainers, lawyers, corporate executives, and other high-bracket investors to be "IRS farmers" even if they have never seen a farm. In terms of the analysis offered in this paper, present tax rules enable those who in the "ordinary accepted sense" would never be considered "farmers" at all to reap the financial benefits of the federal farm tax-loan program.

Under tax shelter operation, the wealthy nonfarm investor becomes an "IRS farmer" by becoming a limited partner in a partnership that is engaged in the business of farming. Under tax rules applicable to limited partnerships, each limited partner is entitled to his distributive share of partnership tax profits and losses.[63] That is, the tax benefits described above are simply apportioned to each individual limited partner.

For example, a 50 percent bracket investor could place $100,000 in a cattle feeding limited partnership which would give him a $100,000 deduction against nonfarm income in the year of investment. This means that in year one, the investor has actually placed only $50,000 of his own funds in the partnership plus his interest-free $50,000 federal farm tax loan. In year two when the cattle are sold, the investor receives funds from the partnership with which he repays the $50,000 tax loan, recovers his investment and (hopefully) makes a profit.

If the foregoing were all that is involved in a farm-loss tax shelter operation, few would presumably invest in it for the tax benefits alone. The only real benefit to the investor is the after-tax savings resulting from the interest-free loan. Assuming that our 50 percent bracket

61. Treas. Reg. § 1.175-3, T.D. 6649, 1963-1 CUM. BULL. 49.
62. *Id.*
63. INT. REV. CODE OF 1954, § 704.

cattle feeder investor would have to pay 10 percent if he borrowed in the commercial money market, his before-tax interest cost would be $5,000 (10 percent of $50,000) and his after-tax cost (because of the deduction for the interest) on the money would be $2,500 (50 percent of $5,000). The investor has thus realized an after-tax return on his $50,000 net investment of 5 percent. If the investor could have purchased $50,000 of tax-exempt bonds paying more than 5 percent interest, he would have been better advised to pay his taxes and forget the tax shelter deal. If the investor is in a 60 percent or 70 percent bracket, however, he gets a larger tax loan and the after-tax return on his tax shelter investment is correspondingly greater—6 percent for the 60 percent bracket investor and 7 percent for the 70 percent bracket investor. But even for these higher-bracket individuals, it is likely that tax-exempt municipal bonds could be purchased that would equal or exceed the net after-tax benefits of the tax shelter operations that are produced by the tax rules alone.

The device which makes the farm tax shelter investment attractive is nonrecourse borrowing by the partnership. Under tax rules, the partnership can borrow funds on a nonrecourse basis and the investor is treated for tax purposes as if he had made an investment of his pro rata share of the nonrecourse liability.[64] He receives the same tax benefits he would have received if he had invested his own personal (or borrowed) funds. Technically this result is achieved by permitting the invester/limited partner to include in his tax basis his pro rata share of nonrecourse liabilities of the partnership. He can then deduct his distributive share of partnership tax losses up to that basis.[65]

Hence, in the example above, suppose that the 60 percent bracket investor was only required to invest $40,000 of his own funds because the partnership could borrow the other $60,000 on a nonrecourse basis. The partnership has the use of the same $100,000. Under the transaction outlined above, the partnership derived this $100,000 from the limited partner; his net investment, though, was $40,000 because of the tax saving represented by the $60,000 federal tax loan. With the nonrecourse borrowing technique, the partnership has obtained $60,000 in the normal money market and only $40,000 from the investor. But because the investor still gets a full $100,000 deduction against his nonfarm income, he has the interest-free use of the $60,000 government loan. He can invest this $60,000 in 6 percent tax-free bonds for a

64. Treas. Reg. § 1.752-1(e) (1960).
65. INT. REV. CODE OF 1954, § 705(a)(2).

return of $3,600. At the end of year one, the investor can repay his government loan by selling his bonds. But the investor's rate of return on his $40,000 has been increased from 6 percent to 9 percent ($3,600 after-tax interest on $40,000 invested).

This is merely an example, in simplified terms, of how "leverage" in tax shelter operations enhances the value of tax deferral.[66] Of course, the results of leverage obtain for an individual as well as a limited partner. But as a practical matter, a bank likely would not be inclined to loan $60,000 on a nonrecourse basis to a dentist who has never been near a farm. The manager of the partnership, however, can obtain such financing if he is an experienced farm operator. Thus, it is only by joining forces with a farm operator that the dentist can actually get the tax benefits of nonrecourse financing.[67]

Tax shelter operations investing in breeding herds and horses use these same principles and can also provide their investors/limited partners with the advantages of capital gains, since the character of the partnership income remains the same for individual partners. Thus, the 60 percent bracket investor could obtain even greater financial advantages in a cattle breeding operation where the loan period is longer and only one-half the loan must be repaid.

7. *Distribution of the Benefits of the Farm Tax-Loan Program*

The distribution of the financial benefits of the farm tax-loan program among income groups can be seen from the Table 1 below, which reflects the total expenditures by adjusted gross income (AGI) class under the farm tax-loan program for calendar year 1972. The table also sets forth the average tax expenditure within each AGI class for those returns showing farm profit or loss in 1972:[68]

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66. For other ways of describing the interaction of deferral and leverage, *see* S. SURREY, PATHWAYS TO TAX REFORM 108-13 (1973).

67. A number of farm-loss tax shelter operations are described in STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., TAX SHELTERS: FARM OPERATIONS 9-20 (Comm. Print 1975), and in J. Dangerfield, Sowing the Till (background paper prepared for the Agribusiness Accountability Project) (reproduced at 119 CONG. REC. 15988 (1973)). *See also* R. HAFT, TAX SHELTERED INVESTMENTS, §§ 6.01-7.04 (2d ed. 1974).

68. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1972, INDIVIDUAL INCOME TAX RETURNS 15 (1974); STAFFS OF THE TREASURY DEP'T & JOINT COMM. ON INTERNAL REVENUE TAXATION, 93D CONG., 1ST SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES 7 (Comm. Print 1973).

TABLE 1

AVERAGE FEDERAL EXPENDITURES BY AGI CLASS UNDER FARM TAX-LOAN PROGRAM FOR INDIVIDUALS CALENDAR YEAR 1972

AGI Class (thousands)	Total Farm Tax-Loan Benefits Received by AGI Class (Expensing and Capital Gains) (millions)	Number of Returns Reflecting Farm Profit or Loss (thousands)	Average Benefit Per Farm Return
$ 0-3	$ 15	557.2	$ 26.92
3-5	50	341.0	146.63
5-7	90	340.0	264.01
7-10	130	468.2	277.66
10-15	170	553.3	307.25
15-20	100	249.3	401.12
20-50	185	234.5	788.91
50-100	60	34.7	1,729.11
100 & over	50	11.3	4,424.78
TOTALS	$ 850	2,790.4	$ 304.62

As can be seen from Table 1, the individual who had over $100,000 of adjusted gross income received an average tax subsidy more than 160 times greater than the farmer with adjusted gross income of less than $3,000.

Data prepared by the Treasury Department for fiscal year 1974 reflect the same pattern. Table 2 sets forth the distribution of the farm tax-loan benefits for fiscal year 1974 by AGI class:[69]

69. These calculations are reproduced in 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 107 (Supp. 1975). They were prepared by the Treasury Department at the request of Senator Mondale. *See* 121 CONG. REC. 9174 (daily ed. June 2, 1975) (statement of Sen. Walter F. Mondale).

TABLE 2

DISTRIBUTION OF BENEFITS OF FARM TAX-LOAN PROGRAM BY AGI CLASS, FISCAL YEAR 1974

AGI Class (thousands)	Expensing of Certain Agricultural Capital Outlays (millions)	Percentage Distribution by Segment	Capital Gains Treatment of Certain Agriculture Income (millions)	Percentage Distribution by Segment
$ 0-3	$ 10	33.6%	$ 10	33.7%
3-5	35		30	
5-7	60		55	
7-10	90		80	
10-15	115	31.9	105	31.7
15-20	70		60	
20-50	125	21.6	115	22.1
50-100	40	12.9	35	12.5
100 & over	35		30	
TOTALS	$ 580	100.00%	$ 520	100.0%

Table 2 shows that in fiscal 1974 the rules permitting immediate deduction of otherwise capital expenditures produced a revenue loss to the United States Treasury of $580 million. Of this amount, 12.9 percent (or $74.8 million) went to the wealthiest 1.3 percent of individuals, those with over $50,000 of adjusted gross income; 21.6 percent of the $580 million (or $125.2 million) went to the 13.4 percent of individuals with adjusted gross incomes between $20,000 and $50,000. Thus, 34.5 percent of the benefits of the loan program went to the 14.7 percent of taxpayers in the United States who reported the highest income in 1974. By contrast, about the same percentage of the benefits went to the 37 percent of taxpayers with adjusted gross income below $10,000. The capital gain benefits were similarly distributed: 12.5 percent of the $520 million expended went to the 1.2 percent of taxpayers with incomes in excess of $50,000 per year; 34.6 percent of the benefits went to the 14.6 percent of taxpayers with adjusted gross incomes in excess of $20,000.

C. Evaluation of the Farm Tax-Loan Program

1. *Comparison of the Tax and Direct Subsidy Programs for Agriculture*

One useful way of evaluating the subsidy program contained in the present tax provisions is to compare it with federal programs providing direct financial assistance to agriculture. The question for policy makers should be: are the results of the tax program consistent with the results and objectives of direct federal agricultural programs? As the following discussion indicates, the tax-loan program appears to produce results that are in several important respects directly antithetical to those the Government is trying to achieve in its direct aid programs.

The Government has various programs offering financial aid to agriculture. Some of the programs involve direct cash payments; others are credit subsidies; and a few provide benefit-in-kind assistance.[70]

a. *Direct cash payment programs*: The largest direct cash payment programs are the price and income support programs for feed grain, wheat, and cotton—an estimated $1.4 billion in fiscal 1976 under current legislation.[71] In terms of their after-tax benefits to farmers these programs are the exact opposite of the tax program because the benefits received under the direct programs are included in the income of the recipient for federal tax purposes.[72] As a result, under the direct cash assistance programs, the relative after-tax benefits are greatest for low-income farmers and these benefits decrease as income increases.[73] The

70. On price and income support programs generally, *see* Woods & Carlin, *Utilization of Special Farm Tax Rules*, in Income Tax Rules and Agriculture, *supra* note 53, at 17, 19.

71. 1977 Federal Budget, *supra* note 11, at 97.

72. All government payments must be included in gross income whether received in cash, materials, or services. Internal Revenue Service, Farmer's Tax Guide 22-23 (IRS Pub. No. 225, 1975 ed.). *See also* Baboquivari Cattle Co. v. Commissioner, 135 F.2d 114 (9th Cir. 1943) (amounts received by a corporation under the Soil Conservation and Domestic Allotment Act for construction of approved conservation projects held not "capital subsidies" and properly includible in gross income); Harding v. Commissioner, 29 CCH Tax Ct. Mem. 789 (1970) (amounts received under the Great Plains Conservation Program for construction of approved conservation project held includable in gross income); Rev. Rul. 60-32, 1960-1 Cum. Bull. 23 (acreage reserve and conservation payments received under the Soil Bank Act are received in lieu of receipts from farm operations and as such are includible in gross income); I.T. 3379, 1940-1 Cum. Bull. 16 (subsidies received under various government programs were received in lieu of receipts from normal farm operations and as such constituted taxable income); I.T. 2767, XIII-I Cum. Bull. 35 (1934) (rental or benefit payments made to producers for reduction in acreage or reduction in production of specified commodities constituted taxable income).

73. The statement focuses on the impact of tax rates. The absolute amount received by each income group under direct payment programs must also be considered.

farm tax-loan program produces precisely the opposite result: benefits are smallest for low-income farmers and increase as income increases.

For example, treating the cash subsidy as taxable income results in the following pattern of net after-tax benefit for a $1,000 direct payment to farmers. For the poverty-level farmers, the net benefit is the full $1,000 since the payment is not subject to federal income tax;[74] under the tax-loan program this farmer receives nothing. For a farmer with $10,000 of taxable income, the net benefit of the direct cash payment is $750 (because he is in the 25 percent marginal income tax bracket); under the tax-loan program his loan is $250. For a farmer with $100,000 of taxable income, the net benefit of the direct cash payment is $310 (assuming a 69 percent marginal tax bracket); but under the tax-loan program his loan is $690. In short, under the direct cash payment programs, the maximum financial aid is provided to the poverty-level farmer and the relative net benefit declines as income increases. Under the tax-loan program, no financial aid is provided to the poverty-level farmer and the relative net benefit increases as income increases. The income redistribution effects of the farm tax-loan program are thus precisely the opposite of those provided by the direct aid programs.

Another of the government's direct cash assistance programs, the Rural Environmental Assistance Program (REAP),[75] provides direct cost-sharing payments to farmers for land and water conservation projects. When the effects of REAP are compared to those of the tax program for soil and water conservation,[76] it is apparent that the results are divergent.

Under REAP, the rate of federal cost sharing is generally set at 50 to 75 percent of total project costs. But in the case of "low-income" farmers or ranchers, the federal cost sharing percentage can be increased to 80 percent.[77] In addition, payments received by farmers under the

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Criticism has been leveled at the direct crop subsidy programs because they are structured to provide amounts to high-income farmers that are considered too great by critics of these direct programs.

74. The low-income allowance and the personal exemptions are structured to exempt poverty-level families from federal income tax.

75. 16 U.S.C. §§ 590d, g-q (1970).

76. For a comparison of the economic effects of REAP and the applicable tax provision, INT. REV. CODE OF 1954, § 175, *see* Boxley & Anderson, *An Evaluation of Subsidy Forms for Soil and Water Conservation*, in SUBCOMM. ON PRIORITIES AND ECONOMY IN GOVERNMENT OF THE JOINT ECONOMIC COMM., 93D CONG., 1ST SESS., THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS, pt. 7, at 953 (Comm. Print 1973).

77. 7 C.F.R. § 701.36 (1975).

REAP program must be included in income for federal income tax purposes.[78] These two factors differentiate the REAP program from the farm tax-loan program. REAP payments are taxable, the maximum net economic benefit is provided to poverty-level farmers, and the relative net benefits decrease as income rises. The tax program has precisely the opposite results: no assistance is provided to poverty-level farmers, and the relative net benefit increases as income rises. Although the tax program benefits are restricted to an amount equal to 25 percent of the gross income derived from farming, the excess over that amount is available in succeeding years. In effect, the tax program provides cost sharing based not on project costs, but on the income of the farmer. As a result the farm tax-loan program has a regressive income distributional effect while the REAP program has been structured to produce the opposite effect, progressive income redistribution.

b. *Direct credit programs*: Since the farm tax program is essentially a loan program, it is also useful to compare it to direct federal credit programs for farmers. Under one Farmer's Home Administration Program, the Secretary of Agriculture is authorized to make operating loans to farmers.[79] The terms and conditions of these direct loans[80] are in marked contrast to those discussed above for obtaining farm tax loans:

(1) Loan applicants must have "a farmer background and training or farming experience" which will "assure reasonable prospects of success in the proposed farming operations."

(2) Loan applicants must be operators of a farm "not larger than family farms."

(3) Under the regulations, no one is eligible for a loan who is "already earning sufficient income to have a reasonable standard of living" since he can obtain commercial credit on reasonable terms.

(4) The regulations limit the amount of the loan by the "needs of applicant and his ability to pay," but in no event may the loan exceed $50,000.

(5) Interest is charged at the rate of 6⅜ percent per annum.

(6) The loans may be secured by various commercial security instruments.

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78. *See* note 72 *supra*.
79. 7 U.S.C. § 1989 (1970).
80. 7 C.F.R. § 1831.10(d) (1975).

The farm tax loans available for operating purposes are virtually the exact opposite of the direct operating loans:

(1) An "IRS farmer" need have no experience in farming and, indeed, need never come near a farm.

(2) Commercial success in tax farming is irrelevant: the tax-loss farmer can show a profit even if the operation produces an economic loss.

(3) Tax loans are not restricted to "family farmers."

(4) No interest is charged and the government has no security for repayment.

(5) There is no requirement that the recipient demonstrate a need for the tax loan; indeed the largest tax loans are made available to those who have demonstrated by their incomes that they have the least need of federal aid.

(6) There is no upper limit on the amount of a tax loan that can be obtained.

It is worth noting that the direct operating loan program has no provision by which the Government forgives part of the loan. Under the tax-loan program, of course, it is possible in some cases to be relieved of the obligation to repay one-half of the loan. Even if a direct operating loan were forgiven in part, the results would still differ from the tax program. If a direct loan were forgiven in part, the amount forgiven would have to be included in income (or basis reduced).[81] As a result, the relative net benefit of the loan forgiven would be greatest for low-income farmers and least for high-income farmers. But, as detailed above, the partial forgiveness of the tax loan produces the opposite result.

A comparison of other direct federal credit programs to the farm tax-loan system produces results following the same general pattern outlined above. This analysis supports the following conclusions with respect to the farm tax-loan program:

(1) It is inconsistent with direct farm programs with respect to loan eligibility and the terms and conditions of the loan.

(2) Its distributional effects relative to income are the opposite of direct programs.

81. INT. REV. CODE OF 1954, §§ 108, 1017.

2. *The Tax Loan Program and Aid to Family Farmers*

One of the primary justifications offered for the present tax expenditure program is that it aids the small family farmer. The concern is that if present tax rules are changed, it is the small family farmer who will suffer.

Several agriculture economists who have examined the matter suggest that in fact the opposite may be true: present tax rules may be hurting the small farmer and hastening the demise of the family farm. For example, industry spokesmen have claimed that the cash method of accounting is essential to the small family farmer. It is "workable," "simple," and provides needed cash flow.[82] A Michigan State University study[83] has pointed out the fallacy in this argument. The tax rules, the study agrees, constitute a loan program. As a result, leverage is provided for farm operations. But in an inflationary economy the advantages of this leverage are realized in full only if it is perpetually maintained. This can only be done by continuous expansion. Therefore, the maximum advantages of the tax-loan program can only be obtained by becoming a large-scale farmer.[84] Hence the results of the cash method of accounting may be precisely the opposite of those sought to be achieved. Because the largest benefits are provided to the wealthiest and because the maximum advantage of leveraging can only be obtained by continued expansion, the present tax-loan program may well be detrimental to the small farmer and help to insure the disappearance of the family farm as a major feature of our agricultural structure.

Many direct federal programs for agriculture attempt to solve the problem of the family farmer by specifically providing that benefits are

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82. *See* testimony cited in note 19 *supra.*

83. Kyle, *Consequences of Income Tax Law and Regulations: Financial Management Practices*, in Income Tax Rules and Agriculture, *supra* note 53, at 32. *See also* the statement of the American Nat'l Cattlemen's Ass'n in *Public Hearings Before the House Comm. on Ways and Means on the Subject of General Tax Reform*, 93d Cong., 1st Sess., pt. 3, at 1083 (1973): "The deferral aspect of cash accounting does permit, even encourages, expansion of the livestock enterprise. If a farmer reduces his operation, the so-called deferrals catch up to him." In an inflationary economy, the deferrals "catch up" (*i.e.*, the loan is called) to the farmer even if he just stays the same size.

84. The Michigan State University study concluded that "[s]mall farmers who have little intention of expansion will wake up some day and insist that all farmers be put on an accrual basis." Kyle, *Consequences of Income Tax and Regulations: Financial Management Practices*, in Income Tax Rules and Agriculture, *supra* note 53, at 32.

to be used exclusively for those engaged in "family farming" operating "established family farms."[85] When Congress perceives financial assistance as a direct spending issue, it refuses to permit financial benefits intended for farmers to be used by nonfarmer high-bracket investors. For example, the Emergency Livestock Credit Act of 1974,[86] provides that any financial assistance to the livestock industry is restricted to bona fide farmers and ranchers; corporations and partnerships may qualify only when a majority interest is held by persons who themselves are "primarily and directly engaged" in agricultural production.[87]

Yet the Ways and Means Committee continues to make federal loans available to high-bracket tax shelter investors through the present tax expenditure program despite the warnings by several farm groups that the presence of tax shelter operations is detrimental to the welfare of those who depend on realizing an economic profit from their farms.[88]

3. *Costs and Benefits of the Tax-Loan Program*

Although extensive cost-benefit studies of the present tax subsidy program to agriculture have yet to be undertaken, the findings of several agricultural economists suggest that the farm tax-loan program is inefficient—*i.e.*, the costs of the program exceed its benefits.

a. *Costs*: the most visible cost of the program is the foregone revenue which otherwise would have been collected in taxes had the ordinary tax rules been applicable. This cost will amount to over $1 billion in 1977.[89] Furthermore, to the extent that the tax subsidies provide capital where none is needed because private credit markets are adequate to the task, the government is simply wasting money. For example, a recent University of Missouri study of the present tax subsidy for cattle feeding asked whether, from the point of view of the public interest, there has been a shortage of capital in cattle feeding which justified a public subsidy. The study concluded that "there were no

85. 7 C.F.R. §§ 701.2, 1831.4-.5 (1975); *see* text accompanying note 80 *supra*.

86. Act of July 25, 1974, Pub. L. No. 93-357, 88 Stat. 391.

87. This provision, which precludes tax shelter investors from obtaining the benefits of the credit program, was added as an amendment on the House floor. The amendment was adopted by a vote of 405 to 7. Not a single member of the Ways and Means Committee voted against the amendment. 120 CONG. REC. H. 6540-41 (daily ed. July 16, 1974).

88. *See, e.g., 1969 Ways and Means Hearings, supra* note 19, at 2007-09 (statement of Angus McDonald, Director of Research, Nat'l Farmers Union).

89. 1977 FEDERAL BUDGET, *supra* note 11, at 94-97.

market barriers to the inflow of capital into cattle feeding which would have created a need for tax-subsidized capital."[90]

A second major cost of the tax subsidy is the tendency to encourage more capital in some sectors of the farm economy than is needed to spur optimal levels of production. For example, the University of Missouri study again concluded that instead of correcting the supposed deficiency in cattle feeding operations and infusing enough capital to spur production to market clearing levels, "the tax-subsidy brought in too much capital and added a small, but significant, contribution to the present market bust."[91] With regard to operations in orchards, groves, and vineyards, the University of California at Davis study concluded that, as a result of the influx of capital produced by the farm tax-loan program, many producers of tree crops will receive lower total crop revenue.[92] These findings suggest that the subsidy may be partly responsible for boom and bust cycles in the farm economy generally, and that it thus disrupts the stability of farming operations. The major economic costs which are associated with such instability probably arise in the form of higher administrative burdens in the management of rapidly fluctuating price schedules, and as increased government expenditures for direct-aid payments to cushion the effects of the bust

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90. Rhodes, *Consequences of Income Tax Law and Regulations: Cattle Feeding*, in Income Tax Rules and Agriculture, *supra* note 53, at 28, 31. Similar conclusions were reached as to the effect of tax shelter arrangements involving cattle breeding operations in V. HARRISON & W.F. WOODS, FARM AND NONFARM INVESTMENTS IN COMMERCIAL BEEF BREEDING HERDS: INCENTIVES AND CONSEQUENCES OF THE TAX LAW, (U.S. Dep't of Agriculture, Econ. Research Serv. Pam. No. 497, 1972); Carman, *Tax Shelters in Agriculture: An Example for Beef Breeding Herds*, 50 AM. J. AGRICULTURAL ECON. 1591 (1968).

91. Rhodes, *Consequences of Income Tax Law and Regulations: Cattle Feeding*, in Income Tax Rules and Agriculture, *supra* note 53, at 28, 31.

92. Professor Hoy F. Carman, an agricultural economist at the University of California at Davis, reported that

> Previous research indicates that the farm level demand for most tree crops is inelastic. Thus, producers of orchard and vine crops receive a tax incentive but as a result of increased production they also receive lower product prices. Many producers will have lower total crop revenue as a result of the planting [tax] incentives.

Carman, *Consequences of Income Tax Law and Regulations: Orchard Development*, in Income Tax Rules and Agriculture, *supra* note 53, at 34, 35 (footnote omitted). Professor Carman points out that the results he describes caused citrus fruit and almond producers to back the enactment of INT. REV. CODE OF 1954, § 278, which requires capitalization of preproductive costs for citrus fruit and almond groves. Professor Carman predicts that similar pressures will soon be felt by Congressmen as an excess supply in other agricultural products results from tax-subsidized investments. Section 504 of H.R. 1040, 93d Cong., 1st Sess. (1973) would extend § 278 treatment to any fruit or grove or vineyard.

cycle. These costs admittedly are difficult to quantify, but they nevertheless appear to be the expected results of the tax subsidy.

b. *Benefits*: According to the University of Missouri study of cattle feeding operations, the benefits which are attributable to the current farm tax-loan program are "hard to find."[93] The principal benefit resulting from lower crop revenue is, of course, lower retail prices. The available research in the area of tree crops, for example, indicates that "consumers have been the primary beneficiaries of orchard development tax incentives."[94] This outcome is, in effect, a transfer payment from taxpayers generally to consumers of tree crops.

Industry representatives maintain that the subsidies provide needed cash flow for small farmers and needed capital for the industry. For example, the present tax rules tend to generate cash flow during periods when farmers, for market reasons, hold crops off the market.[95] Another benefit which appears to obtain for farmers in general is the simplicity of the subsidy mechanism. By eliminating the need to take actual inventories and to allocate costs according to amount of income generated, the present tax rules provide a workable and low cost means of assistance.[96]

It is obvious that an analysis of all the costs and benefits of the present tax subsidy programs is a complex undertaking, and in the final analysis judgments will be required about who should be benefited and who should bear the costs of federal subsidies for agriculture. But intelligent evaluation of how burdens and benefits should be allocated among consumers, farmers and ranchers, investors and taxpayers generally can be accomplished only if the present tax program is analyzed and evaluated for what it is—a federal credit program for farm operators and investors. It is a fair question to ask whether that evaluation should take place in the Treasury Department and the tax-writing committees of Congress or in the Department of Agriculture and the congressional committees responsible for agricultural policy.

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93. Rhodes, *Consequences of Income Tax Law and Regulations: Cattle Feeding*, in Income Tax Rules and Agriculture, *supra* note 53, at 28, 30.

94. Carman, *Consequences of Income Tax Law and Regulations: Orchard Development*, in Income Tax Rules and Agriculture, *supra* note 53, at 34, 35.

95. *See* text accompanying note 50 *supra*. *See generally 1969 Ways and Means Hearings*, *supra* note 19.

96. *See 1969 Ways and Means Hearings*, *supra* note 19; text accompanying note 50 *supra*.

IV. PROPOSALS FOR CHANGE

Measures which may be taken to correct the inequities and inefficiencies inherent in the present farm tax-loan program involve either the outright termination of the tax provisions effecting the program, or the modification of those provisions in a manner which will insure results more consistent with the goals of efficiency and fairness expressed in direct farm subsidy programs. The consequences of either approach must be assessed in terms of their effect on both agricultural and tax policy.

A. TERMINATION OF THE TAX LOAN PROGRAM

1. *The Accounting Rules*

From the standpoint of *tax policy*, the measures required to eliminate the inequities created by the tax expenditures for farm operations are suggested by the previous examination of the accounting rules themselves: farm operations should be required to use the accrual method of accounting; inventories should be required where they are a significant factor in the business; and options to deduct current preproduction expenditures and other capital expenditures should be repealed and capitalization of these items required.

These tax changes terminate the mechanism under which farm tax loans are currently made by the government and therefore eliminate the basis for the "tax shelter" in farm operations. High bracket investors will not be able to reap the advantages of the interest-free loans originally intended for farmers. Such across-the-board changes, of course, prevent full-time farmers as well as in-and-out investors from enjoying the benefits of the farm tax-loan program.

Does such a step represent sound *agricultural policy*? In fiscal 1977, termination of the loan program would mean that $475 million in farm tax loans would not be made to farmers (both individuals and corporations) and to farm investors. As discussed above, expenditure of this amount through the tax system appears to a significant degree to be inefficient and inequitable from the standpoint of our overall national agricultural policy. Thus the case for terminating this *means* of making $475 million in federal loans to farmers is quite strong.[97]

The above, of course, does not resolve the problem of what use the government should make of the $475 million in revenue which would be

97. For data with respect to current tax accounting rules, *see* V. HARRISON, ACCOUNTING METHODS ALLOWED FARMERS: TAX INCENTIVES AND CONSEQUENCES (U.S. Dep't of Agriculture, Econ. Research Serv. Pam. No. 505, 1973).

produced. The money could be made available to farmers under direct programs already in existence. The *need* for this level of federal subsidy is a matter best determined by the congressional agricultural committees. Once the tax expenditure is reduced by $475 million, the agriculture committees could determine if the funds could usefully supplement existing direct subsidy programs or fund new ones.

If the current tax-loan rules were repealed in their entirety, it would be appropriate to provide transition rules for affected taxpayers. On the one hand, the change from the cash to the accrual method could provide a windfall to taxpayers who had deducted currently noninventory expenditures that would not properly be deducted until a later year under the accrual method. For example, a cash basis farmer, who deducted certain prepaid expenses in 1975 and was then shifted to an accrual method for 1976, could argue that the accrual method required him to deduct the same 1975 expenses in 1976, thus permitting deduction of the same costs twice.

But the transition problem can work in the other direction also. The requirement that inventories be established could bunch income for farmers in the transition year. This would result when the farmer had no opening inventory because of the previously allowed deductions. An artificial liability in the year of change could thus result.

To remedy both these problems, Congress should adopt a 10-year transition rule applicable whether the result of the change in an individual case favored the government or the taxpayer. If the net of the changes produced additional tax liability for a taxpayer, that increase would be reflected over a 10-year period; similarly, if the taxpayer realized a net benefit, he could only take advantage of that benefit ratably over a 10-year period.[98] Such a transition rule should smooth the effects of the change both for taxpayers and the Treasury. Similar transition rules for capital expenditures[99] can be effected simply by requiring that all such expenditures be capitalized if incurred after a specified date, such as December 31, 1976. The benefits of expenditures incurred before that date can be allowed to expire over time.

98. The version of the Tax Reform Act of 1975 (H.R. 10612, 94th Cong., 1st Sess. (1975)) which was passed by the House adopted the transition approach suggested. *See* H.R. REP. No. 94-658, 94th Cong., 1st Sess. 96-97 (1975). For comparable rules where the change is made from the cash to the accrual method in other situations under current law, *see* Treas. Reg. § 1.441-1(e) (1960); Rev. Proc. 70-27, 1970-2 CUM. BULL. 509.

99. In particular, preproduction costs and special expenditures for soil and water conservation (INT. REV. CODE OF 1954, § 175), fertilizer (*id.* § 180), and land clearance (*id.* § 182).

2. *The Capital Gain Rules*

Correction of the basic accounting rules leaves for consideration the question of capital gains benefits for certain farm operations. The repeal of the present accounting rules for farmers would mean termination of the tax-loan program. This in turn would change the capital gains benefits for farmers from a loan-forgiveness program under current law to an outright direct grant program. As such, it would provide $605 million (at fiscal 1977 levels) to selected farmers and investors. As a direct grant program, the capital gains benefits for agriculture would have all the peculiarities discussed above when viewed as a loan-forgiveness program. The question again is whether the farm sector *needs* this $605 million in aid and, if so, whether the *means* of providing the funds to agriculture are consistent with the goals of effectiveness, efficiency, and equity.

As in the case of the accounting changes proposed above, the best course for Congress to adopt is to repeal the capital gains benefits for farm operations. This would terminate a program that appears inequitable and counter-productive from the standpoint of both tax and agricultural policy. The funds could then be made available to the congressional agriculture committees to use, if needed, in the most effective manner in terms of national agricultural policy.

Those accustomed to regarding the capital gains preference as a *tax rule* may argue that it is inequitable to withdraw capital gains treatment from farm assets, but to leave it for other types of investment. But, as the 1977 Budget, the House Budget Committee, and the Treasury Department and Joint Committee staffs have pointed out, the capital gains rules are not tax rules at all, but rather are spending provisions. When viewed as a spending program, repeal of the capital gains treatment for farm income is not inequitable in the least. It is certainly not considered unusual or unfair for Congress to terminate or change federal agriculture programs without at the same time changing or terminating federal housing or pollution control programs. The committee thus should not be constrained from terminating the spending programs for agriculture effected through the capital gains provision simply because it is not at the same time terminating federal spending programs for other sectors of our economy that happen also to be funded by capital gains provisions. The spending program which results from capital gains treatment of income must be evaluated and justified independently in each sector of the economy.

B. Limiting the Scope of the Farm Tax-Loan Program

A number of proposals have been advanced in recent years that would not terminate the present tax expenditure program for farm operations, but would limit its scope. Although the various proposals adopt different mechanisms, the general thrust is to preclude the nonfarm investor from taking advantage of the tax subsidy intended for farmers.

The following discussion examines the most important legislative proposals that have been advanced, and assesses the impact of each on the present farm tax-loan program.[100]

1. *Proposals To Limit the Group to Which Loans Will Be Granted*

In the Tax Reform Act of 1975, the House of Representatives adopted two provisions that would exclude some present loan recipients from eligibility for future farm tax loans. The House first decided to require corporations engaged in farming[101] to adopt the accrual and inventory method of accounting.[102] "Family corporations" and subchapter S corporations[103] would be exempted from the new accounting requirements. A "family corporation" generally is defined as one in which 66⅔ percent of the corporation's stock is owned by members of the same family.[104]

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100. The Internal Revenue Service has taken certain administrative steps to limit farm-loss tax shelter operations. Thus, Rev. Proc. 74-17, 1974-1 Cum. Bull. 438, announced stricter conditions under which favorable advance rulings could be obtained for tax shelter limited partnerships. Rev. Rul. 75-152, 1975-1 Cum. Bull. 144, set forth the I.R.S. position on the deductibility of prepaid feed expenses. These administrative actions are best understood as clarifying the rules as to *eligibility* for the farm tax loans and do not limit the program itself.

101. An exhaustive definition of "farming" is included in H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 95 (1975).

102. *See* H.R. 10612, 94th Cong., 1st Sess. § 204 (1975). In addition, any partnership of which such a farming corporation is a partner would be required to adopt the accrual method. These corporations and partnerships would also be required to capitalize preproduction period costs of growing or raising crops or animals. *Id.*

103. A subchapter S corporation can have no more than 10 shareholders and must satisfy Int. Rev. Code of 1954, §§ 1371-77.

104. *See* H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 96 (1975). The proposed change would affect relatively few corporations, and would raise only $30 million in revenue. In 1970, there were a total of 3.2 million sole proprietorships, partnerships, and corporations engaged in farming. In 1969, for example, there were only 20,466 farming corporations, and over 6,500 of these were subchapter S corporations. *See* Internal Revenue Service, Statistics of Income—1970, Business Income Tax Returns 4 (1973). Corporations excepted from the accrual requirement would be subject to the Limitation on Artificial Losses (LAL) provisions of the Tax Reform Act of 1975, discussed at text accompanying notes 106-10 *infra*. Interestingly, these are the only types of corporations that are subject to LAL. The Senate Finance Committee deleted

The proposal to place selected corporations on a proper method of tax accounting represents a decision that the federal tax-loan program will be limited to family farming corporations and other closely held corporations which meet subchapter S requirements. It is clear that the proposal represents a step forward in tax policy. It is less clear that such an unequivocably positive assertion can be made from the standpoint of agricultural policy.

The House decision reflects the view that while the cash method of accounting may be appropriate for "small" farms, it should not be available to sophisticated corporate farming operations. Yet a corporation which is "small" in terms of assets or sales would be denied the tax-loan program benefits if it either did not or could not elect subchapter S treatment, for example, because it had more than 10 shareholders. Similarly, a small corporation would be ineligible if more than one-third of its stock were held by members of a second family. On the other hand, a family corporation would retain its eligibility even though its operations were so large as to render the financial necessity for the loan questionable. Similarly, a qualified subchapter S corporation, which may be small in number of shareholders but quite large in terms of assets or sales, would also continue to be eligible for the tax loan. Thus, for example, it would seem appropriate to ask whether the congressional agricultural committees would structure a direct program that provides annual federal loans to a corporation with $1 million in sales if two-thirds of its stock were owned by a single family, but deny the loans to a corporation with $10,000 in sales if it were owned by 11 unrelated persons. Any farm loan program may have to draw some arbitrary eligibility lines; nevertheless, the agricultural committees in Congress, if assessing a similar proposal as a direct spending program, arguably would fashion the eligibility requirements to more clearly effectuate goals which those committees have deemed worthy of federal attention.[105]

The other provision of the House-passed version of the Tax Reform Act of 1975 that would limit scope of the present farm tax-loan program is the Limitation on Artificial Losses (LAL) measure.[106] As

both the accrual accounting and LAL provisions when it reported H.R. 10612 (retitled "The Tax Reform Act of 1976") to the Senate. *See* S. Rep. No. 94-938, 94th Cong., 2d Sess. 39, 58 (1976).

105. The very uncertainty of the logic of the eligibility requirements as a matter of agricultural policy may be seen as one more example of why the tax writing committees should defer to the agriculture committees on such matters.

106. H.R. 10612, 94th Cong., 1st Sess. § 101 (1975). The LAL proposal was originally advanced by the Treasury Department in its U.S. DEP'T OF THE TREASURY

applied to farm operations, LAL would limit the extent to which "accelerated deductions" (*i.e.*, the farm tax-loan program) could be used to offset nonfarm income. Under LAL, prepaid and preproduction period expenditures, and the accelerated portion of depreciation during the productive period of the business,[107] could be deducted currently only to the extent of farm income plus $20,000 of nonfarm income. For each dollar of nonfarm income above $20,000 the allowable current deduction in excess of farm income would be reduced by $1. Hence, an individual with nonfarm income in excess of $40,000 would not be allowed any current deductions for the specified farm expenditures in excess of farm income. Any expenditures disallowed as current deductions, however, could be carried over under the LAL proposal and deducted against farm income in future years.[108]

The LAL proposal is intended to curtail sharply the farm tax-loan program for tax shelter investors. Generally, LAL would permit accelerated deductions from one farm activity to offset income from any other farm activity; for example, deductions from cattle feeding could offset income from crops. However, in the case of a "farming syndicate," each farm activity would be treated separately, and income from one activity could not be offset by deductions from another activity.[109] The test would be applied to farming syndicates on a yearly basis. For

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91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS, pt. 2, at 152-63 (Comm. Print 1969). Compare H.R. 1041, 93d Cong., 1st Sess. § 307 (1973); S. 1439, 93d Cong., 1st Sess. § 303 (1973).

107. These terms are defined in H.R. 10612, 94th Cong., 1st Sess. § 101 (1975).

108. LAL would not apply to those corporations and partnerships required to adopt the accrual method of accounting under § 204 of the Tax Reform Act of 1975. H.R. 10612, 94th Cong., 1st Sess. § 101 (1975). However, family corporations and subchapter S corporations subject to LAL do not get the benefit of the $20,000 to $40,000 phase-out. *Id.* As previously noted (*supra* note 104), the Senate Finance Committee deleted LAL from its version of H.R. 10612.

109. H.R. REP. No. 94-658, 94th Cong., 1st Sess. 46-47 (1975). This aspect of LAL is apparently intended to prevent the restructuring of present farm-loss tax shelter programs to provide the investor with current farm income to offset the "accelerated deductions." A "farming syndicate" in general would include any partnership or other form of enterprise in which interests have been offered for sale in an offering required to be registered with a state or federal regulatory agency, or in which more than 50% of the losses during any period are allocable to limited partners. *Id.* at 47-48. The Senate Finance Committee imposed capitalization requirements on "farming syndicates" with respect to certain specified expenditures. *See* H.R. REP. No. 94-658, 94th Cong., 1st Sess. 58-62 (1975).

It should be noted that LAL would impose limits on the granting of the farm tax loan through special deductions; it has no impact on capital gains. Thus, nonfarm investors in farm assets that produce capital gains could still obtain the government grant upon the sale of qualifying farm assets.

example, accelerated deductions from a cattle feeding operation begun in 1976 could not offset income from one begun in 1975. Thus, LAL would appear to terminate the farm tax-loan program for investors in tax shelter syndications. The upside down effects of the loan program would be continued for those still eligible—sole proprietorships, general partnerships, and qualified family and subchapter S corporations—but the group that is eligible would be significantly limited.

LAL would have very limited impact. At 1970 levels, a flat restriction to $20,000 of nonfarm income would have affected an estimated 14,500 returns.[110] The small long-term revenue gain predicted for LAL—$45 million per year—indicates its modest scope.

Again, the tax policy considerations behind LAL are clear—the desire to terminate tax shelter operations in the farm sector. The action also appears to represent sound agricultural policy by eliminating from the farm sector investors whose presence creates artificial and sometimes adverse effects for farmers trying to produce an economic profit. Thus, the decision to withdraw $45 million per year in federal loans from this group should produce greater tax equity and sounder farm policy. One further question, however, remains to be addressed.

As a matter of agricultural policy the House Ways and Means Committee report did not focus on the *need* of the farm sector for the $45 million in annual aid presently provided through the tax rules. The farm tax-loan program would simply be curtailed to this extent. In a rational process, it would appear that a determination should be made whether the farm sector needs this aid, albeit distributed in a more equitable and rational manner. Presumably, the House and Senate Agriculture Committees are in the best position to respond to this question.

2. *Limiting the Advantage of Leverage*

In another proposal aimed at farm-loss tax shelter operations, the 1975 Act would disallow, in the case of investments in farm operations involving raising, feeding, or caring for livestock, or involving the raising and harvesting of certain specified crops, deductions for losses in excess of the amount of capital or credit the taxpayer has "at risk" in the

110. *See* A. CARLIN & W.F. WOODS, TAX LOSS FARMING (U.S. Dep't of Agriculture, Econ. Research Serv. Pam. No. 546, 1974). The House Ways and Means Committee estimate indicates a revenue gain from LAL of $100 million in calendar year 1976, dropping to $45 million by 1981. H.R. REP. No. 94-658, 94th Cong., 1st Sess. 54 (1975).

venture.[111] A taxpayer is not considered "at risk" with respect to nonrecourse loans.[112] The limitation is applicable regardless of the method of accounting employed by the taxpayer and without regard to the nature of the deductions giving rise to the loss.

The provision is not limited in application to investors in limited partnerships engaged in one of the covered activities. It would apply, for example, to both an individual farmer and a general partnership able to obtain nonrecourse financing. The new provision thus would repeal on a selective basis the principle of *Crane v. Commissioner*.[113] For example, although a taxpayer would initially compute the deduction for depreciation by including the amount of a nonrecourse mortgage in his depreciable base, as under *Crane* principles, if the deduction so computed exceeded the amount at risk, the excess would be disallowed as a current deduction and would not be deductible until the taxpayer increased his "at risk" investment in subsequent years.[114] The House decision obviously reflects its increasing awareness of and concern with the advantages of leveraging a tax shelter investment. But by concentrating on particular types of farming operations, rather than the nature of the limited partnership, the proposal does not appear to be based on sound tax principles.

Even in a world in which there were no tax expenditures, the proper tax treatment of nonrecourse financing must be resolved. If the only deductions permitted under the Internal Revenue Code were deductions for the costs of producing income (properly matched under accounting rules), one would still have to decide if those deductions could be claimed against the portion of the taxpayer's cost reflected by nonrecourse financing. The proper functioning of an income tax system premised upon equality of tax treatment requires that nonrecourse financing be treated uniformly. This could be accomplished by requiring either that the amount of the nonrecourse financing be included in

111. H.R. 10612, 94th Cong., 1st Sess. § 207 (1975). The Senate Finance Committee likewise adopted an "at risk" approach to the farm tax shelter problem. *See* S. REP. No. 94-938, 94th Cong., 2d Sess. 62-64 (1976).

112. A taxpayer is considered not "at risk" to the extent he has a right to be reimbursed for any loss on the investment whether the protection against loss is afforded by insurance, by a "stop loss" order, by a guaranteed repurchase agreement, or by other similar arrangements. *See* H.R. REP. No. 94-658, 94th Cong., 1st Sess. 108-09 (1975).

113. 331 U.S. 1 (1947).

114. *See* H.R. REP. No. 94-658, 94th Cong., 1st Sess. 109 (1975). Under the bill even if a deduction is not disallowed by the "at risk" limitation, the LAL rule must be satisfied.

the taxpayer's basis (or that negative basis be recognized)[115] or, on the other hand, that the deductions in excess of equity investment be deferred until a greater equity investment is made. Present rules provide that nonrecourse financing is included in the taxpayer's basis both for deduction purposes and computation of gain or loss purposes. That is a perfectly acceptable decision in a tax system with no preferential deductions. It would be equally acceptable to require suspense account treatment for deductions attributable to nonrecourse financing if this treatment were applied to *all* taxpayers.

However, House Report 10612 only applies the deferred technique to certain taxpayers—primarily those engaged in livestock and certain crop operations.[116] In effect, in a system where the general rule is that nonrecourse financing is properly included in basis, the proposed rule amounts to a tax penalty. While this penalty is presumably being imposed to stop an undesirable activity—tax shelter operations—it is difficult to defend in terms of consistent tax principles. Why, for example, should a farmer who can borrow on a nonrecourse basis be placed on a deferral technique, while a real estate operator can continue to use the *Crane* rule?[117]

If one concludes that the present tax treatment of nonrecourse financing is an acceptable one in an income tax system, it does not follow that present rules concerning the treatment of nonrecourse financing are correct when applied to limited partnerships. The present rule[118] permitting limited partners to include their ratable share of nonrecourse financing in basis assumes that the partnership is an *aggregate of individuals* (to whom the rules developed for individuals should apply) rather than a tax *entity* separate and distinct from its partners (as a corporation is a tax entity separate from its shareholders). The application of rules intended for individuals to investors in a limited partnership does not conform to consistent tax principles because an

115. *See* Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950).

116. Investors in motion pictures are also affected by the proposal, which imposes similar restrictions on oil and gas drilling funds. H.R. 10612, 94th Cong., 1st Sess. § 208 (1975). The Senate Finance Committee version of H.R. 10612 likewise applied an "at risk" rule to equipment leasing transactions. S. REP. No. 94-938, 94th Cong., 2d Sess. 81-86 (1976).

117. One can argue that the House provision is justified by the fact that the present tax world is one in which there are accelerated deductions. Therefore, this action is simply the first step in converting all taxpayers to a suspense account technique where nonrecourse financing is utilized. If this is the justification, the Ways and Means Committee did not so state.

118. Treas. Reg. § 1.752-1(e) (1960).

investor in a farming limited partnership is much more like a corporate shareholder than like an individual engaged in the business of farming. The sole proprietor remains fully liable for all his activities. But the limited partner has, by definition, limited the liability that he will incur as a result of the partnership farm activities. He is not responsible for tort damages, salary claims, vendor's liens, or similar partnership liabilities. Like his corporate shareholder counterpart, he has insulated himself from these threats to his personal financial security. It is therefore appropriate to apply corporate tax rules for nonrecouse financing to limited partners rather than the rules developed for individuals.

By not correctly focusing on the need to restructure the tax rules applicable to limited partnerships, House Report 10612 would produce a situation that is difficult to defend. Individual farmers within the areas of livestock and the specified crops are denied the advantages of nonrecourse financing available to individuals in other businesses. Meanwhile, limited partner-investors in most tax shelter operations *except* those involving livestock and the specified crops would continue to enjoy the benefits of nonrecourse financing.

A principled and effective response to the problem of leverage in tax shelters is to apply to all limited partnerships the same rule that applies to investors in subchapter S corporations. Nonrecourse loans of the partnership would not be included in the limited partner's basis of his partnership interest.[119] Such a rule does no violence to the fundamentally sound *Crane* rule since the proposal would not apply to individuals, but it would end the advantages of nonrecourse leveraging in tax shelter operations.

3. *Limiting the Scope of the Loan Forgiveness Program*

The House version of the Tax Reform Act of 1975 did not impose any limits on the scope of the capital gains loan forgiveness program. Several possible actions could be taken to remedy the omission.

One way to limit, without repealing, the advantages of the capital gains preference is by the minimum tax. The present 10 percent minimum tax,[120] for example, raises the maximum rate applicable to

119. H.R. REP. No. 94-658, 94th Cong., 1st Sess. 110 (1975), recognizes that the Tax Reform Act of 1975 in effect achieves this result for farm and motion picture limited partnerships. Legislation to effect the change recommended in the text was introduced in the Senate as an amendment to H.R. 8217, 93d Cong., 1st Sess. (1973). *See* 120 CONG. REC. S. 10116 (daily ed., June 10, 1974).

120. INT. REV. CODE OF 1954, § 56(a).

capital gains from 35 percent to 36.5 percent.[121] If, as has been proposed, the present minimum tax were strengthened by reducing the $30,000 exemption,[122] repealing the deduction for regular taxes paid,[123] and introducing progressive rates up to 35 percent, the maximum rate on capital gains would be increased from 35 percent to 52.5 percent.[124] This change would limit the maximum forgiveness to one-fourth, as opposed to the presently allowed one-half of the farm tax loan.[125]

The 1975 House bill would increase the minimum tax rate from 10 percent to 14 percent, lower the exemption from $30,000 to $20,000 (with the exemption phasing out between $20,000 and $40,000), and eliminate the deduction for regular taxes paid.[126] In effect, the maxi-

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121. *See* 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 940 (1972).

122. INT. REV. CODE OF 1954, § 56(a)(1).

123. *Id.* § 56(a)(2).

124. McDaniel, *Tax Reform and the Revenue Act of 1971: Lesions, Lagniappes and Lessons*, 14 B.C. IND. & COM. L. REV. 813, 847 (1973).

125. The present minimum tax affects capital gains because it is an additive tax—an addition to the taxpayer's liability as regularly computed. The House Ways and Means Committee, however, tentatively approved in 1974 an alternative minimum tax. Under the alternative minimum tax, "economic income" is computed by adding back to adjusted gross income the items of tax preference utilized by a taxpayer, including the excluded one-half of capital gains. Rates equal to one-half the normal rates are then applied to this economic income. If the resulting figure exceeds the tax liability computed under regular rules, the higher minimum tax is due.

The alternative minimum tax as thus structured, however, has no effect on capital gains because the minimum rate achieved by the alternative minimum tax is 35%, which is no higher than the maximum effective rate under regular tax rules. Hence if a taxpayer's only income were capital gains, his tax would be the same under the proposed alternative minimum tax and under regular tax rules. Under the additive minimum tax, this individual would incur both the usual capital gains and the minimum tax liability. In terms of the tax expenditures for farm operations, adoption of the alternative minimum tax means that the present farm tax-loan forgiveness program will continue at present levels. On the other hand, strengthening the present additive minimum tax would reduce the financial benefits of the tax-loan forgiveness program. Arguments for choosing one form of minimum tax over the other have been explored elsewhere. *See* S. SURREY, PATHWAYS TO TAX REFORM 267-79 (1973); McDaniel, *Tax Reform and the Revenue Act of 1971: Lesions, Lagniappes and Lessons*, 14 B.C. IND. & COM. L. REV. 813, 840-42 (1973). The House in its floor debate on H.R. 10612 rejected a floor amendment to substitute the alternative form of minimum tax for the additive form. 121 CONG. REC. H. 11,837-43 (daily ed. Dec. 4, 1975).

126. H.R. 10612, § 301, 94th Cong., 1st Sess. (1975). The House bill would also repeal the carryover of unused regular taxes in INT. REV. CODE OF 1954, § 56(c). The long-term revenue increase from the changes is estimated to exceed $1 billion annually. *See* H.R. REP. No. 94-658, 94th Cong., 1st Sess. 130-32 (1975). The Senate Finance Committee version of H.R. 10612 provided an exemption equal to $5,000 over the amount of regular taxes paid, whichever is greater, and adopted a 15% minimum tax rate. S. REP. No. 94-938, 94th Cong., 2d Sess. 108-114 (1976).

mum rate in capital gains would be increased from 36.5 percent to 42 percent.

The 1975 House changes in the minimum tax would obviously reduce the benefits of the farm tax-loan forgiveness program. But the change would not be dramatic. If the minimum tax is to be the technique utilized to limit the benefits of capital gains, the far more progressive rates suggested above will have to be adopted.[127]

4. *The Need for Cost-Benefit Studies*

While Congress might hestitate to terminate the farm tax-loan program in its entirety because comprehensive cost-benefit analyses are not presently available, it is incumbent upon it to order that such studies be promptly commenced. The lack of such studies may justify delay now; but the failure to require that the studies be undertaken cannot be justified in the face of the arguable inefficiencies and inequities of the present program.

Accordingly, if Congress adopts a limited approach to the problems created by present tax rules for farm operations, it should instruct the Staff of the Joint Committee on Internal Revenue Taxation to commence immediately a comprehensive cost-benefit analysis, in terms of agricultural policy, of the continuing farm tax-loan program. That study should enlist the aid of the Treasury and Agriculture Departments, the staff of the congressional agricultural committees, the staffs of the congressional budget committees,and the Congressional Budget Office. In addition, the Staff should secure the input of persons in the private sector who are knowledgeable in farm operations—lawyers, economists, accountants, bankers, and investment advisors.

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127. It would be possible to adopt an alternative form of minimum tax that would have an impact on capital gains like that of the alternative form adopted by the House. It would be necessary, however, to raise the top minimum tax rates to 45-50% in such a system.

Other provisions in the Tax Reform Act of 1975 may impose indirect limits on the benefits of capital gains. H.R. 10612, 94th Cong., 1st Sess. § 206 (1975) would strengthen the limitations on the deductibility of interest on investment indebtedness in present INT. REV. CODE OF 1954, § 163(d). In addition, § 205 of H.R. 10612 would impose limits on the deductibility of prepaid interest by a cash method taxpayer. *See* H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 99-101 (1975) (deductibility of prepaid interest); *id.* at 103-05 (deductibility of interest on investment indebtedness). The Senate Finance Committee recommended repeal of section 163(d) in its entirety, inclusion of investment interest in excess of investment income in the minimum tax, and adoption of the House-passed rules on prepaid interest. S. REP. NO. 94-938, 94th Cong., 2d Sess. — (1976).

CONCLUSION

The federal income tax system currently provides an annual $1 billion subsidy to farm operations. The tax rules employed to effect this subsidy impair the equity of our income tax system. Further, from the standpoint of agricultural policy the subsidy appears in significant part to run counter to other programs, to harm small family farms, and to produce undesirable distortions in the farm economy.

Tax policy objectives require the termination of the tax expenditures for farmers and farm investors. At the least, sound agricultural policy requires a comprehensive study of cost-benefit and equity aspects of the farm tax subsidies.