Cattle Feeding as a Tax Shelter—Alive but Cumbersome

by

Clark S. Willingham

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CATTLE FEEDING AS A TAX SHELTER—ALIVE BUT CUMBERSOME

Clark S. Willingham*

The 1976 Tax Reform Act made significant changes in the tax treatment of expenses in agriculture. Tax deferral benefits from cattle feeding operations still exist, however, in the right situation. This article illustrates the possible tax deferral benefits and then reviews the accounting methods available to the different classes of agricultural taxpayers. It provides an update on tax treatment of a "farmer's" expense items and ends with a discussion of planning possibilities, including a checklist of steps necessary to insure the deductibility of prepaid feed.

INTRODUCTION

In the early 1970's Wall Street discovered the tax deferral possibilities of feeding cattle and utilizing the cash basis method of accounting. Millions of dollars poured into syndicated cattle feeding "tax shelters." Not surprisingly, Congress responded by changing the tax treatment of expenses in agriculture in the Tax Reform Act of 1976.

For the first time Congress created three classes of agricultural taxpayers: "farmers," "farm syndicates" and "farm corporations." The new rules did not change the law for farmers and therefore prior case law remains valid. Farm syndicates, however, must use a modified cash method of accounting (hereinafter referred to as the farm syndicate method), wherein the taxpayer must inventory expenditures for feed, seed, fertilizer and other farm supplies and deduct them only when actually used or consumed.[1] A farm corporation, as defined in I.R.C. section 447 and not meeting one of the three exceptions set forth therein, must now use the accrual method of accounting.[2]

Investments in cattle feeding in syndicated offerings apparently dropped off dramatically after 1976. Unfortunately a good deal of the credit for this reduction in tax shelter activity must go to Wall Street's disfavor with cattle feeding as a viable investment because of the concurrent poor economics the cattle industry suffered. While the tax law changes did reduce the attractiveness of cattle feeding, the actual changes are far less than the changes perceived by the investing public.

To better understand the tax ramifications, an oversimplified illustration of how cattle feeding works should be beneficial. It should be noted at the outset, however, that any deduction for agricultural expenses presup-

* Partner, Kasmir, Willingham & Krage, Dallas, Texas: B.B.A., Texas Tech University, 1967; J.D., Southern Methodist University, 1971.

1. I.R.C. § 464.
2. I.R.C. § 447.

poses that the taxpayer is in the business of farming for profit and is not subject to the so-called hobby loss provision.[3]

THE ABC'S OF CATTLE FEEDING

Let's look at one hypothetical steer.

Cost of Steer	(650 lbs × $.80)	$ 520.00
Expense of Feeding	(450 lbs. × $.56)	250.00
Total		$ 770.00

To purchase this steer the investor would generally put up $150 cash equity and the bank would finance the balance of the cost. Therefore, $150 of the investor's money and $620 of the bank's money was used to purchase and fatten the steer in this example. These figures assume that all interest costs are included in the $250 of expenses of feeding.

To illustrate the tax characteristics and benefits, let us assume a breakeven on the sale of the cattle. It is important to note at this point that a taxpayer should feed cattle for economic profit. A taxpayer cannot make money in any tax shelter by losing money. Economics should come first and the tax benefits second.

Assuming a breakeven the arithmetic is as follows:

Sales Proceeds	$ 770.00
Cost of Steer	(520.00)
Expense of Feeding	(250.00)
Net Profit	$ -0-

The tax return, however, may look different. Assume the investor buys the steer in August and the animal is fat and sold on January 1. The two tax returns would look like this:

	1980	1981
Sales Proceeds	$ -0-	$ 770.00
Cost of Steer	-0-	(520.00)
Expense of Feeding	(250.00)	-0-
Net Profit (Loss)	$(250.00)	$ 250.00

The use of the cash method of accounting results in showing a $250 loss in 1980 but a $250 gain in 1981.[4] Obviously, there was no real economic gain or loss. The investor has simply shifted income from one year to the next.

3. I.R.C. § 183.

4. The "at-risk" rules of I.R.C. § 465 specifically apply to farming. This section provides that loss deductions are limited to the amount an investor has at risk. This includes money and property contributed by the investor, and borrowed amounts for which he is personally liable or has pledged property as collateral. In this example, the taxpayer must be personally liable for at least $100 of the $620 borrowed in order to increase his "at-risk" amount to cover the $250 deduction ($150 cash investment + $100 personal borrowings = $250 at risk).

Taxable income has been deferred or delayed but not eliminated. Cattle feeding simply delays recognition of taxable income and in no way converts ordinary income into capital gains. The investor has gained something, however. By delaying recognition of the taxable income, he has gained time—time to plan his taxable income to his best advantage.

Cattle feeding becomes "tax shelter" instead of "tax deferral" if the investor can utilize *time* to allow the income to become taxable at a lower tax bracket in a subsequent year. Let us add tax brackets to our previous example and see how cattle and tax brackets work together.

	1980	
Cash Invested		$ 150.00
Tax Deduction	$ 250.00	
Tax Savings (assume 50% rate)		(125.00)
Actual Cash Out of Pocket		$ 25.00
	1981	
Cash Received (breakeven)		$ 150.00
Taxable Income	$ 250.00	
Tax Paid (50% rate)		(125.00)
Total Profit		$ -0-

If the investor is in the same tax bracket in each year, there is obviously no tax benefit or economic benefit, with the possible exception of the use of money. Let us examine what would happen, however, if the 1981 tax bracket is only forty percent.

	1980	
Cash Invested		$ 150.00
Tax Deduction	$ 250.00	
Tax Savings (assume 50% rate)		(125.00)
Actual Cash Out of Pocket		$ 25.00
	1981	
Cash Received (breakeven)		$ 150.00
Taxable Income	$ 250.00	
Tax Paid (40% rate)		(100.00)
Net Cash Received		50.00
Net Profit		$ 25.00

The investor enjoys a $25.00 net profit on his $150 investment, even though his cattle feeding investment only broke even. The advantages increase as the investor's 1980 tax bracket increases. The following table illustrates the profit to the investor who successfully defers income from the seventy per-

cent tax bracket to the forty percent bracket while his cattle investment breaks even.

1980		
Cash Invested		$ 150.00
Tax Deduction	$ 250.00	
Tax Savings (70%)		(175.00)
Net Investment		$(25.00)
1981		
Cash Received (breakeven)		$ 150.00
Taxable Income	$ 250.00	
Tax Paid (40%)		(100.00)
Net Cash Received		50.00
Net Profit		$ 75.00

The foregoing illustrations simply point out the tax savings that can be generated by a breakeven operation. If the investment does generate profits, these profits are taxed as ordinary income.

The tax savings illustrated above remains significant where there is actual economic profit or loss. The following example assumes first, a ten percent actual economic profit on the $150 cattle feeding investment, and second, a ten percent actual economic loss on the $150 investment. Assuming that the investor's tax bracket is fifty percent in 1980 and forty percent in 1981, the results are as follows:

	10% PROFIT		10% LOSS	
1980				
Cash Invested		$ 150.00		$ 150.00
Tax Deduction	$ 250.00		$ 250.00	
Tax Savings (50%)		(125.00)		(125.00)
Net Cash Investment		$ 25.00		$ 25.00
1981				
Cash Received		$ 165.00		$ 135.00
Taxable Income	$ 265.00		$ 235.00	
Tax Paid (40%)		(106.00)		(94.00)
Net Cash Received		59.00		41.00
Total Profit		$ 34.00		$ 16.00

As the example illustrates, the ten percent profit is increased by the tax savings. In the loss situation example, the investor could lose a portion of his investment and still make an actual economic profit after taxes. The apparent profit, however, is strictly because of the large amount of taxable income transferred from the 1980 fifty percent tax bracket to the 1981 forty percent tax bracket.

METHODS OF ACCOUNTING

The exact treatment of the feed expenses outlined in the previous examples is dependent upon whether the taxpayer is classified as a "farmer," "farm syndicate" or "farm corporation." A "farmer" may be an individual, partnership, corporation, trust, or any other entity as long as it cultivates, owns, operates or manages a "farm."[5] A "farm" includes stock, dairy, poultry, fruit or truck farms, plantations, ranches, and nurseries.[6] "Whether or not one is a farmer for tax purposes does not depend on his tilling the soil by his own labor rather than by that of hired hands, tenant farmers, or even professional nurserymen."[7] Likewise, a person does not need to actually reside on a farm to be classified a "farmer." Neither the degree of mechanization of the operation nor its size or scope has any bearing on this question,[8] and even Wall Street Cowboys can qualify as farmers.[9]

A "farm syndicate" is generally a passive investment in agriculture. It includes any entity required to be registered with any securities regulatory body and any enterprise in which more than thirty-five percent of the losses are allocated to someone not actively engaged in the management of the business.[10]

The definition of farm syndicate is obviously not limited to Wall Street Cowboys. A long time "real" farmer who retires from active management of his own farm could find himself no longer classified as a "farmer" for tax purposes. There are, however, built-in exceptions for interests which will not be considered to be held by a passive investor or "limited entrepreneur." The exceptions are for:

1. Any individual who has actively participated in the trade or business of farming for not less that five years.
2. Any individual whose principal residence is on a farm and the enterprise in question is carried on *at such* farm.

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5. Treas. Reg. § 1.16-4(d), T.D. 7198 (1972).
6. *Id.*
7. Maple v. Commissioner, 440 F.2d 1055, 1057 (9th Cir. 1971).
8. United States v. Chemell, 243 F.2d 944 (5th Cir. 1957); Auburn Packing Co. v. Commissioner, 60 T.C. 794 (1973); Hi-Plains Enterprises v. Commissioner, 60 T.C. 158 (1973); Maple Leaf Farms, Inc. v. Commissioner, 64 T.C. 438 (1975) Gold-Pak Meat Co. v. Commissioner, 522 F.2d 1055 (9th Cir. 1975); W.P. Garth v. Commissioner, 56 T.C. 610 (1971).
9. Tim W. Lillie v. Commissioner, 45 T.C. 54 (1964); Estate of Frank Cohen, [1970] T.C.M. (P-H) 39: ¶ 70-272; MacMurray v. Commissioner, 21 T.C. 15 (1953).
10. A farm syndicate is defined in I.R.C. § 464(c) as:
    (1)(A) any partnership or other enterprise other than a corporation which is not an electing small business corporation (as defined in section 1371(b)) engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale, or
    (B) a partnership or any other enterprise other than a corporation which is not an electing small business corporation (as defined in section 1371(b)) engaged in the trade or business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.

    Limited entrepreneur is further defined in I.R.C. § 464(e)(2) as a person who:
    (A) has an interest in an enterprise other than as a limited partner, and
    (B) does not actively participate in the management of such enterprise.

3. Any participation in the further processing of livestock by a person who has raised that livestock.
4. An individual whose *principal* business activity involves the active participation in the management of a trade or business or farming.
5. Any interest held by a member of the family of someone who qualifies in exceptions 1-4.[11]

Thus a person who meets one of the five exceptions could be involved in a partnership or other operation on a completely passive basis and still not be involved in a "farming syndicate." It is important to note, however, that these five exceptions for active management are applicable only to the second part of the farming syndicate definition and do not allow an exception for a partnership or an enterprise that is registered with the Securities and Exchange Commission.

Corporations, and partnerships in which a corporation is a partner, that are engaged in the business of farming may no longer use the cash method of accounting.[12] There are, however, three exceptions to this rule. The following corporations will not be considered "corporations" for purposes of I.R.C. section 447:

1. Subchapter S corporations.
2. Family corporations in which one family owns at least fifty percent of the outstanding stock.
3. Corporations with annual gross receipt of less than $1,000,000.[13]

If a corporation engaged in agriculture does not meet one of the three exceptions, it must use the accrual method of accounting and must capitalize preproductive period expenses.[14] Absolutely no tax deferral benefits result from feeding cattle under this method of accounting.

TAX TREATMENT OF A "FARMER'S" EXPENSE ITEMS

It is unassailable that a farmer may deduct expenditures for his farm supplies. The question is simply one of timing. The tax advantage of the prepayment for feed, seed, fertilizer and other supplies is obviously the ability to utilize the deduction in the year that the prepayment is made. The example used earlier resulted in a $250 tax deduction for each $150 invested.

The IRS enumerated three tests in Revenue Ruling 75-152 that must be met before a farmer using the cash method of accounting may deduct feed expenses in the year of payment. Revenue Ruling 75-152 was later restated

11. I.R.C. § 464(c)(2).
12. I.R.C. § 447(a).
13. I.R.C. § 447(c).
14. These rules do not apply to the business of operating a nursery or raising Christmas trees. I.R.C. § 447(a). The term "preproductive period expenses" means any amount which is attributable to crops, animals or any other property having a crop or yield during the preproductive period of such property. The preproductive period is the period before the disposition of the first marketable crop or yield in those cases where the property has a useful life of more than one year and will produce more than one crop or yield and, in the case of any other property, the period before such property is disposed of. There is an exception to the capitalization rule for taxes and interest and any amount that incurred on account of fire, storm, flood or other casualty or on account of disease or drought. I.R.C. § 447(b).

and amplified in Revenue Ruling 79-229. The three tests are: (i) the expenditure must be a payment for the purchase of feed rather than a deposit; (ii) the prepayment must be made for a business purpose and not merely for tax avoidance; and (iii) the deduction of such cost in the taxable year of prepayment must not result in a material distortion of income.[15]

The Deposit Issue

To be deductible, the expenditures for supplies must be an actual payment and not merely a deposit. The cases litigating this issue have generally been decided in favor of the taxpayer, except in situations indicating the payment was "refundable" or where the prepayment included a payment for future services.

One of the earliest cases addressing this issue was *Ernst v. Commissioner*.[16] Chicken feed was purchased in December for delivery in the following year. The contract did not mention refunds and Mr. Ernst was not required to pay in advance. The seller did not treat the transaction as a sale on his books and did not even have sufficient feed on hand to make the delivery. Some future "mixing services" were included and the price was not fixed until the date of delivery. The Tax Court, however, allowed Mr. Ernst his tax deduction because the "payments were absolute" and he was irretrievably out-of-pocket the amounts paid.

In a later decision, the Tax Court disallowed the prepaid feed deduction for a dentist.[17] The feed was delivered and ultimately consumed but a refund was obtained in one of the four years in question. The court stressed this "refund" and also pointed out that substantial services were included in the price of the prepaid feed.

A Tax Court memorandum decision involving a sweepstakes winner's attempt at tax shelter set forth the "how-to's" and "how-not-to's" for cattle feeding.[18] Two feeding agreements were involved; one called for a fixed price for feed and the second provided for a set "price-per-pound weight gain during feeding." The fixed price contract was accepted, but the price-per-pound contract was rejected under the deposit theory. The court's opinion also included the acceptable contract in full, thereby giving tax planners a good blueprint.

The high water mark for the deposit issue is probably *Mann v. Commissioner*.[19] A check was delivered on the last day of the year by a hog farmer to his feed supplier without any specificity as to feed purchased. Nevertheless, the court held that a valid payment was made and again the key point was the lack of refundability.

15. Rev. Rul. 79-229, 1979-31 I.R.B. at 7, (*superseding* Rev. Rul. 75-152 1975-1 C.B. 144).
16. 32 T.C. 181 (1959).
17. Tim W. Lillie v. Commissioner, 45 T.C. 54 (1964).
18. Estate of Frank Cohen, [1970] T.C.M. (P-H) 39: ¶ 70-272. For another good review of the cases *see* Gaddis v. United States, 330 F. Supp. 741 (S.D. Miss. 1971).
19. 483 F.2d 673 (8th Cir. 1973).

Some of the factors the Service will consider in determining whether the payment was a purchase or a deposit are set forth in Revenue Ruling 79-229. Those factors are the absence of specific quantity terms, a right to a refund of any unapplied credit at the termination of the contracts, the treatment of the expenditure as a deposit by the seller, and the right to substitute other goods or products for the feed ingredients. With all the guidance from the case law and Revenue Rulings, the tax case reporters still abound with examples of how not to do it.[20]

The Business Purpose Issue

In addition to being an actual payment and not merely a deposit, the prepayment must be made for a business purpose and not merely for tax avoidance to be deductible. This business purpose test seems to have grown out of the general Section 162 requirements.

Section 162 allows a taxpayer to deduct "all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." Regulation Section 1.162-12 states:

> A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming . . . . The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay . . . .

The courts appear to require prepayment for feed to be both ordinary and necessary to be deductible. In *Welch v. Commissioner*,[21] the Supreme Court stated that an expense is "necessary" if it is appropriate and helpful to the taxpayer's business, and "ordinary," generally speaking, if it is a common and accepted kind of expense in the commercial context. It might be unique to the individual; indeed, it might be a one-shot payment, but it should not be unique to the group or community. The Court recognized

20. In E. Keith Owens v. Commissioner, 64 T.C. 1 (1975), a corporation entered into four different Oppenheimer contracts to feed cattle. Each contract specified dollars of feed per head and allowed a bonus or penalty if that set amount was not exactly correct. The contract did not specify exact quantities of any feed being purchased. The court placed some reliance on this lack of specificity. The court also found that the bonus and penalty provisions pointed in the direction of a deposit and found the $5.00-per-head guarantee indicative of a deposit.

It is interesting to note that the Oppenheimer contracts used by Ownes were very similar to the Oppenheimer contracts used by Cohen, *supra* note 18, with a price-per-pound weight gain during feeding, which also failed. The court notes in its opinion that the Cohen contract with a fixed price for specified feed was valid.

In Wisebart v. Commissioner, [1976] T.C.M. (P-H) 45:¶76-237, the taxpayer tried to purchase cattle feed with an exchange of contracts from a wholly-owned subsidiary. He failed on the basis of lack of payment.

See also James A. Smith v. Commissioner, [1976] T.C.M. (P-H) 76: ¶ 76-1223. This case points out numerous ways not to do it. The seller of the feed debited payments to accounts receivable and credited to the sales account only as the feed was actually fed. The charge for the feed included a charge for services and interest, mixing and carrying. The charge for the feed itself was based on the current market price and at various times exceeded the per ton charge set forth in the initial invoice. The taxpayer did in fact receive a refund on part of the payment. The court found that there was no valid payment for feed.

21. 290 U.S. 111 (1933).

that the word "ordinary" carried a "strain of constancy within it."[22]

In *Cravens v. Commissioner*,[23] the Tenth Circuit allowed the taxpayer's deduction for feed bought in December of 1953 for use in 1954, 1955, and 1956. The court relied heavily on the fact that the taxpayer was facing a continuing drought and secured preference on his feed delivery because of the prepayment. The Tax Court had denied the deduction because the payment had not met the deposit test.[24]

Most of the decisions in prepaid feed cases seem to center on the deposit issue and only use the business purpose issue to strengthen their opinion.[25] In *Van Raden v. Commissioner*,[26] however, the government stipulated that the deposit test was met; the central issue then became "business purpose." The Tax Court rejected the Commissioner's contention that there was no business purpose and allowed the December prepaid feed deduction of a publicly syndicated limited partnership in which the Van Raden brothers were limited partners. The majority opinion found substantial business purpose and the court went into great detail on the credibility of the testimony and evidence relating to business purpose. The Service has appealed *Van Raden* to the Ninth Circuit Court of Appeals.

The Service has stated that examples of business purpose include fixing minimum prices, securing an assured feed supply, and securing preferential treatment in anticipation of a feed shortage. Whether the prepayment was a condition imposed by the seller or whether such condition was meaningful should also be taken into consideration in determining whether there was a business purpose for the prepayment.[27]

The Material Distortion Issue

The Service is now using the material distortion test as its chief tool in disallowing prepaid feed deductions. The early cases were all won by the taxpayers[28] and for a time, an ad hoc group was even successful in having

22. *Id.* at 113.

23. 272 F.2d 895 (10th Cir. 1959), *rev'g* 30 T.C. 903 (1958).

24. The taxpayer was entitled to a refund if the price of feed was less when delivered, the taxpayer could "exchange" ingredients, and the feed seller did not guarantee delivery. 30 T.C. at 907-08.

25. In Tim W. Lillie v. Commissioner, the court found the prepayment secured no economic benefit other than tax advantage. 45 T.C. 54 (1964). In Estate of Frank Cohen the business purpose was not closely looked at and the case turned on specificity of contract. [1970] T.C.M. (P-H) 39:¶ 70-272. In Gaddis v. United States, the court mentioned that an increase in the price of corn was anticipated but did not materialize. 330 F. Supp. 471 (S.D. Miss. 1971). In Mann v. Commissioner, the lower court found no indication of business purpose. The Eighth Circuit reversed solely on grounds of the deposit-purchase issue and virtually ignored the business purpose test. 483 F.2d 673 (8th Cir. 1973). In E. Keith Owens v. Commissioner, the Tax Court relied solely on the deposit issue and, therefore, found it unnecessary to deal with the " 'ordinary and necessary' business expense requirement of Section 162." 64 T.C. 1, 17 (1975).

26. 71 T.C. 1083 (1979).

27. Rev. Rul. 79-229, 1979-31, I.R.B. at 7.

28. In Ernst v. Commissioner, 32 T.C. 181 (1959), the material distortion issue was clearly rejected by the court and the Service later acquiesced. 1959-2 C.B. 4. In Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944), the Supreme Court held that the cash basis of accounting does not "distort income" where the deduction was taken in the year paid. In Cravens v. Commis-

the Service enjoined from publishing its original prepaid feed ruling.[29]

In 1977 the Trial Division of the Court of Claims in *Clement v. United States* held that the material distortion test did not apply because the taxpayer was a farmer using the cash basis method of accounting.[30] This well-reasoned opinion was overturned by the Court of Claims on July 14, 1978, by a three-judge panel, which determined that the material distortion test did apply and that a farmer/taxpayer must deduct prepaid feed only when it was consumed.[31] This court held that farmers did not need to keep inventories but merely needed to know how much feed or other farm supplies were used. A short time later the Southern District of New York followed the *Clement* case and also stated that Revenue Ruling 75-152 was a correct statement of the law and should be followed as precedent.[32]

The Tax Court then added its opinion as to the validity of the material distortion test. In *Van Raden*,[33] the court held that a substantial business purpose satisfied the material distortion test. Great weight was given to the customary industry practice, but the majority opinion stopped short of saying that the material distortion test did not apply to farmers.[34]

Five judges did join in a concurring opinion in *Van Raden* which criticized the *Clement* decision and asserted that the material distortion test had no valid application to farmers because farmers have special rules that override the Service's general rules.[35]

The Tax Court has since followed *Van Raden* in *James F. Haynes, et al*,[36] in *Harold J. Heinold*,[37] and in *Robert J. Frysinger*.[38] The Service's position is set forth in Revenue Ruling 79-229. Some of the factors the Service

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sioner, the court stressed "no distortion of income" and that the drought conditions made the prepayment a purchase of "preferential treatment." 272 F.2d 895 (10th Cir. 1959).

In Auburn Packing Co. v. Commissioner, Judge Dawson considered the apparent conflict between the general "clearly reflect income" standard contained in Section 446, and the specific, special rule for farmers in the inventory regulations, and concluded that the specific rules for farmers prevailed. 60 T.C. 794 (1973).

29. Cattle Feeders Tax Committee v. Schultz, 504 F.2d 462 (10th Cir. 1974). Judge Chandler enjoined the issuance of Rev. Rul. 73-530 (the predecessor to 75-152) and called the application of the income distortion test null and void. The decision was reversed by the Tenth Circuit on the basis of the Anti-Injunction Act and because the lower court did not have jurisdiction to enjoin the Service from publishing its own Ruling.

30. Clement v. United States, Trial Div. No. 131-75 (Ct. Cl., August 19, 1977).

31. Clement v. United States, 580 F.2d 422 (Ct. Cl. 1978) *cert. denied*, 440 U.S. 907 (1979). It is interesting to note that because of the small amount of tax involved, the taxpayer chose not to be represented by counsel at the appellate level and merely rested on the Trial Division opinion and the taxpayer's briefs. The three-judge appeals panel thus heard oral testimony and persuasive argument from the government only.

32. Dunn v. United States, 468 F. Supp. 991 (S.D.N.Y. 1979).

33. 71 T.C. 1083 (1979).

34. For a complete discussion of why the material distortion of income test should not apply to "farmers" at all, *see* Willingham & Kasmir, "*Prepaid feed deduction: How to cope with IRS' restrictive new ruling*", 43 J. OF TAX. 230 (1975).

35. Van Raden v. Commissioner, 71 T.C. 1083 (1979). In the concurrence, Judge Tannenwald quoted Gertrude Stein's "A rose is a rose, is a rose, is a rose" for the proposition that a farmer is a farmer. *Id.* at 1111.

36. [1979] T.C.M. (P-H) ¶ 79,240.

37. [1979] T.C.M. (P-H) ¶ 79,496.

38. [1980] T.C.M. (P-H) ¶ 80,089.

will consider in determining whether the deduction results in a material distortion of income include, but are not limited to, the customary business practice of the taxpayer in conducting his livestock operations, the amount of the expenditures in relation to past purchases, the time the purchase was made and the materiality of the expenditure in relation to the taxpayer's income for the year.[39]

Tax Treatment of a Farm Syndicate's Expense Items

The farm syndicate method differs only slightly from the regular cash method of accounting. The primary difference is that farm syndicates can only deduct prepayments for feed, seed, fertilizer and other farm supplies as they are consumed or utilized. It would, therefore, still be necessary for the payments for the consumed feed expenditures to meet both the deposit and business purposes tests. It is uncertain at this time whether or not the material distortion test would apply to consumed expenditures since the test itself seems to be based on the reasons for prepayments and the length of time the farm supplies are on hand before their actual use. It is conceivable, however, that the Service could still take the position that consumed feed deduction could distort the income of the taxpayer.

Planning Possibilities

In the simple example used earlier, a $150 investment generated a $250 deduction in year one. One of the assumptions used in the example was that the animal was purchased August 1, 1980, and the entire $250 was "consumed" by December 31, 1980, but the animal was sold in January of the next taxable year. This timing situation would give the same tax deferral for a cash basis "farmer" or a "farm syndicate." If the animal was purchased on December 31, 1980, the "farmer" could prepay the cost of fattening the animal and still enjoy the high leverage deduction, whereas the "farm syndicate" could deduct nothing in 1980.

The new area of litigation will be over whether or not farmers qualify for the cash method of accounting, or because of the way their operations are transacted, fall under the farm syndicate method. Thus far, no cases have addressed this question. It will become much more necessary to document active participation in the management by taxpayers engaged in agriculture.[40] This will be especially true if the taxpayer does not actually live on the farm and do the work himself.

It must be reiterated that cattle feeding simply defers income from one year to the next. Ordinary income is not converted into capital gain and, in fact, earned income can be converted into unearned income. It must also be noted that the "at-risk" rules specifically apply to farming and require actual

39. Rev. Rul. 79-229, 1979-31 I.R.B. at 7.

40. No Revenue Rulings, Regulations or cases have, as yet, addressed the issue of "active participation."

personal liability of at least the amount of the tax deduction in excess of investment.[41]

In order to insure the deductibility of prepaid feed, the taxpayer should take the following necessary steps to properly document the transaction.

(1) Have a binding written contract.
   (a) Specify price, quantity and quality.
   (b) Purchase reasonable amounts of feed for the number of cattle owned or expected to be fed in the next year.
(2) Have the taxpayer pay all property taxes, insurance and storage fees on the feed. Risk of ownership must pass in a valid purchase.
(3) Establish a business purpose for the purchase. A business purpose includes:
   (a) Establishing a set price,
   (b) Insuring supply.
(4) Have the seller treat the transaction as a sale on his books.
(5) Make sure there are no provisions for refunds.
(6) All charges for services (yardage, mixing, handling, doctoring, etc.) should be billed separately as incurred.
(7) The payment must be an "actual outlay" of money. Pay in cash. Notes won't work.
(8) Document a reasonable expectation for profit.

CONCLUSION

Cattle feeding can give just as much tax deferral after the Tax Reform Act of 1976 as it did before that Act. The taxpayer, however, must now be personally liable to comply with the at-risk rules, and if he is a "farm syndicate," he must start feeding in August instead of December.

New York dentists can still qualify as "farmers" and, therefore, prepay feed if they can prove they are "active in the management" of their farming venture. Care, however, to document that active position is essential.

Cattle feeding has proven to be a high risk economic investment. The tax *deferral* benefits still do exist, however, for the right taxpayer in the right situation.

41. *See* note 4 *supra*.