How Tax Reform Affects Cattle Breeding

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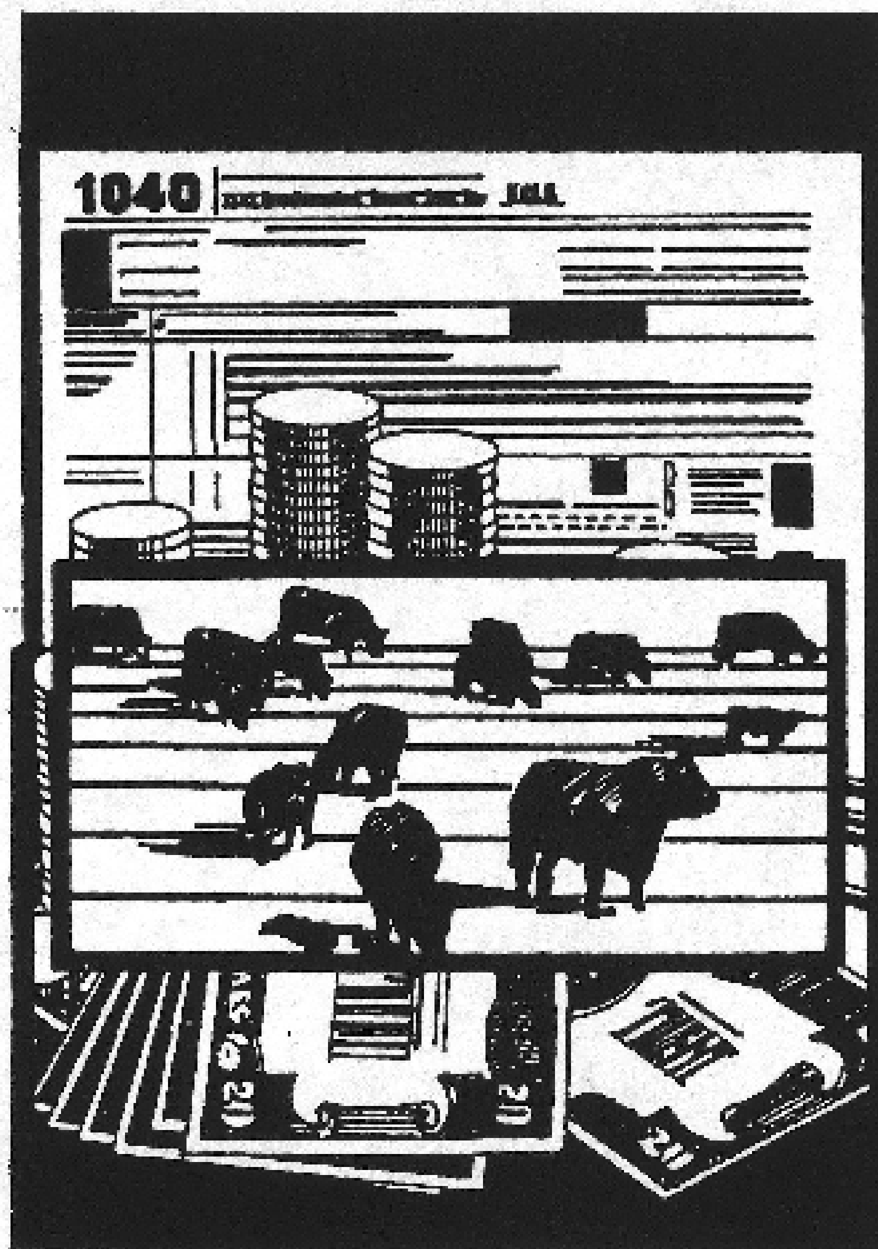
In the late 1970s two partners in a real estate venture decided to enter the cattle business. They signed sales agreements for the purchase of cattle at $30,000 per unit. Each unit consisted of five breeding cows. (The actual fair market value of the cows was approximately $600 each.) The contracts called for the purchase price to be paid in amounts ranging from $1,000 to $1,500 in cash and the balance in non-recourse promissory notes payable out of the profits. In addition, management services of $3,000 per year for the first three years and thereafter at 25 percent of the net proceeds were called for in the agreement.[1]

This situation is an example of kind of arrangements that brought many investors into cattle breeding in the past.

Why would a taxpayer be interested in such arrangement? Under prior tax law the availability of cash accounting for farming and ranching activities, coupled with the possibility of current expense deductions—along with rapid depreciation (Accelerated Cost Recovery) and the investment tax credit—plus the possibility of converting ordinary income into long term capital gain, provided sufficient tax incentives for many taxpayers to become involved in agriculture including cattle breeding. In 1982 alone, $18 billion in farming losses was used to offset other income resulting in $5.3 billion in tax savings to taxpayers.



The most far-reaching effect of the 1986 Tax Reform Act is likely to be on aggregate agricultural investment rather than on individual taxpayers who are already involved in agricultural activities. The previous tax system encouraged outside investment and attracted tax-motivated investments in agriculture. The effect of the new tax bill will mean future decisions to invest in agriculture will likely be based more on economic returns and less on tax benefits.

Restrictions on agricultural investment

The tax system had made some efforts to limit tax sheltering activities prior to the 1986 Tax Reform Act. For example, the real estate investors referred to above were challenged by the Internal Revenue Service under existing law. The court found that the entire transaction lacked sufficient economic substance, apart from tax manipulation, to be recognized as a sale of livestock.

And, in another recent case, the court was faced with a similar situation in which the factors used in reaching a determination were reviewed.[2] The court found an arrangement for the purported sale of cattle to be so lacking in economic substance as to preclude its being treated as a sale for tax purposes.[2] The factors considered:

(1) Whether the stated price for the cattle was within the reasonable range of their value (and whether nonrecourse notes had economic substance).

(2) Whether there was any intent that the purchase price would ever be paid.

(3) Whether the "purchaser" had any control over the cattle purportedly purchased and, if so, the extent of that control.

(4) Whether the "purchasers" did or could receive any benefit from the disposition of the cattle.

In other similar cases the courts have ruled the same way, although, in some situations, tax sheltering concepts have been approved if the underlying transaction appears to have an economic purpose apart from tax manipulation.

For example, in a 1980 Letter Ruling, tax advantages were available in a similar cattle breeding tax shelter where investors actually bore a risk of loss. The investors had issued partial guarantees for a portion of the non-recourse debt each year and the potential for gain or loss actually hinged on the productivity of specific, and identified, animals.

The hobby loss restriction

Probably the most common restriction on agricultural investment has been the so-called "hobby loss" provisions of section 183 of the Internal Revenue Code. Under law in existence well before the 1986 changes, expenditures classified as "hobby losses" were not deductible. Many investors find themselves faced with the question of whether or not the activity that they are investing in actually constitutes a trade or business (farming or ranching) in which they can show a profit motive. If they are unable to do so, the characterization as hobby losses means a loss of deductions.

To avoid characterization as hobby losses under section 183, the activities must actually constitute a trade or business (farming) in which the operator has a profit motive.

Under IRS regulations the factors to be considered in such cases include: (a) the manner in which the taxpayer carries on the activity; (b) the expertise of the taxpayer or his advisors; (c) the time and effort expended by the taxpayer in carrying on the activity; (d) the expectation that assets used in the activity may appreciate in value; (e) the success of the taxpayer in carrying on other similar or dissimilar activities; (f) the taxpayer's history of income or losses with respect to the activity; (g) the amount of occasional profits, if any, which are earned; (h) the financial status of the taxpayer and (i) elements of personal pleasure or recreation.

These provisions were not changed by the 1986 Tax Reform Act except that under prior law, a taxpayer was presumed to have been engaged in a business for a profit if such a profit was shown in two out of five consecutive years. The 1986 law changes the presumption so that it applies only if a net profit is generated in three out of five consecutive taxable years. In absence of the presumption, a taxpayer may still be able to prove a profit motive and that the activity is engaged in as a trade or business based on proper proof related to the factors outlined above.

"At Risk" provisions

Under another existing provision of the

Internal Revenue Code (Section 465), deductions of losses from investment activities (and even active farming operations) are limited to the taxpayer's actual risk of economic loss in the investment. The amount "at risk" is the money and the basis of property contributed by the taxpayer for which he has personal liability for payment. This limitation continues in effect following the 1986 changes.

Losses from passive activities

The existing provisions designed to limit investment for tax purposes were supplemented in the 1986 Tax Reform Act by a major new provision (Section 469) which denies deductions from passive activities to the extent they exceed income from all such activities. Credits from passive activities are limited to the tax allocatable to such activities.

A "passive investor" is someone who does not "materially participate" in a business.

Taxpayers are considered to be "materially participating" if they are "involved in the operations of the activity on a regular, continuous, and substantial basis."

The "Statement of the Managers" provides the following clarification:

> With respect to material participation in an agricultural activity, clarification is provided regarding the decision-making that, if bona fide and undertaken on a regular, continuous, and substantial basis, may be relevant to material participation. The types of decision-making that may be relevant in this regard include, without being limited to, decision-making regarding (1) crop rotation, selection, and pricing; (2) the incursion of embryo transplant or breeding expenses; (3) the purchase, sale, and leasing of capital items such as cropland, animals, machinery, and equipment; (4) breeding and mating decisions; and (5) the selection of herd or crop managers who then act at the behest of the taxpayer, rather than as paid advisors directing the conduct of the taxpayer.

The effect of this new passive loss limitation is to make it less attractive for outside investors to invest their money in cattle breeding operations unless they can develop agreements which *clearly define their role* in the operation in order to provide for "material participation."

Tax treatment of individual farmers and ranchers

In addition to the restrictions on losses from farming to shelter other income, the most significant changes in the new tax bill affecting agriculture include: (1) reductions in individual and corporate tax rates; (2) elimination of the investment tax credit; (3) changes in tax depreciation

rates and write-off periods; (4) restrictions on deductions for the prepayment of farm expenses; (5) repeal of the capital gains exclusion; and (6) changes in the deductibility of various development costs.

Cash basis

Most livestock farmers and ranchers operate as cash basis taxpayers. That is, they report income when received and claim deductions as items of expense as paid. Amounts paid in tax years beginning after March 1, 1986, are deductible when economic performance has occurred (when items are used or consumed) if *prepaid* expenses exceed 50 percent of total deductible expenses, excluding prepaid expenses, except:

(1) if the aggregate prepaid expenses for the last three taxable years are less than 50 percent of the aggregate deductible expenses for those years.

(2) if the taxpayer has excess prepaid expenses by reason of a change in business operation directly attributable to extra-ordinary circumstances.

This restriction would not pose too great a problem for the typical cow-calf operation but might pose difficulty for operations where large amounts of feed or other input items are used (and purchased prior to the year of use).

Pre-productive period expenses

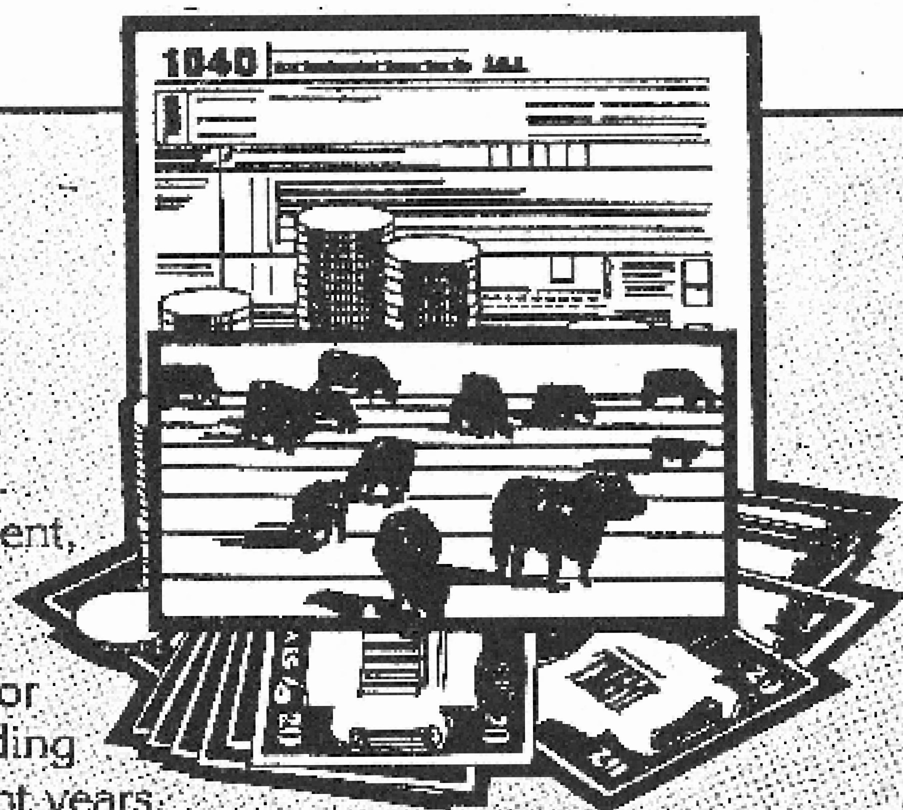
After December 31, 1986, pre-productive period costs incurred for livestock with a preproductive period of more than two years are subject to new Uniform Capitalization rules.

The pre-productive period begins at the time of acquisition, breeding, or embryo implantation and ends when the animal becomes productive (for cattle, this would be at calving).

This rule, if applicable, would force cattle operators to keep detailed records of all expenses associated with raising replacement animals and allocate a share of all expenses to those animals as a part of the basis rather than as a current deduction. Farmers and ranchers may elect to disregard the pre-production period capitalization rules and claim current deductions for these expenses but, if so, they cannot use the Accelerated Cost Recovery System and must use a straight line method of depreciation for *all* assets used in farming. The latter option is likely to be exercised by most operators to avoid the recordkeeping and allocation problems created by the new rule.

Reform means re-thinking

By Dr. Neil Harl • Professor of economics Iowa State University, Ames, Iowa



Since the federal income tax was enacted nearly 75 years ago, numerous provisions have been adopted which have affected beef production. But none of the amendments through the years have approached the Tax Reform Act of 1986 in terms of impact on the cattle industry.

Neil E. Harl, professor of economics at Iowa State University, said most of the short-term effects of the new tax laws will be negative, as producers adjust to a larger tax bite from loss of capital gains treatment for breeding animals.

"Long-term, the effects should shift toward the positive side of the ledger to the extent that tax-motivated investment has led to greater aggregate production," Harl said. "Less aggregate output means disproportionate increases in price and profitability, but the long-term effects are just that—long-term."

For the next two or three years, the short-term effects will be at center stage, Harl said.

For more than 30 years, beef breeding animals have been eligible for long-term capital gain treatment if held for 24 months or longer. For individuals, this meant a 60 percent exclusion of long-term capital gains income with the remaining 40 percent taxed as ordinary income, Harl said. For corporations, capital gains have been taxed at a flat 28 percent.

The new tax legislation does not change the character of gain from property as capital gain or ordinary income. However, it does repeal the 60 percent capital gains exclusion for individuals, effective for the taxable years after Dec. 31, 1986.

The alternate corporate capital gains rate is 34 percent, effective after 1986. But the alternative tax rate for corporate capital gains will not apply for years beginning after June 30, 1987. Capital gains will merely be taxed as ordinary income, Harl said.

"For many producers, the repeal of special treatment for long-term capital gains means more income to report," Harl said.

Since enactment, the investment tax credit has been available for purchased breeding animals. In recent years, the credit has been available at a 10 percent rate for cattle. The 1986 legislation repealed investment tax credit, effective for property placed in service after 1985. A farmer is permitted to carry-back unused investment tax credits for up to 15 years with a maximum refund of $750.

The new legislation revamps the Accelerated Cost Recovery System (ACRS). The most significant change is to shift from four classes of depreciable property to eight, and to use the asset depreciation range (ADR) published guidelines to classify assets into the eight classes.

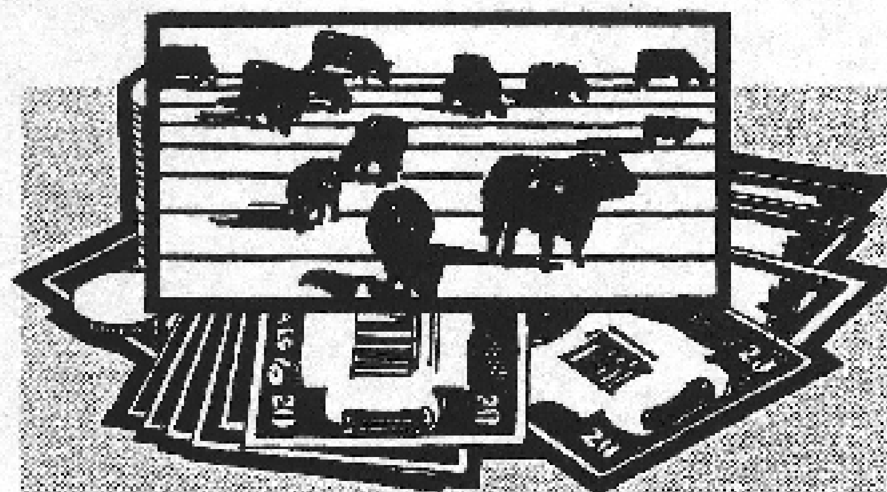
Breeding cattle falls into the five-year classification, with the allowable depreciation rate switching to straight line from double declining balance.

"For cow-calf producers, one of the surprises in the 1986 tax legislation is the requirement that costs involved in producing animals with a preproductive period of more than two years must be capitalized," Harl said.

The bill requires the producer to capitalize, and not deduct currently, the direct costs of production and the "proper share" of the indirect costs.

"This means the costs involved in producing a replacement heifer, for example, must be carried along and eventually depreciated after the animal reaches maturity rather than being deducted each year as the costs are incurred," Harl said.

"A cattle producer may elect to have the new capitalization rules not apply, but such a producer faces straight line depreciation rather than faster depreciation on all assets," Harl points out.



Accelerated Cost Recovery System (ACRS)

Under the Accelerated Cost Recovery System, the basic concept is to allow the producer to recover the cost of the capital invested in depreciable, tangible property as a deduction against income over a period of time in which the property is used in the trade or business or is held for the production of income.

"Recovery Property" includes purchased livestock if used in the trade or business or held for the production of income.

Livestock held for draft, breeding, dairy, or sporting purposes qualifies as recovery property subject to ACRS. The 1986 Tax Reform Act specifically provides for new recovery periods for livestock (placed in service after December 31, 1986) which commence in the year in which the asset is placed in service.

Livestock costs, including the cost of cattle, are recovered over five years. (The cost of breeding hogs over two and race horses over 12 may be recovered over three years.)

Single-purpose agricultural structures are in the seven-year class. The method of depreciation applicable to three-year, five-year, seven-year and ten-year classes is the double declining balance-method with a switch to straight line at a time to maximize the deduction.

The cost recovery system would apply to purchased livestock when placed in service. The basis subject to ACRS would include the original purchase price plus any costs associated with the animals preproductive period under the new Uniform Capitalization rules unless the taxpayer opts to deduct such expenses currently. If so, the ACRS recovery periods are not used and the taxpayer must use straight line depreciation instead.

The ACRS would also apply to the basis of raised livestock if the new Uniform Capitalization rules are used. For example, if a rancher decides to keep track of the cost associated with raising replacement heifers prior to production, this total becomes the basis which is recoverable under the ACRS.

Expensing of purchase price

Recovery property, including livestock other than horses, acquired by purchase for use in a trade or business may qualify for expensing—that is, up to $10,000 may be deducted as a current expense for the taxable year in which the personal property is placed in service. This maximum amount is reduced dollar for dollar for expenditures in excess of $200,000 and may not exceed the amount of income from an active trade or business.

Investment Tax Credit

The investment tax credit is repealed for property placed in service after December 31, 1985.

Capital Gain

In the past, gain from the sale of animals, raised or purchased, held for the required period (24 months in the case of cattle) was treated as long term capital gain and was taxed in a favorable manner. (Only 40 percent of the gain was reportable for tax purposes). The exclusion is repealed for tax years after 1986, and such gains will be fully taxed just as is ordinary income. The sale of "capital gain" property still retains its character but is fully taxed.

Some key provisions to remember

The Tax Reform for Fairness, Simplicity and Economic Growth Act of 1986, better known as the 1986 Tax Reform Act, is not intended to increase or decrease total tax revenue. However, it will have a tremendous impact on agriculture, according to an agricultural economist at New Mexico State University.

"The new tax law is a negative factor for most self-employed people, which includes most farmers and ranchers. They will likely pay more under the new tax laws," said James Libbin.

The greatest impact on producers will likely come from losing the capital gains exclusion. Long-term capital gains will be 100 percent taxable, instead of the former 40 percent taxable level. Capital gains is still a class of income, however, so producers must still keep records, Libbin said.

"Many people expect the capital gains exclusion to come back. It's been lost before, and there is no doubt it will come back," the economist predicted.

He is less certain that the investment credit, also a casualty of the 1986 reforms, will be brought back. No investment credit is allowed on property purchased after 1985. Investment credit earned but not used before 1987 must be reduced by 17.5 percent before it can be applied to tax year 1987. It must be reduced by another 17.5 percent before it can be applied to tax years after 1987. Some farmers might qualify for a special 15-year carry-back provision for investment credit carryover.

"The capital exclusion and tax credit were big losses to farmers and ranchers and will have the most impact on producers," Libbin said.

"On the good side, it will make farming and ranching less attractive to non-agriculture investors. It's hard to compete with the guy who intends to take losses for taxes," he added.

Another tax reform that will affect producers deals with preproduction expenses on breeding livestock and non-timber crops with two-year or greater preproduction periods. Instead of writing off expenses as they occur, producers must capitalize. For example, ranchers will have to keep records until the animals reach breeding age, and then depreciate.

"This is going to involve very complex record keeping," Libbin said. "In reality, the rules don't allow time for animals to reach breeding age."

Libbin pointed out that ranchers could break the two-year record keeping ruling by taking straight-line depreciation or by selling heifer calves and buying them back at a later date.

Changes in depreciation and tax shelter rules will have negligible effects on most producers. Exceptions are producers involved in orchards, vineyards, and other long-term depreciation operations.

In other changes, Libbin advised independent contractors to be aware that 1099s must be filed and filed properly. There is a $50 penalty for not filing and a $5 penalty for filing incorrect information.

Also, any child more than five years old claimed on 1987 tax forms as a dependent must have a social security number.

By Tina M. Prow • New Mexico State University

Special issues associated with embryo transfer

Investment opportunities in embryo transfer plans have been an important part of the "outside" investment in cattle breeding in recent years. The major hurdle faced by investors was to show an "active trade or business."

Once an investor was classified as being in the trade or business of farming with a profit motive, the tax savings opportunities discussed earlier became available and particularly attractive due to the nature of embryo transfer. The upfront costs are often significant and the income is deferred into future years. Obviously, the loss of general tax incentives, such as investment tax credit, capital gain, and rapid depreciation, as well as the new Uniform Capitalization rules for pre-productive period expenditures, will make embryo transfer plans less attractive for many investors.

Deductibility

Some of the impetus for the use of embryo transfer as an attractive investment opportunity came from two Letter Rulings[4] in which taxpayers who paid for embryo transfers were allowed to deduct, as ordinary expenses, the fees paid for the purchase of the embryos, the costs of preparing the cycling of recipient cows, and the transfer fee. The portion of the fee attributable to the purchase of recipient cows was subject to capitalization and was not currently deductible. These rulings were based on the fact that there was no guarantee of a live and healthy calf and, thus, the purchaser bore the risk of loss. Had there been such a guarantee, the entire fee could be considered equivalent to the purchase price of the calf and not deductible. In both of the letter rulings, there was agreement that payment of the full fee was contingent only upon a positive pregnancy test of the recipient.

In the most recent ruling dealing with embryo transfer[5], the IRS apparently changed its view and disallowed current deductibility on the theory that no risk passed until after the pregnancy test. The taxpayer was, in effect, purchasing calves.

The 1986 **Farmers Tax Guide** instructs taxpayers regarding these expenses as follows:

> "If you acquire an embryo transplant by purchasing a recipient cow pregnant with the embryo, you must allocate to the cost basis of the cow, the portion of purchase price equal to the fair market value of the cow. Allocate the remainder of the purchase price to the basis of the calf. Neither the cost allocated to the cow nor the cost allocated to the calf is deductible currently as a business expense."[6]

Note that neither the latest Letter Ruling nor the instructions in the **Farmers Tax Guide** deal with the deductibility of embryo transfer expenses associated with the use of this technology by a producer already in the business who employs the technology in his existing herd. Presumably, embryo transfer expenditures for such a taxpayer would continue to be treated as deductible items such as breeding fees have been in the past. The deductibility of these expenses would be subject to the new Uniform Capitalization rules for pre-productive period expenses.

Embryo transfer costs as pre-productive period expenses

The new Uniform Capitalization Rules would appear to have an effect on deductibility of embryo transfer costs. If the rules are applicable in a given situation, a portion of costs attributed to the new offspring might be considered pre-productive period costs and not deductible but subject to the Uniform Capitalization rules. The original Report of the House Ways and Means Committee referred to the pre-productive period as beginning "at the time of acquisition, breeding, or embryo implantation". If these costs are considered to be incurred "at the time of" implantation, they seem to fall within the pre-productive period just as breeding fees would. If the new rules are applicable, these costs add to the basis of the animal

and are subject to recovery under the ACRS once the animal reaches production.

If the Uniform Capitalization Rules are not applicable (because a farmer elects to currently deduct such expenditures), then embryo costs would seem to be deductible for the producer using the technology in his own herd. If the rules are disregarded, then a slower depreciation schedule must be followed for all assets, including livestock placed in service during the tax year.

Confusion may result relating to embryo transfer costs associated with first calf heifers bred during the pre-productive period (before they reach "production") if they serve as donors for embryo transfer.

If the intended product is embryos instead of calves, it is conceivable that a heifer might reach the production stage prior to two years from the original breeding date of her dam. If so, the pre-productive period rules do not seem applicable. This is of doubtful use because the producer will have other animals as well and because some do not reach production with two years, the Uniform Capitalization rules become applicable.

Allocation of costs

An interesting question is raised in those situations where a taxpayer purchases a pregnant recipient cow with a transplanted embryo. The issue is whether a portion of the purchase price should be allocated to the basis of the unborn (presumably more valuable) calf?

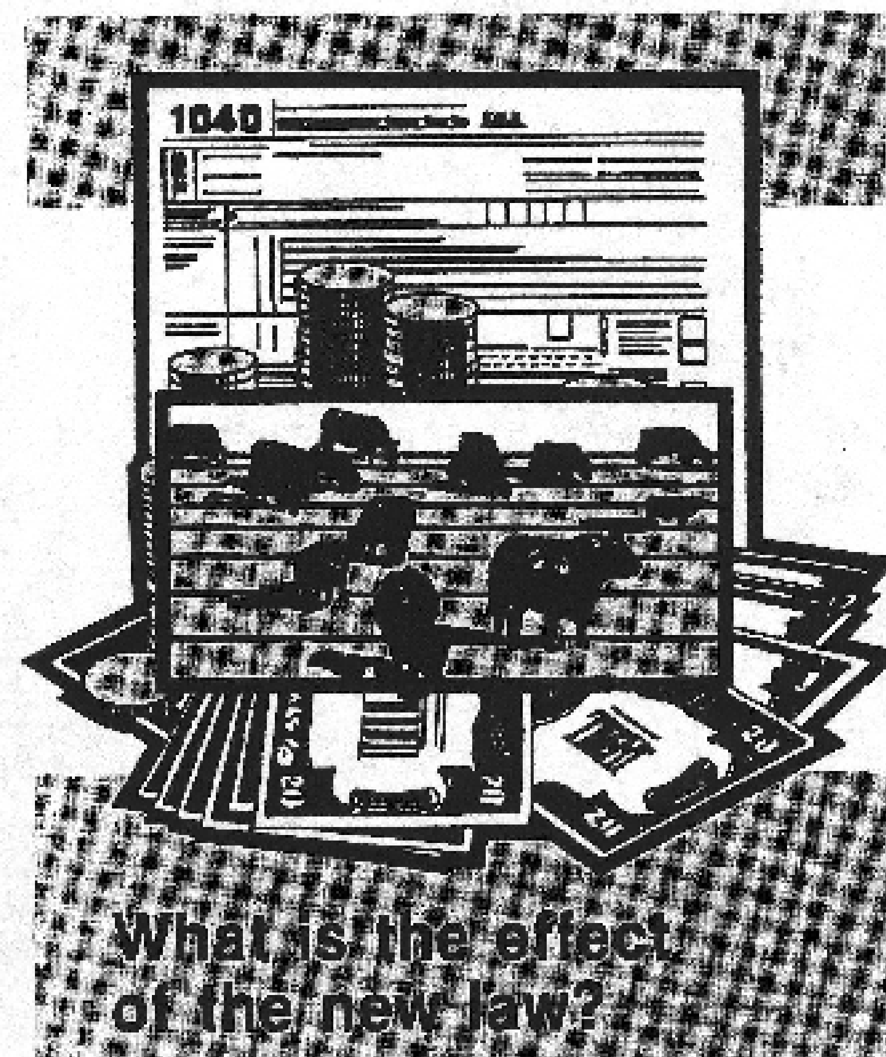
In **Gamble v. Commissioner** [7], the taxpayer sold a 16-month-old colt which had been acquired as an unborn foal. A specific portion of the purchase price paid for the brood mare in foal was allocated to the colt. The IRS unsuccessfully argued that the entire price should have been allocated to the mare but lost to a taxpayer challenge in court.

Later, in a letter ruling[8] related to embryo transfer in cattle, IRS took a position contrary to its argument in **Gamble** and held the price paid for cows with embryos in place must be allocated between the cows and unborn calves.

This was in apparent reaction toward one practice, promoted by some in the embryo business, to suggest that one can pay, say $10,000, for a cow with a valuable embryo in place; immediately sell the recipient cow after weaning of the calf for, say $500; and take a $9,500 loss on the cow regardless of what is done with the calf.

This ruling indicates that IRS will not permit such treatment. This was confirmed in a subsequent Revenue Ruling[9] where the IRS held that the "amount allocatable to the embryo is an amount expended in purchasing livestock and must be capitalized . . ."

This ruling was the first indication that IRS might consider embryos to be capital items rather than deductible expenditures.



How will the new law affect specific types of farming operations? Because of differences among farms and the wide range of tax changes, the effects vary significantly depending on the type of operation and particularly on the amount on capital investment involved and the proportion of income resulting from capital gain items.

The USDA has developed comparisons of various types of operations—orchards,

livestock, and crop operations[10]. For example, under the Tax Reform Act, costs for developing orchards will no longer be currently deductible. The cost will be capitalized by all orchard developers (not just citrus and almond growers as in the past) and since all long-term capital gains will be taxable, the net result is that for most orchard operators, the tax bill will increase.

The same can be said for dairy operations, hog operations, and for many beef operations. The particular effect in these operations is through the loss of investment credit and the change in capital gain treatment.

Although there is some net reduction in tax by the changing in the tax rates, most of these operations will see increases in taxes. For crop operations, the effect is much less. In fact, some crop operations will see a decline in total tax liability primarily because they are not dependent on capital gain income.

During the initial discussions of the tax reform bill, it was touted as being "tax simplification"—one in which there would be a "massive reform" of the tax system. It does reduce the number of tax brackets (a simplification); it does eliminate some deductions (a simplification) which makes it somewhat easier to follow the logic of the tax system.

But, there is nothing simple about the new tax bill. In fact, for farmers and ranchers, tax planning may become even more complicated. AJ

Sources

1. **These facts are based on Grodt & McKay Realty, Inc., v. Commissioner, 77 T.C. 1221 (1981).**
2. **Seigel v. Commissioner, T.C. Memo 1985-441, (August 22, 1985).**
3. **Ltr. Rul. 8019009. (October 21, 1980)**
4. **Ltr. Rul. 8007002 (October 30, 1979) and Ltr. Rul. 8304020 (October 22, 1982).**
5. **Ltr. Rul. 8625007 (March 14, 1986).**
6. **Farmers Tax Guide (October, 1986) at page 16.**
7. **68 T.C. 800 (1977).**
8. **Ltr. Rul. 8421004, (January 25, 1984).**
9. **Rev. Rul. 86-24, IRB 1986-8.**
10. **Agricultural Outlook, November, 1986 at pages 26-33.**

Dr. Looney addressed Angus breeders on tax matters at the American Angus Association's annual meeting in Louisville, Ky., November, 1985.