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*Cattle - Feeding*

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TAX RULES FOR CATTLE FEEDING ARE A TWO-EDGED SWORD

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Introduction

Tax deductions for feeding cattle makes it attractive for the individual facing a 50 percent income tax bracket toward the end of the year. Tax shelter funds brought a bundle of cash to cattle feeding contracts for custom feedlots in the early 1970s.

A cattle feeders tax committee survey of 1973 estimated one-fourth of the nation's fed beef came from so-called outside investors with the tax shelter idea causing a mushrooming of large-scale contracts marketed by the investment houses from Boston to Biloxi and from Chicago to California. One study showed that in a recent five year period over \$420 million in equity offerings were cleared by the Securities and Exchange Commission in Washington for financing cattle on feed for custom feedlots serving in-and-out cattle feeders through contracts. These offerings specified the investor should be in the 50 percent income tax bracket. With \$100 or more of equity per head in cattle, a \$420 million offering would finance 4 million head, a sizeable portion of the nation's cattle on feed at any one time.

Other funds for financing cattle on feed, operate beyond the publicly offered funds cleared by the Securities and Exchange Commission. These tap the larger investors who have \$30,000 upwards of equity to place in cattle feeding and to match it by a bank loan of two to three times their equity for sharing in the custom feedlot contract.

As stories of bankruptcy from the feedlot empires built by these tax shelter funds come into the farm and ranch and livestock press these days, many a farmer and rancher feels that the tax shelter boys have learned their lesson and will stay out of the feedlot contract for the future, having burnt their fingers badly in the cattle bust of the 1974 period.

The collapse of the Wheatheart cattle feedlot empire came recently in the North Texas Panhandle after the firm pioneered the public cattle feeding tax shelter funds and captured feedlots as far away as the Pacific Northwest. Reports suggest other once affluent custom feedlot chains faced financial difficulty.

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## Funds Still Selling

Yet one does not have to probe very deep nor very long to find feedlot funds are still being sold to the high income tax shelter investor who seeks to reduce reportable cash income in one calendar and move it forward into a later year when he can rejugle his finances to save further on taxes or have a lower total income from his business and profession.

While some cattlemen were singing the blues in 1974, a tax shelter fund operating in Nebraska today reported to me its success at selling a several million dollar offering to the high income nonagricultural income around for reducing taxes.

In recent days I contacted two investment houses to see if it is true that the custom cattle feeder investors got burned badly and would run from the corral like a wounded coyote. Here is what I found. One firm reported feeding cattle for investors in its own feedlot. However, it escapes publicity by not clearing its funds with the Securities and Exchange Commission.<sup>a/</sup> This firm does tap the investor putting in a minimum of \$30,000 equity for financing feed and cattle supplemented by a bank loan.

The other one of two investment firms I contacted sent me their \$5 million limited partnership offerings made in 1974. This firm still operated seven feedlots in several states, plus a vertically integrated operation of cattle buying, grain buying and even a loan company to provide the debt capital to the equity investor.

## Concentration of Cattle Feeding

This latter firm sought to capture five percent of the nation's fed beef supply. That sounds like a lot of market control to me, but perhaps others in agriculture and cattle feeding are not too alarmed over the growing concentration of control by a few firms that, through horizontal integration over a number of existing feedlots and vertical integration over grain, meat packing, financial firms and other ties do exert at least some sizeable regional control over the nation's red meat supply.<sup>b/</sup>

The SEC-cleared tax shelter funds led to 25 feedlot firms owning a total of 74 feedlots. These 25 firms controlled an estimated 15 percent of the nation's fed cattle in 1972.

<sup>a/</sup> Unless the custom lot firm has a capacity of 50,000 head or more it is less expensive to tap a limited number of large investors through so-called private placement by use of limited partnership funds on a state-by-state basis instead of federal clearance through the SEC.

<sup>b/</sup> One feedlot firm in Oregon alone provided for twenty percent of the state's beef.

## New Types of Cattle Funds

New trends appear in today's cattle feeding funds. Expansion of the investor's base includes not only cattle on feed but also sometimes ownership in the feedlot facilities, and also involves ownership of breeding stock. This enables the custom cattle investor to reap tax benefits from capital gains in breeding and in later selling the feedlot facilities even if the tax rules allowing deduction for prepaid feed of cash accounting for farmers is weakened in the current session of Congress.

## Tax Rules a Double-Edged Sword

Still, the total tax picture for the farmer, the cattle industry, and especially the cattle feeder is a double-edged sword. Cow-calf ranchers gloated over the upward pressure on prices for their calves when the funds were reportedly bidding heavily at the Missouri river markets for feeder cattle in the 1972-73 period. One Missouri farmer asked that the tax regulations allowing cash accounting for prepaid feed costs to be continued for "it sure makes me money on my calves." But this same farmer decried the margins between feeder cattle and fat cattle at that time which cost him profits in feeding his own cattle. If he had entered custom cattle feedlot ownership, perhaps he could have had the best of both worlds. But maybe his peace of mind would be short-lived as the big city newspapers focus on tax farming.

Meanwhile, back at the ranch, the cow-calf man of today wonders where the tax shelter boys went to, and wishes there were more of them today to buoy the price for calves and feeder cattle. In the hazy mist of another recent cattle bust, too many elements arose to prevent putting the finger on any one of them as the cause for the collapse of the cow-calf business and the cattle feeding sector.

Price ceilings, rising feed costs, trucker strikes, and total problems of an inflation situation leaves one able to pin the problems of the cattle feeder on his favorite target. In the midst of it all, those interested in the cattle feeding industry need to fathom the future. The tax shelter investor will have his role there.

Traditional agriculturalists have used the income tax regulations to their advantage. Cattle feeders found it wise to expand their operation even as an individual cattle feeder without any feeding for others on custom contract. A year of high income could be shoved forward by investing heavily in feed for feeding more cattle next year. Thus, the cattle feeder found the tax advantages of real value. They were advantageous for the many thousands of farmers who found themselves in the same situation with high incomes from higher price for grain crops. The total reaction of all cattle feeders of the Cornbelt led to much greater expansion in the industry than mere economic (before tax) profits would call forth.

## Future of Outside Investors

The past performance of the custom feedlot industry may appear unimportant to today's cattle feeder who notes the wave of bankruptcies in the feeding funds, from the fall in cattle profits a couple of years ago. Still, the industry has been restructured in such a way that the cattle feeder will be affected.

Consider first that the feedlot facilities that were built with tax shelter investors paying service charges in the early 1970s have been paid for. These feedlot facilities still exist for feeding cattle. Ownership of the feedlot can take many forms. It can be sold to a grain exporting firm as in the case of Cargill, now owning several lots and seeking operations in Nebraska to add to its growing feedlot system. Such a diversification by a firm owning grain for export and feedlots for feeding cattle gives the firm the market advantages of the traditional Cornbelt feeder who raises his grain and finds that when grain prices are low the profit margins on livestock are improved, generally speaking.

However, other types of industries can own a feedlot, be it an investment firm on Wall Street, as in the case of one Texas feedlot (now feeding for tax shelter investors able to put up to \$30,000 or more equity for cattle feeding cycle.) Firms diversified in several fields - be they agricultural or nonagricultural - generally have the broad equity base from investors to own a feedlot and feed cattle in it and ride through a profitless period in a cattle feeding cycle. The relatively large firm that sells its common stock to the public and engages in several different industries generally can outlast a Cornbelt cattle feeder when the cattle cycle dips and losses occur for several months or several years. Therefore, the custom feedlot facilities that were built by earlier cattle feeding investors a few years ago can continue to survive in this age of conglomerate ownership of their facilities and to outlast some of the farmer-feeders, assuming there are no major diseconomies of scale with the large feedlots.

## Farmer Feeder Versus Custom Feeder

The farmer or rancher who feeds cattle, faces further financial concern in coming months. Rising cost of production for grain and falling prices for grain tend to reduce profits and the income tax bracket for these food producers. Additionally, unlike the custom cattle feeder who enters cattle feeding during good years and withdraws during years when he can end up in a lower tax bracket to save on total taxes, the farmer-feeder tends to be more steady in cattle feeding. He does not always enter cattle feeding when convenient for his cash flow situation. Generally, a farmer either feeds cattle or does not feed cattle. Furthermore, a farmer cannot enter cattle feeding with the ease of the custom feedlot contractor who needs no knowledge of the industry, the markets or the breeds, feeds and gains. These several features give the custom cattle feeder

some advantages over the farmer feeder. Nevertheless, the farmer-feeder with an efficient operation and who does grow much of his own feed can continue to compete, to a degree, if income tax advantages are removed from cattle feeding. If the farmer feeder does not have to invest in new feedlot facilities he can hope to compete with the existing and paid for feedlot facilities of the large lots built by custom feeding fees for the custom feeder.

Again, as an illustration for the feature of cattle feeding attracting the high income person to enter feeding to shove a portion of his income forward, a \$100 equity investment per head can provide some savings. Consider the \$100 going for feed expenses to reduce the current year's reportable income. If the \$100 is reported out in a later year when the investor has fallen into a tax bracket 10 percent below where he was formerly at the time the investment was made, he has gained \$10 per head on tax savings alone. There are many variations of this oversimplified illustration, but it still shows possible advantages for feeding cattle for tax advantages. Furthermore, if prepaid feed is not allowed to be deducted, by entering the feeding contract in August instead of December the investor can consider the feed not prepaid but an actual expense for the particular year and thus possibly meet the requirements of the law. Additionally, with higher feed costs there would appear to be greater advantages in tax deducted cattle feeding than otherwise.

#### Alternative Measures to Save Both Cash Accounting and Cattle Feeders Seeking Profits

To talk of modifying cash accounting rules for agriculture appears to be a topic many fear to discuss even if it does lead to sizeable "tax farming" by investors who can continue in cattle feeding when economic profits are too low to justify it. Other indirect measures to cut tax sheltered cattle feeding may be available to those interested in such. By raising the minimum level of taxes required from high income persons, the incentive to shelter income from taxes may be decreased. If the higher income individual is required to pay a sizeable percentage of his income in income tax instead of attempting to shelter most of his income from income tax, then he may be less inclined to enter cattle feeding for tax shelter purposes. Also, liberalizing the rules for allowing income averaging may be of importance to the curbing of use of cattle feeding for income tax sheltering, or more correctly, income tax averaging. Individuals who expect to be in the 50 percent income tax bracket in one year and a 20 percent bracket in the near future could arrange to average their income over these years and thus cut their income tax bracket to something approximating a 30 to 40 percent income tax level. Current rules for income tax averaging do not appear to encourage this degree of income averaging. As a result, high income individuals do seek ways to shelter their income from high income taxes.

Finally, altering the total progressive tax structure would lead to the reduction in the use of cattle feeding, agriculture in general, and other investments for purposes of tax sheltering. It is the progressive tax rate that leads to efforts to shove income around from one year to another by creating deductible cash accounting expenses in one year with the income from the investment to be reported in a later year. A proportional tax, of 25 percent on all income over a minimum level, would curb the attempts to avoid the relatively higher income tax levels.

## Summary and Conclusions

Meanwhile, until such measures as discussed above are considered, how serious will agriculture in general, and cattle feeding in particular, seek to reduce the investor seeking income tax considerations in entering cattle feeding? Other sectors of agriculture have grown concerned about nonagricultural capital overexpanding their industry and leading to a lowering of profits. The tree crop sector of California called for an end to tax write-offs of expansible items in order to curb the attractiveness of this crop for in-and-out tax shelter investors. The wine grape industry is presently suffering the effects of an over-investment binge that was tax-shelter related.

For those who argue that cattle feeding needs nonagricultural investors or sizeable flows of so-called outside capital, the lesson of the tree crop sector suggests that the expansion of production by flow of such funds greatly lowers the returns to the producers in the operation for economic profits. Generally, economic theory suggests producers in any industry want to avoid over-production of their product in order to obtain viable prices and profits. Cattlemen generally do not want to limit production. But still, many cattlemen do like to have an economic profit. Few cattlemen, if any, are in the business for prestige and fun. Thus, the question remains Who will finance cattle feeding? The providers of equity for feeding cattle will be the ones who earn the profits in cattle feeding. If cattle feeders find they do not provide the equity capital, the profits from the industry will go to those others who do. Meanwhile, the industry can be expected to shift its structure toward custom feeding firms where the profits are in the service charges instead in the ownership of cattle. But then new risk takers can be expected to capture even more of the cattle feeding profits from the rancher and the farmer.