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Farm Taxation: A Lesson from History

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FARM TAXATION: A LESSON FROM HISTORY

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That the taxation of farms has a separate history of its own probably would surprise many. But that it does surprise is also revealing. Taxation of farms has been, and continues to be, quite different from the taxation of other investments.

From the beginning of the income tax until the 1986 act, farms were tax shelters.[1] It does not appear that the 1986 act eliminated them as tax shelters, but certainly their use in the future will be somewhat different from their use in the past. The future, however, is left to others, and this paper speaks only to the past.

Estate of Wilbur is one of the few farm tax cases that did not appear to be a tax shelter case.[2] It was, of course, because all farm tax cases are tax shelter cases. There was nothing particularly unique about the case. Indeed, since the Jamison article in 1961,[3] there has been nothing left for others to discover. They have only to read what he so cogently laid out.

For reasons never articulated but about which there has been some speculation, administrative decisions made early in the income tax separated farm investments from other investments for tax purposes. Farmers—the word continues to defy definition three quarters of a century later—were permitted to use cash accounting and ignore inventory values. They were also given a special dispensation to expense what certainly would have been capital expenditures in any other industry.[4] That the dispensation had the effect of allowing deductions for capital costs has been denied by the IRS on several occasions,[5] but nobody doubted that it did.

Speculation would have us believe that the administrative difficulty of identifying costs, the lack of sophisticated accounting practices and principles and the probable burdens—cost and inconvenience—that would be imposed by normal accounting led to permission to use cash accounting without inventories.[6] The same speculator suggested that a rule which required

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1. *Comprehensive Tax Reform: Hearings Before the Comm. on Ways & Means*, 99th Cong., 1st Sess. part 3 2597 (1985)(statement of Charles Davenport).

2. Estate of Wilbur, 43 T.C. 322 (1965).

3. O.M. JAMISON, *Tax Planning with Livestock and Farming Operations*, 1961 S. CAL. TAX INST. 583 (1961)[hereinafter JAMISON].

4. DAVENPORT, *A Bountiful Tax Harvest*, 48 TEX. L. REV. 1, 2, 12 (1969)[hereinafter *Tax Harvest*].

5. Mimeo. 6030, 1946-2 C.B. 45.

6. *Tax Harvest*, *supra* note 4, at 14.

capitalization of capital costs might have been considered inconsistent with the dispensation of inventory and perhaps arguably equally inconvenient.[7]

But whatever the reasons underlying them, the rules probably did not have great impact in the early days of income taxation,[8] although they did permit the deferral of tax, and sometimes the exemption of income from tax. Interest rates were low during much of the early period, and the income tax was not yet a mass tax. It did not reach many farmers[9]—or for that matter, many other taxpayers. Interestingly, there were hobby farmer cases[10] even back in those days, and the characterization of the battle as one involving the question whether the taxpayer intended to make a profit undoubtedly slowed the proper analysis of the farm tax shelter by several years or even decades. Despite the literature which clearly indicated that the farm shelter came from an unusual set of accounting rules,[11] the Treasury and the IRS acted as if the question was one of intent to make a profit.[12] This could occur only because of the history of that issue. The past does shape the present and the future to some extent.

Although many of the disputes concerning the Revenue Act of 1942 were not resolved until the Tax Reform Act of 1969,[13] the 1942 act brought a benefit that put some real money into the farm tax shelter. Gain realized from the sale of assets such as livestock and orchards would be taxed as long-term capital gain.[14] Since the difference between ordinary income tax rates and long-term capital gains rates soon became as much as 66%—that's right—this is the difference between 91% and 25%—a lot of taxes could be saved by deducting costs, selling the asset produced by them, and reporting the proceeds as long-term capital gain.

This treatment had been opposed by the Treasury. It tried its hand at litigation with respect to livestock but lost the major case.[15] The livestock interests were not willing to rely on this case, however, and they lobbied for and obtained an amendment to the predecessor of section 1231. This amendment specified that livestock used for draft, breeding, and dairy purposes were to be treated as assets used in the trade or business and thus

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7. *Id.* at 15-16.

8. *Farmworkers in Rural America, 1971-72: Hearings on Land Ownership, Use and Distribution Before the Subcomm. on Migratory Labor of the Senate Comm. on Labor & Public Welfare*, 92d Cong., 1st and 2d Sess. 1065 (1972)(statement of Charles Davenport)[hereinafter *Farmworkers*].

9. *Id.* at 1067.

10. Commissioner v. Field, 67 F.2d 876 (2d Cir. 1933); Fisher v. Commissioner, 29 B.T.A. 1041 (1934), *aff'd*, 74 F.2d 1014 (2d Cir. 1935); Vanderbilt v. Commissioner, 5 B.T.A. 1055 (1927), *aff'd*, 23 F.2d 975 (D.C. Cir. 1928).

11. *See Tax Harvest*, *supra* note 4, at 5-9.

12. *See supra* note 10.

13. 26 U.S.C. § 1231(b)(6) (1969).

14. I.R.C. § 117(j) (1939).

15. Albright v. United States, 173 F.2d 339 (8th Cir. 1949).

entitled to long-term capital gain treatment.[16] While the Treasury was vigorous in opposing this amendment,[17] its presentation was not as sharp as it might have been,[18] and the farm properties, including livestock, were added to the category of business assets qualifying for long-term capital gain treatment. Sporting animals were added in 1969 at the request of the horse racing industry.[19]

In an era when gain produced by the use of accelerated depreciation on boxcars and real estate was also given favorable treatment, farms apparently did not attract much attention as special investments. Jamison did, however, outline the tax shelter at the USC tax conference.[20] Also, there were economists, largely at the Department of Agriculture, who were mystified that their estimates of farm income could differ so radically from the amounts of farm income shown on tax returns. Indeed, they even made futile attempts to reconcile the two, but they were never able to do so. The difference was striking. It was not unusual to find that USDA farm income was from five to eight times that of IRS farm income.

This paucity of taxable farm income apparently bothered the Internal Revenue Service, because it litigated numerous hobby cases and urged that failure to realize a taxable profit indicated that the requisite intent was missing.[21] It is difficult to pronounce a judgment on this litigation. It certainly did nothing to stem the use of farms as tax shelters. In a sense the litigation and its results were distracting because they were not directed at the right issue. If every hobby farm in the country had been put out of business, it seems unlikely that the difference between USDA farm income and taxable farm income would have been appreciably changed. While hobby farms were a highly visible target, they were certainly far removed from the bull's-eye. Even so, as late as 1969, there was talk about the farm hobby loss problem.

Interestingly, there is no indication that the farming community had the slightest interest in the question being pursued by a few academics and bureaucrats: Why did USDA farm income differ so radically from taxable farm income? The answer was not that obscure. All expenses were deducted on the farm schedule, Schedule F, but in many operations much of the income was not reported on that schedule. Rather, it was found on the capital gains schedule, Schedule D. Furthermore, inventory values would not be found in tax returns. While it is possible that the total of these two items

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16. I.R.C. § 117(j) (1939).

17. Letter from Secretary of Treasury Snyder to the Chairman of the Senate Finance Comm., 98th Cong., ____ Sess., ____ CONG. REC. 8307, 8308 (1952).

18. *Id.*

19. DAVENPORT, *Farm Losses Under the Tax Reform Act of 1969: Keepin' 'Em Happy Down on the Farm,* 12 B.C. INDUS. & COM. L. REV. 319, 323-24 (1971).

20. *See generally* JAMISON, *supra* note 3.

21. *See* McLean v. Commissioner, 285 F.2d 756 (4th Cir. 1961); Wise v. Commissioner, 260 F.2d 354 (6th Cir. 1958).

would not have explained the full discrepancy, examination of those items would have been a major step in the right direction.

During this period Colonel Oppenheimer wrote his books about cowboys.[22] Even so, the publicity given the farm tax shelter was not great, although it seems clear that many had begun to understand the arithmetic involved.

The stage was set for some change in the tax laws. The 1969 Tax Reform Act provided the vehicle for the debate, and two approaches were offered to deal with the farm tax loss problem. They were the first indication that anybody in official Washington understood the nature of the problem. The approach finally adopted was the excess deductions account.[23] Without going into its details, it accepted the deductibility of expenses under then existing accounting methods but required some gain on farm property to be reported as ordinary income rather than capital gain.[24] It was the application of the recapture notion to farm properties. It was terribly complex because acceptance of the existing accounting methods made impossible a precise determination of what should have been recaptured. Even so, it followed the lead taken several years earlier with depreciation.

The other approach offered that year was, to my knowledge, the first legislative proposal that attempted to confine the use of overly liberal accounting rules to the investment in which they were employed. Under this alternative approach, offered by Senator Metcalf of Montana, a farm loss could be used against nonfarm income only in limited amounts.[25] Despite the fact that it had the nominal support of nearly a majority of the Senate, it was never given serious consideration, in part because the administration did not support it and in part because the intense political lobbying which we now accept as normal for any tax provision was applied to the bill. That should give some perspective to political ideas which appear to be popular but which never seem to have any movement. This approach was resurrected under a different name in 1974,[26] and it was enacted on a much broader basis in 1986 as a limitation on passive activity losses, your 1986 tax reform PAL.[27]

Despite what must be a gloomy assessment of the 1969 legislation, there was one remarkable feature. The Florida citrus industry had been concerned about the wall-to-wall planting of citrus groves by Minute Maid Orange Juice, a subsidiary of Coca-Cola. It struck the industry that it could not

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22. *See generally* H.L. Oppenheimer, Cowboy Arithmetic (1985); H.L. Oppenheimer, Cowboy Economics (3d ed. 1976); H.L. Oppenheimer, Cowboy Securities (1975); H.L. Oppenheimer, Land Speculation (1972).

23. I.R.C. § 1251(b) (1954), *repealed by* Tax Reform Act of 1984.

24. *Tax Harvest, supra* note 4, at 21-24.

25. S. 500, 91st Cong., 1st Sess., ___ Cong. Rec. ___ (1969).

26. Limitation on Artificial Accounting Losses, commonly referred to as LAAL or LAL.

27. I.R.C. § 469 (1986).

compete with this kind of capital, and it asked the Congress for legislation that would prevent the write-off of development expenses for citrus. The Congress responded.[28] In 1970 the almond industry asked for and received the same treatment[29]—development costs had to be capitalized during the first four years of the grove's life.

Rather than being curative for other farm investments, the 1969 act apparently operated as an advertising announcement. Now everybody knew about the almost unlimited tax shelter possibilities in farm investments. No public relations firm could have hoped for a campaign as effective as the 1969 debate and adoption of the loose and toothless excess deductions account.

The salad days of the farm tax shelters followed. Syndications grew at amazing rates. Cattle, hog, and even chicken syndicates proliferated. Tomato "rollovers" became common.[30] In California syndicated vineyards led to the wholesale planting of grapes—so much so that the health of the industry was gravely threatened. In a search for new tax shelter crops that did not have markets glutted by overly stimulated tax shelter products, syndicators found pistachio nuts and kiwi fruits. Annual farm syndications ran into the billions of dollars, and they were growing.[31]

The economic results of these shelters were not favorable. Some appeared to be outright frauds; many were sold at inflated prices; some seemed merely to have been poorly managed by inexperienced promoters rushing to cash in on the tax shelter; others fell into hard financial times, particularly later in the the decade of the 1970's when interest rates and other costs, especially land prices, rose much more quickly than product prices.

By 1973 the Congress was willing to consider the problem again. It assembled a panel of experts to talk about farm losses.[32] It also considered several other tax shelters, and from all of this labor, the limitation on artificial accounting losses (LAAL) emanated. This again was an effort to keep losses produced by generous accounting rules confined to the industries in which they arose.[33] In those turbulent times, however, tax reform was not high on any list—after all, we were about to impeach a president. Instead, political reform was the name of the game, and political reform came. It ended or nearly ended whatever control legislative leaders had over mem-

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28. I.R.C. § 278 (1954)(amended 1969).

29. *Id.* (amended 1970).

30. *Comprehensive Tax Reform: Hearings Before the Comm. on Ways & Means*, 99th Cong., 1st Sess. part. 3 2597, 2601 (1985)(statement of Charles Davenport)[hereinafter *Comprehensive Tax Reform*].

31. *Tax Harvest*, *supra* note 4, at 5-9.

32. *Farm Operations, General Tax Reform, Comm. on Ways & Means*, 93d Cong., 1st Sess. 615 (1973)(statement of Charles Davenport).

33. R. MEYER, RUNNING FOR SHELTER 5-6 (1985); *see generally* Anderson, *Limitation on Artificial Accounting Losses: Another Assault on the Tax Shelter*, 5 ST. MARY'S L.J. 596 (1973).

bers of the Congress. This political reform was, I think, to make tax reform much more difficult.

The farm problem simply would not go away, however. As land and energy prices escalated, some members of the farm community began to ask what the reasons were. Product prices were not on a similar upward climb, and the distance between costs and receipts grew. Some farm leaders simply did not understand how it was that Adam Smith could apparently have been so wrong. How could it be that agricultural inputs were expanding when crops were in surplus? But usually farm leaders were not playing with a full deck. They did not factor in the subsidy provided by the farm tax loss. It's frequently hard to recognize that what is beneficial to you can be so much more beneficial to others. Except for a few farm economists and tax reformers, very few focused on the tax law inducement to make farm investments.[34] Clearly, however, the farm tax rules, when combined with the full deductibility of interest in a tax system with progressive rates, made land a very attractive investment in inflationary times.[35]

On the legislative front, the 1976 act[36] marked the beginning of a decade that would ultimately produce some limits on tax sheltering. In the farm area, corporations were singled out for denial of cash accounting except for family corporations,[37] which of course made up nearly all corporations engaged in farming. Legislation aimed at farm syndications denied some premature deductions,[38] and capitalization was required for the development costs of their fruit and nut groves.[39] Farm investments were made subject to the "at risk" rules.[40] Under those rules, a deduction is not allowed for expenses paid by funds borrowed on a nonrecourse basis. All of these provisions had the effect of cutting back on syndication of farm investments.

The same year that this trimming at the edges was taking place, Congress was creating, at the behest of farm lobby groups, a farm tax shelter under the estate tax.[41] In legislation so complex that it is not yet understood, the Congress allowed some farm land to be preferentially valued for estate tax purposes. The complexity was yet another attempt to define a farmer—only farmers were supposed to avail themselves of the preferential valuation. Even the most inexperienced tax theoretician could have told the Congress that a farmer cannot be defined. Also, the rules for deferred payment of estate tax were liberalized in 1976,[42] and some farm investments

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34. *See generally Farmworkers, supra* note 8; DAVENPORT, BOEHLJE & MARTIN, THE EFFECTS OF TAX POLICY ON AMERICAN AGRICULTURE (1982)[hereinafter TAX POLICY].

35. *See generally Farmworkers, supra* note 8; TAX POLICY *supra* note 34.

36. Pub. L. No. 94-455, 90 Stat. 1536 (1976).

37. I.R.C. § 447 (1954)(amended 1976).

38. I.R.C. § 464 (1954)(amended 1976).

39. Pub. L. No. 94-455, 90 Stat. 1536 (1976).

40. I.R.C. § 465 (as amended by Pub. L. No. 99-514, 100 Stat. 2085 (1986)).

41. I.R.C. § 2032A (1976).

42. *Id.* at § 6166A.

qualified under them. In sum, the 1976 act was schizoid in its view of farm investments. It had some provisions designed to lessen the tax shelter[43] and other to increase it.[44] The farm community had been very active in its quest for lower estate taxes without seeming to understand that preferential estate taxation for farm assets would simply make them more attractive.[45]

In 1978 the differential between ordinary income and capital gains was increased,[46] and the minimum tax on capital gains was significantly lowered.[47] A farm operation that previously had paid no tax even if its receipts were double its costs could, under the new legislation, suffer a price increase until receipts were 250% of costs without incurring a tax. This undoubtedly made farm land, and some other farm assets, much more attractive. Certainly it did nothing to stop the upward pressure on farm land prices.[48]

In 1979 the tax court decided the *Van Raden* case.[49] It gutted the administrative guidelines[50] worked out by the Internal Revenue Service for determining whether prepaid expenses should be attacked on the ground that they did not clearly reflect income.[51] Again the tax shelter was enhanced.

In 1981 the Congress enacted ACRS[52] and reduced the top marginal rate on ordinary income.[53] Under ACRS structures and improvements to real estate were depreciated over as little as fifteen years, although later legislation raised the life first to eighteen and then to nineteen years.[54] Other improvements, such as vineyards, plants, and trees, could be depreciated over five years.[55] They also qualified for the investment tax credit,[56] and the combination of this super depreciation and the ITC made purchases of vineyards and groves as attractive as, if not more attractive than, their development—which had been a little circumscribed for syndications.

As we moved into the 1980's, it appeared that the liberalization of depreciation had made real estate structures so attractive that major promot-

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43. I.R.C. §§ 278, 464 and 465 (as amended by Pub. L. No. 94-455, 90 Stat. 1536 (1976) and Pub. L. No. 99-514, 100 Stat. 2085 (1986)).

44. I.R.C. §§ 2032A and 6166.

45. *See* Surrey, *Our Troubled Tax Policy*, TAX NOTES, Feb. 2, 1981, at 179.

46. The capital gains preference was increased from 50% to 60% of the net long-term gain, reducing the highest rate of tax from 35% to 28%.

47. The tax was changed from an add-on tax to an alternative tax. Previously, long-term gain might have borne a 49.125% rate when both regular tax and minimum tax were considered. This act reduced the rate to a maximum of 28%.

48. *See Farmworkers*, *supra* note 8, at 17, 18.

49. Van Raden v. Commissioner, 71 T.C. 1083 (1979).

50. Rev. Rul. 75-152, 1975-1 C.B. 144.

51. Van Raden v. Commissioner, 71 T.C. 1083 (1979).

52. I.R.C. § 168 (1981).

53. I.R.C. § 1 (as amended by Pub. L. No. 97-34, 95 Stat. 176 (1981)).

54. I.R.C. § 168 (1985).

55. Some tax experts believed that they had no life under administrative procedures and they were argued to be five-year property.

56. I.R.C. § 38.

ers shifted nearly all of their resources into them.[57] Furthermore, the livestock shelter had been made more difficult by the syndication rules[58] and the numerous frauds that arose in it. Livestock shelters continued to be offered under so-called agency contracts that were said not to be syndications.[59] Development of orchards had not waned, and their purchase was exceedingly attractive although large publicly-offered syndicates had slowed to a mere trickle.[60] But ingenuity is not to be denied. Jojoba and guayule plants became a favorite of the tax shelter operators. They argued that they were not subject to the tax syndication rules because the plants that they grew did not grow in groves, orchards, or vineyards to which limitations on farm syndications applied.[61] This almost mystical faith in the judiciary was rewarded earlier this year when the tax court upheld this claim without ever once considering whether the decision it rendered could possibly be proper given the obvious purpose of the legislation concerning farm syndications.[62]

This fixation on guayules and jojobas is interesting. While it is arguable that there may be some use for jojobas, none was known for guayules at that time. In 1985 guayule syndicators did not know of any use for guayule although they had heard that pressings from it might be used in making synthetic rubber. They were uncertain of its culture, and they did not know how it would be harvested. They did suggest that the plant could be shaken so that the guayule would fall to the ground. The land could then be flooded. The guayule would float to the top and be carried by the current to a collection bin. They had not, however, asked whether guayules floated. Such was the knowledge of the latest tax shelter crop. It was reminiscent of the way in which pistachio orchards grew in the early 1970's. The pistachio boom of the early 1970's was a blessing in disguise. The domestic industry was able to take up the slack which occurred after the severing of relations with Iran over the seizure of our embassy in 1979. There would have been a pistachio crisis if the California trees planted earlier in the decade had not begun to move into production at that time. Undoubtedly this is the most significant contribution that the farm tax shelter has made to our economy.[63]

In 1984 agency contracts were supposedly brought under the rules for farm syndicates if the activity had the principal purpose of tax avoid-

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57. *Comprehensive Tax Reform, supra* note 30, at 2597 (statement of Charles Davenport).

58. I.R.C. § 464.

59. *Comprehensive Tax Reform, supra* note 30, at 2597 (statement of Charles Davenport).

60. R. Meyer, Running for Shelter 5-6 (1985).

61. *See* Laglia v. Commissioner, 88 T.C. 894 (1987).

62. *Id.*

63. *See generally* Tax Policy, *supra* note 34.

ance[64]—a purpose which could be inferred if the arrangement was a marketed arrangement.[65]

The 1980's have for the most part been evil days for syndicated tax shelters—probably because of uncertainty. Investments in tax shelters do not warrant the transaction costs that would arise from good economic analysis of the investment. Thus, the economic returns are very uncertain. In the early 1970's the tax returns were not uncertain. The shelter was evaluated on the basis of tax shelter benefits, and farm investments were ideal.

This certainty was, however, thrown into question by the "at risk" rules,[66] enacted in 1976, which prevented deductions generated by nonrecourse borrowing. While the "at risk" rules might be avoided by some devices, the hard economic times that came in the early 1980s led to investor disenchantment. The devices circumventing the "at risk" rules also allowed the investor's personal assets to be reached despite early promoter assurances that letters of credit and similar devices would not be enforced. The threat or reality of that enforcement had to occur in only a few cases before investors learned the hard truth. The investor might be at risk for the full amount of the tax shelter loss. The certain tax loss was rendered uncertain, and the possibility of real loss became sufficiently certain to be avoided.

The sour farm economy of the 1980s, combined with the cut of the top marginal rate to 50% and the liberalization of real estate depreciation, reduced the value of the farm shelter relative to the real estate shelter, where the "at risk" rules did not apply. In real estate developments, but not in farm investments, the decrease in tax benefits from the lowering of the top marginal rate could be compensated for by increasing the nonrecourse leverage.

One should not infer from the foregoing that the farm tax shelter was eliminated. Nothing had been done to prevent the sheltering of farm income by artificial farm losses. Furthermore, an estate tax shelter was, and still is, provided by an appropriate farm investment. It is possible for a farm husband and wife to pass as much as $2.7 million to a second generation free of estate tax.[67] In contrast, nonfarmers may pass only $1.2 million to their heirs free of tax.[68] Proper lifetime giving will increase these amounts.

Many practitioners believe that the estate tax shelter is both theoretical and haphazard. The statute laying out its qualifications is so complex that a determination whether a taxpayer fits into the shelter is difficult and frequently uncertain. As noted above, uncertainty cannot be tolerated if the principal attraction is the tax shelter. In addition, qualification for preferen-

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64. I.R.C. § 6661(b)(2)(c)(ii) (1986).
65. Temp. Treas. Reg. § 263A-1T(c)(2)(ii) (1986).
66. I.R.C. § 465.
67. *Id.* at § 2032A. Each spouse may have $600,000 protected by the uniform credit and another $950,000 by section 2032A.
68. This is the total property passing tax free because of the two uniform credits.

tial valuation must continue for a substantial period beginning before death and running for as long as ten years after death.[69] Qualification may be lost by changes in facts or behavior that would be considered insignificant except for tax purposes.[70] Because it is insignificant for non-tax purposes, this disqualifying behavior is a very likely possibility. Thus the shelter is not always easy to find, and it is not easy to reside in with security. Because of these difficulties some practitioners report that they do little planning for the shelter.[71]

The 1986 act puts us into a new realm. But do not be misled. The farm tax shelter continues to exist. Exploitation of it will produce fewer benefits with the cut in the top marginal rate to 33%.[72] The shelter remains available, although one based on prepaid feed will be limited except for "qualified farmers"[73]—another effort to define what a true or legitimate farmer is. The passive loss limitation[74] will also apply to some taxpayers, and the changes in the alternative minimum tax[75] will be detrimental to others.

Despite all of these substantive changes, the most important change will be the cut in the tax rates and the virtual leveling of those rates. The benefit to be derived from improper deductions remains, but it will be pretty much the same for all persons and it will be smaller. The lack of rate differential means that a low-income tax payer will have little or nothing to sell to a high-income person. The greatest rate differential will be 33% (if one ignores the small number that will face a 49.5% marginal rate),[76] and for many the differential will be only 18%. For a substantial block of persons, the differential will be no more than 13%. For many, it will be zero. These differences are simply too small to justify the transaction charges that are frequently levied on those seeking shelter. On the other hand, the real estate tax shelter has been made less attractive. While that might make farms more attractive, it seems unlikely that the relative change will be enough to overcome the rate changes. While the farm shelter will be of less importance, it has not been eliminated. Importantly, it has not been eliminated for those who do a lot of farming.

That is pretty much the history of the taxation of farm investments.

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69. I.R.C. § 2032A(c)(1).

70. For example, if the heir ceases to be a material participator.

71. Address by Phillip Wile, Seminar on Taxation of Agriculture (October 1980).

72. I.R.C. section one's highest marginal rate is 28%, but the benefit of the 15% rate on an individual's first $17,850, and the benefit of the personal exemption, are phased out. The amount of tax imposed is increased by 5% of taxable income over $43,105 ($71,900 for married couples filing jointly) until the benefit is exhausted, making the marital rate 33%. I.R.C. § 1(g). A few persons might have a top marginal rate of 49.5% if they are suffering a phase-out of the loss for actively-managed real estate.

73. *Id.* at § 464(f).

74. *Id.* at § 469.

75. *Id.* at § 58(a)(1)(A).

76. *See supra* note 72.

Some reflections on this history seem in order.

First, the tax subsidy has reinforced the cyclical nature of farm land prices.[77] When the shelter was at its most attractive in the 1970s, it was reinforcing the general upward push on land prices. While that effect has never been quantified, economic theory may support the notion that it was far greater than generally thought. It is the marginal demand that sets the price, and the tax shelter price certainly was at the margin, and it was high. It, however, increased values for real farmers, whoever they might be, who had to buy in a market artificially stimulated by the tax shelter attraction. On the other hand, when the economy turned sour in the early 1980s, the downward pressure on land prices was undoubtedly exacerbated by the declining interest in farm assets as tax shelters—particularly after the 1981 act made real estate such a much more attractive tax shelter.

All of this is, of course, impressionistic. But the impression is supported by facts. California land prices have generally declined less than midwestern land prices. The tax shelter in California was not as well curbed as the tax shelter in the midwest. The midwestern shelter was largely built around livestock—which were drastically affected by tax reform in 1976 and competing real estate after 1980. A good part of the California tax shelter was centered on tree crops which were less severely impacted. Furthermore, the California shelter simply moved to different crops which absorbed land that might otherwise have depressed the market.

The political process is such that no other result could be expected. It responds to constituencies who have a vested interest in the status quo even after some of them realize that it is not favorable. When land prices were rising, the constituency for higher land prices along with other political forces was sufficiently great to prevent tax reform. When land prices began to fall, the culprit which made them high was attacked. The political process is much slower than the economic process.

Second, education is a very slow process. The farm community first perceived that it benefited from the generous tax rules. Only a few realized that others might benefit more than they. That the subsidy fostered unfair competition was denied or simply ignored so long as times were good. It was only when some farmers were going bankrupt that they began to question why it was that their neighbors could be apparently prosperous.

Third, the direct is understood while the indirect is likely to be misunderstood. A tax benefit was thought desirable even though it was economically demonstrable that it was capitalized into farm input prices and thus decreased the profit margin. Farmers simply would not believe that the impact on costs was as great as the benefit of lower taxes. Education on this score was slow. The turnaround was remarkable. In the 1970s I met with only one farm group that would entertain the notion that tax reform could

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77. *See generally* TAX POLICY, *supra* note 34.

be beneficial. Yet in the 1980s there were several ready to listen. Again, I think that this receptivity must have come about because the harder times demanded an explanation of the paradox of affluence and poverty existing simultaneously.

By the time of tax reform in 1986, the agricultural tax shelter produced an annual revenue loss of about $1 billion. This was nearly the same as it had produced over a decade earlier. The reduction in farm tax shelter activity, over a decade of substantial inflation, probably was not as great as the revenue loss might imply. After all, tax rates had fallen significantly in that period, and more importantly, the differential between some capital gains and ordinary income had fallen even more. But certainly farm tax shelters were much less a factor in 1986 than they had been a decade or more earlier. It makes no difference whether significance is measured relative to farm investments or to other tax shelters. It seems likely that by 1986 farm tax shelters produced no more than 5 or 6% of all tax shelter revenue losses—certainly a lesser percentage than they had produced a decade earlier. In 1982 syndicated farm tax shelters were estimated to be less than 1% of all syndicated tax shelters. In the first four years of the 1980s, syndicated farm shelters were estimated to be less than one-third of a billion dollars—in a period when total tax shelter equity investments were estimated to have exceeded $48 billion. In contrast, farm investments apparently amounted to over $1 billion in the first four years of the 1970s, when total tax shelter offerings were estimated at only $6 billion. The decline in syndicated investments undoubtedly was far more dramatic than the decline in unsyndicated farm investments. Even so, farm shelters had declined relative to other shelters despite the fact that they might have grown slightly in absolute dollars.

Is there then some irony in the fact that the 1986 act attacked farm shelters more directly than previous legislative efforts? Does one derive the rule that legislation came about only because the supporters had weakened? While I think not, certainly the weakening of the farm economy and those depending on farm shelters for a livelihood were helpful in obtaining the 1986 legislation.

There is another lesson to be drawn from the legislative fights over farm tax rules. The Congress spent a lot of time on the farm tax problem. It always drew back from doing that which would be effective, and I doubt that the 1986 act will be fully effective. Usually, the Congress moved to prevent the undeserving from entering the promised land of the deserving. But it never found a drafter who could separate the deserving from the undeserving. The drafter's pen does not always separate the sheep from the goats. The 1969 legislation attempted to do that in terms of off-farm income. The 1976 legislation focused on the marketing of farm investments as the line in the sand. In the estate tax area, it relied on material participation and active participation. Yet four years later, one of the leading farm practitioners opined that the net was frequently too big and yet at times much too

small. Certainly there is a lesson to be learned. Whether farmers are defined simply as farmers to be recognized without definition, or are defined so minutely as to defy comprehension, the results will not be satisfactory. A part of this deficiency lies in the legislative process; a part of it arises from the lack of precision of the English language; and a part arises from the somewhat amorphous notion of what a farmer is.

These definitions must be applied to innumerable cases by taxpayers, administrators, and courts. However precise and certain the image was in the mind of the legislator or drafter, the decider of cases must speculate about what the rule would have been if the case to be decided had been before the policymaker. Paradoxes are sure to result, and we should not expect more from an imperfect world.

Of course, all of this effort makes the law much more complex. A statute based on fine distinctions will forever be prolix. The lengthier it becomes, the more likely it is that a court will decide that the legislature has not done its job adequately. For example, we find a court holding that jojobas are not subject to the same rule that applies to nut crops.[78] The court reasoned that the legislature had not covered the specific case and thus must have excluded it. This is the ultimate in deference paid to the legislature—the exclusion of a case that did not exist at the time of the legislation but that certainly would have been covered had it existed. That is not deference to the legislature but simplemindedness. The court thus requires the legislature to act. It must fix up the loophole created by the court's restraint. When it does so, it sows the seeds for a later court to be more restrained. After all, the statute has been made longer and more precise, creating the impression that the Congress has adverted to all cases and deliberately chosen to exclude some. The next court will be even more impressed with the legislature's comprehension and thus even more deferential. The consequence is more detail, more complexity, more unequal results. These are undesirable, but it may be too late to stop the process.

The history of farm taxation teaches these many lessons. I fear that even now they have not been learned. If not, what are we to conclude? Should taxation be a smaller player in our national economy? But how do we arrange that? Perhaps by abandoning those principles which have largely distinguished our taxation from that of other countries. We can abandon progressive taxation, and we can rely largely on taxes other than the net income tax. Certainly, if these steps had been taken during the last 75 years, the farm tax shelter would have been rendered less of an economic force. We have now largely eliminated progression. Are we ready to take the next step? That is not a lesson from history. Rather, that lies for those who prognosticate the future. As a historian, I foreswear the ability to do that and surrender the opportunity to others who may be more prescient.

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78. *See generally* Laglia v. Commissioner, 88 T.C. 894 (1987).