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REPORT BY THE U.S.

General Accounting Office

Pension Fund Investment In Agricultural Land

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Federal, State, and local laws and regulations limit the types of investments pension funds can make. Although comprehensive data is lacking, GAO found that a substantial portion of the $623 billion of 1979 pension funds is limited to certain types of investments. Federal laws alone limit about $98 billion in public pension fund assets to investment in Federal or federally backed securities.

Seven pension fund fiduciaries, which oversee about $93 billion in pension funds, told GAO that about $21 million of the $93 billion is in direct ownership of farmland. An additional $2 billion is invested in mortgages to farmers.

In general, pension fund fiduciaries said that they did not expect their portfolios to show an increased percentage devoted to farmland investment.

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

B-202446

The Honorable Daniel K. Akaka
The Honorable Beryl Anthony, Jr.
The Honorable Berkley W. Bedell
The Honorable E. Thomas Coleman
The Honorable Thomas A. Daschle
The Honorable Thomas R. Harkin
The Honorable Leon E. Panetta
The Honorable Frederick W. Richmond
The Honorable William M. Thomas
House of Representatives

The Honorable Charles E. Grassley
United States Senate

Your July 16, 1980, letter asked us to evaluate the impact that the American Agricultural Investment Management (AAIM) Company's plan to seek investment opportunities in farmland for pension funds is likely to have on the family farm structure of agriculture. Subsequently you asked us to respond to a series of questions (see enc. I) concerning the issues of the attractiveness of agricultural land as an investment for nonfarm capital; the proposed business and plans of the AAIM; and the potential immediate and long-range impact of pension fund investment in agricultural land.

On January 29, 1981, we briefed your office on the results of our review. We are providing below a synopsis of the information presented at that briefing. Enclosure II contains detailed information in response to each of the questions.

IS U.S. AGRICULTURAL LAND AN ATTRACTIVE INVESTMENT FOR NONFARM CAPITAL? IS U.S. AGRICULTURE LACKING IN CAPITAL? WHY?

Although real estate in general has become a progressively more attractive investment during the last decade, pension fund fiduciaries told us that agricultural land does not appear to be as attractive an investment as other commercial real estate.

Institutional investors 1/ that invest pension funds indicated a reluctance to buy farmland as opposed to other commercial property. We interviewed seven pension fund fiduciaries that in aggregate oversee about $93 billion or over one-fourth of all private pension fund assets. In general, they told us that commercial property other than farms was a more attractive investment. They said that:

--More managerial concerns arise than would in managing an apartment or office building because farmers generally work such unusual hours and because farming requires someone concerned with soil conservation.

--Total returns on investment would be reduced if developmental costs had to be incurred to turn farmland into other commercial real estate.

--Because income from farming is subject to such uncertain factors as the weather and pests, farmland is even less attractive for pension funds.

According to Department of Agriculture (USDA) officials, agriculture is not lacking in capital because, generally, farmers can obtain capital through debt financing. They pointed out, however, that exceptions to this may be entry-level farmers and existing farmers who want to expand but who have little or no capital or off-farm income. If entry-level farmers do not have access to sufficient debt financing, or equity capital, agriculture could become a closed system with few or no new entrants. Entry farmers may need to start as tenants, but unless they can accumulate enough money they will not be able to own land in the future.

1/Throughout this report we will use the term "pension fund fiduciaries" for institutional investors that invest pension fund assets.

STRUCTURE AND PLANS OF THE AMERICAN AGRICULTURAL INVESTMENT MANAGEMENT COMPANY. WHAT IS AAIM'S PROPOSED BUSINESS?

According to AAIM officials and public documents that AAIM filed with the Securities and Exchange Commission, the company provides advice on acquiring farm properties. AAIM would also manage farm properties and may also manage funds for clients in short-term debt securities, such as commercial paper, prior to a farm purchase. AAIM may also invest farm operating cash in short-term debt securities. AAIM officials told us that the company does not plan to take title to farmland.

The company plans to charge a one-time fee of 2-1/2 percent of the property value for advice on acquiring farm property and an annual fee of three tenths of 1 percent of the value of the assets for managing farm properties and short-term debt securities. The farm management contracts are to be for 1 year and may be canceled after that period on 90 days notice.

AAIM officials told us on March 10, 1981, that the company did not have any pension fund assets under management.

POTENTIAL IMMEDIATE AND LONG-RANGE IMPACT OF PENSION FUND INVESTMENT IN AGRICULTURAL LAND

To evaluate the immediate and long-range impact of pension fund investment in agricultural land, we tried to determine the (1) amount of pension funds available for potential investment in farmland, (2) extent to which pension funds are currently invested in farmland, (3) investment strategy used by pension fund fiduciaries, and (4) the likelihood that pension funds would increasingly invest in farmland.

We found that Federal, State, and local laws and regulations place certain limitations on the types of investments pension funds can make. Although our review was hampered by lack of comprehensive data, in our opinion, a substantial part of the total pool of pension fund assets of about $623 billion in 1979 had limitations as to the specific types of investments that could be made with the funds. Federal laws alone limit about $98 billion in public pension fund assets to investment in Federal or federally-backed securities only.

Our survey of seven pension fund fiduciaries that oversee about $93 billion in pension funds, disclosed that about $21 million or $1 to every $4,429, or 0.02 percent, in pension fund assets is in direct ownership of farmland. We also were told by pension fund fiduciaries, however, that of the $93 billion, about $2 billion or about $1 to every $46, or 2.2 percent, of pension funds is in mortgages to farmers.

Of the amounts invested in farmland, all of the direct investment was by two companies. In aggregate the companies manage about $29 billion in pension fund assets. According to company officials, some of the $21 million is in land owned in partnership with farmers. Officials of the companies said that:

--They buy most of their farmland at the request of an existing farmer or an entry-level farmer.

--They sell most of their agricultural land to tenants or other farmers.

--They are passive investors in that they generally do not manage the farms.

Most pension fund fiduciaries we talked to told us they did not expect their portfolios to show an increased percentage devoted to farmland investment. Four which oversee about $39 billion said they did not expect to buy any farmland in the foreseeable future. Others said that while they may buy some farmland, the purchase would be a shift from the farm mortgage market and would not represent an increased percentage of their portfolios devoted to farmland.

The availability of mortgage money from pension funds may be a positive factor in providing farmers a source of capital. In addition, the current levels of direct investment in farmland under the investment strategies described above may provide much-needed capital to entry-level farmers and enable existing farmers to expand. If pension funds substantially increase their direct investment and do not eventually return the land to farmers through sales, the number of family-owned farms could be reduced. However, according to pension fund fiduciaries we interviewed, a substantial increase in direct investment is unlikely in the foreseeable future.

We were specifically asked to evaluate the impact AAIM's plan to seek investment opportunities in farmland through pension fund investment is likely to have on the family farm structure of agriculture. While it is difficult to assess the likely impact, indications that (1) about $1 of every $4,429 of pension assets is now in direct investment in farmland, (2) pension fund fiduciaries we talked to generally do not intend to increase the percentage of their portfolios devoted to farmland, and (3) no pension funds are subscribing to the company's services is evidence that the pension investment plan is not attractive and does not currently have significant impact on the structure of agriculture. As mentioned above, pension fund fiduciaries we talked to indicated that a substantial increase in direct investment in agricultural land in the foreseeable future is unlikely.

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Our review consisted primarily of interviewing cognizant individuals and organizations from industry and government concerned with pension fund issues. We reviewed trade magazines and talked to industry officials to identify pension fund fiduciaries that manage the largest blocks of pension funds in the country. Because of time constraints we did not perform detailed audit work to verify information received through those interviews. The answers to your questions, therefore, are based primarily on the information obtained as a result of those interviews.

We interviewed agricultural economists and specialists, pension fund fiduciaries, institutional investors, and officials of private research organizations. We also interviewed officials at the Departments of Agriculture, Commerce, and Labor; the Iowa State Attorney General's Office; the Internal Revenue Service; the Federal Reserve Board; the Railroad Retirement Plan; the Securities and Exchange Commission; the Social Security Administration; the Office of Comptroller of the Currency; the President's Commission on Pension Policy; the American Agricultural Investment Management Company; and the American Council of Life Insurance. We also reviewed research literature, legislation, and publications concerning farmland investments and pension fund investment issues.

At your request, and because the report is not directed at any agency program, we did not obtain formal agency comments.

We are sending copies of this report to Richard M. Nolan and Keith G. Sebelius, joint signers of the request letter, who are now private citizens.

At your request we are also sending copies of the report to all members of the Subcommittee on Forests, Family Farms, and Energy, House Committee on Agriculture.

Your office requested that we make no further distribution of this report until 7 days from the date of the report. Unless you publicly announce its contents, no further distribution will be made until that time.

At that time, as you requested, we will also send copies to Representatives Cooper Evans, Pat Roberts, and Vin Weber, now serving the districts of requestors that have left the House of Representatives. We will also send copies to the Secretary of Agriculture, other interested congressional committees, and other interested parties.

Henry Eschwege

Henry Eschwege
Director

SPECIFIC QUESTIONS

SUBMITTED BY REQUESTORS

PURPOSE OF THE GENERAL ACCOUNTING OFFICE STUDY: To evaluate the background and potential impact of the American Agricultural Investment Management Company's (AAIM) pension investment plan on the family farm structure of agriculture in the United States.

I. Is United States agricultural land an attractive investment for non-farm capital? Is U.S. agricultural lacking in capital? Why?

   1. What are the current sources of information on non-farm capital investment in agriculture? What do they indicate as to the extent of such investment? Are these sources generally viewed as accurate, reliable indicators?

   2. What attractions and advantages would there be in agricultural land for a pension fund? Are any pension funds or similar investment funds investing in agricultural land now or in the past? Are there any reasons why agricultural land would be better for a pension fund than other more traditional investments?

   3. Are there any tax advantages to pension funds investing in agricultural land that would not be available to farmer/owners or other owners of farmland?

   4. Does the federal government require diversification of pension fund investments? If so, under what authorities? Would such requirements stimulate or encourage investment of such funds in agricultural land?

   5. Some states restrict absentee ownership of agricultural land. Do any states restrict pension fund investment in farmland or investment or ownership of farmland by similar funds?

II. Structure and plans of the American Agricultural Investment Management Company. What is AAIM's proposed business?

1. What are AAIM's sources of capital?

2. What individuals and firms are involved?

3. What legal and registration requirements must AAIM comply with at the federal and state levels before it can conduct its proposed business?

4. What information is available from the public record as to the plans and proposals of AAIM?

5. Has AAIM actually begun operation of its pension fund investment plan? What is that plan, and what indications do you have as to its feasibility?

III. Immediate and long-range impact of pension fund investment in agricultural land.

1. What is the scope of potential pension fund investment; that is, how much total capital is available in pension funds for investment in agricultural land or anything else?

2. What impact might there be on the price of farmland if such a large source of capital were focused on purchase of agricultural land?

3. What effects might this have on existing family farmers, and especially on new entry into farming?

4. Does your analysis indicate that pension fund investment in farmland might have adverse effects on family farms in the United States over the short or long term, or threaten the family farm system in any way.

5. Does your analysis indicate that pension fund investment in U.S. agricultural land is likely to be substantial in the future?

GAO RESPONSES TO QUESTIONS

RAISED IN ENCLOSURE I

I. Is United States agricultural land an attractive investment for non-farm capital? Is U.S. agricultural lacking in capital? Why?

Is United States agricultural land an attractive investment for non-farm capital?

According to most pension fund fiduciaries we talked to, real estate has become progressively more attractive than other potential investments during the last decade. However, compared with agricultural land other types of real estate, such as office and apartment buildings, and shopping centers, appear to be more attractive.

On October 8, 1980, in hearings before the Senate's Select Committee on Small Business, a Department of Agriculture (USDA) official presented information comparing the annual yield (the returns to investment from current income) and capital gains from various types of investments from 1960 through the second quarter of 1980. The investments compared were long-term Treasury bonds, high grade corporate bonds, municipal bonds, secondary market yields on Federal Housing Administration residential mortgages, real estate investment trusts, common stock, and farmland.

The information indicates that while farmland did not always have favorable total returns relative to other investments, farm real estate values have increased significantly since 1973 and thereby increased total returns to among the highest. USDA attributed this increase to a boom in grain prices during that period. According to USDA's comparisons, in recent years (1975-1979), total returns to farmland investments (both current income and capital gains) have outpaced all other investment returns compared except real estate investment trusts.

However, caution must be exercised in interpreting this data. Most of the investment return figures USDA used are based on actual returns through interest, dividends, and sales. The capital gain figures for farm real estate, however, were derived from interviews with farmers and based on the farmers' estimates of the appreciated values of their farms. The values were not based on actual sales prices. Also, any fixing-up costs to sell the property would have to be deducted to compute actual capital gains. Therefore, the farmland capital gain USDA used may or may not be a comparable figure. This is important because capital gains is the component of total returns that has been making farmland investment appear more attractive recently.

USDA does publish farm real estate sales data for voluntary and estate sales in its "Farm Real Estate Market Developments" report. The most recent report was issued August 1980. According to a USDA official involved with the report the statistics in that report are less reliable than the above information to show changes in real estate values because of the sample methodology. The official told us that the sales were reported by farm realtors and others, including some second-hand sources that had only heard of a sale and were not a party to the sale. The official said that the information was not based on a random sample and only represented about 10 percent of all real estate transfers for a given period.

Often the need for the individual investors to become involved in personally managing an investment may be a criterion in an investment decision. For example, stocks and bonds usually require little time investment. With these items one can usually call a broker and within minutes buy or sell. However, when an individual buys real estate, generally much more time is required to negotiate the transaction. Exceptions are real estate investment trusts which through sales of shares provide the quick-sale ability much like stocks and bonds. In addition to the time savings, this quick-sale ability provides liquidity for the investor and a means to minimize risk.

Pension fund fiduciaries indicated a reluctance to buy farmland as opposed to other commercial property. We interviewed 7 pension fund fudiciaries that in aggregate oversee about $93 billion or over one-fourth of all private pension fund assets. In general, they told us that commercial property other than farms was a more attractive investment. They told us that:

--More managerial concerns arise than would in managing an apartment or office building because farmers generally work such unusual hours and

On August 6, 1980, we issued a report entitled, "Nonresident and Nonfarm Operator Ownership of Farmland" (CED-80-125) that identified the sources of information available on farmland ownership patterns.

In that report and through more recent work we identified four basic sources of data on farmland ownership in the United States: the Census of Agriculture compiled by the Bureau of the Census; and the U.S. landownership survey and reports on farm real estate development and foreign ownership of farmland by USDA. Our observations on these data sources on farmland ownership in the United States follow. 1/

According to the report our inquiries indicate that the Census of Agriculture does not provide information on all farmland owners since its data deals only with farmland owned by farm operators and does not provide data on farmland owned by others. However, the Bureau has initiated two efforts to complement its 1978 Census of Agriculture which should provide useful information on this subject.

The 1978 Census of Agriculture - Area Sample, a survey, covering 40,000 to 50,000 farms, was initiated to provide estimates for the farms not included on the mail list for the agriculture census. The Bureau added inquiries to this vehicle that will provide data on the extent to which farmland owners hire managers to operate the farms. According to recent discussions with Census officials, the results of the manager inquiries will probably not be available until at least late 1981.

1/During our interviews, we were frequently referred to two reports issued in January 1981 as potential data sources on farmland ownership: "National Agricultural Lands Study, Final Report" a joint report by USDA and the Presidents Council on Environmental Quality and "A Time to Choose: Summary Report on the Structure of Agriculture" by USDA. Both of these studies used the same basic data sources as we discuss in this section.

because farming requires someone concerned with soil conservation.

--Total returns on investment would be reduced if developmental costs had to be incurred to turn farmland into other commercial real estate.

--Because income from farming is subject to such uncertain factors as the weather and pests, farmland is even less attractive for pension funds.

Is U.S. agricultural lacking in capital? Why?

According to USDA officials, farmers generally can obtain capital through debt financing. They pointed out, however, that exceptions to this may be entry farmers and existing farmers that choose to expand, but who have little or no capital or off-farm income.

On the basis of our past work, we agree that entry-level farmers could have problems in obtaining financing. Agriculture is very capital intensive and without access to debt financing, it may become difficult to continue to attract people to farming. Some new farmers start as tenant farmers but unless they can accumlate enough money they will not be able to own land in the future.

1. What are the current sources of information on non-farm capital investment in agriculture? What do they indicate as to the extent of such investment? Are these sources generally viewed as accurate, reliable indicators?

What are the current sources of information on non-farm capital investment in agriculture?

According to USDA and Bureau of the Census officials we talked to, they know of no data collected that provides information on farm ownership defined as "non-farm capital investment" in agriculture. (See below for a further discussion of this definitional problem.) Both USDA and Census officials told us that farmland ownership data collected by USDA and the Bureau are the best and most comprehensive data available to give some insights into who owns the land and therefore whether it is owned by farm operators or landlords.

The 1979 Farm Finance Survey is to show characteristics of farmland operators and landlords and should be published by spring of 1982. It is composed of two separate surveys.

--Operators Report (79-A9A) which was sent to about 45,000 farm operators and will provide data on operator ownership, identify landlords renting land to farm operators, and indicate whether there was a hired manager.

--Landlords Report (79-A9B) which was sent to the landlords identified in the operators report described above. The results will show the characteristics of landlords by type of ownership, place of residence, and occupation.

In addition, the Bureau will have county-level data available from the 1978 Census of Agriculture in an unpublished form that will show farmland owned and operated and farmland operated but rented from others.

USDA's report "Landownership in the United States, 1978," which was based on the results of its 1978 U.S. landownership survey, showed about 1.35 billion acres of privately owned land in the United States. The report also provides national and regional statistics about the land and information on characteristics of those who own it, such as age, occupation, income, and place of residence. 1/

1/Additional USDA staff reports have been published providing more detailed data, collected in the landownership survey, for particular regions of the country. The reports are available from the Natural Resource Economics Division, Economics and Statistics Service, USDA.

USDA's report entitled "Farm Real Estate Market Developments," provides serial information on farm real estate transfers. The most recent publication is August 1980.

USDA also publishes periodic reports entitled, "Foreign Ownership of U.S. Agricultural Land" which present data based on reports filed by foreign owners. The reports are required by the Agricultural Foreign Investment Disclosure Act (P.L. 95-460, February 2, 1979). The most recent report was published in November 1980.

What do they indicate as to the extent of such investment?

As stated above, we could not find any data explicitly on "non-farm capital investment" in agriculture but some sources do provide general ownership information. The following will provide a summary of the data derived from each source mentioned above.

Census of Agriculture

As stated above our inquiries indicated that the Census of Agriculture does not provide information on all farmland owners because the data only deals with farmland owned by operators and does not provide data on farmland owned by others.

USDA--"Landownership in the United States, 1978"

This report states that there are about 937.8 million acres of privately-owned farmland. Summary information derived from the report and supplementary data provided by USDA's Economics and Statistics Service on the residence and occupation of the landowners follows. This information with certain additions was contained in our August 1980 report.

Residence of landowners	Farmland Acres (millions)	Farmland Percent
County in which land is located	711.5	76
State in which land is located but different county	152.7	16
Different State	59.0	6
Foreign country	.3	0
No response	14.3	2
Total	937.8	100

Landowners Occupation	Landowners Percent	Farmland Acres (millions)	Farmland Percent
Farmer	25	528.9	57
Retired	24	156.6	17
White collar	21	134.1	14
Blue collar	22	68.5	7
Other	8	49.7	5
Total	100	937.8	100

USDA--"Farm Real Estate Market Developments," August 1980

The USDA report entitled "Farm Real Estate Market Developments," dated August 1980 reports the percentage distribution of purchases, acres, and value by type of farm real estate buyer for the years ending March 1, 1979, and 1980. The data is summarized on the following page.

Type of buyer	Percentage of Distribution (note a)					
	Purchases		Acres		Value	
	1979	1980	1979	1980	1979	1980
Tenant	15	15	11	10	12	12
Owner-operator	51	50	55	62	59	56
Retired farmer	2	2	1	1	2	1
Local nonfarmer	13	13	6	6	8	8
Absentee	10	11	20	13	13	14
Other	9	9	7	8	7	8

a/Percentages may not add to 100 because of rounding.

USDA--"Foreign Ownership of U.S. Agricultural Land," November 1980

This report states that foreigners owned 5.6 million acres of U.S. agricultural land as of February 1, 1980. This is slightly less than 0.5 percent of all privately held agricultural land, and less than 0.25 percent of all land in the United States. The report concludes that this share is unlikely to have any aggregate impact on agriculture, either positive or negative. However, some communities could be locally affected in areas of heaviest concentration.

Are these sources generally viewed as accurate, reliable indicators?

According to both Census and USDA officials, the above sources do provide fairly reliable information on what they were designed to report. In our August 1980 report we did attempt to evaluate the accuracy of the Farm Real Estate Market Developments report. We said that

> "* * *because of the survey design, it is not possible to say whether the reported statistics are accurate for a specific period of time."

In addition, because of definitional problems the data may be inadequate to provide information on nonfarm capital investment which could be used for policymaking purposes. None of the sources categorizes its data or defines it as "non-farm capital investment" and there is no universal understanding by officials we talked to on what the term means.

Also, USDA, Census, and others cautioned against arbitrarily classifying individuals such as the following as nonfarm capital investors:

--retired farmers renting to someone else;

--current farmers renting to someone else; or

--part-time farmers who employ tenants and currently work other jobs, but intend to become full-time farmers.

They said that the sources currently available are not adequate to make those distinctions. Most said that public policies developed that would have the effect of discouraging certain of those groups from owning agricultural land may have detrimental effects on the agricultural sector.

2. What attractions and advantages would there be in agricultural land for a pension fund? Are any pension funds or similar investment funds investing in agricultural land now or in the past? Are there any reasons why agricultural land would be better for a pension fund than other more traditional investments?

What attractions and advantages would there be in agricultural land for a pension fund?

Pension fund fiduciaries told us they make investment decisions based on the relative attractiveness of all potential investment opportunities such as stocks, bonds, and real estate. Those decisions are made based on many things, for example, risks, current income and stability, potential capital gains, and subjective judgment. Given those considerations, however, which we discuss in response to other questions, pension fund fiduciaries did not perceive any special attractions or advantages for pension funds to invest in agricultural land.

Are any pension funds or similar investment funds investing in agricultural land now or in the past?

No aggregate data exists on the extent of pension fund investment in agricultural land. We discussed this question with pension fund fiduciaries in banking, insurance, real estate firms, and those responsible for company-managed funds who oversee the largest blocks of private pension funds in the country. In aggregate these firms oversee about $93 billion in private pension funds. Of that amount the officials told us that about $21 million, or 0.02 percent, is invested in direct ownership of agricultural land. This amounts to about $1 to every $4,429 in pension funds. All of the direct ownership investment was by two companies which in aggregate manage about $29 billion in pension fund assets.

Pension fund assets have been a source of mortgage money for farmers seeking to buy land. We were told by pension fund fiduciaries that of the $93 billion, about $2 billion, or 2.2 percent, is in mortgages to farmers. This amounts to about $1 to every $46 of pension funds.

Are there any reasons why agricultural land would be better for a pension fund than other more traditional investments?

As mentioned in our response to previous questions, farmland has become a relatively more attractive investment. But, according to pension fund fiduciaries, farmland does not at this time have any special attributes that would make it a better investment than other more traditional investments.

3. Are there any tax advantages to pension funds investing in agricultural land that would not be available to farmer/owners or other owners of farmland?

Pension funds are generally tax exempt as provided for in the Internal Revenue Code under sections 401 and 501. Pension funds can become subject to taxation if they conduct an unrelated trade or business. Tax would be due on that portion of income that results from such unrelated trade or business. The tax laws relating to pension funds and specifically to pension fund investment in agricultural land are extremely complex. Therefore, we requested the Internal Revenue Service to provide us with a summary of the tax-exempt status of pension funds; particularly those investing in farmland. (See enc. III.)

4. Does the federal government require diversification of pension fund investments? If so, under what authorities? Would such requirements stimulate or encourage investment of such funds in agricultural land?

Does the Federal Government require diversification of pension fund investments?

As discussed below, Federal law requires that pension fund investments be diversified. However, this is subject to certain qualifications.

If so, under what authorities?

The Employee Retirement Income Security Act (ERISA) of 1974, (Public Law 93-406, Sept. 2, 1974) provides general guidance to private pension fund fiduciaries concerning their duties. Section 404(a)(1)(C) states that a fiduciary shall discharge duties with respect to a plan solely in the interest of the participants and fiduciaries and shall diversify the investments so as to minimize the risk of large losses, unless under the circumstance it is prudent not to do so. The act stipulates that any plan fiduciary that breaches his or her fiduciary responsibilities shall be personally liable to make good losses resulting from the breach.

Would such requirements stimulate or encourage investment of such funds in agricultural land?

It would be difficult to conclude that ERISA's diversification requirement would cause pension funds to be invested in agricultural land. We reviewed implementing regulations for ERISA and discussed this provision with an official of the Department of Labor (DOL) the agency responsible for enforcing ERISA and the fiduciary standards. Neither the act nor the regulations suggest alternative investments by name or type. The official pointed out that the requirement to diversify investments could be met by investing in common stocks of different industries or producers of different products.

According to many individuals we interviewed, it would be unlikely that pension fund fiduciaries will be inclined to invest a larger percentage of their portfolios in agricultural land given the current rates of return on such land relative to other potential investments and the management concerns mentioned in response to your first question.

In addition, because pension fund fiduciaries can be sued for violating ERISA's "prudence rule" it is even less likely that they would invest in farm real estate on a large scale. The prudence rule in Section 404 (a)(1)(B) of ERISA states that fiduciaries shall discharge their duties

> "* * *with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims* * *."

According to DOL officials, fiduciaries have been sued under the liability rules of ERISA by the Federal Government and pension plan beneficiaries. According to pension fund fiduciaries and other officials we interviewed the prudence rule has been responsible for pension fund investors generally using a conservative investment strategy. This has resulted in pension fund assets generally being invested in traditional and noncontroversial assets. Many officials we interviewed said that because of the controversy created in the press by farm groups, and by congressional committees concerning pension fund investment in farmland, pension funds will probably shy away from investment in such land.

5. Some states restrict absentee ownership of agricultural land. Do any states restrict pension fund investment in farmland or investment or ownership of farmland by similar funds?

The most recent comprehensive data we could find on State restrictions on farmland ownership is a December 1978 USDA publication entitled "State Regulation of Corporate Farming." The publication pointed out that 10 States had enacted legislation restricting corporate investment to some degree. According to a co-author of the publication, Iowa is the only State that has a law that could be interpreted as restricting pension fund investment in farmland. He said, however, that the Iowa law does not specifically mention pension funds. The Assistant Attorney General for the Farm Division of Iowa told us that although the law does not specifically mention pension funds, it is meant to dissuade them from investing in Iowa agricultural land. He said that the law has not been tested in court.

II. Structure and plans of the American Agricultural Investment Management Company. What is AAIM's proposed business?

To answer this series of questions on AAIM's structure and plans we interviewed the company's president, Mr. William S. P. Cotter, and reviewed AAIM's application for registration to become an investment advisor that the company filed under the Investment Advisers Act of 1940 (P. L. 76-768) with the Securities and Exchange Commission. This is public information.

According to the application AAIM provides advice on acquiring farm properties. AAIM would also manage farm properties and may also manage funds for clients in short-term debt securities, such as commercial paper, prior to a farm purchase. AAIM may also invest farm operating cash in short-term debt securities.

1. What are AAIM's sources of capital?

In addition to any capital the officers of the corporation may provide, John B. Kilroy, Sr. has provided a $250,000 line of credit to the AAIM. The application stated that it was anticipated that Mr. Kilroy will receive some equity participation in AAIM, the specifics of which are still subject to negotiation. According to the president of AAIM, as of March 10, 1981, Mr. Kilroy has taken equity participation in AAIM as a minority stockholder. According to the president Mr. Kilroy's background is in real estate development primarily on the west coast.

2. What individuals and firms are involved?

According to AAIM's registration application, the individuals involved are:

1. Mr. William Stephen Patrick Cotter, President

2. Mr. Harry Joseph Bourn, Executive Vice President

3. Mr. Frank Byron Chauner, Vice President, Secretary-Treasurer

AAIM is affiliated with the firm of Chauner and Cotter, Inc., which is a registered investment advisor, furnishing investment counseling services to individuals and organizations. Mr. Cotter and Mr. Chauner are officers and stockholders of Chauner and Cotter, Inc.

3. What legal and registration requirements must AAIM comply with at the federal and state levels before it can conduct its proposed business?

Based on discussions with Mr. Cotter and DOL officials, the only registration requirements AAIM must fulfill are those prescribed by the Investment Advisers Act of 1940. Because AAIM plans to offer investment advice, it is required to file Securities and Exchange Commission form ADV, Application For Registration As An Investment Adviser Or To Amend Such An Application Under The Investment Advisers Act of 1940. Because the firm plans only to offer investment advice and management services and does not plan to take title to land which may be bought by pension funds it does not have to file any forms with DOL under ERISA requirements.

4. What information is available from the public record as to the plans and proposals of AAIM?

As already mentioned, AAIM has filed Form ADV with the Securities and Exchange Commission; this is public information. In addition, the company has given us an informational packet on its plans.

5. Has AAIM actually begun operation of its pension fund investment plan? What is that plan, and what indications do you have as to its feasibility?

<u>Has AAIM actually begun operation of its pension fund investment plan?</u>

AAIM was incorporated on February 12, 1980, and has been soliciting pension funds to invest in farmland since that date. According to AAIM's president, however, as of

March 10, 1981, no pension funds have agreed to this arrangement.

<u>What is that plan, and what indications do you have as to its feasibility?</u>

As stated above, AAIM would provide advice on acquiring farmland. AAIM would also manage farm properties and may manage funds for clients in short-term debt securities. The firm would charge fees for advice on acquiring farm properties of 2-1/2 percent of the property value, to be charged at the time of acquisition. An annual fee of 3/10 of 1 percent of the value of the assets involved would be charged for managing farm properties and short-term debt securities. The farm management contracts would be for 1 year and may be canceled on 90 days notice after 1 year.

Our indications of the plan's feasibility come from discussions with pension fund fiduciaries and AAIM officials. Indications that about $1 of every $4,429 of pension fund assets we surveyed is now in direct investment in farmland, and that no pension funds are presently subscribing to AAIM's services show that the plan is not now very attractive for pension funds. Because of the relative attractiveness of other investments and the prudence rule, the plan does not appear to be feasible at this time.

III. Immediate and long-range impact of pension fund investment in agricultural land.

1. What is the scope of potential pension fund investment; that is, how much total capital is available in pension funds for investment in agricultural land or anything else?

According to the American Council of Life Insurance which publishes statistics on pension fund assets, assets and reserves of major pension and retirement programs in the United States totaled about $623 billion in 1979. However, based on our review, in our opinion, Federal, State, and local laws and regulations restricting the investment strategy of pension funds, effectively prohibit a substantial amount of those assets from being invested in direct ownership of agricultural land.

There are two basic categories of pension funds--public and private. Public plans generally are those administered for Government employees. This includes Federal civilian, State, and local retirement plans. The Federal Old-Age Survivors, and Disability Insurance system, more commonly known as social security, and the Railroad Retirement Plan are also defined as public plans.

The American Council of Life Insurance defines private pension plans as

> "* * *plans established by private agencies including commercial, industrial, labor and service organizations, nonprofit organizations, and nonprofit religious, educational and charitable institutions."

Public plans account for about $260 billion and private plans account for about $363 billion of the total $623 billion of pension fund assets and reserves.

According to our staff study, entitled "Investment Policies, Practices, And Performance Of Federal Retirement Systems" (Aug. 31, 1979), as a general rule, laws require Government retirement systems to invest their funds in Federal securities. While there are certain exceptions to this requirement, most of the $66 billion assets of Federal Government employee pension plans are limited to investments in Federal securities.

According to officials at the Social Security Administration, the Federal Old-Age Survivors, and Disability Insurance plan, which had over $30 billion in assets and reserves in 1979, is also limited to investments in Federal securities.

Also, according to officials of the Railroad Retirement Plan, which had over $2 billion in assets and reserves, that plan's assets and reserves are also limited to investment in Federal or federally-backed securities.

Of the total $260 billion in public pension assets in 1979 about $162 billion was held by State and local employee plans. Although no readily available data exists on the investment strategies of all these plans, we issued seven reports in fiscal year 1977 that gave us some insight into the investment strategies used by some State and local public sector retirement plans. The reports were issued to assist the Senate Committee on Human Resources in analyzing several aspects of public sector retirement plans, including the adequacy of financing arrangements and fiduciary standards. The reports discussed one statewide plan and one local plan in each of seven states: New Jersey, New York, Georgia, Tennessee, Colorado, Michigan, and Virginia. These reports were published by the Committee on Human Resources in a May 1978 Committee Print entitled "Investment Decisionmaking In Selected Public Sector Retirement Plans."

The majority of those plans surveyed are restricted legislatively or administratively from directly owning real estate. Some exceptions would allow direct real estate investments, but generally only in real estate that is to be rented or leased to the State or locality.

Our seven reports on State and local plans also gave us some understanding of investment prohibitions on private plans. Some of the seven States and local plans followed their States' insurance laws regarding pension fund investments. While each States' insurance laws may differ they usually require a very conservative investment strategy and, in effect, significantly limit investment in real estate. Consequently, it would appear that a portion of the $139 billion of private pension funds administered by insurance companies may not be available for investment in farmland.

The aggregate impact of these limitations on the investment strategies of public funds and insurance companies is to effectively remove much of those funds from the pool of pension assets available to invest in agricultural land. Due to the lack of comprehensive data, any estimate of total pension funds available for investment in farmland would be a best guess figure.

2. What impact might there be on the price of farmland if such a large source of capital were focused on purchase of agricultural land?

Increased demand for any product with a fixed supply would tend to push up the price of that item. Generally, demand could be expected to increase if a new source of capital is focused on agricultural land. Substituting farm real estate mortgage money for farm real estate purchases would not necessarily increase demand for agricultural land. Also any new demand must be effective demand. Effective demand or actual demand for agricultural land is a result of an individual's willingness and ability to pay for the land.

If pension funds would be a new source of capital and they were willing to bid up the price until they landed the sale, it is certain that the price of farmland would increase dramatically. However, if some of the capital was diverted from other types of investment in agricultural land, such as mortgage money, and the pension fund was conservative and unwilling to bid competitively, then it is unclear what would happen. Under current economic theory, the effective demand may not be significantly altered enough to affect the price. While the price of farmland may not be affected on a national scale, regional farmland prices could be affected if a sufficient amount of investment was focused on the purchase of farmland in a certain locality.

3. What effects might this have on existing family farmers, and especially on new entry into farming?

We discussed pension fund investment in agricultural land with some of the country's largest pension fund fiduciaries. As previously stated, very little of their pension funds were invested in farmland ownership. Even then, they told us their investment strategies, for the most part, resulted in existing farmers expanding or a new farmer getting started.

According to these fiduciaries of the about $2 billion invested in agricultural land, about 99 percent represents over 9,500 mortgages to farmers. Of the 1 percent that is in direct ownership investment by the companies, 50 percent was acquired by foreclosure and 50 percent was purchased. Most of the purchases resulted from an existing or entry farmer asking the companies to either go into a partnership with them or buy a piece of land for them so they could expand their existing farm or get started. According to fiduciaries of the funds that own farm real estate, their policies are to give current tenants or other farmers first chance at buying the land. They said that in the past they have sold most of their agricultural land to tenants or other farmers. They also said that they are prohibited from getting involved in farm real estate management by their State insurance laws.

It would appear that pension funds made available to farmers to secure mortgages or become tenants under a lease-option-to-buy provision may well promote existing farmers' and entry farmers' ability to get into and stay in farming. To the extent that these farmers are family farmers this source of capital may be viewed as beneficial by family farm proponents. However, to the extent that a family farm is purchased or financed by a company for an individual or corporation other than a family, each purchase or mortgage extended would tend to reduce the family farm presence in agriculture.

4. Does your analysis indicate that pension fund investment in farmland might have adverse effects on family farms in the United States over the short or long term, or threaten the family farm system in any way?

It is unclear what effect even the current level of pension fund investment in farmland has on family farms. As mentioned in our response to the previous questions, the current level of pension fund investment is apparently providing entry capital to farmers and enabling other existing farmers to expand. Certainly, if pension funds substantially increase their direct investment and do not eventually return the land to farmers through sales, then the number of family-owned farms may decline.

According to pension fund fiduciaries we interviewed, a substantial increase in direct investment is unlikely. They told us that they did not expect their portfolios to show an increased percentage devoted to farmland investment. They pointed out that other real estate investments are currently more attractive because they involve less management problems and their rates of return are somewhat higher and more stable.

5. Does your analysis indicate that pension fund investment in U.S. agricultural land is likely to be substantial in the future?

Most pension fund fiduciaries and other professionals we talked to said that they did not expect the percentage of pension fund portfolios devoted to farm real estate to increase. Many of the pension fund fiduciaries said that pension funds they serve have never brought up the subject of or expressed interest in farmland investments. According to our survey of private pension fund fiduciaries responsible for $93 billion in pension fund assets, about 0.02 percent of those funds are invested in direct ownership of farmland.

Four pension fund fiduciaries which oversee $39 billion in assets said that they did not expect to buy any farmland in the foreseeable future. Others said that while they may buy some farmland the purchase would be a shift from the farm mortgage market and would not represent an increased percentage of their portfolios devoted to total farmland investment.

There will soon be a way to monitor the extent of private pension fund investment in direct ownership of real estate. DOL plans to publish by mid-1981 certain private pension fund investment data reported to it under requirements of ERISA. The data is to provide information on the amount of employee benefit plan assets invested in certain assets such as real estate, stocks, and bonds. Although it will not provide information on investments in agricultural land, it can provide some perspective on the upper limit of potential direct ownership investment in agricultural land. According to DOL, the information to be published in mid-1981 for the 1977 reporting year will show that private pension funds had less than 8/10 of 1 percent of their assets invested in real estate.

According to DOL officials, ERISA data is the most extensive statistical data available on private pension fund investment portfolios. It represents about 87.5 percent of all private pension fund assets. This information does have its limitations because plans having less than 100 participants and certain pension funds with assets invested in insurance contracts do not have to report investment information.

There are other sources of information on trends in pension fund investment, but there are some questions about the reliability of such information. For example, according to a survey done by Coldwell Banker, a company which provides investment management services, pension funds with real estate investments have between 1 to 3 percent of their assets in real estate equity. The survey found that the funds responding to the survey plan to increase their investment in real estate in the next 5 years with goals ranging from 5 to 15 percent of their total portfolios. Results of the Coldwell Banker study must be viewed with caution because only 20 percent of the 800 pension funds in the sample responded.

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Mr. Johnny C. Finch
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Comptroller General of the
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11 FEB 1981

Dear Mr. Finch:

You have asked that we provide you with information concerning the tax implications of the investment of pension funds in agricultural land, so that you may respond to the House Committee on Agriculture, Subcommittee on Family Farms, Rural Development and Special Studies.

Specifically, you have asked that we provide you with a brief written summary of the tax-exempt status of pension funds, including how tax-exempt pension funds, particularly those investing in farmland, would incur unrelated business income. Further, you have asked that our summary not involve the disclosure of tax returns or return information. In accordance with your request, our summary generally discusses the situation which exists when a tax-exempt pension fund purchases agricultural land, but will not deal with any specific taxpayer or factual situation.

Generally, the Internal Revenue Code provides special tax treatment for retirement plans that meet the qualification requirements of Code section 401(a). This treatment includes the deductibility of employer contributions when made, the deferral of tax liability on employees, with respect to employer contributions and earnings, until distributions are made and, where a trust is used to fund plan benefits, the exemption of the trust from income tax liability on its corpus and income pursuant to Code section 501(a). It should be noted that so long as any investment by a tax-exempt pension fund, including the purchase of agricultural land, is consistent with the trust agreement, state law, Title I of the Employee Retirement Income Security Act of 1974 and the exclusive benefit requirement of Code section 401(a)(2), such investment will not adversely affect the qualified and tax-exempt status of the retirement plan and its related trust.

An exception to the general exemption from income tax with regard to an exempt employees' trust is the imposition of a tax, under section 511 of the Code, on the exempt trust's unrelated business taxable income. In the case of an exempt employees' trust, unrelated business taxable income, as defined in section 512 of the Code, is income derived by the trust from any regularly carried-on trade or business, less the deductions directly connected with the carrying on of such trade or business. Thus, if an exempt employees' trust purchases farmland and operates the farm itself in a manner consistent with a regularly carried on trade or business, the income and deductions resulting from such farm operations will be taken into account in computing unrelated business taxable income.

However, we would not expect that most exempt employees' trusts, which have purchased farmland, will be interested in operating the farms themselves. Rather, these trusts could be expected to lease the farms to others who would operate the farms and pay rent to the trusts, or the trusts would hold the land for its potential appreciation in value. Pursuant to certain exclusions enumerated in Code section 512(b), income may not be includible in unrelated business taxable income unless such income is debt-financed. These exclusions are applicable even though the trust is engaged in a regularly carried on trade or business involving such farmland.

Code section 512(b)(3) provides an exclusion for rents derived from real property. Thus, even if an exempt employees' trust derives rental income from farmland used in a regularly carried on trade or business, such income will be excluded in computing unrelated business taxable income. Many questions arise as to whether amounts characterized as rents by the parties will, in fact, be characterized as rents for purposes of this exclusion. Thus, for example, rent based, in whole or in part, on the income or profits derived from the leased farmland will not be subject to the exclusion for rents. On the other hand, rents based on a fixed percentage of receipts on sales will be subject to the exclusion.

Code section 512(b)(5) provides an exclusion for gain or loss derived from the sale, exchange or other disposition of property. Thus, any gain or loss, except to the extent it is debt-financed, derived by an exempt employees' trust from the sale of its farmland will be excluded in computing unrelated business taxable income regardless of whether the trust was engaged in a regularly carried on trade or business involving such farmland. However, this exclusion will not apply if the farmland was held by the trust primarily for sale to customers in the ordinary course of a trade or business.

As suggested above, rent derived from the leasing of debt-financed farmland and gain or loss derived from the sale of debt-financed farmland owned by an exempt employees' trust will be includible in unrelated business taxable income to the extent that such income is debt-financed. In general, Code section 514(b) defines debt-financed property as any property held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year or during the 12 month period prior to the dispositon of the property. It should be emphasized that debt-financed income is includible as an item of unrelated business taxable income whether or not the trust is engaged in a regularly carried on trade or business involving such property.

However, an important exemption may apply with reference to debt-financed income derived from farmland owned by an exempt trust which is part of a retirement plan qualified under section 401(a) of the Code.

This exception was enacted as part of the Miscellaneous Revenue Act of 1980. Section 110 of this Act amended section 514(c) of the Code so as to generally exclude from the definition of acquisition indebtedness any indebtedness which is incurred by such an exempt employees' trust in acquiring or improving real property. This amendment is effective for taxable years beginning after December 31, 1980. The effect of this amendment will be to generally exclude from unrelated business taxable income debt-financed rental income derived from a lease of farmland owned by an exempt employees' trust and debt-financed gain or loss derived from the disposition of farmland owned by such a trust.

We hope that the above summary will be of assistance to you in responding to the Committee on Agriculture.

Sincerely yours,

Billy M. Hargett

Billy M. Hargett
Director, Employee
Plans Division

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