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Tax Implications of Selected Drought Management Strategies

I. Introduction

During the most recent period of drought, livestock producers in Wyoming adopted several management strategies with income tax implications. This bulletin examines the tax implications for cash-based taxpayers of three of these tactics: 1) purchase of additional feed or rental of additional grazing land, 2) partial herd liquidation, and 3) participation in government programs.[1] The bulletin also outlines requirements to engage in income tax deferral, postponement, or averaging in the case of partial liquidation and summarizes what producers must do to implement these three tactics.

Readers should consult their legal and financial advisors before implementing any of the tactics described in this bulletin. The bulletin provides only general information; it is not a substitute for competent professional advice.

Identified Strategies

A 2005 survey, described in the *Western Economics Forum*, found that Wyoming cattle producers adopted a variety of strategies and tactics in the face of recent droughts. These strategies are presented in Table 1.[2] The tactics most frequently used were purchase of additional winter feed, partial liquidation, and participation in government feeding programs. The tactics selected often differ by the size of the ranch operation. Few respondents - none of the large operators - carried out a total liquidation.

The survey and subsequent analysis generally do not consider how federal income tax law affects producers' management or what specific income tax tactics the respondents had adopted. This report focuses on specific issues surrounding income tax tactics. The 2005 survey did ask producers whether or not they engaged in one tax management tactic, income averaging (see Table 2). This bulletin will clarify what is required to utilize this and several other tactics available to reduce federal tax liability.[3]

II. Acquiring Additional Feed

Most respondents sought to counter drought conditions during the 2000-2005 period by acquiring additional feed. More than half of the respondents purchased additional winter feed in 2002, 2003, and 2004. A somewhat smaller number rented or purchased additional grazing land.

According to the 2008 *Farmer's Tax Guide*,[4] cash-based taxpayers may deduct the added expense in the year winter feed was purchased or rental payments were made. With respect to winter feed purchases for use in both the current and subsequent tax years, to take a current deduction the taxpayer must show: 1) [t]he payment is a purchase rather than a deposit; 2) the prepayment has a business purpose and is not merely for tax avoidance; and 3) the deduction of the prepayment will not materially distort the taxpayer's income.[5] As a general rule, deductions for prepaid feed expenses may not exceed 50 percent of a taxpayer's other deductible farm related expenses. This limitation does not apply, however, if the rancher is a farm-related taxpayer and prepaid expenses exceed the other deductible expenses due to "unusual circumstance."[6]

To take a deduction for the additional winter feed purchases or rental of additional grazing land, report them on Part II of Schedule F.

III. Partial Liquidation and Forced Sales

Partial liquidation of herds is also one of the top three methods used to mitigate the effects of continuing drought. Table 1 shows that more than one-third of respondents reduced the number of breeding stock during one or more of the 2001-2004 years. Additionally, many also sold yearlings that would normally have been retained on the ranch. Both of these actions result in an increase in income over what would otherwise normally be recognized in the tax year of the sale. Such an increase in income can trigger an increase in taxes and in some instances an increase in the applicable tax rate under current progressive federal tax rates.

The federal tax code provides three alternatives for producers to reduce their income tax exposure under such circumstances:

1. tax postponement of income;
2. tax deferral of income; and
3. income tax averaging.

Each of these alternatives requires taxpayers to satisfy certain requirements.

A. Alternative 1: Postponing Gain

Covered Transactions

Generally, gains from involuntary conversion of breeding livestock are not required to be recognized when the proceeds are used to purchase replacement livestock within two years. Selling breeding animals due to a drought is considered an "involuntary conversion." As is pointed out below, the federal tax code extends the repurchase period if certain restrictions are met.

First, the rule applies only to the sale of breeding animals. Note that this is different than the early sale of yearlings also described in Table 1.

Second, the taxpayer must establish that the sale is in excess of normal sale numbers. It is this excess that is covered by the postponement provisions. Sales in the last three years are used to compute normal sales numbers.

Third, replacement property does not necessarily have to be breeding livestock. Previously, to avoid tax liability the livestock sold through an involuntary conversion must be replaced by livestock similar or related in service and for similar purposes.[7] The American Jobs Creation Act of 2004 modified this rule somewhat. IRC § 1033(f) provides:

> *"(f) Replacement of livestock with other farm property in certain cases.— For purposes of subsection (a), if, because of drought, flood, or other weather-related conditions, or soil contamination or other environmental contamination, it is not feasible for the taxpayer to reinvest the proceeds from compulsorily or involuntarily converted livestock in property similar or related in use to the livestock so converted, other property (including real property in the case of soil contamination or other environmental contamination) used for farming purposes shall be treated as property similar or related in service or use to the livestock so converted."*

Thus, Wyoming producers who can show "it is not feasible" may invest in other personal property "used for farming" and still qualify for postponement.

Fourth, the replacement period may be extended beyond the two-year period in two cases. The traditional replacement period to postpone recognition of income under IRC §1033(a) is two years. However, IRC §1033(f)(2) provides two ways to extend this period. First, if the area is "designated as eligible by the federal government" as a result of drought, the repurchase period is extended to four years.[8] Second, the Secretary of the Treasury is authorized to extend the replacement period by region "for such additional time as the Secretary determines appropriate if the weather-related conditions which resulted in such application continue for more than three years."[9]

Fifth, the basis for replacement breeding animals will not necessarily be their purchase price. Basis refers to the amount a taxpayer has invested in property like breeding stock. It is used to calculate the gain a taxpayer earns when such property is subsequently sold. Cash-based taxpayers typically deduct purchased feed and other expenses associated with raising their own breeding animals. Thus, the basis for such breeding stock is generally zero.

How is the basis for repurchased animals calculated? For producers taking advantage of this section, it is not simply the purchase price; instead, it equals the basis in the livestock sold (generally zero for cash-based taxpayers) plus any amount invested in the replacement livestock that exceeds the proceeds from the sale. Thus, if a cash-based producer pays a $500 premium over the price received for the breeding animals sold, the basis for the replacement animals would be $500 per head.

How to Elect to Postpone Gain

The *Farmer's Tax Guide* outlines the procedures that must be satisfied to elect to postpone income from a drought-related sale. The 2008 *Guide* tells us:[10]

> ***Reporting weather-related sales of livestock.*** If you choose to postpone reporting the gain on weather-related sales or exchanges of livestock, show all the following information on a statement attached to your return for the tax year in which you first realize any of the gain.
>
> - Evidence of the weather-related conditions that forced the sale or exchange of the livestock.
> - The gain realized on the sale or exchange.
> - The number and kind of livestock sold or exchanged.
> - The number of livestock of each kind you would have sold or exchanged under your usual business practice.
>
> Show all the following information as well as the preceding information on the tax return for the year in which you replace the livestock.
>
> - The dates you bought the replacement property.
> - The cost of the replacement property.
> - Description of the replacement property (for example, the number and kind of the replacement livestock).

B. Alternative 2: Deferring Income

1. Covered Transactions

A second tactic producers might consider is to defer reporting income from the early sale of livestock until the next tax year. To qualify for this tactic, IRC § 451(e) requires that:

1. the taxpayer's principal business is agriculture,
2. the taxpayer must use cash-basis accounting,
3. the taxpayer must show that the excess livestock sold would have been sold in a subsequent year,
4. the area must be declared a disaster area, and
5. the excess sale was caused by this disaster.

Reexamine the strategies outlined in Table 1. Both the sales of breeding animals and the yearlings would qualify for deferring income, assuming the other requirements are satisfied.

2. How to Elect Deferring of Income

The 2008 *Farmer's Tax Guide* indicates a deferral election is made by attaching a statement to the current return for the tax year in which the drought sale occurred, including:[11]

- A statement that you are postponing gain under section 451(e) of the Internal Revenue Code.
- Evidence of the weather-related conditions that forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government because of weather-related conditions.
- A statement explaining the relationship of the area affected by the weather-related condition to your early sale or exchange of the livestock.
- The number of animals sold in each of the three preceding years.
- The number of animals you would have sold in the tax year had you followed your normal business practice in the absence of weather-related conditions.
- The total number of animals sold and the number sold because of weather-related conditions during the tax year.
- A computation, as described above, of the income to be postponed for each class of livestock.

This postponement statement normally must be filed with that year's income tax return. Taxpayers making involuntary, weather-related sales "in an area eligible for federal assistance" may file the statement any time during the replacement period. Taxpayers, not initially delaying the gain in their original tax return but subsequently wishing to do so, may still file an amended return within six months of the original due date for their return. To do so, the taxpayer must attach the above statement to the amended return and write at the top of the return: "Filed pursuant to section 301.9100-2." If such a statement is filed, a taxpayer must obtain IRS approval to cancel the requested postponement.

C. Alternative 3: Income Averaging

1. Covered Transactions

Farmers may elect to spread their eligible taxable income over the three preceding years, as authorized by the Taxpayer Relief Act of 1997 and made permanent by the Tax and Trade Relief Extension Act of 1998. This provision covers any income attributable to an individual's "farm business."

"Farm business" income includes the following:

- Net income from Schedule F,
- Owner's share of net income from an S corporation, partnership, LLC, and
- Gain from the sale of assets used in the farm business and reported on Form 4797.

It does *not* include:

- Wages,
- Rental income for non-materially participating landlords,
- Income to beneficiaries of trusts or estates, and
- Income of corporations, estates, or trusts.

The federal income tax code places limits on the total amount of income that may be averaged (*i.e.*, no more than the taxpayer's total taxable income and net capital gains from farming may not exceed the taxpayer's total net capital gains).[12] Taxpayers interested in utilizing this alternative should work carefully with their attorney and accountant to satisfy all statutory requirements.

2. How to Elect to Average Income

The election is made by filing Schedule J, Farm Income Averaging, with the current year's income tax return.

3. Income Tax Average in Wyoming: Reexamining Tables 2 and 3

As shown in Table 2, 27 percent of producers completing the 2005 survey choose to engage in income tax averaging. This is not particularly enlightening without additional information regarding how many used either postponement or deferral. It may suggest that the respondents, who answered this question in the affirmative, and their tax advisers, determined they would not be repurchasing breeding animals within the applicable replacement period and thus would not qualify for the postponement provisions of the federal tax code. This conclusion is reinforced by Table 3 that shows few respondents repurchased livestock to pre-drought levels. Additionally, postponement is not available for the early sale of yearlings. Those who implemented this management strategy are limited to two tax-reduction tactics: income averaging or deferral.

What is interesting is that respondents choose to engage in income averaging rather than deferring the income to the subsequent tax year. The respondents and their tax advisers apparently determined that less taxes would be paid by spreading the additional earnings over the preceding two years rather than deferring them to the next year. This suggests that the marginal tax rate in the preceding two years was low and probably less than what was anticipated for the subsequent year.

IV. Government Supplemental Feed and Income Payments Programs

Wyoming ranchers may participate in a variety of disaster payments and services associated with governmental programs such as crop insurance, livestock compensation, feed, and conservation programs.

A majority of respondents to the 2005 survey took advantage of supplemental feed programs administered by the government during the five-year period. A significantly smaller number participated in other government income payment programs. Because the survey does not identify the types of income payments received, we limit our discussion here to the tax consequences associated with participating in government feed programs and federally subsidized crop insurance.

A. Tax Consequences Associated with Participating in Government Feed Programs

1. Income Tax Consequences

The *Farmer's Tax Guide* outlines the scope of federal feeding programs and which transactions constitute taxable income under the federal income tax code. For example, the 2008 *Guide* notes:[13]

> *"The Disaster Assistance Act of 1988 authorizes programs to provide feed assistance, reimbursement payments, and other benefits to qualifying livestock producers if the Secretary of Agriculture determines that, because of a natural disaster, a livestock emergency exists. These programs include partial reimbursement for the cost of purchased feed and for certain transportation expenses. They also include the donation or sale at a below-market price of feed owned by the Commodity Credit Corporation."*

The *Guide* indicates that the following items are "income" for federal income tax purposes: "[1)] The market value of donated feed, [2)]The difference between the market value and the price you paid for feed you buy at below market prices, and [3)] Any cost reimbursement you [the taxpayer] receive." [14]

2. Postponement and Reporting

Taxpayers must include any income they earn from participating in a federal feeding program in the year they receive the benefits. The earnings may not be postponed or deferred. The earnings are reported on Schedule F, Part I, as agricultural program payments.

B. Crop Insurance and Disaster Payments

1. Income Tax Consequences

As a general rule, crop insurance payments, from policies like range insurance, are income in the year they are received. IRC § 451 (d) provides for deferred recognition of such income:

> *"In the case of insurance proceeds received as a result of destruction or damage to crops, a taxpayer reporting on the cash receipts and disbursements method of accounting may elect to include such proceeds in income for the taxable year following the taxable year of destruction or damage, if he establishes that, under his practice, income from such crops would have been reported in a following taxable year… An election under this subsection for any taxable year shall be made at such time and in such manner as the Secretary prescribes."*

To take advantage of this deferral provision, the taxpayer must show: 1) s/he is a cash-based taxpayer, and 2) the crop insurance or disaster payments received comes from the federal government under the Agricultural Act of 1949, as amended, and disaster payments received under the Disaster Assistance Act of 1988.

2. How to Defer Income from Crop Insurance

To make the deferral election for these crop insurance payments:[15]

> *"…[R]eport the amount you received on Schedule F, line 8a, but do not include it as a taxable amount on line 8b. Check the box on line 8c and attach a statement to your tax return. The statement must include your name and address and contain the following information.*
>
> - *A statement that you are making an election under section 451(d) of the Internal Revenue Code and Regulations section 1.451-6.*
> - *The specific crop or crops destroyed or damaged.*
> - *A statement that under your normal business practice you would have included income from the destroyed or damaged crops in gross income for a tax year following the year the crops were destroyed or damaged.*
> - *The cause of the destruction or damage and the date or dates it occurred.*
> - *The total payments you received from insurance carriers, itemized for each specific crop, and the date you received each payment.*
> - *The name of each insurance carrier from whom you received payments"*

V. Conclusions

A survey during a recent drought identified many strategies Wyoming ranchers were using to manage herds in drought conditions. Several of the identified strategies– purchase of additional winter feed and lease of additional feed ground - increase the deductible expenses for cash-based producers and reduce their taxable income. Several others - supplemental income and feed programs provided by the government - will likely increase producers' taxable income. Finally, the two sales strategies - partial liquidation and early sale of yearlings - will also increase producers' taxable income.

Current tax law permits ranchers who sell livestock to reduce their tax liability through postponement, deferral, and income averaging. Ranchers considering these alternatives must evaluate the tax consequences of each and determine if the sale in question satisfies that tactic's requirements. In some instances, it may make sense to not take advantage of any of these tactics and simply recognize the income in the year it is received. Ranchers and their advisers should assess the likelihood of continued drought and future cattle prices, consider their available alternatives, and calculate their tax consequences to determine which tactic is best for them.

Table 1. Proportion of Producers Using Drought Management Strategies by Operation Size (n=759).

Management Strategy	Operation Size	Year 2000	2001	2002	2003	2004
Partial Herd Liquidation	Small	27%[1]	33%	48%	43%	43%
	Medium	30%	42%	57%	51%	49%
	Large	29%	36%	57%	50%	36%
Total Herd Liquidation	Small	1%	2%	2%	2%	2%
	Medium	2%	3%	3%	2%	5%
	Large	-	-	-	-	-
Selling Retained Yearlings	Small	5%	7%	9%	10%	10%
	Medium	6%	10%	18%	15%	19%
	Large	14%	14%	21%	21%	21%
Lease/Purchase Addl. Grazing	Small	15%	20%	27%	29%	32%
	Medium	19%	24%	32%	37%	36%
	Large	14%	21%	43%	36%	50%
Purchase Addl. Winter Feed	Small	34%	41%	56%	54%	57%
	Medium	39%	51%	66%	64%	64%
	Large	50%	64%	79%	71%	64%
Early Weaning to Reduce Feed	Small	11%	14%	26%	30%	33%
	Medium	11%	18%	35%	36%	36%
	Large	14%	14%	36%	29%	36%
Gov't. Feed Assistance Program	Small	14%	21%	49%	52%	39%
	Medium	20%	30%	63%	64%	52%
	Large	7%	21%	57%	93%	43%
Gov't. Income Assist. Program	Small	4%	6%	10%	11%	9%
	Medium	4%	7%	13%	13%	13%
	Large	-	-	7%	14%	7%
Earn Off-Farm Income	Small	41%	45%	47%	49%	49%
	Medium	22%	24%	28%	31%	32%
	Large	14%	14%	14%	14%	14%
Added Alt. Livestock Enterprise	Small	4%	4%	4%	6%	7%
	Medium	1%	1%	3%	4%	5%
	Large	-	7%	21%	21%	21%
Added Alt. Crop Enterprise	Small	1%	1%	2%	2%	3%
	Medium	1%	1%	2%	2%	5%
	Large	-	7%	14%	14%	7%
Other	Small	3%	3%	4%	4%	4%
	Medium	2%	3%	3%	5%	4%
	Large	-	7%	7%	7%	7%

[1] Frequency of binary response for category being checked (indicated as a 1), reported as percentage of respondents indicating negatively impacted by drought (n = 759; small 20-299 bred cows n = 569; medium 300-999 bred cows n = 176; large >1,000 bred cows n = 14).

Source: Christopher T. Bastian, Siân Mooney, Amy M. Nagler, John P. Hewlett, Steven I. Paisley, Michael A. Smith, W. Marshall Frasier and Wendy J. Umberger, "Ranchers Diverse in Their Drought Management Strategies," *Western Economics Forum* (Fall 2006).

Table 2. Producers Using Income Averaging to Reduce Tax Liability if They Liquidated Some or all of Herd with Intention of Replacement Within 24 Months.

All Ranches	By Operation Size		
	20-299 Bred Cows	300-999 Bred Cows	≥ 1,000 Bred Cows
n = 598	n = 439	n = 144	n = 15
27%[1]	24%	38%	20%

[1] Percentage of respondents answering question and indicating "yes."

Source: Christopher Bastian, Siân Mooney, Amy Nagler, John Hewlett, Steven Paisley, Michael Smith, W. Marshall Frasier & Wendy Umberger, "Ranchers Diverse in Their Drought Management Strategies," *Western Economics Forum* (Fall 2006).

Table 3. Producers Replacing Liquidated Animals with Purchased Breeding Livestock to Pre-drought Levels.

All Ranches	By Operation Size		
	20-299 Bred Cows	300-999 Bred Cows	≥ 1,000 Bred Cows
n = 571	n = 418	n = 144	n = 9
11%[1]	9%	13%	33%

[1] Percentage of respondents answering question and indicating "yes."

Source: Christopher Bastian, Siân Mooney, Amy Nagler, John Hewlett, Steven Paisley, Michael Smith, W. Marshall Frasier and Wendy Umberger, "Ranchers Diverse in Their Drought Management Strategies," *Western Economics Forum* (Fall 2006).

Endnotes

[1] Information in this bulletin is also useful for accrual-based taxpayers. Typically, cash-based taxpayers immediately deduct feeding and other expenses associated with raising breeding animals from that year's income for tax purposes while accrual taxpayers generally include such costs as part of the basis for the breeding livestock (see discussion of basis in the text). Accrual-based ranchers still may expense such costs and thus effectively operate like cash-based taxpayers. For additional discussion of differences between cash- and accrual-based taxpayers see the 2008 *Farmer's Tax Guide*, Publication 225, 5-6, available at www.irs.gov/publications/p225. Citations to the *Farmer's Tax Guide* in this publication are to pages in the hardcopy of the 2008 edition.
[2] Christopher Bastian, Siân Mooney, Amy Nagler, John Hewlett, Steven Paisley, Michael Smith, W. Marshall Frasier and Wendy Umberger, "Ranchers Diverse in Drought Management Strategies," *Western Economics Forum* (Fall 2006).
[3] The original analysis of the survey is confusing. It argues that producers using income averaging were required to repurchase livestock within two years of the sale and points out that only 11 percent of the respondents had purchased breeding animals to the pre-drought level - a number which can be found in Table 3 of this bulletin. As is shown in this bulletin, the repurchase requirement is only applicable to postponement (not declaring the income in the year it was earned) and does not apply to those engaged in income averaging.
[4] The *Farmer's Tax Guide* is updated annually.
[5] Id., at 20.
[6] Id.
[7] Id., at 19.
[8] IRS § 1033(a)(1).
[9] IRC §1033(f)(2)(A).
[10] IRC §1033(f)(2)(B).
[11] *Farmer's Tax Guide*, at 72.
[12] Id, at 9.
[13] Id, at 18.
[14] Id, at 11.
[15] Id.
[16] Id.

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