FARM Library

Financial and Risk Management Database

Improving farm management skills one topic at a time

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Tax Consequences of Weather Related Sales

Every few years we seem to be faced with reasons to dust off these tax laws, but it has been a long time since it hasn't been for drought. In 2019, we are looking at how these apply to flooding in the Midwest.

Livestock Deferrals:

ONE YEAR DEFERRAL:

A one-year deferral is available for all types of livestock (draft, dairy, breeding, and feeding) if you qualify for the following:

- You are a cash basis farmer or rancher
- Your normal business practice would be to sell the livestock in the following year
- The weather-related conditions caused your area to be designated as eligible for federal assistance.

What is your "normal business practice"? If you would "normally" sell your calf crop in January of 2020, but are forced to sell in 2019, you can elect to recognize the income on your 2020 tax return. This is an election that must be filed with your 2019 tax return. Along with this election. a calculation to determine your "normal" sale amount based on a three year average must be made.

FOUR YEAR DEFERRAL:

If you have to sell a draft, dairy, or breeding animal, you have another option to replace the animal and defer the gain within four years. The gain from the sale of the animal will reduce the basis of the replacement animal, much like the pre-2018 rules for trading a piece of equipment. The elimination of the Section 1031 exchange rules for non-real estate property does not affect a casualty loss situation. If the conditions continue beyond four years, you can extend the replacement period to one year after the conditions end. This is likely to only occur during an extended drought.

If it is still not feasible to replace the animals, a third option would be to replace the animals with other assets that can be used in your farming business, given the weather conditions extend beyond four years. Real property (specifically land) is excluded from this option, but you can use

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the proceeds of the livestock sale to purchase a tractor and defer the gain on the sale of the livestock. You must wait until the end of the four year period to use this option. Until that time, you can only replace livestock with livestock of the same purpose. For example, you can only replace beef with beef and dairy with dairy.

Much like the one year deferral, you must determine the normal number of animals you would have sold in the year. For example, if you normally cull 10 cows per year, and due to the drought you have sold 25, you can defer the proceeds from the extra 15.

What Constitutes a Federally Declared Disaster Area?

In order to be eligible for either of these special provisions, the area must be declared a federal disaster area by the president, under the Robert T Stafford Disaster Relief and Emergency Assistance Act. A list of the areas that are eligible for either public of individual assistance under the act is available on the FEMA website. FEMA.gov/disasters

You must be able to prove that the drought, flood, or actual reason for the disaster declaration did in fact cause the livestock to be sold. In other words, assume you were affected by a flood in March, which caused an emergency declaration, and also a tornado in June which did not rise to a federal emergency. You will need to prove that your early sales were caused by the flood and not the tornado. If your county or one that borders you has been declared a Federal Disaster Area, you have sufficient cause to use the elections.

Other Considerations

Before you decide to go ahead with the deferral, there are several things you should consider. It may not be in your best interest to use either of these elections in 2019.

1. If you don't intend on replacing the breeding animals, or fail to get them replaced, the gain must be recognized in the year of sale. This means if you don't replace them, you will have to amend your 2019 tax return to report the income. If your tax plan for the year does not include that income, you may end up paying a higher rate than if you had planned to include the income in the first place.
2. Raised breeding livestock animals are subject to preferred capital gains rates of 0% or 15% at this time, depending on your regular income tax bracket. If you defer the income and replace them within the four year period, your basis in the new animals becomes significantly lower. This basis is the amount that you would be able to depreciate, which offsets self-employment as well as income taxes.

For example: You have 25 head of raised cows to sell at $1,200 per head. Since they are raised, they have no basis and a gain of $30,000 would be realized. If you recognize that gain in 2019, your tax would be $1,500 (assuming 0% Federal and 5% State).

If you then purchased animals back in two years for the same $30,000, you would have depreciation spread over 5 years (or be eligible for Section 179 Expense Election) that would offset $30,000 of income and self-employment taxes of $9,690 (assuming 12% Federal Income tax, 5% State Income Tax and 15.3% Self-Employment Taxes).

By recognizing the gain today and having the basis in the future, you would save $8,190 in taxes over the time period. You would also have the flexibility to invest the $30,000 in a different enterprise or reduce debt.

If instead of recognizing the gain, you take the election to defer the $30,000 gain, you pay no tax in 2019. You also will have $0 basis (and therefore $0 depreciation) when you replace the animals since you will take the $30,000 purchase price minus the $30,000 gain deferred.

3. The disaster may have a negative effect on all your income in 2019 and the gain on the sale of the livestock may be needed this year to avoid showing a loss on the tax return.

What About Crops?

Crop insurance, due to any condition, works in a similar manner to the one-year deferral for livestock. If you are a cash basis farmer, normally sell your crop in the following year, and receive payment for a crop loss, you may elect to defer that income to the following year.

There are a few caution areas:

- You must be careful with crop insurance payments from revenue loss, as the tax law is very specific that only losses from crop damage can be deferred into the year following production.
- If crop insurance proceeds are received in the year following production, they cannot be deferred another year. For example, if you received the crop insurance payment in January of 2020 for 2019 crop damage, you cannot elect to tax it in 2021.
- The crop insurance election is an "all or none" deal. You must elect to defer all eligible proceeds from all crops grown in that year, or none. Even if your "normal business practice" is to sell your beans in the fall and your corn the following year, if you received crop insurance for both crops, it has to be treated the same way.

Conclusion:

As in any tax situation, each case is unique and the circumstances surrounding each year are different. The important thing to remember is that options exist, and that the election doesn't have to be made until the return is filed. Please contact your tax preparer to discuss how the elections will affect your tax return.

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