# G96-1301 Income Tax Issues Related to Scaling Down or Liquidating a Beef-Cow Operation

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# Income Tax Issues Related to Scaling Down or Liquidating a Beef-Cow Operation

**This NebGuide discusses the tax implications of reducing or shutting down a beef-cow operation.**

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Downsizing cattle numbers is occurring through herd reductions and complete liquidations. Whether partial or complete, liquidations have income tax implications. Those implications vary depending on the timing of liquidation, origin of the animals liquidated, nature of the liquidation, and organizational structure of the business. This publication considers the tax situation of the sole proprietor beef cattle business owner who uses cash accounting for tax purposes.

While the information contained in this document is thought to be accurate, it should not be used as a substitute for professional advice. Consult with your legal and tax advisors before making any decisions.

Generally, a "cash accounting" tax payer reports income and expense when received or paid and ignores inventory changes and payables or receivables to determine taxable income. The majority of Nebraska farmers and ranchers report income and expense for tax purposes using the cash method.

Let's consider the situation of the beef cattle owner who is liquidating a major portion or all of his or her beef cattle herd with no other property liquidation. It is possible that the herd will contain animals with four types of tax status: raised breeding animals, purchased breeding animals, raised feeding animals, and purchased feeding animals. It is important for the business owner to classify accurately and record separately the sales of each type.

## Raised and Purchased Breeding Livestock

**Raised cows have a "zero" tax basis for cash basis taxpayers**. Using the cash method, all production costs involved with raising replacement heifers are deductible in the year expended. The result is a mature raised cow with a "zero" income tax basis. Sale proceeds are 100 percent taxable for federal and state income tax purposes.

Recently purchased breeding livestock may have a high purchase cost and, therefore, a high tax basis. However, many purchased breeding cattle have a very low or "zero" tax basis as cows and bulls purchased for breeding are generally assigned a five-year depreciable life. After the sixth year of ownership, they are fully depreciated. In addition, breeding livestock generally qualify for the "Section 179 Expense Election" which would allow full depreciation in the year of purchase.

Breeding cows and bulls held over two years are eligible for long-term capital gain treatment. Currently, long-term capital gains have a maximum federal income tax rate of 28 percent. However, previous depreciation claimed must be recaptured as ordinary income. Thus, purchased breeding livestock are eligible for capital gains treatment only to the extent that sale price exceeds original purchase cost. Raised breeding livestock receive the capital gain benefit on the entire sale amount.

To illustrate, let's assume a breeding bull was purchased four years ago at a cost of $1,500. Total depreciation claimed in the four years was $1,125. Therefore, the bull has a remaining value of $375 ($1,500 - $1,125) for tax purposes. If the bull is sold this year for $600, an ordinary income of $225 ($600-$375) is realized, and the balance ($375) is not taxable. The $225 gain is not eligible for treatment as capital gains income since we are merely "recapturing" depreciation previously claimed. However, if the same business owner sold a seven-year-old raised cow for $450, the entire sale amount of $450 is taxable income. All of the $450 is eligible for treatment as capital gain.

Neither the capital gain nor ordinary income reportable on the sale of livestock retained for breeding are eligible for "Self-Employment Social Security Tax" treatment. Therefore, there is no Social Security tax due on the proceeds. In addition, for taxpayers currently drawing Social Security benefits, the proceeds are not counted as "Earned Income" for calculation of annual maximum earnings.

## Raised and Purchased Feeding Livestock

"Feeding livestock" here refers to any livestock held primarily for sale and **not** "held for breeding purposes" in one's own herd. The sale of raised feeding livestock is reported in full on "Schedule F" as ordinary income. Purchased feeding livestock are also shown on "Schedule F" and the purchase cost is shown as a deduction in the year of sale. All expenses for feeding livestock are deductible as production expenses on "Schedule F". Net "Schedule F" income (after all expenses are deducted) is subject to federal and state income tax and Social Security tax.

## Tax Planning Ideas

As described above, taxable income from sale of livestock "held for breeding" is not subject to "Self-Employment Social Security tax" (currently 15.3 percent) and may be limited to a maximum 28 percent federal income tax. Therefore, it can be very important to properly identify sales as "breeding" or "feeding." Note that when a liquidation occurs, even young stock (heifer calves) being held for breeding in the normal course of business are includable as "breeding livestock." However, an animal is not "held for breeding purposes" merely because it is suitable for that purpose or because it is held for sale to others for such purposes.

At liquidation, a large taxable gain, accumulated over a long period of time, may be realized. This often results in a sizable income tax liability. Tax planning may reduce this liability (sometimes significantly). However, you will need to start planning early with the assistance of a professional knowledgeable in federal income tax law and familiar with your business operation. Obviously, tax planning needs to be consistent with an orderly business liquidation acceptable to creditors, family members, and others involved in the business. Here are some tax planning ideas to consider:

1. Identify animals "held for breeding" and document breeding livestock sales separately in your records.

2. By timing sales or in other ways, allocate sales proceeds into two or more tax years to benefit from the lowest tax rate (15 percent) on as much income as possible.

3. Become familiar with "tax attributes" on your previous year's tax return. For example, "Net Operating Losses" may be available to carry forward to the current year. It is usually advantageous to absorb the loss carry forward in full in the first year of liquidation. Or, you may have a "Capital Loss Carry Forward" which could be used only to offset capital gains.

4. Consider selling high cost basis assets at a loss to offset gains realized on sales of "zero" or low basis assets. This may come into play if you have recently purchased heifers or are selling real estate purchased at a high price.

5. Avoid large "Schedule F" loss in one year and potential large gains in another by timing your sales of feeding livestock with payment of deductible business expenses. For example, consider the taxpayer who elects to liquidate his or her entire breeding herd late in the current year and uses those proceeds to pay accumulated interest, feed, and other operating expenses, while deferring the sale of steers and heifers "retained for sale" to the following year with little or no operating expenses carried to or incurred in that year. The result is a large "Schedule F" income and resulting large Social Security tax liability in the following year. This could have been avoided by timing "Schedule F" expenses in the same year as "Schedule F" income.

6. Consider a "Tax Free Exchange" of assets, particularly if business relocation and continuation is underway. Always consider the possibility of a "Tax Free Exchange" if all or a portion of the proceeds from the sale of business assets will be used to purchase other business assets. If debt reduction is the primary objective this may not be an option.

7. Repossession of assets for debt payment and debt forgiveness have vastly different tax consequences. Seek professional assistance prior to entering into any agreement with your creditor that is based on repossession or debt forgiveness.

8. Consider making a large contribution to a qualified retirement plan in the year (or years) of liquidation. This could be particularly advantageous for someone nearing retirement age.

9. Accurately record hours of labor provided by family members and pay them a fair compensation.

10. Review current depreciation schedule for errors or omissions and to verify items sold on the depreciation schedule.

11. Check business loan history to determine "roll-over interest" (if any) not previously deducted. If you have loans on which no payments were made in previous years you undoubtedly will have some "roll-over" interest.

12. If you or your spouse have non-farm income and your cow-herd liquidation will result in high taxable income, try to arrange deferral of the non-farm income into another tax year.

Finally, two ingredients are very important to successful income tax planning for any business in any year. One is keeping "good records," which allows all transactions to be properly recorded and distributed. The second ingredient is assistance from a professional income tax advisor. Suggestions provided in this publication may be valuable advice in general but many may not be feasible nor advisable for your individual operation. Only a professional tax advisor who knows your operation and tax situation can advise you on income tax issues of a cow-herd liquidation. Remember, seek assistance from your tax advisor **before** you decide on any aspect of your cow-herd liquidation.

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