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Drought Issues and Taxes

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CORNHUSKER ECONOMICS

UNIVERSITY OF
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Institute of Agriculture & Natural Resources
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Drought Issues and Taxes

Even with the recent rains that have fallen across parts of Nebraska, drought continues to plague farmers and ranchers and always brings up the question of consequences to the tax bill.

Livestock Deferrals

There have always been two options when talking about an election to defer the gain on sale of livestock to future years. The first is a one-year deferral for cash basis farmers that allows income received in the year of disaster to be recognized in the year following, if the normal business practice is to sell the “crop” the following year. This one-year deferral applies to all livestock.

For example, if you “normally” sell your calf crop in January, but are forced to sell at weaning in 2006, you can elect to recognize the gain on your 2007 tax return. This is an election that must be filed with your 2006 tax return and a calculation to determine your “normal” sale amount based on a three year average must be made.

Draft, Dairy and Breeding livestock have a second option that has received some “tweaking” in the recent past. Previously, you had a two year period in which to replace breeding livestock sold due to drought conditions and not have to recognize the gain on the sale of those animals. Due to the continuous drought conditions, they have lengthened that time to four years. In addition, they have added the clause that at the end of the four year window, if it is still not feasible for reinvestment, the gain may be invested in other property that is used for farming purposes. Although they

Market Report	Yr Ago	4 Wks Ago	6/23/06
<u>Livestock and Products,</u>			
<u>Weekly Average</u>			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight	\$81.40	\$79.64	\$81.83
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb	*	120.91	140.65
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb	117.06	108.60	116.68
Choice Boxed Beef, 600-750 lb. Carcass	134.61	146.41	152.28
Western Corn Belt Base Hog Price Carcass, Negotiated	64.45	63.77	78.07
Feeder Pigs, National Direct 45 lbs, FOB	45.02	48.16	50.42
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean	64.81	69.22	81.76
Slaughter Lambs, Ch. & Pr., 90-160 lbs., Shorn, Midwest	113.25	77.00	80.00
National Carcass Lamb Cutout, FOB	254.58	211.20	218.01
<u>Crops,</u>			
<u>Daily Spot Prices</u>			
Wheat, No. 1, H.W. Imperial, bu	3.00	4.61	4.58
Corn, No. 2, Yellow Omaha, bu	1.86	2.14	1.99
Soybeans, No. 1, Yellow Omaha, bu	6.54	5.50	5.56
Grain Sorghum, No. 2, Yellow Columbus, cwt	2.93	3.20	2.68
Oats, No. 2, Heavy Minneapolis, MN, bu	1.75	1.99	2.25
<u>Hay</u>			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton	115.00	130.00	130.00
Alfalfa, Large Rounds, Good Platte Valley, ton	62.50	65.00	80.00
Grass Hay, Large Rounds, Good Northeast Nebraska, ton	57.50	55.00	55.00
* No market.			



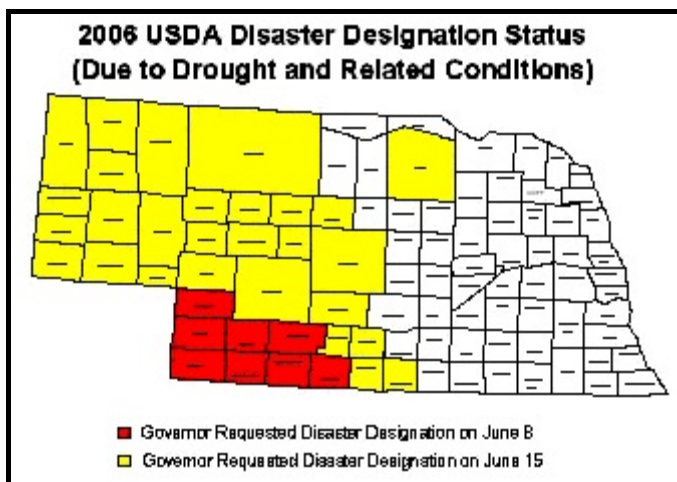
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did exclude land from that option, you could sell cows now, and in four years purchase a new tractor. Until the end of the four years though, you can only replace livestock with livestock of the same purpose (dairy for dairy, etc.).

What Constitutes a Drought?

You must be able to prove that the drought did, in fact, cause the livestock to have been sold. With the recent request of 36 Nebraska Counties to be declared Federal Disaster Areas due to drought, those counties and the ones surrounding them have sufficient cause to use the elections. Another proof that can be used is the release of CRP for grazing or haying. The following map shows the counties that have requested to be declared disaster areas.



No Questions Then, Right?

There may be several good reasons why it wouldn't be in your best interest to use either of these elections in 2006.

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 that if you don't plan on the income this year, you may end up paying much more tax on those animals than was originally needed.
2. Raised breeding livestock animals are subject to preferred capital gains rates of 5 percent or 15 percent at this time. If you defer the income and replace them in two years, 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 2006, your tax would be \$3,000 (assuming 5% Federal and 5% State tax).

If you then purchased animals back in two years for the same \$30,000, you would have depreciation spread over five years that would offset \$30,000 of income and self-employment taxes of \$10,590 (assuming 15% 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 \$7,590 in taxes over the time period.

If instead of recognizing the gain, you take the election to defer the \$30,000 gain, you pay no tax in 2006. 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 drought may have a negative effect on all your income in 2006 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 conditions 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.

Conclusion

As in any tax situation, each case is unique and the circumstances surrounding each year is unique. The important thing to remember is that the option exists and that the election doesn't have to be made until the return is filed. Please call your tax preparer if you have any further questions.

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