DROUGHT ASSISTANCE PROGRAMS AND TAX IMPLICATIONS OF DROUGHT INDUCED LIVESTOCK SALES

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Government payment assistance during or after a drought is a very real possibility. Drought assistance has been more likely ever since the Disaster Assistance Act of 1988 was legislated. Through this act the Secretary of Agriculture can authorize feed assistance payments for a county or reservation due to a natural disaster or livestock emergency. Programs of relevance for Arizona include the Livestock Assistance Program (LAP), Livestock Indemnity Program, and the American Indian Livestock Feed Program (AILFP).

DROUGHT ASSISTANCE PROGRAMS

Livestock Assistance Program: LAP provides direct payments to eligible livestock producers who have suffered grazing losses due to a natural disaster. A county must have suffered a 40 percent or greater loss of available grazing for at least three consecutive months as a result of damage due to drought, hot weather, insects, etc. Producers must meet certain criteria which include having a financial risk in eligible livestock that they have owned for at least three months before the payment period. LAP assistance is based on the value of feed calculated on a corn equivalent basis. Information needed to apply for LAP benefits includes: 1) number and share of livestock owned, 2) acres, location and type of grass or forage used to support livestock, 3) estimated percentage of grazing loss, and 4) dates of any significant livestock inventory changes.

Livestock Indemnity Program: Another program administered by the Farm Service Agency is the Livestock Indemnity Program. LIP assistance is possible for areas that have received a Presidential Disaster Declaration or requested a Secretarial Disaster Designation and received this status. This program provides partial reimbursement of livestock losses to eligible producers. If a producer's livestock losses exceed the normal mortality rate for the animal category under consideration, a producer may be eligible for payments. Producers must provide documentation to support their claims, and animals used for purposes other than human food or the production of food are not eligible. To not discourage private means of insuring livestock losses, Livestock Indemnity Program payments are not reduced to account for any insurance indemnity payments received from other sources.

American Indian Livestock Feed Program: The purpose of AILFP is to provide emergency financial feed assistance to livestock owners on tribal-governed land affected by a natural disaster. Under AILFP, the Commodity Credit Corporation contracts with governments of affected tribes to administer the program. When a tribal government determines that a livestock feed emergency exists, the tribal government may submit a request to implement the program. Damaging weather conditions, such as drought, which cause more than a 35 percent reduction of feed produced in a region for a defined period may qualify for payments. Livestock owners need not be American Indian nor a member of a tribe in order to receive payments under this program. Eligible owners must own or lease tribal governed land in the approved region and have had livestock on this land during the time of the qualifying disaster. Payments of this program are based on the smaller of either a) 30 percent of Animal Unit Day feed minus any feed sales, or b) actual livestock feed purchases minus sales of livestock feed.

All of the above programs are generally subject to a fixed sum of dollars that is allocated to a program, region, and/or nation. Thus, even if your county or tribe has been declared eligible to receive disaster assistance, judging how much reimbursement or assistance you will actually receive can be difficult. You may have to decide to sell livestock, buy hay, or lease pasture from another region before drought assistance programs are known. Uncertainties surrounding payment assistance, the weather, future market prices, and potential income tax liabilities make decisions regarding livestock sales during a drought difficult. Both drought assistance benefits and added revenues from drought-induced livestock sales need to be considered.

DROUGHT-INDUCED SALES

Managing tax liabilities during a drought can be a challenge due to more livestock sales than "normal" and the tax consequences of drought assistance payments. Special tax treatment is generally available to producers that are forced to sell animals because of a shortage of water, feed, or other drought-induced consequences. There are two basic tax treatments to defer income from drought sales. Both require that drought sales exceed the normal level of sales. Eligibility for the two different treatments depends on the class of livestock sold and whether the federal government has designated your area as eligible for assistance.

TAX TREATMENT #1— POTENTIALLY ALL LIVESTOCK

The deferred sales receipt method has the broadest class of animals which qualify. That is, only breeding livestock are eligible for the involuntary conversion tax method which follows. Yearlings and even"sporting livestock" are potentially eligible for the deferred sales method described here. Income from livestock sold in excess of normal sales, whether raised or purchased, may be deferred for up to one year if the following are satisfied:

1. Your (the taxpayer's) principal business is farming or ranching.
2. You utilize the cash method of accounting.
3. You state you are making an election under I.R.C. section 451 (e) and attach it to your drought-year return. You also attach a statement explaining the reasons that forced sales were necessary (lack of water, feed, etc.).
4. You provide evidence that "excess livestock" sales are due to drought and not a sell-off that is beyond drought-induced conditions. A three-year average is used to compute normal sales levels when making the calculation for "excess livestock" sold.
5. Your county or a neighboring county is designated as eligible for federal disaster assistance. The designation may be made by the president, an agency of the federal government (e.g., the Federal Emergency Management Agency or the Small Business Administration), or a Department of Agriculture agency (e.g., Farm Service Agency). The sale of livestock can occur before or after an area is designated a disaster area.
6. You total the number of animals sold this year and the number sold because of the drought. Any gain realized from weather-related sales must be provided. Income from normal sales is reported on this year's Schedule F while excess sales are reported on next year's Schedule F.

Livestock held for sale (e.g., steers, feeder heifers) can only qualify for tax treatment #1 or a one-year postponement in drought-induced income. Not all income needs to be deferred to the following year though. An advantage to this treatment is that some drought sale income can be taken as income for that year and some can be deferred to the following year. How much income is to be reported in the year of the sale or the following year must be decided by the due date of the return for the tax year in which the drought sale occurred. Another advantage to this treatment is that the tax basis for purchased replacements is not reduced by the amount of the postponed gain. Thus, if a raised cow is sold for $500 and a replacement is later purchased for $500, the entire $500 paid for the replacement is depreciable.

If prices are low and you expect to be in a zero or low marginal tax bracket, counting some if not all drought-induced sales as income for the drought year may likely be your best alternative. Keep in mind that any drought-assisted aid will need to be declared as income for the tax year that monies are received regardless of the method used for reporting livestock sales. See the box below for an example of the deferred tax treatment method. A disadvantage to this method is that you must rely on your area being declared eligible for federal disaster assistance. Also, the "involuntary conversion" tax treatment below for breeding animals may be preferred since it allows for drought-induced gains to be deferred for two years or one year beyond the one-year postponement described above.

Example of Tax Treatment #1 [election under I.R.C. 451 (e)]

Every year in the fall, Rancher Joe normally sells 100 yearlings, 13 cows, and 2 bulls (most recent 3-year average). Due to the drought this year, Joe sold 100 yearlings in May along with 15 pairs (30 head). In June, Joe sold 30 cows, 5 bulls, and 50 lightweight calves that were born earlier in the year. Normally, Joe doesn't sell any pairs or calves that are less than a year old.

Sale prices were $275/head for the yearlings, $400 average for the 15 pairs sold, $325/head for the 30 cows sold, $600/head for each bull, and $150/head for the calves that were less than a year old.

An election is made for each generic class of animals (e.g. cattle, sheep), not specific to an animal's age, sex, or breed. Thus, the average sale price for cattle is determined by dividing the total income received by the number of all cattle sold ($53,750 / 215 hd. = $250/hd.).This average is multiplied by the excess number sold (i.e., 215-115=100) due to drought to give the "excess sales." In this example, 115 hd. x $250/hd., or $28,750 in sales may be deferred for up to one year.

The election of how much income to postpone must be made in the tax year of the drought sale. After accounting for drought assistance benefits and other income and expenses, a plan should be devised for minimizing tax liabilities. The decision to buy breeding stock or retain more heifers in the following year needs to be considered in determining the amount of income to postpone for one year.

TAX TREATMENT #2— BREEDING CATTLE

Tax treatment #2 fits under the terminology of "involuntary conversion" in the tax guides. Gains from livestock sold as the result of a drought do not have to be recognized if the proceeds are used to purchase replacement livestock within two years from the end of the tax year in which the sale takes place. An advantage to this treatment is that your area need not be declared a disaster area by the federal government. Basic rules of this treatment, many similar to Tax Treatment #1, include the following:

1. Your drought-induced sales must exceed a normal three-year average.
2. You must purchase an equal or greater number of replacement livestock within two years of the end of the tax year of sale.
3. There is no minimum holding period. That is, bred heifers that you may have just purchased last year qualify as breeding livestock.
4. You must use replacement livestock for the same purpose.
5. An area need not be declared a federal disaster area, but there must be evidence that a drought occurred. For example, newspaper clippings or rainfall reports are generally sufficient proof.
6. You must provide a computation of the number and kind of livestock sold by category and the accompanying gain realized from drought sales.

When you buy replacements, attach to the tax return the date replacements

Example of Tax Treatment #2 [election under I.R.C. 1033 (e)]

Rancher Bob normally sells 20 cows and bulls from his beef herd every year but this year he sells 50, 30 more than normal due to the drought. The average selling price for all 50 head is $300/head. Thus, Bob defers the income of 30 head or $9,000 for this year if the cows were raised and have a zero basis.

If in the following two years Bob buys only 25 cows to replace the 30 sold, a gain of $300/head for five head must be reported regardless of what was paid for the 25 replacements purchased. Bob would need to report an additional $1,500 ($300 x 5) of income to an amended return for the year in which the drought sales occurred and any additional taxes must be paid.

If Bob purchased replacements for $400/head, then the tax basis for the 25 replacements would be $100 (replacement price minus the gain on the drought-induced sale that wasn't taxed). But if Bob purchased 25 replacements for only $250/head then an additional $1,250 gain ($50/head x 25 head) would have to be filed to an amended tax return for the drought year.

Keep in mind that any gains associated with feed assistance or indemnity payments have to be claimed for the tax year that they are received. It is conceivable that feed assistance combined with having to file an amended return of additional income could push a rancher into a higher marginal tax bracket for a drought year than planned.

were purchased, the cost of replacement animals, and the number and kind of replacements. Carefully consider your future intentions for rebuilding your herd when opting for the involuntary conversion treatment. Raised replacements are not eligible for "replacement livestock." Also, attention needs to be given to the selling price and expected purchase price. Consider the example of involuntary conversion on page 178.

Since every tax situation and ranch plan is different, no standard recommendation can be given as to whether the one-year postponement is preferred to the two-year involuntary conversion. Close consultation and planning with a tax advisor or accountant is likely to pay a heavy dividend if you have or plan to make substantial drought sales this year. Please refer to the Farmer's Tax Guide (Publication 225) or contact the IRS (1-800-829-1040) for more current and complete tax information. The Farmer's Tax Guide along with other tax forms and publications are available on the Internet at

http://www.irs.gov

Current information related to drought-assisted aid programs can be found at

http://www.fsa.usda.gov

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