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TAX PLANNING AND THE DAIRY HERD BUYOUT

Part VI of Material Prepared By The National Dairy Herd Buyout Extension Program Committee

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National Dairy Herd Buyout Extension Program Committee

In November, 1985 a group of agricultural economists representing six land-grant universities informally organized the National Dairy Herd Buyout Extension Program Committee. The milk production termination program, as the buyout program is formally called, became official policy when the President signed the Food Security Act of 1985 on December 21.

The purpose of this ad hoc committee effort is to formulate materials that could be widely used in cooperative extension programs designed to help dairy farmers, lenders, and other industry groups to better understand and make decisions relative to the new milk production termination program. The individuals and institutions who have contributed to this effort are listed below.

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INTRODUCTION

Dairy farmers who are considering participation in the Milk Production Termination Program must recognize its income and social security tax consequences before a rational bid can be made. Income and self-employment taxes are going to reduce the net income resulting from buyout payments, the sale of dairy cattle, and the sale of other farm commodities and assets. Understanding the tax implications associated with various "buyout" alternatives followed by wise tax management can help maximize after tax income.

A. General Tax Consequences

Here are the general tax consequences associated with the Milk Production Termination Program. Each dairy farmer must recognize and evaluate the tax implications that apply to his or her own situation before formulating a buyout bid.

1. Buyout payments received from the government will be ordinary farm income just like milk receipts. However, once the herd is sold, many deductible farm expenses will disappear. Many dairy farmers who had enough deductions and credits to avoid paying income taxes in recent years may now have taxable income. The amount of tax liability will depend upon the size of the buyout payments, remaining farm deductions, other taxable income, and personal exemptions. These factors and others are discussed below.

2. Sale of the herd will result in some ordinary income, some capital gain income, and probably some losses. Raised dairy animals two years of age or older will produce capital gains and under current tax law only 40 percent of capital gains becomes ordinary income. Calves and yearlings sold will be all ordinary income. The sale of purchased dairy livestock at beef prices will result in losses if the adjusted basis (undepreciated balance) is greater than the sale price. Losses on purchased animals held two years or more will offset capital gains, losses on purchased cows held less than two years will offset ordinary gains. The sale of fully depreciated cows and those that are nearly fully depreciated will produce ordinary income because prior depreciation must be recaptured.

   Assume a raised dairy herd consisting of 85 cows, 15 two year old heifers, 25 yearlings, and 25 calves were sold for approximately $48,000. All animals are sold for beef. The total gain, capital gain exclusion, and ordinary income from this sale is estimated as follows. Cow prices were based on average weights of 13,300 pounds and $.30 per pound in this example.

Example 1. SALE OF RAISED DAIRY HERD

Number & Description	Est. $ per Head	Total Gain	Capital Gain Exclusion*	Ordinary Income
85 raised cows	$400	$34,000	$20,400	$13,600
15 raised heifers (2 years old)	360	5,400	3,240	2,160
25 yearlings	240	5,900	0	5,900
25 calves	100	2,500	0	2,500
TOTAL		$47,800	$23,640	$24,160

*60 percent of total gain under current tax law.

The above sale will produce nearly $24,000 of capital gain exclusion and just over $24,000 of ordinary income.

If the herd consists of purchased as well as raised cows, total gain on the sale will be reduced by the amount of adjusted basis (unrecovered cost) of the purchased animals. Assume that 40 of the cows in our example are purchased animals and they have an average basis of $200. The effect that selling purchased animals has on total gain and ordinary income is illustrated in Example 2.

Example 2. SALE OF DAIRY HERD INCLUDING PURCHASED COWS

Number & Description	Est. $ per Head	Total Gain	Capital Gain Exclusion*	Ordinary Income
40 purchased cows (average basis = $200)	$400	$ 8,000**	$ 0	$ 8,000
45 raised cows	400	18,000	10,800	7,200
15 raised heifers (2 years old)	360	5,400	3,240	2,160
25 yearlings	240	5,900	0	5,900
25 calves	100	2,500	0	2,500
TOTAL		$39,800	$14,040	$25,760

*60 percent of total gain under current tax law.

**Total gain equal sales price less adjusted basis times number of head (400 - 200 x 40).

Total gain from the sale of this herd has been reduced by $8,000 to $39,800 but ordinary income has increased to $25,760. Note that the sale of purchased cows results in less total gain but all the gain is ordinary income. As the proportion of purchased cows in the herd increases total gain declines but the part subject to ordinary income increases until essentially all of the gain becomes ordinary income.

3. Sale of feed and supplies will produce ordinary income. All raised feeds have a zero basis since the costs associated with growing feed crops are deducted during the production year. The costs of purchased feeds and supplies are deducted in the year of purchase as ordinary farm expenses. Therefore, the entire amount received from the sale of feed and supplies will be added to farm income in the year the money is received.

4. Machinery and equipment that can be sold will usually produce gains and nearly all the gain will be ordinary income. Gain results when the sale price exceeds the undepreciated balance. Most machinery and equipment is depreciated faster than its decline in market value and when sold a gain occurs. All gain to the extent of depreciation claimed must be recaptured as ordinary income and all of it must be reported in the year of sale regardless of when the money is received.

5. Recapture of investment credit can occur when machinery, equipment, and purchased dairy cattle are sold. Nearly all farm investment credit property purchased after 1981 and some bought in 1979 and 1980 has not yet earned all its credit. If it is sold before five years are up, (seven for non-ACRS property), the credit used but not earned must be added to the current year's tax bill. The tax liability caused by recapture can be thousands of dollars where investment credit claimed and used have been high in recent years. However, many farmers have large balances of unused credits that can be used to minimize recapture.

6. The sale of farm real estate presents the greatest potential tax problem and planning opportunity. Since the sale of land and buildings is not likely to be directly connected with the herd buyout decision, most of these tax implications are omitted from this paper. However, here are a few very important reminders.

   a. The sale of single purpose livestock structures will trigger investment tax credit recapture as well as depreciation recapture.

   b. The conversion of a single purpose dairy structure to some other use will cause investment credit recapture but not depreciation recapture unless the new use is personal.

   c. The temporary nonuse of a single purpose dairy structure should not trigger investment credit recapture providing the structure is maintained in a condition ready for service. However, there is no official IRS ruling on this specific issue at this time.

   d. The gain from the voluntary sale of a farm cannot be "rolled over" tax free into other business property. Only the gain from the personal residence can be excluded from income. Usually all

of the gain from the sale of land and general purpose farm buildings qualifies as capital gain. The sale of real estate qualifies for installment sale reporting.

7. <u>An alternative minimum tax liability may occur</u> when the raised dairy herd is sold even if ordinary income is low enough to escape the regular tax. Selling land and buildings can create a larger alternative minimum tax problem. Alternative minimum taxable income (AMTI) includes the capital gains deduction as well as ordinary income. Currently AMTI in excess of $40,000 is taxed at 20 percent. Sale of the 150 head raised dairy herd illustrated in Example 1 could generate a small amount of tentative alternative minimum tax since total gain is $47,800. Total gain plus other taxable income less allowable deductions equals AMTI. There is an AMT liability only when AMT is greater than the regular income tax.

8. <u>Quarterly returns and payments will not be triggered</u> by the sale of the dairy herd but a farmer may lose his or her preferable filing status after machinery and equipment or real estate are sold. A farm taxpayer is not subject to quarterly estimates if at least two-thirds of gross income is from farming in the current or past year. Gross income from farming includes all the gain from dairy cattle sales but excludes machinery, equipment, and real estate.

9. <u>Buyout payments and the sale of feed and supplies will increase the self-employment income and self-employment taxes for many farmers.</u> This will adversely affect farmers who are trying to minimize total tax liability and may interfere with the retirement plans of those reaching retirement age in 1986 by delaying receipt of social security benefits. Some farmers may welcome the increase in self-employment income as an opportunity to become more fully insured for benefits. To become fully insured in 1986, 35 quarters of coverage are needed.

10. <u>The opportunity to select different herd buyout and payment options</u> has important tax implications. In general, the options that will result in the most even distribution of taxable income over the five year period will minimize taxes.

11. <u>New federal tax legislation</u> can have a major impact on tax planning. At this time one cannot be certain of what changes will be made or when they will become effective. It is possible that the capital gains exclusion will be reduced, alternative minimum tax will be expanded, investment credit will be eliminated, and individual tax rates will be cut. If tax laws are changed the net result could mean higher taxable income in the year a raised herd is sold partially or fully offset by lower tax rates during the payment period.

12. <u>If increased taxes do result</u> from participation in the Milk Production Termination Program, the tax liability must be paid by the farmer even if no money is left after paying debts and liabilities.

B. Tax Planning Suggestions

Here are a few additional tax planning suggestions that can help dairy farmers as they evaluate their options relative to the Milk Production Termination Program (MPTP).

1. Know what the current individual farm tax situation is and what it is likely to be if one does not participate. The tax consequences of participating in the MPTP should be evaluated by comparing them to the tax consequences of not participating.

2. Net operating losses from current and past years may be available to offset taxable income in one or more future years. Unused balances of investment credit can be used to offset recapture or future income tax liability.

3. Use the installment method to report the sale of real estate, feed and supplies, and livestock where payments are received in one or more years after the sale is made.

4. Check the ownership of all cattle before selling the herd. Income from the sale of cattle owned by children and other family members must be reported on their tax returns.

5. Consider making gifts of livestock, feed and/or supplies to other family members prior to the buyout. If such arrangements do not violate MPTP rules they may be used to distribute taxable income more evenly between two or more family members.

6. Spread the sale of farm assets over two or more years only if the potential tax savings are greater than potential lost revenues. Sales delayed to future years must be discounted at prevailing interest rates and are subject to changes in prices.

7. Farmers approaching age 65 should check out their social security status to determine what effect their participation in MPTP will have on eligibility and benefits. They should also remember that at age 65 each taxpayer becomes eligible for the double personal exemption under current tax law.

8. Contributing to an IRA or Keogh plan is a strategy that should be considered to postpone taxable income into retirement years when taxable income may be lower.

9. Income averaging may be used by eligible taxpayers to reduce federal income taxes if participation in MPTP causes a significant increase in any year's taxable income. To be eligible for income averaging taxable income in the computation year must exceed base period income by 140 percent plus $3,000. The base period is the three years immediately before the high income year.

10. Complete and accurate records are extremely important for keeping track of all costs and deductible expenses associated with the sale of farm business property. Prior years' records showing the cost basis, date of purchase, depreciation, and adjusted basis of all assets to be sold must be reviewed and brought up to date. Every dollar of cost and adjusted basis not deducted from income will result in unnecessary taxes.

11. Consult a knowledgeable farm accountant or tax planning expert to get help with major tax problems. Also refer to North Central Regional Publications 2 and 43, Income Tax Management For Farmers and Tax

<u>Planning When Buying or Selling a Farm</u> for additional tax planning suggestions.

The preceding list of tax consequences and planning suggestions certainly does not cover all the tax implications every deliberating and participating dairy farmer should consider. No reference is made to state income taxes which vary greatly from state to state but move in the same direction as federal income taxes when income increases.

The tax ramifications of re-entering the dairy business at the end of the five year MPTP are impossible to predict at this time because tax laws and re-entry costs are subject to major change. Nevertheless, tax deductions and credits must be considered when estimating the net cost of re-entry. Although large expenditures in re-entry years may create net operating losses and credits that can be carried back to some MPTP years, MPTP participants should not rely on that happening.

In conclusion, there are many tax consequences and planning strategies that should be considered before and after a decision is made to participate in the Milk Production Termination Program. Each dairy farmer should recognize and understand the major tax implications of various buyout options and plan tax management strategies to maximize after tax income providing they are consistent with wise business management practices.