Tax Concepts For Cattle Breeders

An Introduction

by Walter Schmidt

Federal tax rules concerning breeding cattle are numerous and complex. Even without the use of sophisticated tax-sheltering devices, knowledge and correct application of basic principles can save a taxpayer considerable sums. This article is intended as an introduction to several federal tax concepts as they apply to cattle breeding for profit by an individual. While the principles are similar for other livestock and for taxation of partnerships and corporations, a rule discussed in the article may not apply to those situations.

This article is not intended as tax advice and tax-related decisions should not be based solely on the information in this article. Before any significant changes are made that may have tax consequences, a cattle breeder should consult a qualified tax advisor. For the reader wishing more detail, a comprehensive discussion of farm and ranch taxation can be found in O'Byrne and Davenport's "Farm Income Tax Manual," published by the Allen Smith Company.

Accounting methods

The IRS will generally permit reporting based on any fair, good faith accounting method. The most common is the cash receipts and disbursements method, where items of income and disbursement are reported in the year actually or constructively received or paid. Next most common is the accrual method which requires the taxpayer to report income or deductions when the right to receive or the obligation to pay becomes fixed and the amount is determinable with reasonable accuracy.

The cash receipts method is the simpler of the two. No inventory is kept for tax reporting purposes. The breeder deducts the costs of raising the animal when they are incurred. Then, when he sells the animal, his profit is the difference between the sale price and the animal's adjusted basis.

NOTE: The adjusted basis of acquired property is the original cost to the purchaser (the animal's basis) minus any depreciation or cost recovery taken before sale. If an animal is farm raised, the initial basis will be zero and there will be no depreciation or cost recovery.

Income from cattle

Some income from the sale of livestock is taxed as ordinary income, some as capital gain. The latter is preferable because the tax rate for capital gain is 60 percent less than that for ordinary income. Gain from a sale of breeding cattle, regardless of age, which have been held for 24 months for use in a trade or business may be treated as capital gain. Under some circumstances, losses on the same sale may be treated as ordinary losses. These gains or losses are reported on Form 4797 and Schedule D or Form 1040.

A number of factors affect qualification for capital gains treatment. First, date of birth, not gestation period, determines the 24-month holding period for animals raised on the farm. Second, the animal may not be held primarily for sale to customers. However, capital gains can be claimed even if the animal was not actually used for the purpose held. For example, animals intended for breeding but not bred because the owner detects when they are young that they are unsuitable may nevertheless qualify for capital gains treatment.

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On the other hand, simply because the animal can be bred or even has been bred does not prove it is held for breeding. In general, the IRS or a court faced with the issue will look to the primary purpose for holding the animal. Even if it will ultimately be sold to customers it may still be found to be held for breeding purposes. In one case, a herd regularly produced a predictable surplus of calves that were sold to avoid overstocking; those calves were found to be held for sale (and the gain was ordinary income) while calves added to the herd qualified for capital gains treatment when they were sold after the two-year holding period had elapsed.

What about the sale of breeding cattle which have not been held for 24 months? That is reported on the ordinary gains and losses portion of Form 4797. It should not be included on Schedule F to Form 1040; reporting it there would not affect the income tax paid, but would subject any gain to the self-employment social security tax. That result is avoided by using Form 4797.

NOTE: The basis of a raised animal for a cash-basis breeder will be zero if the costs of raising have been previously deducted. If breeding cattle raised and breeding cattle purchased are both sold in the same year, be certain to deduct the basis of the purchased animals before computing gain. In a year with many transactions this can be easy to overlook, but the results can be significant.

None of these income-reporting requirements apply if the breeding cattle are sold or destroyed because of disease and the taxpayer replaces the animals with other breeding cattle. Such an exchange is called an involuntary conversion. The same principle applies if the cattle are sold and replaced because of drought. An involuntary conversion election must be made in the first taxable year in which any gain from the sale is realized.

The only exception to the strict requirement that breeding cattle must be replaced with breeding cattle is if the sale or destruction was forced because of environmental contamination rendering the land unfit for further use. The proceeds in that case may be used to acquire other property, including land, to be used for farming purposes.

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There is an exception to this contamination exception however. If the land is contaminated as a result of a brucellosis infestation, applying the liquidation proceeds to other farming property does not merit a deferral. Gain in that case, whether ordinary or capital, must be reported. The view of the IRS is that Congress intended the rule to apply only to toxic chemical contamination.

Deductions

The greatest favor a breeder (or any other business taxpayer) can do for himself is give meticulous attention to recording ordinary and necessary expenses. Necessary in the tax sense does not mean indispensible, nor does ordinary mean habitual or often. If there are adequate business ends to be served and the expenditure is common to breeders in general, the requirement is met.

The most obvious expense deduc tion available to a cash basis breeder is the cost of raising the animal. The cost of feed is deductible unless it is feed grown on the farm. Prepaid feed purchases are deductible for feed consumed in the following year if three conditions are met: 1) the expenditure must be a payment, not a deposit; 2) there must be a valid business purpose other than tax avoidance for the payment; 3) the payment must not materially distort income. Any cooperative dividend or rebate should be subtracted from the feed deduction unless the amount was treated as income.

Costs, including feed, that are incurred in transporting purchased livestock to the farm are not deductible but are part of the capitalized cost basis of the livestock. Payment for pasturage or forage is deductible as a feed deduction and advance rent payments on pasture can be deducted over the period of the lease.

Breeding fees, veterinary services, and medicine are deductible after subtracting any cooperative dividend or rebate. Embryo transplants present special questions. (See the discussion in the September 1983 Angus Journal, page 60.) Insurance on livestock is a deductible expense, as are costs of pedigree and registration papers.

If the costs of raising an animal have been deducted, its loss through accidental death, theft or straying is not deductible. The amount of the adjusted basis of a purchased animal may be deducted for such a loss. Losses from diseases are not deductible losses.

CAPITAL GAINS/ORDINARY LOSS RULE: To determine if losses by casualty or theft are treated as ordinary losses, the taxpayer subtracts the amount of any losses from any gains caused by the casualty or theft. If there is a net gain, all the transactions are treated as capital gain or losses. A net loss will be treated as a fully deductible ordinary loss.

Accelerated Cost Recovery System

Under the Economic Recovery Tax

Act (ERTA) of 1981, recovery for capital outlays for livestock and other tangible property placed in service after 1980 is made through the Accelerated Cost Recovery System (ACRS). Assets placed in service before 1981 are depreciated over their "useful life."

For depreciable assets, the useful life is the length of time the taxpayer expects to use the asset in his business. The IRS has asset depreciation ranges which may be used as guides. For breeding (and dairy) cattle the middle guideline period is seven years, the lower limit is 5.5 years, and the upper limit is 8.5 years. The guidelines are not binding, but the taxpayer should be able to justify any major deviation. Any salvage value of depreciable property cannot be deducted.

Under ACRS, assets placed in service after 1980 are grouped into classes of "recovery property" and their cost is recovered over the period applicable to the class. Breeding cattle are classified as five-year property; their cost is deductible over a five-year period at the following rates: Year 1, 15 percent; year 2, 22 percent; year 3, 21 percent; year 4, 21 percent; year 5, 21 percent. There is no salvage value taken into account.

An alternative ACRS method is available using a straight line rate of recovery and allowing deductions over longer periods of time. Its primary use would be for taxpayers who anticipate substantially larger tax liability in the future, when a delayed deduction would be of more value.

RECAPTURE OF DEPRECIATION AND COST RECOVERY: As a result of depreciation or cost recovery, the adjusted basis of the property is reduced each year. When cattle are sold, the difference between the adjusted basis and the sales price is gain. To the extent that the gain represents depreciation or cost recovery taken after 1969, it is reported and taxed as ordinary income (i.e., it is "recaptured"). The remaining gain may be treated as capital gain if the cattle have been held for at least 24 months.

The recapture provisions will ordinarily apply to purchased or inherited animals; in most cases raised livestock will have no basis in the hands of a cash-basis taxpayer.

Expensing of purchase price

Breeding cattle acquired by purchase for use in a trade or business may qualify for expensing—that is, a portion of the purchase price may be deducted as a current expense for the taxable year in which the property is placed in service. The aggregate deduction is limited to $7,500 in 1984 and 1985, and to $10,000 in 1986 and thereafter.

This deduction is available only for purchased property, not for inherited property or property which has a basis determined by reference to the basis of other property such as in a tax-free trade or exchange. It is not available on transactions between relatives and between members of a controlled group.

An election to expense all or a portion of the purchase price will affect the taxpayer's use of the investment tax credit. No investment credit is available on any portion of a purchase which has been expensed.

An informed breeder working with a qualified tax advisor is in an excellent position to use investment strategies and tax-sheltering devices to full advantage.

Investment tax credit

Investment Tax Credit (ITC) rules allow a cash-basis taxpayer to reduce tax liability by 10 percent of the purchase price of breeding cattle used in a farm business. The purchase may not be from a related taxpayer. Accrual-basis taxpayers who choose to treat breeding cattle as inventory may not use the ITC.

Unlike the deductions discussed above, which are subtracted from the taxpayer's gross income before tax is computed, the ITC is subtracted from the amount of tax due. The amount of the ITC is limited to $25,000 of income tax liability plus 85 percent of any liability over $25,000.

NOTE: The ITC is **not** an election. If a credit should have been taken but was not, a claim for refund should be filed. Otherwise, an audit after a sale may require recapture of all or part of a credit which was not originally claimed.

The basis of the property for which an ITC is claimed must be reduced by one-half of the amount of the credit unless the taxpayer elects to reduce the credit by two percentage points. In the case of breeding cattle, the credit would be reduced to eight percent and no basis reduction would be required.

The ITC is not allowed where the cattle purchased are substantially identical to cattle sold six months before or after the purchase. A credit is allowed for any part of the purchase price in excess of the sale price, or, if an ITC was recaptured, on the sale of old livestock.

A distinction is made between new and used property for the purpose of applying the ITC. Since 1981 the credit has been allowed to be applied to only $125,000 of used property in any given year. In 1985 the limit will increase to $150,000. There is no dollar limit on new property. Livestock is regarded as "new" at the time it is first suitable for a purpose which would qualify it for capital gains treatment—for example, when an animal is first able to bear a calf or capable of giving milk. If an animal has been previously used for dairy purposes (or as a draft animal), however, it will not be "new" when then used for breeding.

An ITC may be taken for a single-purpose agricultural structure used for housing, raising and feeding a particular kind of livestock. The structure must be designed for the single use and the use must require that some kind of equipment be installed in the structure (to avoid possible multiple uses). Activities incidental to the main use may be carried on within the building. Multi-purpose agricultural buildings do not qualify for the ITC.

ITC RECAPTURE: If breeding cattle are sold before a full five years pass, a portion of the ITC is recaptured. The taxpayer "earns" one-fifth of the ITC for each full year he retains the animal. For example, a bull purchased for $5,000 in 1984 would qualify for a $500 ITC. If it is kept for a full five years, no recapture is required. If it is sold after three full years, the taxpayer will have earned $300 of the ITC but will have to report (and pay) a $200 recapture.

Conclusion

This overview of federal tax rules illustrates the complexity of the process involved. Recognizing the need for careful and extensive recordkeeping should be one result of a familiarity with the concepts. Care taken in recording transactions throughout the year can create substantial savings in two ways. First, it allows the breeder to plan purchases and sales to the best tax advantage. Second, it permits the maximum use of deductions and credits when a return is filed.

The tax concepts discussed in this article are the basic elements upon which investment strategies and tax-sheltering devices are based. The Tax Code offers a number of such possibilities to farmers and ranchers. An informed breeder working with a qualified tax advisor is in an excellent position to use them to full advantage. AJ