Leaving Dairy Business? Consider The Tax Effects Before Selling The Cows

UNIVERSITY PARK (Centre Co.) — It's a Pennsylvania farm family's nightmare. After 20 years in the dairy business, unfortunate circumstances and economic forces have left a family of four $125,000 in debt. The family decides to quit dairying, sell the cows and equipment to pay off the debt, and combine an off-farm job with crops and beef cattle.

They sell 100 raised cows and replacements for $97,500 and dairy equipment for $27,500 in May, and both husband and wife take jobs in town. Both salaries total $35,000 for the period of June through December. The salary money is used for family living and to catch up on education expenses for two teen-age children, so none is available for debt payment.

The ax falls when they have their tax return prepared the next April. "When the tax return is complete, the family finds they have a total income tax bill of almost $34,000, plus nearly $1,000 self-employment tax from the sale of calves and other items," says Dr. Larry Jenkins, associate professor of agricultural economics at Penn State.

"Withholdings on wage income cover about $2,700 of the tax, but there is an outstanding balance of about $31,000 due on April 15. The family has to take out a new loan just to pay the tax."

What happened? "The money from the sale of their dairy cattle is all taxable," explains Jenkins. "The cattle were all raised, so there is no basis to offset sale price. The remaining basis in the equipment is $10,000, but there are recaptures on the gain from the equipment sale because the family took depreciation deductions over the past three yeras. The $17,500 gain on the equipment is taxed as ordinary income."

The family nightmare is that the earning assets — the cows and the dairy equipment — have been sold, but now a new debt that is nearly a fourth of the original one appears because of the taxes related to the sale of assets to pay the original debt.

Jenkins says that a few options can alleviate the tax burden of a farm liquidation, but most people fail to take advantage of them because they sell assets first and talk to their accountant later. "That process should be reversed," he says. "Talk to the accountant first, and sell assets later based on the accountant's analysis of the tax result and ways to reduce the tax bite."

Many people think that there is no income tax to pay when a farmer sells assets and uses the proceeds to pay off a large debt. "In perfectly logical thinking that individual has no money because it was used to pay debt," Jenkins says. "Unfortunately, the Internal Revenue Service doesn't agree. That agency views a sale as a sale, unless the money is donated to charity. To the IRS, if there is a sale and resulting gain, tax is due even if the income was all used for debt payment."

What are some ways to reduce the tax burden that can result from quitting dairying? "If possible, spread the liquidation over two tax years to keep the income in a lower bracket," Jenkins says. "For instance, if mature animals can be sold one year and replacements the next year, it will prevent the surge in taxable income that results from selling everything in one year. In some cases, livestock and equipment can be sold in different years to achieve a similar result."

If the lender agrees, an installment sale might be used to spread income over several years. "This will keep more of the income in a lower tax bracket, and it should produce some interest income on the unpaid balance that can be used to offset interest payments on loan obligations," Jenkins says.

If two or more families are involved in the farm operation, be sure asset sales are properly divided so that income is reported on the correct tax return. "This can divide the total sale proceeds so that each family pays tax in the lowest tax bracket possible," Jenkins says.

Sales that will be subject to self-employment tax should be carefully reviewed so they don't overburden a single taxpayer. "Self-employment tax on sales reported on schedule 'F' often prove to be a bigger burden than income tax," Jenkins notes.

If the farming operation will be continued with a change in enterprises, consider exchanging some assets for property that will be needed in the new farming operation. "For example, a family quitting dairy farming but planning on a beef operation might consider an exchange of dairy breeding animals for beef breeding animals," Jenkins says. "This 'like-kind' exchange is accomplished tax-free — that is, no gain is recognized and no tax is due, as long as there is no transfer of cash and the property given up has the same value as the property received."

The rules on "like-kind" exchanges are complex, so be sure to check with a competent tax accountant about the specific exchange being considered. "Some exchanges do not qualify," Jenkins notes. "For instance, you cannot exchange dairy cows for beef or dairy steers, because they are not considered 'like-kind' property."

Dairy operators who have experienced a net operating loss during recent years may be able to use the operating loss to offset part of the gain from liquidating the dairy herd and equipment. "A net operating loss occurs when operating expenses for a year exceed operating revenue," Jenkins says. "Typically, the loss is carried back for up to three years and used to get a refund of income tax previously paid in one or more of the prior three years."

In some cases, income tax was not paid in the three-year carry-back period, and that makes it possible to carry-forward the operating loss for up to 15 years into the future. "When the carry-forward option is chosen, it is necessary to include a statement with the tax return for the year of the operating loss indicating that the loss is being carried forward rather than carried back," Jenkins says.

The process of preparing the loss carry-forward statement and including it with the tax return is the responsibility of the tax accountant who prepares the tax return for the year of the operating loss. "However, if an operating loss occurs, the farm manager should be sure to remind their tax accountant to either carry-back or carry-forward the loss so it can be used to secure an income-tax benefit," Jenkins says.

If you're seriously considering quitting dairy farming and beginning a beef cattle operation, Jenkins urges you to check the records for historical farm profits earned by Pennsylvania beef cattle operations. "Do that before you invest in a group of beef cows, unless you have a really good job in town," he warns.

USDA Announces EQIP Funding

HARRISBURG (Dauphin Co.) — The U.S. Department of Agriculture has allocated $3.4 million to Pennsylvania to implement the Environmental Quality Incentives Program (EQIP), according to William Baumgartner, state executive director of the Farm Service Agency (FSA).

This new program was authorized by the 1996 Farm Bill and replaces the Agricultural Conservation Program (ACP) that has been so successful for the last 60 years. In 1996, Pennsylvania received $1.6 million in ACP funds and $2.2 million for an Interim EQIP.

EQIP is a voluntary program providing cost-share assistance to agricultural producers who install needed conservation practices on their land. Conservation practices are available to assist farmers with soil erosion control, water quality improvement, wildlife habitat enhancement and forestry. The Natural Resources Conservation Service (NRCS) and County Conservation Districts in Pennsylvania will provide technical and educational assistance to farmers who perform conservation practices according to a farm plan.

USDA in Pennsylvania is required to submit a plan to the National Office in Washington, D.C. outlining how EQIP funds will be utilitized in the state. Cost-share funds will be made available to designated conservation priority areas in Pennsylvania and for identified resource concerns outside of priority areas. When the state plan is approved by USDA, EQIP funds will be allocated to county FSA committees for cost-sharing with farmers.

Farmers may participate in EQIP by signing a long-term contract for five to 10 years to carry out needed conservation practices. Most conservation practices that were available under ACP will continue to be available under EQIP.

A sign-up period will be announced in the near future. However, applications may be accepted at any time. Contact your local FSA office for more information about EQIP and how to apply for this new program.