



University of Kentucky
College of Agriculture,
Food and Environment
Cooperative Extension Service

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Tax Management Strategies, Issues, & Tools

COW-CALF PROFITABILITY CONFERENCES



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DEPRECIATION RECAPTURE

Gains: Ordinary Vs. Capital

DEPRECIATION RECAPTURE

- Gain realized when taxpayer disposes of an asset that had previously provided an offset to ordinary income.
- Two most common gains
 - Section 1231 Gain (capital gains)
 - Section 1245 Gain (ordinary income)

DEPRECIATION RECAPTURE EXAMPLE

- Tractor is purchased for \$50,000 in 2010.
- Tractor has fully depreciated.
 - The amount depreciated each year from 2010 to 2018 was an offset to ordinary income.
- Same tractor was sold for \$30,000 in 2019. Depreciation is to be “recaptured” in the amount of \$30,000. **This is ordinary income, but is not subjected to SE tax**
 - **15.3% savings!!!**

2020 Federal Income Tax Brackets and Rates for Single Filers, Married Couples Filing Jointly, and Heads of Households

Rate	For Single Individuals	For Married Individuals Filing Joint Returns	For Heads of Households
10%	Up to \$9,875	Up to \$19,750	Up to \$14,100
12%	\$9,876 to \$40,125	\$19,751 to \$80,250	\$14,101 to \$53,700
22%	\$40,126 to \$85,525	\$80,251 to \$171,050	\$53,701 to \$85,500
24%	\$85,526 to \$163,300	\$171,051 to \$326,600	\$85,501 to \$163,300
32%	\$163,301 to \$207,350	\$326,601 to \$414,700	\$163,301 to \$207,350
35%	\$207,351 to \$518,400	\$414,701 to \$622,050	\$207,351 to \$518,400
37%	\$518,401 or more	\$622,051 or more	\$518,401 or more

Source: Internal Revenue Service

<https://taxfoundation.org/2020-tax-brackets/#brackets>

DEPRECIATION RECAPTURE EXAMPLE

- If tractor had sold for \$55,000, then \$50,000 is considered ordinary income (1245 gain).
- \$5,000 would be treated as capital gains income (1231 gain)

WHEN 1231 GAINS ARE TREATED AS ORDINARY INCOME

- Continuing tractor example
 - If there had been 1231 losses in previous years, these were taken off ordinary income.
 - There is a 5-year look-back period for 1231 gains.
 - A portion or all of your current 1231 gain, could be treated as ordinary income to offset 1231 losses in previous years

1231 GAIN TREAT AS ORDINARY INCOME

- Tractor purchased in 2010 for \$50,000. Sold in 2019 for \$55,000. Farmer had the following 1231 situation from

Year	Net 1231 Gain/Loss
2014	\$0
2015	\$0
2016	(\$2,500)
2017	\$0
2018	\$700

WHEN A CAPITAL GAIN IS TREATED AS ORDINARY (AT LEAST IN PART)

Net 1231 Gain 2019	\$5,000
Net 1231 Loss 2016	\$-2,500
Net 1231 Gain 2018	\$700
5 year “netting”	\$-1,800
Gain Treated as Ordinary Income	\$1,800
Gain Treated as Long-term Capital Gain	\$3,200

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WHY IS THIS?

- The rationale behind 1231 loss recapture is that when a 1231 loss occurs, it is treated as an offset to ordinary income
- Therefore, if you have had a section 1231 loss in the previous 5 years, your ordinary income was reduced by that amount.
- When there is a section 1231 gain, that gain is treated as ordinary income up to the amount of section 1231 losses that occurred in the previous 5 years.

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- Assume Farmer Fred purchased a \$1,500 wagon in 2013

■ Depreciation allowed in 2013	\$160.71
■ Depreciation allowed in 2014	\$286.99
■ <u>Depreciation allowed in 2015</u>	<u>\$112.75</u>
■ Adjusted basis	\$939.55
■ Sold in 2015 for	\$1,200
■ Gain (treated as ordinary income)	\$261 (\$1,200-\$939.55)



WHAT ABOUT CATTLE?

SELLING PURCHASED BREEDING CATTLE

- If sale price is less than purchase price
 - Ordinary income/loss
- If sale price is greater than purchase price
 - Ordinary income and capital gain

BREEDING CATTLE HELD > 24 MOS.

- Regardless of whether raised or purchased, the gain on these animals qualify as a section 1231 gain (capital gain)



Involuntary Conversion of Draft/Breeding Animals

INVOLUNTARY CONVERSION OF DRAFT OR BREEDING ANIMAL

- IRC Sec 1033(e)
- A producer who sells more draft, breeding, or dairy animals than normal due to weather-related conditions can defer the gains for up to two years
- Must be replaced within 2 years with “like” animals
- Disaster declaration not required but must be able to show that weather-related conditions forced sales above normal

INVOLUNTARY CONVERSION OF DRAFT OR BREEDING ANIMAL

- Delay of gain can be extended to 4 years if there is a persistent weather condition
- IRS NOTICE 2020-74
- If the persistent weather condition lasts 3 years or longer that makes it infeasible to replace with identical livestock, any property can be used to replace

INVOLUNTARY CONVERSION EXAMPLE

- Normally sell 5 cows
- Sells 20 cows this year because of drought
- Can defer the gain from 15 cows if replacements are purchased in the next 2 years
- Tax basis of replacement livestock:
 - Equal to basis in the livestock sold plus any additional amount invested in replacement livestock that exceeds the proceeds from the sale
- If animals are not replaced, or replacement cost is less than gain from their sale
 - Difference must be reported as a gain for the sale year by amending the tax return

INVOLUNTARY CONVERSION EXAMPLE

- Assume the animals were raised (\$0 tax basis) and sold for \$500 each
 - Gain of \$7,500 deferred ($\$500/\text{head} \times 15 \text{ head}$)
 - If within 2 years, 15 more head are purchased for \$500, tax basis in the replacements would be \$0
 - If within 2 years, 15 more head are purchased but for \$600, tax basis in the replacements would be \$100 ($\$600 \text{ cost minus } \500 proceeds)

INVOLUNTARY CONVERSION EXAMPLE

- Now assume they were purchased beef cows with a \$200 remaining basis and sold for \$500 each
 - The basis in the replacement animals would be \$200 each if the purchased replacements costs \$500
 - If the replacements costs \$600, the tax basis in the replacements would be \$300
 - $\$600 \text{ cost} - \$500 \text{ sale proceeds} + \$200 \text{ remaining basis}$

MAKING THE ELECTION

- Name, address, and ID number
- Evidence of weather-related conditions that forced sale
- Explanation of how sale is related to weather conditions
- Number and kind of animals sold
- Number and kind of livestock that would have normally been sold (convention is 3 year average)
- Computation of realized gain on the transaction
- The amount of income to be postponed

ELECTION EXAMPLE

Example Statement 1: Election under I.R.C. §1033(e) to Postpone Recognition of Gain from Livestock Sold Because of Weather-Related Conditions

Bo Vine (Taxpayer Identification Number)
145 County Road 541
Somares, US 12345

The weather-related conditions evidenced by the attached rainfall reports and news clippings affected availability of forage and feed, and caused taxpayer to sell 40 head of beef cows instead of 25 head in 2016. The raised cows have zero tax basis.

The number of animals sold in each of the three preceding years was:

https://ruraltax.org/files-ou/Livestock_Sales.pdf

1 YEAR DEFERRAL FOR MARKET ANIMAL SALES

- IRC Sec 451(e)
- Can defer, for one tax year, the income of certain livestock sold due to weather-related conditions
- Area **MUST** be federally recognized and declared eligible to received federal assistance
- Must be sales above “normal”
- Animals are not replaced and the elected gain is reported on the following year’s tax return

4 CONDITIONS FOR 1 YEAR DEFERRAL

- Primary business must be farming
- Cash method accounting must be used
- Must document that the sales would not have occurred in a “normal” year
- Weather related disaster caused the sale of the livestock
- *remember, area must be federally designated and eligible for assistance

MAKING THE ELECTION

- 1 year deferral of market livestock sales
- Must include statement with tax return including the following information:
 - Name, address, and ID number
 - Declaration is being made under I.R.C. 451(e)
 - Evidence of weather-related conditions that forced sale and federal disaster designation
 - Explanation of how sale is related to weather conditions
 - Number of livestock and kind/type that would have normally been sold (convention is 3 year average)
 - Total number of animals sold in current year and number sold due to weather related event
 - Amount of income deferred

ELECTION EXAMPLE

FIGURE 14.6 Violet Dubois's Section 451(g) Election

Section 451(g) Election

Violet Dubois, 9786 River Way, Georges, Iowa 50498

TIN 000-00-0000

Taxpayer is postponing gain under I.R.C. § 451(g).

On March 15, 2019, a flood severely impacted Granger County, Iowa, rendering taxpayer's pasture unsuitable for cattle. On March 29, 2019, Granger County, Iowa, was declared a federal disaster area because of the flood (see attached declaration).

Taxpayer has for the prior 3 tax years (2016, 2017, and 2018), sold 49, 50, and 52 head of cattle respectively. In 2019, she would have sold 50 head had the flood not occurred. Instead, she was required to sell the entire herd, which included 150 head of cattle.

Taxpayer sold the 150 head of cattle on March 27, 2019, for \$270,000. She is deferring \$180,000 $[(100 \div 150) \times \$270,000]$ of her income from the sale attributable to the 100 cattle that she would not have sold in 2019, but for the flood.

2019 National Income Tax Workbook. Land Grant University Tax Education Foundation



Farm Income Tax Averaging

FARM INCOME TAX AVERAGING

- Strategic farm income tax management strategy
- Used to “smooth” tax liability over time
- You can elect to “spread” current farm income over the three previous (base) years.
- An equal proportion from your elected farm income moved into each base year

EXAMPLE

Year	Taxable Income	Marginal Tax Rate
2016	\$0	10%
2017	\$5,000	10%
2018	\$10,000	10%
2019	\$105,000 (NFI)	24%

- Married filing joint
- 2019 income is not total taxable income, all others years are not necessarily just farm income. I will explain

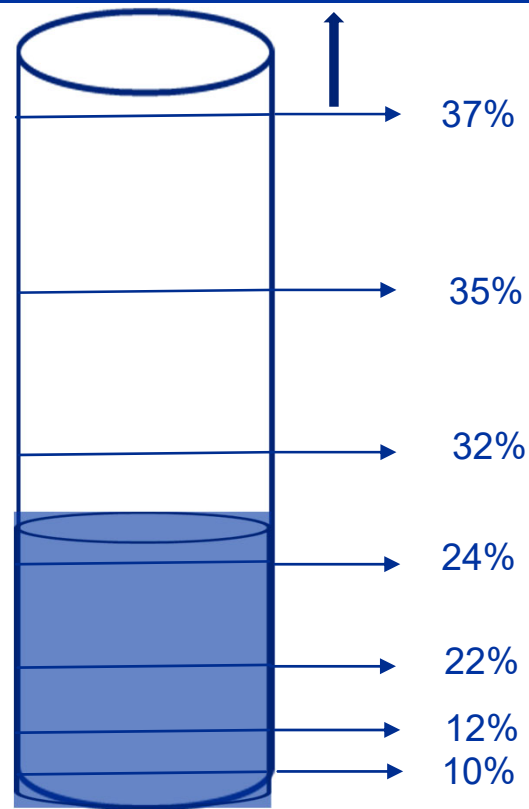
2019 TAXABLE INCOME W/OUT AVERAGING

Tax Rate	Taxable Income (MFJ)	Federal Tax
10%	\$0-\$19,400	\$1,940
12%	\$19,401 -\$78,950	\$7,145.88
22%	\$78,951 - \$168,400	\$5,730.78
Total Federal Income Tax		\$14,817



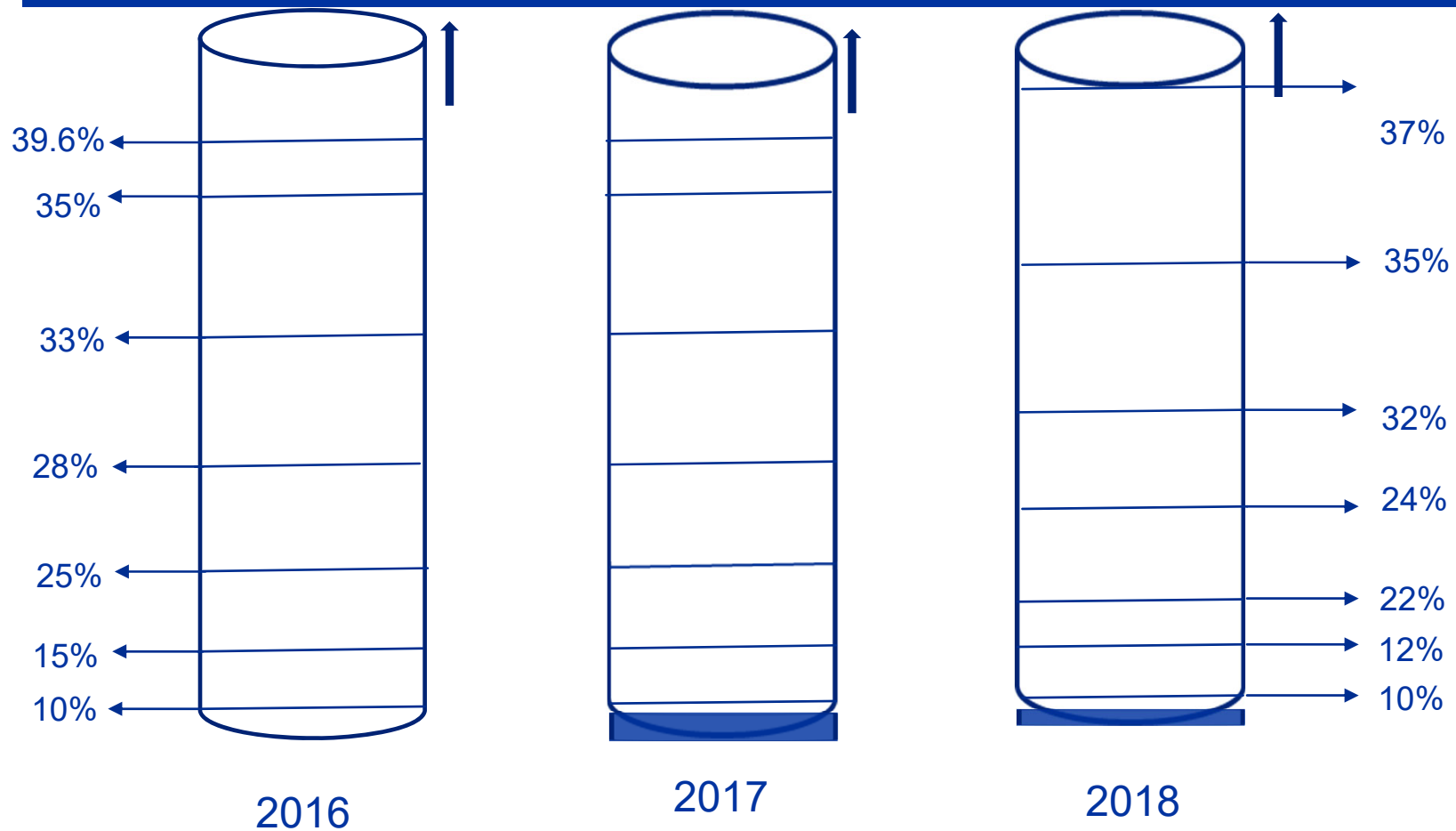
14.11% Effective Tax Rate

2019 TAXABLE INCOME: TAX BRACKETS

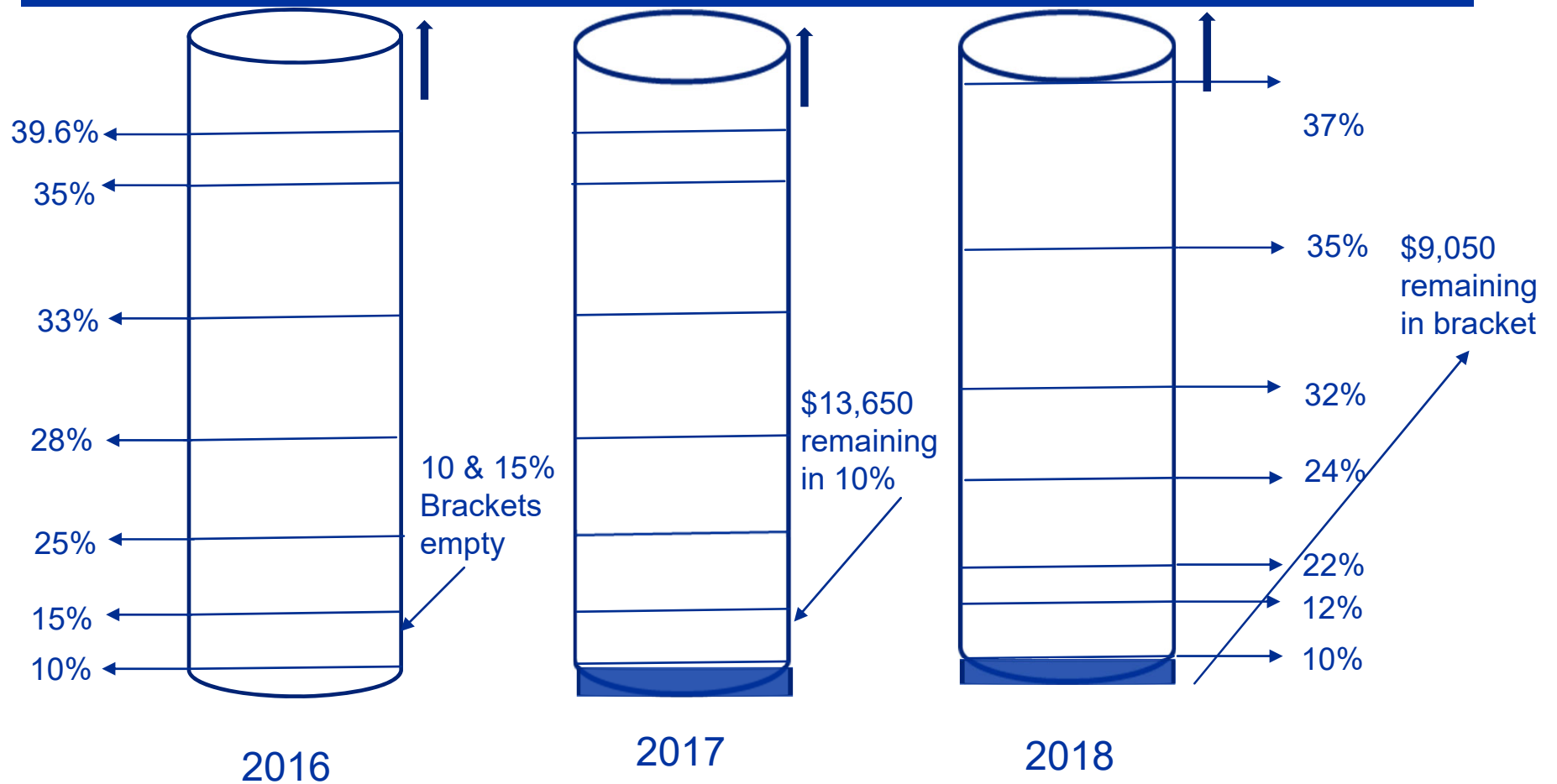


2019

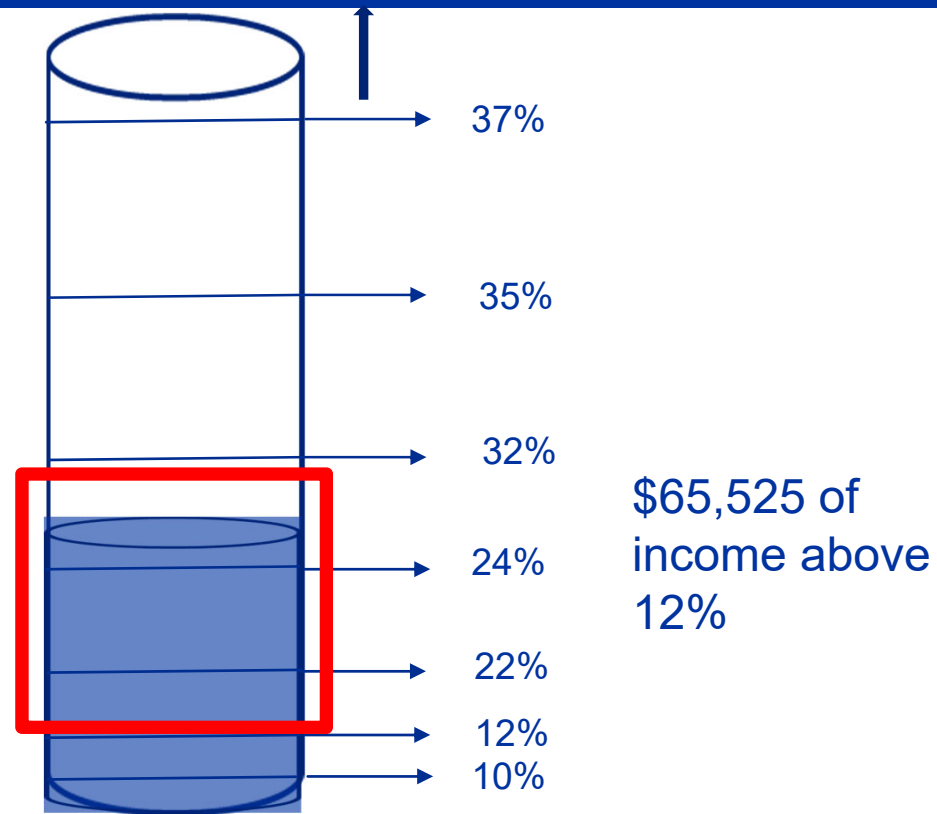
2016-2018 TAXABLE INCOME: TAX BRACKETS



2016-2018 TAXABLE INCOME: TAX BRACKETS

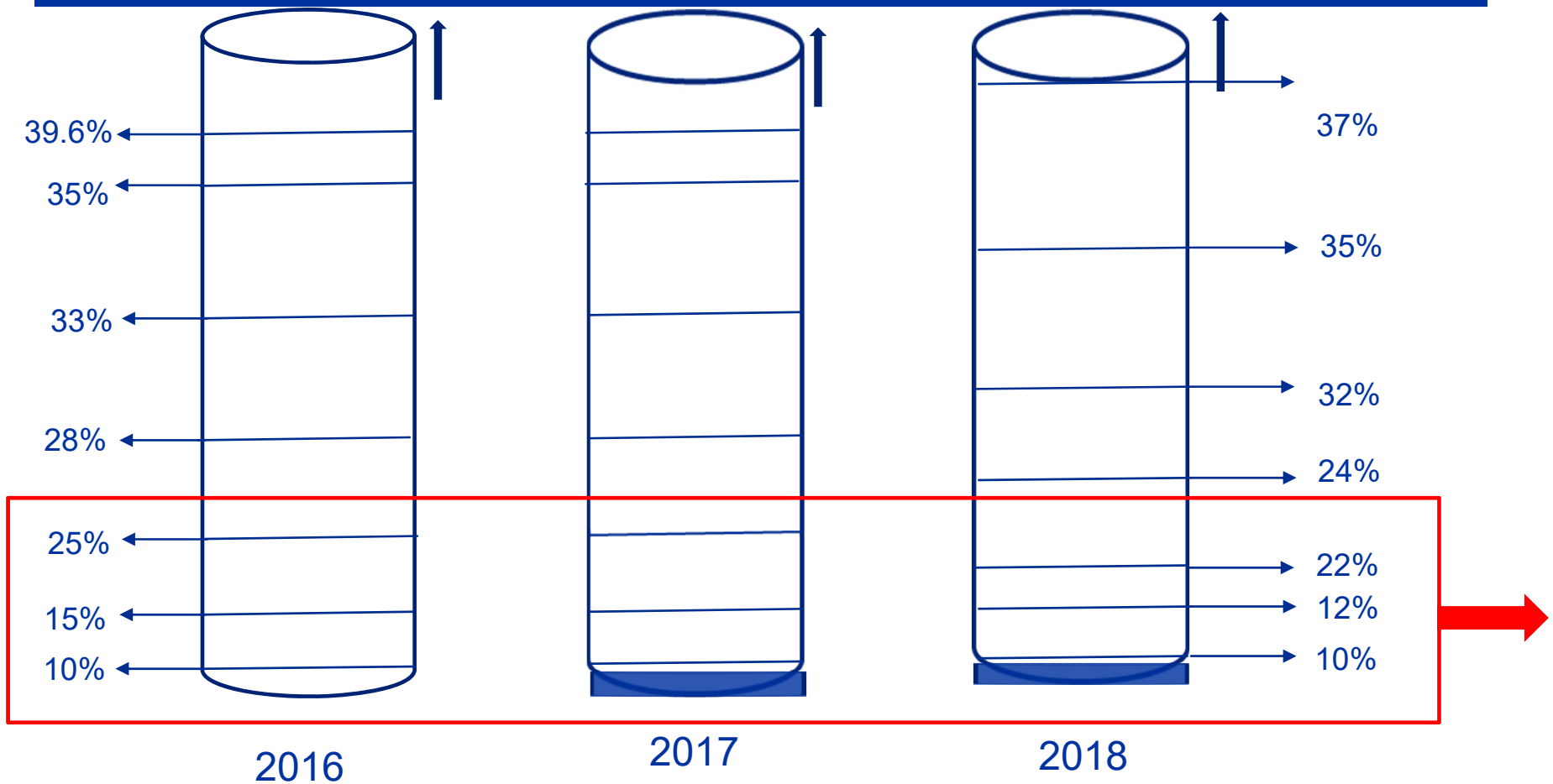


2019 MARGINAL TAX RATE

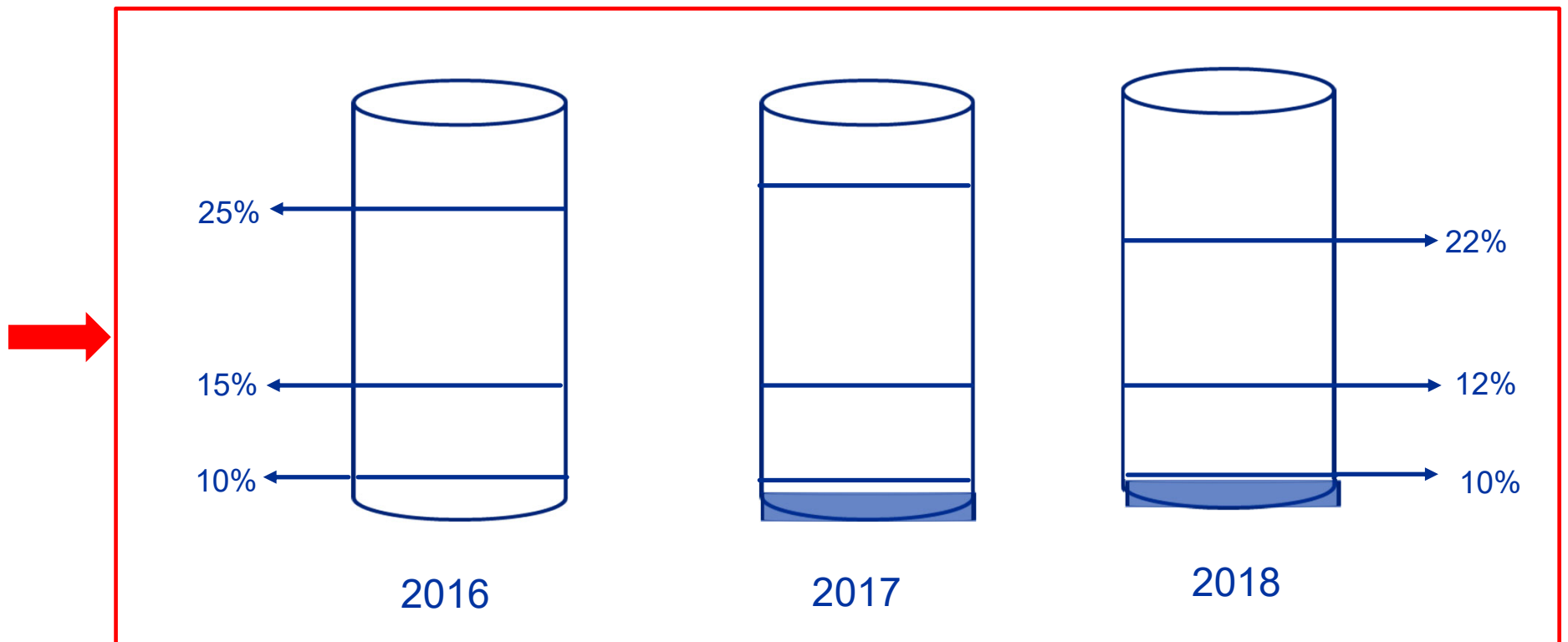


2019

UNUSED "SPACE" IN PREVIOUS YEARS' TAX BRACKETS



UNUSED "SPACE" IN PREVIOUS YEARS' TAX BRACKETS



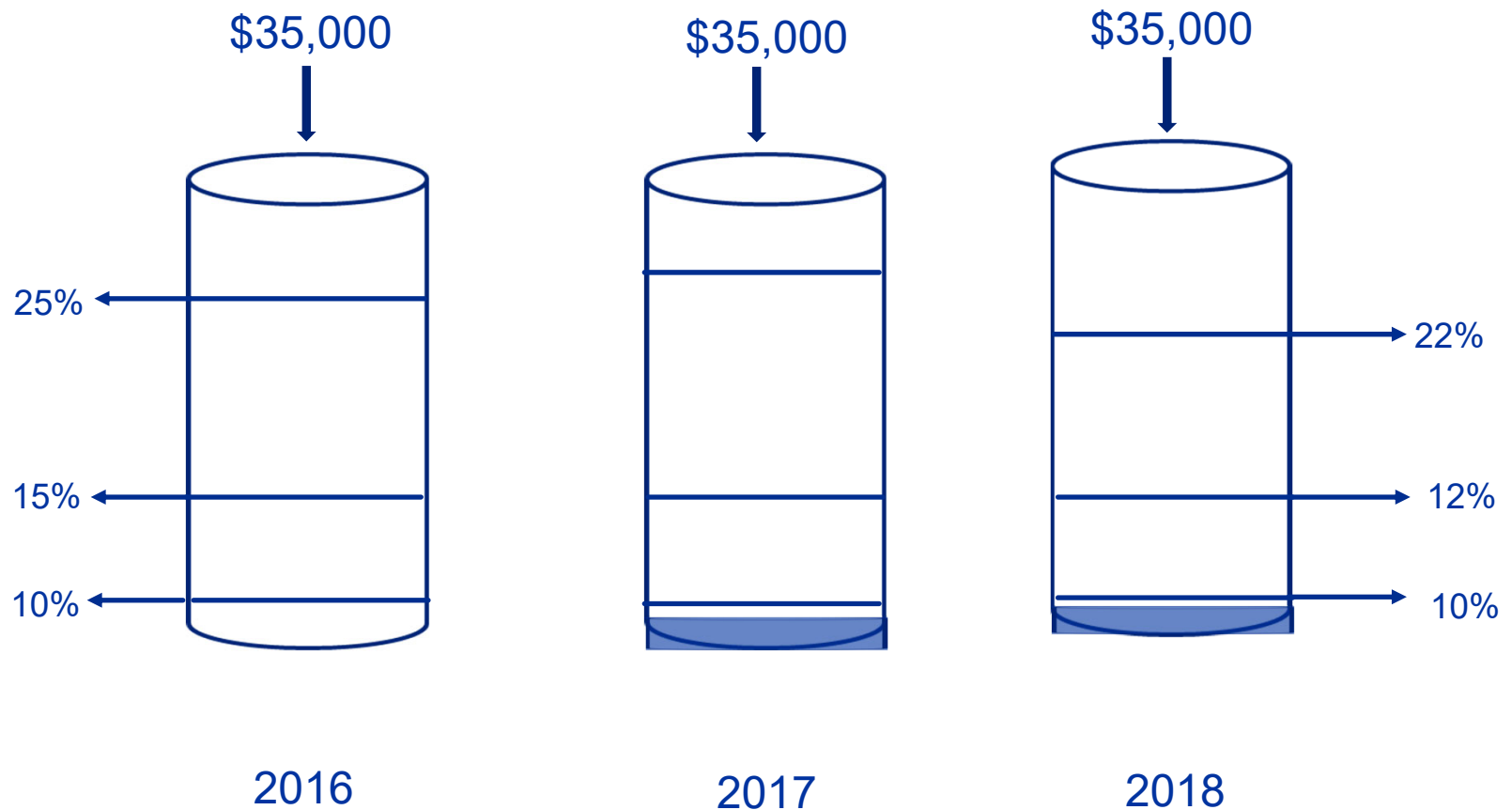
2019 FARM INCOME ELECTION

- Elect to average \$105,000 of 2019 income

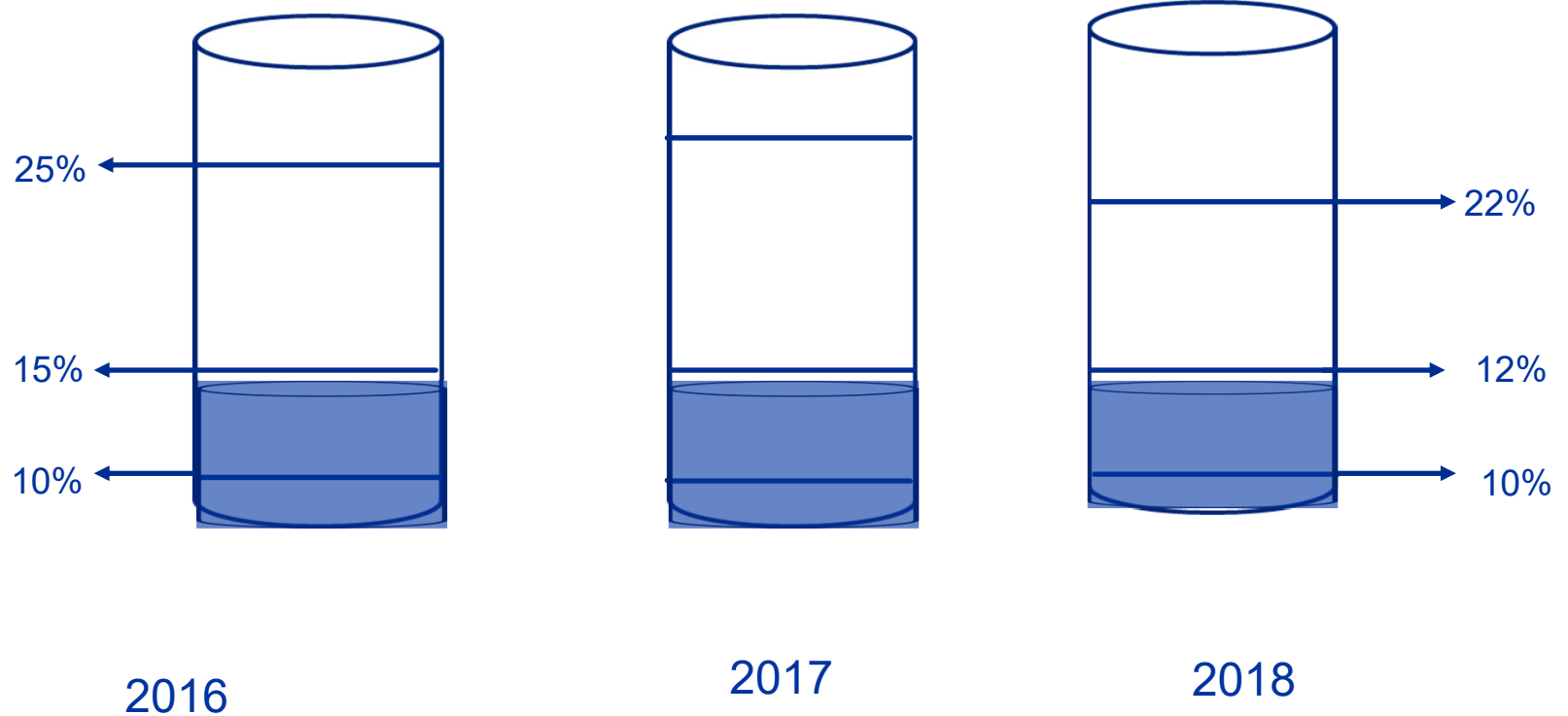
$$\frac{\$105,000}{3} = \$35,000$$

- Will move \$35,000 into each of previous tax years

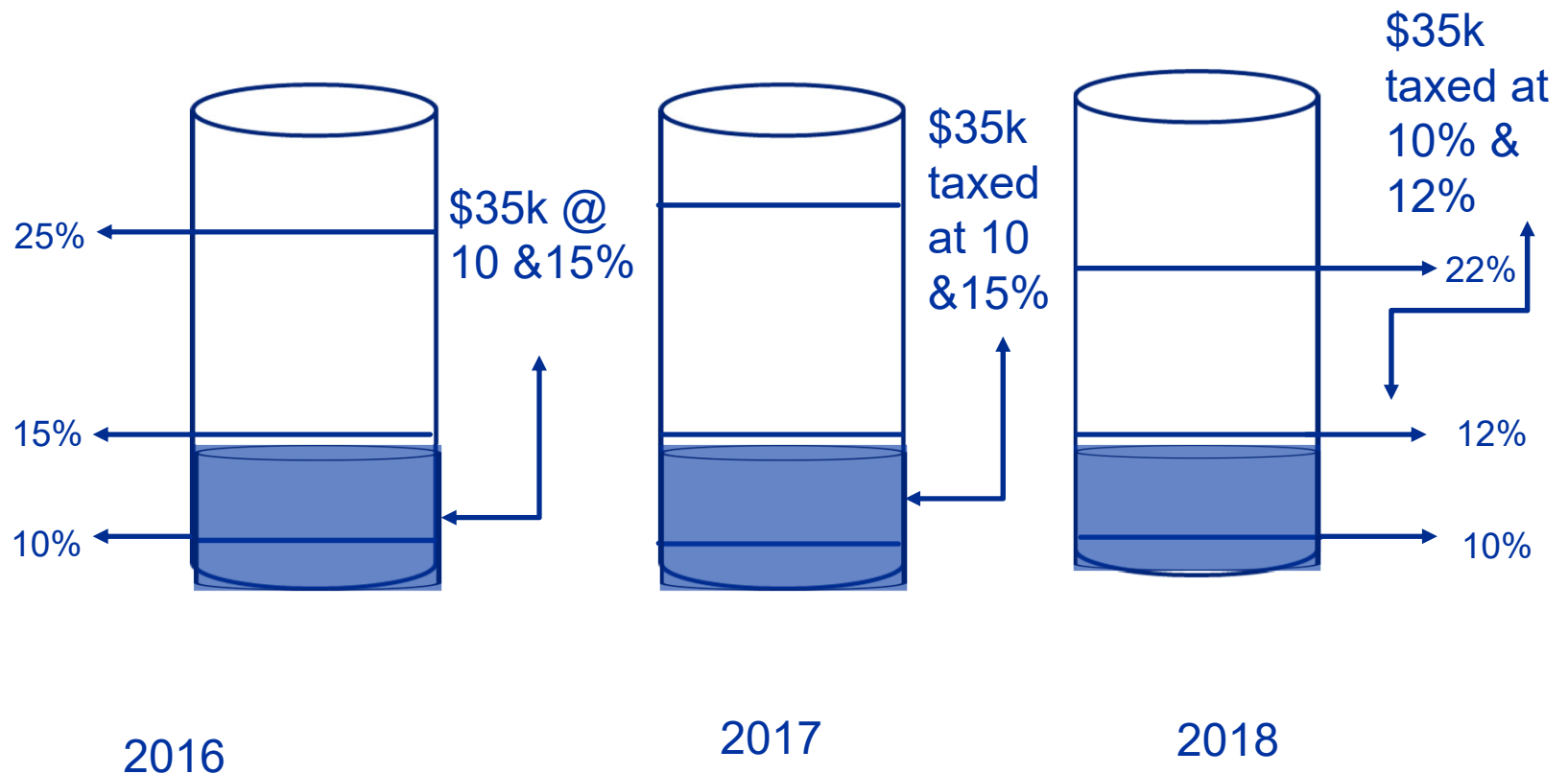
FARM INCOME AVERAGING BASIC CONCEPT



AVERAGING 2019 FARM INCOME



2019 FARM INCOME AVERAGING RESULTS



2019 TAXABLE INCOME WITH AVERAGING

Tax Rate	Taxable Income (MFJ)	Federal Tax
2016 - 10%	\$0	\$0
2017 – 10%	\$5,000	\$500
2018 - 10%& 12%	\$35,000	\$3,819
Total Federal Income Tax		\$4,319



Tax Liability before averaging: \$14,817

Tax Liability after averaging: \$4,319

Tax Savings of \$10,498

4.1% Effective Tax Rate





Easing Concerns of Multiple Year Farm Losses: Farm Losses versus “Hobby” Losses

BUSINESS LOSSES VERSUS HOBBY LOSSES

- Congress says in order to deduct expense in excess of income, must be engaged in said activity for a profit
- Profit in this context refers to income being greater than expense where expenses include depreciation on capital assets
- Not a hobby if profit occurs in any 3 out of 5 consecutive years (2 out of 7 for equine)
- Failure to meet profitability test does not automatically make it a hobby venture
 - Give IRS justification to look deeper into your operation

NINE AREAS OF CONSIDERATION

1. Is the activity carried out in a businesslike manner?
2. Expertise of producer and advisers
3. Quantity of time being invested in activity by producer in the business
4. Is there an expectation of asset appreciation
5. Has the producer done this before
6. What is the history?-previous profits and losses

NINE AREAS OF CONSIDERATION

7. Has the producer made ANY money?
8. Is the producer engaged in other income generating activities?
9. Is the producer having fun?-presence of recreation or pleasure

CONTACT INFORMATION

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