

Tax Issues After a Drought

GUIDELINES FOR CROP LOSS AND LIVESTOCK SALES

Droughts can wreak havoc for farm families. The good news is that come tax time, you have some options that might make things easier. If you have received federal disaster payments, you may be able to postpone reporting them on your income taxes for a year. Likewise, if you were forced to sell livestock because of the drought, you may be able to postpone reporting gains on the sale for as long as two years afterward.

Here are some basic things you need to know. But for the best advice for your situation, see a tax practitioner knowledgeable about farm tax laws and assistance programs.

CROP INSURANCE PROCEEDS AND DISASTER PAYMENTS

If you are a cash method farmer, you are allowed to postpone reporting insurance and disaster payments on crop losses by one year under Section 451(d) of the tax code. Generally, this rule applies when crops cannot be planted or are damaged or destroyed by a natural disaster such as a drought or a flood. It applies to all insurance proceeds and to federal payments received for losses due to a natural disaster.

- ◆ *Qualifying for the election.* You must be able to show that under your normal business practice, the income from the crop would have been reported in the year following receipt of payment for it.
- ◆ *Two options for reporting on tax returns.* If you qualify for the exception, you have the option of reporting the payments as income in the year it is received or as income in the following year. Electing to postpone reporting the payment as income covers all crops from a farm. You must file a separate election for each farming business you operate. Separate businesses are defined as those for which you keep separate books and are allowed to use different methods of accounting.

HOW TO MAKE THE ELECTION

The election must be attached to the return (or amended return) for the tax year in which the payment was received. The statement must include:

- ◆ Your name and address.
- ◆ A declaration that you are making an election under Section 451(d).
- ◆ Identification of the specific crop or crops destroyed or damaged.
- ◆ A declaration that under your normal business practice, the income from the damaged crops would have been included in your gross income for the tax year following the damage.
- ◆ The cause of damage of crops and the dates on which the damage occurred.
- ◆ The total amount of payments received from insurance carriers, itemized with respect to each specific crop and with respect to the date each payment was received.
- ◆ The names of insurance carriers from whom payments were received.

LIVESTOCK SALES

THE LIVESTOCK ELECTION

The election to either roll over the gain or defer it to next year is fairly simple. It is made by not reporting the deferred gain on the tax return and by attaching a statement showing all the details of the involuntary conversion including:

- ◆ **Evidence of existence of the drought conditions that forced the sale or exchange of the livestock.**
- ◆ **A computation of the amount of gain realized on the sale or exchange.**
- ◆ **The number and kind of livestock sold or exchanged.**
- ◆ **The number of livestock of each kind that would have been sold or exchanged under the usual business practice in the absence of the drought.**

Additional resources:

Your county Extension office; the Internal Revenue Service, (800) 829-3676, for forms; your local emergency government office; income tax preparers

Related publications:

UW-Extension publication, "Income Tax Management for Farmers," (NCR002).

IRS Publication 225, "Farmers Tax Guide;"

IRS Publication 334, "Tax Guide for Small Business;"

IRS Publication 547, "Nonbusiness Disasters, Casualties and Thefts."

There are two tax provisions that apply to the sale of livestock because of drought. One allows the taxpayer to roll the gain into the basis of replacement livestock. The other allows the taxpayer to defer reporting the income by one year.

ROLLING GAIN INTO REPLACEMENT LIVESTOCK

If livestock are sold because of drought conditions, the gain realized on the sale does not have to be reported if the proceeds are used to purchase replacement livestock within two years of the end of the tax year of the sale. This applies to livestock (other than poultry) held for any length of time for draft, breeding or dairy (no sporting) purposes.

The new livestock must be used for the same purpose as the livestock that were sold. Therefore, dairy cows must be replaced with dairy cows. The taxpayer must show that the drought caused the sale of more livestock than would have been sold without the drought conditions. The farmer has a basis in the replacement livestock equal to the basis in the livestock sold, plus an amount invested in the replacement livestock that exceeds the proceeds from the sale. In this case, there is no requirement that the drought conditions cause an area to be declared a disaster area by the federal government.

DEFERRING INCOME TO NEXT YEAR

If any livestock are sold because of drought conditions, you may be eligible for another exception to the general rule that the sale proceeds must be reported in the year they are received. This election applies to all livestock. This exception allows the taxpayer to postpone reporting the income by one year.

To qualify, the taxpayer must show that the livestock would normally have been sold in a subsequent year. Additionally, the sale of the livestock must have been prompted by a drought that caused an area to be declared a federal disaster area. It is not necessary that the livestock be raised or sold in the declared disaster area. The sale can take place before or after an area is declared a disaster area as long as the same disaster caused the sale.