

## Chapter 32. Drought Management Considerations

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### Objective

- Review strategies for weathering drought and the financial repercussions expected.

Most Oklahoma producers are impacted by drought one or more times in a ten year period. Typically, the lack of forage (and the scarcity plus high price of hay in some years) forces producers to rethink production, marketing, and management plans. The financial repercussions of one or more years of drought on an individual farm operation depend on its initial financial position, its historical performance and its stage in the business life cycle (start-up, growing, or mature) as well as the financial demands placed on the farm by the family.

Farms with no debt are best positioned to weather financial adversity as they can draw on savings or unused credit to pay for unexpected expenses and support the family through low-income years. The risk of continued operation during poor income years is that owner equity may be eroded unless the investment horizon is sufficiently long to recoup losses. Prolonged periods of low prices and yields might be expected to prompt some older producers with no debt to choose retirement, perhaps liquidating some assets to generate retirement income.

Farms that have been profitable historically may be able to continue operations through several low price and yield years. Lenders may be willing to provide credit to help with cash flow problems or the producers may have sufficient savings or off-farm income to survive. Debt levels will rise and loan repayment will place greater demands on future income, or savings will fall and consequently generate less investment income in the future. Until the operation returns to a profitable status, owner equity will decline.

The operations most vulnerable to low prices and yields are the most highly leveraged farms, often with younger operators. For these producers, one or more years of low prices or yields can jeopardize the operation as the need to generate cash for loan repayment and family living expenses is greater than for comparable size operations with less debt. These producers may contemplate partial or complete

liquidation of the cow herd and, sometimes, the farm or ranch.

Financial stress dictates a reassessment of farm goals and priorities. Goals might include protecting owner equity, minimizing losses, staying in production agriculture regardless of the cost to owner equity, or orderly liquidation of assets. With changing economic circumstances, the risk environment changes, as does the operator's ability to tolerate risk, both personally and financially. New constraints, for instance, limits on borrowing imposed by a lender, must be recognized. Goals that earlier seemed reasonable may no longer be feasible or may conflict with each other. Once goals and priorities have been reassessed, the operator is prepared to develop a plan for dealing with drought and/or financial stress. Discussion of a variety of strategies to cope with scarce forage and financial stress follows. The repercussions—cash flow, profitability, solvency, and tax—of strategies are summarized in Table 32.1.

### BUYING FEED OR HAY

Producers' immediate reaction to a lack of pasture for cows is to begin buying feed or hay. Whether this decision makes sense economically depends on the financial position of the operator and the profitability of the enterprise. For the historically profitable producer, buying feed or hay for more days than usual will reduce the income earned per cow. These producers may be able to afford to feed the cow for several months before incurring a loss. Producers earning less per cow in normal years will have a shorter time frame in which they can afford to buy additional feed or forage for the cow before eliminating potential profit. A producer who has not been profitable historically must decide how much equity he/she is willing to lose in order to feed the cows. If other enterprises are sufficiently profitable or enough off-farm income is earned, purchasing feed for cows may be feasible though not necessarily profitable. However, buying feed or hay for more months than usual will mean that equity will be built up less quickly or, in the case of a loss, eroded more quickly than in the past.

It is an unusual circumstance when drought is accompanied by low non-forage feed prices as happened in 1998. Then, producers could evaluate the possibility of using concentrates to feed cows. It is possible to reduce forage use by 70 to 80% by

**Table 32.1 – Repercussions of management strategies.**

Options for change	Cash flow	Profitability	Solvency	Tax
Buy feed or hay	Increased outflows.	Decreased profitability.	If result is negative net farm income, owner equity will decrease.	More deductible expenses, less income, less income tax. <sup>a</sup>
Rent additional pasture	Increased outflows.	Decreased profitability.	If result is negative net farm income, owner equity will decrease.	More deductible expenses, less income, less income tax. <sup>a</sup>
Extra culling, partial cow herd liquidation	Increased inflows.	Minimizes loss if reducing feed and interest expenses offsets any loss on cull cows sold.	Minimizes loss if reducing feed and interest expenses offsets any loss on cull cows sold.	More taxable income. Some gains can be postponed using one of two elections.
Adjust family withdrawals	Decreased outflows.	No impact on farm profitability.	Retain more farm earnings, increase owner equity. May be temporary effect if only postponing the withdrawals.	No impact on farm income tax. Could reduce itemized deductions.
Adjust farm withdrawals (e.g. postpone capital purchases)	Decreased outflows.	May increase profitability in short run, decrease in long run.	Retain more farm earnings, increase owner equity. May be temporary effect if only postponing the withdrawals.	Fewer deductible expenses, more income tax, but more after-tax profit.
Control costs	Decreased outflows.	Increase profitability if no loss in production.	If profitable, increase owner equity.	Fewer deductible expenses, more income tax, but more after-tax profit.
Increase returns	Increased inflows.	Increase profitability.	Increase owner equity.	More income, more income tax, more after-tax profit.
Change enterprise mix	Depends on enterprise selected. Cash flow plan for alternative enterprise should be evaluated.	Depends on enterprise selected. Increase if enterprise is profitable and complementary.	Increase if enterprise is profitable and complementary.	More net income, more income tax, more after-tax profit.
Change asset ownership <ul style="list-style-type: none"> <li>▪ Renting</li> <li>▪ Leasing</li> <li>▪ Sale/ leaseback</li> </ul>	Increased inflow in short run if assets sold. In long run, decreased outflows if cost of custom hire, renting, or leasing is less than fixed ownership costs, including loan payments.	Increased profitability if cost of custom hire, renting, or leasing is less than ownership and operating costs.	Retained earnings, owner equity increase if cost of custom hire, renting, or leasing is less than ownership and operating costs.	Recapture of depreciation taxed at ordinary income tax rates. Capital gains taxes at 20% (or 10% if individual is in lower tax bracket).
Supplemental income	Increased inflows.	Decline in farm productivity leading to decreased profitability.	If off-farm income offsets farm losses and is invested in farm, increased solvency.	More taxable income, more tax, but greater after-tax cash flow.
Debt rescheduling	Decreased outflows.	Less interest expense in short run will increase profit in short run, decrease profits in years to which repayment is shifted.	Likely to increase solvency in short run, may decrease it in future years if business does not increase profitability.	Less deductible interest expense, more income, more tax (if not operating at a loss). More after-tax profit in early years, less in later years.
Debt restructuring	Decreased outflows, but tarnished reputation regarding repayment.	Increased profitability.	Improves potential to remain solvent.	More taxable income unless insolvent or bankrupt.
Investment by outsiders	Increased inflows.	Increased profitability if invested wisely.	May increase solvency.	More record keeping. Repayment of principal not deductible. More tax when investors repaid.
Complete liquidation	Increased inflows.	N/A	N/A	Recapture of depreciation taxed at ordinary income tax rates. Capital gains taxed at 20% (10% if individual is in lower tax bracket).

<sup>a</sup> Net operating loss = no tax paid. Loss can be carried back 2 years, forward up to 10 years.

limit-feeding some grain to cows. Given the cost of purchasing and hauling hay, limit-feeding grain may reduce the cost of winter-feeding by 25 to 40%. In most cases, a limit-feeding program for cows will require some changes in cow management, may increase labor for feeding, and may require additional feedbunks. These considerations will temper the feasibility of this alternative in some operations.

If the quantities of hay or feed purchased are such that losses are generated, owner equity is decreased. Still, this may be a reasonable strategy if the cows are highly valued seedstock which cannot easily be replaced when circumstances change or if the investment horizon is sufficiently long that losses can be recouped. Buying feed or hay is a flexible strategy in that it may be bought on an “as needed” basis and excess purchases can be stored for future use.

More feed and hay purchases mean more deductible expenses, hence less income tax to be paid at the end of the year. Of course, if a loss is expected, no income tax will be owed anyway. However, if a net operating loss is incurred, it may be carried back two years to generate a refund of taxes paid in the last two years or carried forward up to ten years to reduce future tax.

### **RENTING ADDITIONAL PASTURE**

For the historically profitable producer, renting additional pasture (if it is available) will reduce the income earned per cow and could result in losses to the enterprise. Again, it may be a reasonable strategy if the cows are highly valued seedstock which can not easily be replaced when circumstances change or if the investment horizon is sufficiently long that the losses can be recouped. Renting additional pasture is a longer term, fixed commitment compared to buying feed or hay. Whether it is cost efficient depends on the lease price and the quantity and quality of forage relative to grain and hay. If several additional acres must be rented per cow, potential profits can quickly disappear.<sup>i</sup>

A producer who has not been profitable historically must decide how much equity he/she is willing to lose to pasture the cows if this is the strategy chosen. If other enterprises are sufficiently profitable or enough off-farm income is earned, it may be feasible. However, with the additional pasture costs, as with additional hay or feed costs, equity will be eroded more quickly than in the past.

The tax repercussions of renting additional pasture are the same as those with purchasing hay or grain. Additional expenses reduce current taxable income and after-tax income (or increase the net operating loss).

### **CALF OR COW SALES**

Producers may consider any of the following or a combination of several alternatives for selling calves or cows to reduce forage use and stretch limited forage supplies. Producers facing the most severe forage shortages may consider early weaning calves to reduce the nutritional needs. Selling lighter than usual calves in a down market can result in catastrophic reductions in revenue unless calf retained ownership alternatives are possible. The viability of this strategy depends on available calf management and marketing alternatives.

Normal rates of culling, but earlier than usual, or additional culling, either early or at the normal time, will further reduce forage demands on the ranch, and reduce the need for purchased grain or hay. Cows should be evaluated first for physical and reproductive soundness and productivity. Beyond that, producers may consider additional culling of some older cows. When the cattle industry is in liquidation mode, extra culling is consistent with market signals. Strategically, by culling older cows during a drought when the industry is liquidating cows and replacing them with young cows in the coming months (depending on how fast forages recover), producers will be well positioned to maximize calf production and sales when prices are at cyclical peaks. A producer must not keep more cows than can be maintained in good body condition. Otherwise, poor calf crops and poor herd reproductive performance may later compound the cost of a drought.

The key to deciding how much to cull should be driven by an evaluation of remaining forage resources and the ability to purchase additional feed. Producers are averse to selling cows at very low prices. However, selling more cows than usual generates cash that can be used to feed the remainder and, if enough are sold, proceeds can be applied to operating debt, which will lower interest expenses. Partial herd liquidations provide time flexibility in rebuilding the forage base. For both the historically profitable producer and the cash-strapped, culling extra cows will minimize the losses to equity incurred by operating at a loss.

If partial or complete liquidation of the cow herd is being considered, a question that arises is with respect to timing: When should the cows be sold? Table 32.2 summarizes the increase in cow value needed to justify postponing cow sales. The analysis is based on a 40-cow herd, net sales value of \$425 per cow, other livestock sales of \$540 with a tax basis of \$444, other asset sales of \$4,000 with a tax basis of \$500, and a capital gains tax rate of 20% (plus additional net earnings from renting out land or not leasing land of \$2,400 per year for later sell dates). A spreadsheet to evaluate whether to sell cows now or later is at <http://agecon.okstate.edu/faculty/ffmr.asp>.

**Table 32.2 – Cow-calf analysis: sell cows now or later<sup>a</sup>.**  
Increase in cow value needed to justify waiting to sell

5% opportunity cost on funds	Sell Date		
	2 months	5 months <sup>b</sup>	One Year <sup>b</sup>
No losses	3	69	161
Losses = \$20 per cow	23	89	181
Losses = \$70 per cow	73	139	231
Losses = \$150 per cow	153	219	311
<b>9% opportunity cost on funds</b>			
No losses	6	76	195
Losses = \$20 per cow	26	96	215
Losses = \$70 per cow	76	146	265
Losses = \$150 per cow	156	226	345
<b>Net after-tax price per cow needed to break even with selling now</b>			
	Sell Date		
	2 months	5 months <sup>b</sup>	One Year <sup>b</sup>
<b>5% opportunity cost on funds</b>			
No losses	418	4784	576
Losses = \$20 per cow	438	504	596
Losses = \$70 per cow	488	554	646
Losses = \$150 per cow	568	634	726
<b>9% opportunity cost on funds</b>			
No losses	421	488	610
Losses = \$20 per cow	441	508	630
Losses = \$70 per cow	491	558	680
Losses = \$150 per cow	571	638	760

<sup>a</sup> Assumes current net sales value of \$425 per cow, other livestock sales of \$540 with a tax basis of \$333, other assets that can be sold for \$3,000 with a tax basis of \$500, and a capital gains tax rate of 20%.

<sup>b</sup> Includes additional net earnings from renting out land (or not leasing land) of \$2,400 per year.

## ADJUST FAMILY OR FARM WITHDRAWALS

Producers should be sure that their expectations with respect to the farm's ability to generate income are realistic. Curbing family living expenses frees up cash to be used for cow maintenance. Developing a budget, living within it and minimizing nonessential spending may allow producers to pay down high

interest loans and credit card debts, reducing future cash obligations in loan repayments. Postponing major expenditures or purchases (for example, a new vehicle) may however increase future demands on farm income. Reduction of family withdrawals could reduce itemized deductions if the reduction comes in items such as charitable contributions or medical expenses. However, most farmers' standard deduction is higher than their itemized deductions.

Likewise, delaying farm capital purchases (for example, new machinery, equipment or vehicles) and postponing improvements are obvious strategies to preserve cash for cow maintenance. As with postponing family living expenses, the repercussion may be a greater demand on farm income in future years. Even though producers may be able to write off part of the costs of asset purchases, purchases should not be motivated by tax "benefits." The cash required to make new vehicle payments will pay for substantial repairs on an owned vehicle. And, costs of ownership for some items on a per acre or per head basis may exceed the cost of renting or leasing it.

## CONTROL COSTS

Periods of financial stress are a good time to do an internal audit of the operation. Are inputs being purchased as cheaply as possible, for instance, buying feed in bulk rather than in sacks? Producers should look most closely at high cost items—often interest, machinery, rent, feed, fertilizer, and labor. Some costs may be relatively fixed; others may be negotiable. Some costs may be reduced by substituting comparable but less expensive inputs (for example, adjusting feed rations to utilize low price grains) or using them more efficiently (for example, feeding hay in rings so as to minimize waste). Controlling costs will reduce deductible expenses, but increase after-tax profits.

## INCREASE RETURNS

Improving marketing and production practices can increase farm returns. Having a deliberate marketing plan, producing at the level at which costs would increase more than returns if the crop or livestock yield were increased and utilizing all assets that have income potential are keys to maximizing profits. Perhaps range or timberland could be leased for hunting. Underutilized machinery and equipment could be leased out or used for custom farming.

If grain is relatively inexpensive, it may be beneficial to consider confined feeding of cull cows for 30 to 60 days before marketing. Although this

requires additional feed, the payoff may be quite high. With cheap grain, feeding some concentrate feed (with minimal hay) to cull cows may significantly enhance the value of those cull cows, especially if they are thin because of drought-reduced feed conditions. In addition to having more pounds to sell, feeding cull cows may increase their price because of increased dressing percentage or an increase in quality grade.

In 1998, calf prices dropped sharply in the summer and fall, precisely at the time when drought was forcing many producers to consider early weaning of calves. Fortunately, changes in cattle price relationships and decreasing grain prices simultaneously increased the viability and attractiveness of retained stocker programs. The feasibility of retained stocker programs is driven largely by the relationship between calf and feeder cattle prices. It is a characteristic of the cattle industry that, when prices are high in absolute terms, calf prices tend to be relatively higher than feeder prices. Similarly, when prices decrease, calf prices tend to fall relatively more than feeder prices. Thus, at low prices, the value of stocker gain is higher than at high prices. For example when the 450 lb steers price is \$105/cwt, the 750 lb steer price might be \$80/cwt. Thus, 300 lb of gain has a per head value of \$127.50 ( $7.5 \text{ cwt} \times 80/\text{cwt} - 4.5 \text{ cwt} \times 105/\text{cwt}$ ) or a per pound value of \$0.425. When calf price drops to \$80/cwt, feeder price may drop to \$70/cwt, resulting in a per head value of gain of \$165 ( $7.5 \text{ cwt} \times 70/\text{cwt} - 4.5 \text{ cwt} \times 80/\text{cwt}$ ) or \$0.55/lb for the 300 lb of gain. In 1998, the collapse of cattle prices resulted in a pronounced increase in the value of stocker gain thereby creating a good retained ownership opportunity.

In the absence of forages typically used for grazing stocker cattle, producers can consider limit-feeding calves using concentrate diets in confinement or semi-confinement. Calves can be “program” fed to gain a target rate of gain, probably about 2 lb per day depending on calf size and marketing intentions. This type of backgrounding program requires some changes in management. Producers should evaluate implications for production and health management of the cattle, additional labor requirements and the possible need for additional facilities and equipment for the confinement-feeding program. Moreover, retained ownership exposes the producer to additional market risk so price risk management should be an integral part of the retained ownership program.

Learning new marketing or management skills may require an investment in time and money. Again, more income may increase tax paid but will also increase after-tax cash and profits.

## **CHANGE ENTERPRISE MIX**

A whole farm financial plan, complete with enterprise budgets, is a useful means of identifying farm profit centers. Knowing the relative contributions of different crops and livestock allows producers to redirect resources (for instance, labor or land) to profitable enterprises and away from less profitable enterprises. Producers may want to consider a new, promising enterprise if it fits with the rest of the farming operation and farm and family goals.

Reallocating resources can improve farm profitability, resulting in more taxable income. The impact on cash flow depends on changes in the levels of production of existing enterprises, whether capital assets are sold or purchased, and the cash flow demands of new enterprises added. Since marginal tax rates are less than 50%, additional income or reduced expenses will yield additional after-tax profit.

Individual assistance in farm financial planning is available through the IFMAPS program (<http://agecon.okstate.edu/ifmaps> or 1-800-522-3755).

## **CHANGE ASSET OWNERSHIP**

If loan payments are crippling cash flow, producers should evaluate the cost of leasing rather than owning assets, including land. While producers often feel that they must own land to be farmers or ranchers, some enterprises will not generate the cash necessary to make principal and interest payments. Producers should also evaluate whether machinery and equipment is earning its keep, particularly on small operations. Older equipment that is fully paid for and depreciated will not contribute to cash flow or profitability problems (unless repair costs and associated down time are very large). However, new machinery and equipment purchases can contribute to cash flow and profitability problems if the assets are held for a relatively short period of time and used on small acreage. A financial lease is another alternative to owning machinery and equipment. Custom hiring can also be a reasonable alternative when equipment is expensive and used infrequently.

Selling underutilized assets generates cash which may be needed to maintain cows in the short run. Remember that taxes must be paid on gains as they

were with cull cows. Liquidation of capital assets and recapture of depreciation may increase income tax. This additional tax must be weighed against potential cost savings. And, in planning for the future, annual operating costs will be higher as cash will be needed to make lease payments or hire custom operators. New risks are introduced if assets are sold that make the producer dependent on the custom operator to complete tasks in a timely fashion.

### **SUPPLEMENTAL INCOME**

Farm income can be supplemented through income from an off-farm job, from custom work done for other farmers or from a home-based business. Extra cash will help alleviate cash flow problems. Additional time away from the farm business could lead to a decline in productivity. Thus, the potential benefits of another job or business must be weighed against the costs. More income generated means more income taxes payable but greater after-tax cash flow.

### **DEBT RESCHEDULING**

Large interest and principal payments in a drought year can be devastating. If the farm has been historically profitable, lenders may be willing to reschedule the loan payments by changing the length of the loan. Rescheduling spreads the principal payments over a longer period, thus reducing the principal payments in the short run, but obligating the producer to repayment for more years. If financial conditions improve, the operator may be able to repay during the original time frame if no pre-payment penalty is included in the renegotiated loan contract. If the inability to fully make principal and interest payments is caused by lack of profitability in addition to drought stress, then shortfalls will likely recur despite rescheduling.

Reducing interest expenses reduces deductible expenses, increases taxable income, and increases after-tax profit in the short run. However, lengthening the repayment period means more total interest expenses over the long run and a reduction in profit in later years.

### **DEBT RESTRUCTURING**

A lender may be willing to write down either principal or interest if the repayment ability of the borrower is less than the scheduled payments or if the value of the loan collateral has declined to a level below the debt commitment. The lender's

willingness and ability to negotiate will depend on both the borrower and lender's financial condition as well as the regulations governing the lending institution. A permanent lowering of principal and interest obligations helps both cash flow and producer profitability (it does the opposite for the lending institution), but tarnishes the future business relationship. Forgiven debt is taxable income, unless the farmer is insolvent or in bankruptcy.

### **INVESTMENT FROM OUTSIDERS**

If the producer is willing to give up some share of ownership in the operation, an infusion of cash from outside can alleviate financial problems. An off-farm heir or another producer may be willing to provide cash to reduce indebtedness or pay bills in return for a share of the business; a lender might be willing to trade a debt obligation for an equity position in the operation. An equity infusion increases cash available and reduces financial risk by increasing the equity capital base. However, taking on additional partners means sharing future business returns or repaying in some other fashion, for instance, transferring ownership of specific assets. Repayment of principal is not a deductible expense.

### **COMPLETE LIQUIDATION**

If the financial situation of the farm or ranch is beyond repair, the best choice may be to end the business, salvaging any remaining equity. Recapture of depreciation is taxed at ordinary income tax rates. Capital gain (sales price greater than purchase price) is taxed at 20% (or 10% if the individual is in the 15% tax bracket).

### **TAX CONSIDERATIONS**

A review of existing tax laws that might come into play as producers make operating changes to minimize the negative impacts of drought follows. The Jobs and Growth Tax Relief Reconciliation Act of 2003 also provides some benefits to agricultural producers. Consult a tax professional to determine if you qualify.

The Act reduces the maximum capital gains rate for sales of capital assets from 20 to 15% and from 10 to 5% (for 2008 only, the 5% rate goes to zero), effective for sales after May 5, 2003. These lower rates will generally apply to capital assets sold or exchanged and installment payments received after May 5, 2003. The Section 179 Expense election has been increased from \$25,000 to \$100,000 for tax years beginning January 1, 2003 and ending

December 31, 2008. In addition, the threshold for phasing out the Section 179 expense election has increased from \$200,000 to \$400,000. Therefore, if a farmer placed in service more than \$400,000 of qualified property in one tax year, the amount allowed under Section 179 is reduced dollar for dollar. The 2003 Act has also accelerated the reduction in the tax rates above 15%. For 2003, the tax rates will be 10, 15, 25, 28, 33, and 35%.

Farmers can use either of two provisions to defer gain recognized on the sale of livestock sold after 1996 on account of drought, flood, or other weather-related conditions. Both apply only to weather-related sales of livestock in excess of normal business practice. The first allows farmers to postpone reporting of gain from the sale of any livestock for one year. The other provision allows farmers to postpone gain from dairy, draft, or breeding livestock if like animals are replaced within two years of the end of the tax year of the drought sale. Poultry and livestock for sport are not eligible for postponement of gain. Gain is postponed only for sales in excess of normal sales and is subject to other requirements (see IRS Farmer's Tax Guide, Publication 225). The new replacement livestock must be used for the same purpose as the livestock sold. Therefore, dairy cows must be replaced with dairy cows. And, if the farmer normally culls or sells one-fifth of the herd each year, only the sales in excess of one-fifth qualify for postponement of gains. The farmer's tax basis in the replacement livestock equals the basis in the livestock sold plus any amount invested in the replacement livestock that exceeds the proceeds from the sale. The Farm Service Agency must declare the producers' area eligible for federal assistance.

Income averaging for farmers continues to be allowed. Farmers can elect to remove all or part of current farm income from total taxable income and spread it over the three preceding years. Tax would be based on the marginal rate effective in the last three years. The potential reduction in tax applies only to income tax and would not reduce self-employment tax in the current or prior years. Attempting to keep taxable income level over the years can maximize long run after-tax profit. Because of the progressive nature of tax rates (higher taxable income is taxed at higher marginal tax rates), level taxable income reduces taxes paid.

The Net Operating Loss (NOL) carry-back period is maintained at two years and the NOL carry-forward period is still twenty years. A 3-year carry-

back is allowed for NOLs attributable to casualty losses of individuals and NOLs of small businesses attributable to losses incurred in federally declared disaster areas. The provision is effective for NOLs arising in taxable years after 1997. The carryback period for farming losses is five years.

A larger than normal liquidation of capital assets may cause taxable income to increase if depreciation is recaptured. Decisions to liquidate or sell major assets may hinge on determination of the after-tax proceeds of such sales. Taxable proceeds equal the asset's sale price less its adjusted tax basis. Tax basis depends on how the asset was acquired: purchase, gift, or inheritance. The donor's tax basis transfers to the donee for gifts, and the tax basis of inherited assets is generally the fair market value of the assets at the decedent's time of death. The tax basis of purchased capital assets is the purchase price (even if the money is borrowed). The adjusted basis is the purchase price less depreciation taken. Depreciation is a method of allocating the fixed cost of the purchase of a capital asset over its useful life. Depreciation for tax purposes is limited by the IRS specification of an asset's fixed useful life and fixed depreciation methods. One-half year of depreciation is allowed both in the year of purchase and the year of sale. While most farm assets are assigned a fixed life of 5, 7, 10, or 15 years, a special election (Section 179 Expense election) allows a current expense deduction of up to \$18,500 of the cost of a purchased capital asset. If assets such as purchased breeding livestock are sold for more than the adjusted basis, the gain due to depreciation recapture is taxed at ordinary income tax rates. Proceeds from sales of depreciable assets or land are eligible for capital gain tax rates only to the extent these assets are sold for more than the original purchase price. Thus, the net proceeds are a function of an asset's purchase and sale price, adjusted tax basis and depreciation taken, length of time the asset was owned, and the producer (or business) tax bracket.

For example, a breeding beef cow is purchased in 2004 for \$500, the IRS fixed life is five years, and the method for calculation purposes is straight-line. Depreciation for 2004 is \$50 as only one half year of depreciation is allowed in the year of purchase. Depreciation for 2005 is \$100. If the cow is sold in 2006, an additional \$50 depreciation is allowed in the year of sale. The cow's adjusted basis is \$300. If the cow is sold for \$300, there is no gain or loss and no tax is owed. If the cow is sold for \$400, a gain of \$100 is recognized due to recapture of depreciation

taken, and this gain is taxed at ordinary income tax rates up to 35%. If the cow is sold for \$600, the gain due to the \$200 of depreciation taken is taxed at ordinary income tax rates and the \$100 gain in excess of original purchase price (\$500) is treated as capital gain taxed at 15% (or 5% if in the 10% or 15% tax bracket).

When farmers turn over assets to creditors in lieu of repaying debt, voluntarily or not, a tax liability can result. To continue the above example, assume the original loan to purchase the \$500 cow has been refinanced and a total of \$600 is owed. The cow is turned over to the lender and sold for \$400, and the remainder of the debt is forgiven. The farmer is treated as if he sold the cow for \$400 and owes \$100 of depreciation recapture taxed at ordinary income rates. In the view of the IRS, a \$400 cow has been traded for a \$600 reduction in a liability, which is treated as taxable income to the farmer. Thus, \$300 of taxable income (\$100 of recaptured depreciation plus \$200 debt forgiveness) is generated though not a penny is received. In special cases, where the farmer is not solvent or is in bankruptcy, the debt forgiveness may not be taxable; however, there is no provision to escape the tax owed on the \$100 of depreciation recapture.

## CONCLUSION

Almost annually, some Oklahoma producers experience financial stress due to drought. Adjustments may be needed in the farm plan or family spending to deal with this stress. Strategies to compensate for loss of forage may include purchasing feed or hay, renting additional pasture, or selling livestock. To alleviate cash flow problems, producers may consider adjusting family or farm withdrawals, postponing capital purchases, controlling costs, increasing returns, changing asset ownership or control agreements, and supplementing income through custom work, an off-farm job or another business enterprise. Debt rescheduling, debt restructuring, and investment by outsiders are also

possibilities but require willing partners. If profitability has been an ongoing problem, changes in enterprise mix as well as production and financial management may be needed. The appropriate strategy or combination of strategies for farms with financial stress depends on both family and business factors. While the business financial position and historical performance are very important, the willingness and ability to change, the tolerance for risk both personally and financially, market conditions, potential tax liabilities, and farm and family goals must also be considered.

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<sup>i</sup> OSU CR-216 reports average Oklahoma pasture rental rates.