

Texas Panhandle Producers Face Tax Implications from Drought Related Losses

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Much of the United States has experienced abnormally dry conditions over the past thirty-six months. The situation is especially severe in Texas, where many face financial hardships. At the beginning of 2014, 108 Texas counties were designated as natural disaster areas, primarily due to extreme drought conditions. Many more are experiencing some form of low moisture environment, and state reservoirs are only 65% full. This situation has fueled wildfires, ruined crops and pastures, and strained economic resources. Wildfires pose a significant threat to both people and property. During the 2011-2013 seasons (November 15, 2010 to September 1, 2013), approximately 49,421 fires scorched 4,198,041 acres and 3,030 homes in Texas. Damages were particularly severe in the Panhandle region due to strong winds, unseasonably warm temperatures, and low humidity (Texas Forest Service, 2013).

Agricultural industries have been negatively impacted by low rainfall conditions. Economists estimate more than \$7.6 billion in lost revenues over the past 36 months. Furthermore, the price of hay has increased by 200% during this time, causing feed costs to skyrocket. These factors prompted Texas ranchers to severely cull their herds and sell off large numbers of cattle in auctions. Similar drastic measures have been taken in the Panhandle region due to its large number of livestock operations. According to *The Impact of Agribusiness in the High Plains Trade Area*, this region accounts for 73.6% of state fed cattle production, 9.1% of other beef production, and 24% of dairy revenues (Amosson, 2009).

Recent rainfall deficits have caused wildfire damages and livestock liquidations in the High Plains and throughout Texas. This situation could pose several financial management challenges. For example, in a typical year any gain on property loss reimbursement (insurance payments) or the sale of livestock is subject to taxes. However, additional options should be explored for those who experienced wildfire destruction or were forced to sell cattle due to extreme drought conditions.

The following sections discuss three tax alternatives that apply to property insurance indemnities and cattle liquidations in excess of normal business practices. The first option (IRS Form 4684) allows producers to postpone reimbursement gains for up to four years. The second (IRS code 1033) pertains to draft, breeding or dairy animals that will be replaced within a given time period. The final alternative (IRS code 451) allows a one-year postponement in reporting sales proceeds on raised livestock.



“Good tax management can help minimize potential cash flow problems from wildfire and drought losses.”

**Dr. Steve Amosson, Texas
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Reporting casualty losses on IRS Form 4684 allows farmers and ranchers to defer any gains that result from insurance reimbursements for fire related losses associated with fences, equipment, etc. Producers have up to two years under normal circumstances and four years during times of disaster to utilize any money received for property restoration or replacement. The replacement period begins on the date their property was damaged, destroyed or stolen. It ends two or four years following the tax year in which the gain is realized. The four year option is available only to those located in a federally declared disaster area. To be eligible for deferment, producers must attach a statement to their tax return indicating the date and details of their casualty, the amount of insurance or other reimbursement received, how the gain was calculated, and proof of a disaster declaration (if applicable).

Example

- Two miles of fence with a remaining tax basis value of \$2,500 is destroyed by fire in 2013 in a federally declared disaster county.
- A rancher receives \$7,500 from his insurance company for the loss.
- By utilizing Form 4684, he can postpone a reimbursement gain of \$5,000 (\$7,500 minus \$2,500) for up to four years. During this time, proceeds of the gain can be offset by expenditures incurred to repair and replace the property.

Under the 1033 election, drought liquidations of breeding livestock are considered involuntary conversions of capital equipment. Gains can be postponed for up to two years in typical circumstances and four years during times of disaster if animals are replaced (county must be declared a disaster area). All replacement cattle should be used for the same purpose as the livestock that was sold. For example, beef cows must be replaced with beef cows. The taxpayer also has to show that adverse weather conditions caused the sale of more livestock than normal. Gain postponement is only allowed on those animals sold because of the unfavorable weather.

To be eligible for a 1033 election, producers must attach a statement to their tax return indicating the existence of an adverse weather-related condition, proof of a disaster declaration (if applicable), and documentation listing the amount of gain realized on liquidated cattle. They should also show the amount and kind of livestock sold or exchanged, and estimate the number of animals typically sold or exchanged under normal weather conditions.



Example

- A rancher usually sells about 20 cows per year. During 2013, 40 cows are sold with 20 marketed because of extreme drought. Let's assume the cows were raised (this would give them a zero tax basis), and sold for \$800 per head for a gain of \$32,000.
- Section 1033 allows the producer to defer 50% of the gain (20 cows sold because of drought out of 40 total head), or \$16,000.
- If the rancher replaces the 20 head sold because of drought within four years at \$800 per head, he will have a tax basis of zero dollars in the replacement cows.
- If he replaces the 20 head within four years at \$1,200 per head, there is a tax basis of \$400 (\$1,200 minus \$800) per head in the replacement cows.
- If he replaces 20 head within four years at \$500 per head (\$10,000 total), there is a tax basis of zero in the replacement cows, and he will need to amend the 2013 return to show a gain of \$6,000 (\$16,000 minus \$10,000).
- If the producer only replaces 10 of the 20 head within four years at \$800 per head (\$8,000 total), there is a tax basis of zero dollars in the replacement cows. The 2013 return should be amended and indicate a gain of \$8,000 (\$16,000 minus \$8,000).

Section 451 allows cattle owners to postpone gains for one year on raised livestock only. To qualify for this election, taxpayers must show that their principal business is farming or ranching and use the cash method of accounting. They should also demonstrate that the livestock would normally have been sold at a later date but were liquidated early due to drought. Additionally, they must provide proof that the sale of livestock was caused by weather conditions from a region (county declaration or contiguous county) officially declared a disaster area. The liquidation can take place before or after a disaster is declared as long as the same disaster caused the sale. Income can be postponed only on those cattle liquidated as a result of weather-related causes.



Example

- Assume a rancher sells 70 head of calves in 2010, 72 head in 2011 and 68 head in 2012. He "normally" retains 7 to 10 heifers each year for herd replacement. However, due to dry weather in 2013 he cannot keep the heifers and markets 77 calves. They are sold at an average weight of 450 pounds for \$2.00/lb. Total income received is \$69,300.
- If the average sale in a typical year is 70 cattle $[(70+72+68)/3]$, only the income on the 7 additional head marketed because of drought can be deferred at a value of \$6,300 $[(\$69,300/77)*7]$.



“Wildfire and drought losses are subject to special tax treatments, and producers need to be aware of their implications.”

**DeDe Jones, Texas A&M
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Extreme weather conditions experienced during recent years have produced havoc for Texas agricultural producers and caused many to face property damage and early livestock liquidations. Such unplanned events often create more revenue than usual in a given year, generating income tax issues. Several options including IRS Form 4684, IRS code 1033 and IRS code 451 are available to help farmers and ranchers deal with weather-related issues in excess of normal business practices. Producers are encouraged to contact a tax accountant to determine the option that best fits their operation and business plan.

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