Working With Your Lender In Times of Financial Stress

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Periods of low prices commonly cause farmers and ranchers to: a) have difficulty in making payments on loans, b) seek new loans and/or c) desire a restructuring of loan conditions. In each of these cases, your ability to work with your lender(s) may make the difference between a successful resolution and a decision by a lender that is less than desirable. While no easy solution is available during difficult times, there are things you can do as a borrower to assure the best outcome possible. Your actions will generally center around periods when action is needed. These include early recognition and warning, making plans to meet obligations, meeting with your lender and implementing your plan of action.

Early recognition

There is probably no factor that is as important to a good working relationship with a lender as early recognition that a problem exists. If you will not be able to make a payment or if different payment arrangements are needed, recognize this need before payments are due. Take the opportunity to visit your lender and indicate that you anticipate a need for some change(s). This is also a good time to indicate that you are working on a plan than you want to discuss with him/her at a later date. In short, recognize that a problem exists and **become proactive**. Do not wait to contact your lender after a payment is due. Your lender recognizes that periods of low prices lead to financial difficulties. You also need to know that you are not the only beef operator that is having difficulty. But, you need to make sure your lender recognizes that you are aware of the situation and that you plan to do something about it.

Planning to meet with your lender

Meeting with your lender in times of difficulty will almost always be stressful. But, several things can be done that can make your visit as pleasant and productive as possible. The most important thing that needs to be accomplished is to prepare for the visit. This will involve several steps.

While record keeping is "drudgery at its worst" for many farmers and ranchers, there is probably nothing that is more important to a lender than evidence that you are keeping track of your financial situation. If someone else keeps your records for you (e.g., an accounting firm or record keeping service) obtain the latest information available. If you or a member of your family does this, make sure all of your entries are up to date and summarized. This is the time to carefully review all financial statements that are available (balance sheets, income statements and cash flow budgets). Special attention should be given to the liabilities side of a balance sheet —— what payments are due (principal and interest), to whom and when are payments to be made. Next you should estimate if these payments can be paid. If there is evidence that some of the payments cannot be met, your next step is to formulate a plan of action. Numerous actions might be taken (e.g., selling part or all of the breeding herd, obtaining off-farm employment and restructuring loans) but, actions that will have a major impact on cash flows will differ from what has been done in the past. Many of the actions that might be considered will be discouraging (e.g., selling an asset that has sentimental value) but, ultimately some difficult decisions will either be made by choice or forced upon you if debt payments cannot be met.

Meeting debt payments ultimately means that net cash flow must be increased. This means that some combination of the following actions must occur—increase in revenue, decrease in operating costs, sale of capital assets, reduction in family living expenditures or a change in repayment schedules. Some of these have greater potential than others.

Many actions can affect revenues but these either involve greater efficiency (e.g., reduced death loss) or marketing alternatives that increase the prices received. These actions commonly involve time, may not affect cash flows in the short run (e.g., improvements associated with breeding) and will not be obtained freely. One alternative that may however, assist in the short run is obtaining off farm income. This usually means that other members of the family will need to do more to meet the day to day demands of the ranch (e.g., feeding, irrigation or home care).

Nearly everyone advocates that costs need to be reduced during times of stress as well as times of plenty. The costs that are most commonly suggested are production related (are you a low cost producer?). But, some costs need to be carefully evaluated that are not production related. These include the amount taken out of the business for family living that are commonly paid from ranch funds (e.g., home payments, fuel, health insurance, utilities). One of the most difficult decisions that may be needed involves labor—is extra help really needed? Which of these costs can be reduced without adversely affecting net returns?

The alternative that most borrowers seek for lenders is some redress in payments. This may involve restructuring existing loans and/or taking out a new loan(s). This however, places most of the burden and risk of adjustment on the lender and will be resisted. If this is the preferred alternative, evidence must be shown that the borrower is also making adjustments that he/she considers to be a sacrifice.

The area that many operators least like to consider is the sale of capital assets. But, the sale of non productive assets (e.g., recreational vehicles, extra equipment, vacation homes/timeshares) must be one of the first things considered in times of financial stress.

Meeting with your lender

The time and place you meet your lender(s) to outline your plan of action is important. The most common place to meet is in the lenders office at a time that he/she specifies. This is the place where your lender will feel most comfortable because he/she has access to information (e.g.,files and computers). This is also where your lender will do almost all of the analysis associated with your operation. But, this location may not always be in the best interest of the borrower. Some producers have found that at least one lender/borrower meeting can be profitably held on the ranch—around <u>your</u> kitchen table or in <u>your</u> home office. This does several things that favor you as a borrower. First, your lender is on your turf and can see how you live. Secondly, any additional information concerning your operation (e.g., ability to see assets, access to records) should be readily available. Your ability to "show me" is significantly enhanced in this environment. Third, your ability to have your lenders full attention is enhanced because they are not close to a phone or other normal office operations.

Before you meet with your lender, you need to be prepared in several areas. First, these are extremely important meetings and should be treated as the most important thing that is to occur at that time. Be on time for the meeting and make arrangements so the time needed for discussion will likely be uninterrupted (e.g., children will not interrupt, chores are completed). Secondly, if the meeting is to be held at the ranch take some time to make the place "look good". This does not mean that major efforts are needed but the home, yard and premises are at least as "clean and tidy" as you. Third, a person needs to be designated as the primary spokesperson if the business involves several people. Fourth, and most importantly, have your proposed plan of action clearly outlined. Indicate what actions you plan to take and what you want your lender to do. You should anticipate what objections your lenders may have to your plan. You should try to anticipate what questions your lender will raise and be prepared with a reasonable answer(s)—"I don't know" may be an acceptable answer at the time but every question asked needs to be carefully and honestly answered as quickly as possible. Providing answers to some questions (e.g., what were funds used by the family used to purchase?) may appear to be too personal but commonly are needed by lenders when difficult decisions must be made because these questions will be asked of the lender when he/she meets with superiors or loan committees. Personal opinion rarely carries much weight in these meetings. You need to help prepare your lender for these meetings—documentation and analysis ("number crunching") are essential to a successful loan presentation— if he/she is to be an advocate for a decision that has been mutually agreed upon but, is subject to approval by the lending organization. Other options that you have also considered need to also be discussed with your lender. This will usually require more than one meeting before the actions to be taken by the lender and borrower can be mutually agreed upon.

If your lender is not willing to accept any of the actions that you believe are acceptable, the natural reaction will be anger and frustration. Resist expressing this to your lender because nothing productive is accomplished. If an agreement cannot be reached with your current lender you may need to seek another lender (the same general procedure outlined above is suggested) or other plans are formulated. Should none of these alternatives prove to be acceptable to lenders, it may mean that mediation is necessary (mediation programs are available in most states) or other more drastic action (e.g., liquidation or bankruptcy) may be necessary. In these circumstances, many borrowers turn to the legal system for solution. In some cases this may be justified but, remember that this solution can be very expensive (legal fees are normally high). Most lenders will try to avoid bankruptcy because it is not commonly the least cost way of handling the situation for either the lender or borrower.

Implementing the plan

If your plan of action is accepted by your lender(s), the burden of implementation is squarely on you. Do not expect your lender to follow up and see how you are doing—keep him or her informed of progress and of adjustments that are needed. Regular communication with your lender concerning major decisions that may affect your operation becomes even more important in times of stress.

A strong borrower/lender relationship requires open, honest and regular communication by both parties. If this cannot be developed you should ask to work with someone else in the organization/firm or change your lender. A decision to change lenders however, should not be taken lightly because the monetary and administrative costs are commonly substantial.

Improving your relationship with your lender is an important part of implementing any plan of action. However, nothing will make this relationship stronger than demonstrating that the actions taken were beneficial to you and your lender.

Should I Sell My Cow Herd?

By

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Low cattle prices are discouraging, and may lead you to consider taking drastic steps to combat this problem. You may even be wondering if you need to sell part or all of your cow herd in order to minimize your losses and survive. This fact sheet can't make that decision for you, but it can help you determine the benefits and costs of a herd liquidation. It will also review your investment alternatives for the proceeds of liquidated breeding stock.

As you consider your herd liquidation options, be sure to go back and review your goals (refer to the "Integrated Management and Goal Setting" fact sheet). Will the sale of some or all of your cows allow you to make progress toward any of the goals you have set? If your goals emphasize non-economic factors (such as enjoying a rural quality of life, raising cattle because you like working with livestock, or bringing up children in a farm environment), then selling your cow herd may not contribute much toward achieving your goals. For goals that are primarily related to economics (such as earning at least $20,000 annually, increasing equity by $50,000 over the next five years, or realizing a 10 percent rate of return on your investments), selling your cows may be an alternative worth condsidering.

Unfortunately, economic realities may force you to abandon, postpone, or revise your goals. Overdue loan payments, unpaid bills, or unmet family living needs may require that significant amounts of capital be raised immediately to fulfill a more fundamental goal of financial survival over the next few years. The next section of this fact sheet presents a discussion of the benefits and costs of a herd reduction.

Herd Reduction Impacts

Cost Structure

Why are you considering selling your cows? It is probably because you are losing money on every calf,and you think that selling fewer calves will reduce your losses. But, it's not as simple as that. Before making a rash decision, you must first analyze your unit production cost and cost structure. If you haven't already done so, work through the fact sheet "Determining the Economic Reality of Your Cow Herd" to estimate your total unit cost of production. If your unit production is larger than the current and short-run expected price of calves, then you are indeed operating at a loss, and should consider your downsizing alternatives.

In addition to considering your total unit production cost, you must also evaluate your cost structure. Determine what portion of your production cost is fixed, and what portion is variable. This ration will have a significant impact on the benefits or costs you will experience by liquidating your herd. Consider the following examples.

Jones and Smith operate two different ranches. Refer to Table 1. Each has 200 cows, with a total unit cost of production of $80/cwt. Jones' cost structure includes high variable costs and low fixed costs, while Smith's cost structure has much higher fixed costs and lower variable costs. At their current herd size, assuming each sells about 4 cwt. of calves per cow for $60 per cwt., they are both losing $16,000 per year.

Now suppose the ranches reduce their herds by selling 100 cows, and they each net $35,000 from the sales on an after-tax basis. Refer to Table 2. If they sell their less-productive cows, then average production per cow should increase. This will lower the average variable cost per cwt. of each calf produced. Fixed costs also change. The example assumes that the revenue generated from the cow sales reduces total annual fixed cost by 25 percent of the sale proceeds (or $8,750 per year). Jones' total fixed cost declines to $15,250, and Smith's total fixed cost drops to $31,250. However, each ranch now has fewer cows producing fewer calves to spread their costs around, so average fixed cost per cwt. rises. Because Jones had lower initial fixed costs, the net effect of the herd reduction is a decrease in the ranch's annual loss by $7,750. The Smith ranch loses more money after reducing the herd, because total unit production cost has increased dramatically. Under the stated assumptions, the herd reduction was only beneficial for the ranch with the high variable/low fixed cost structure. Therefore, a reduction of the cow herd during low price periods is not beneficial for every farm.

Cow Sale Prices

The current market value of cows also influences the results of herd reductions. As calf prices fall, the value of breeding stock and cull animals also declines. The chart below illustrates the sharp decline in utility cow prices which has occurred since early 1995, with prices dropping from about $50 per cwt. on average during 1990 through 1994, to $35 per cwt. by the Spring of 1996. Remember the marketing maxim: "Buy low, sell high." Sales of cows over the next couple of years will probably not take place at high prices. In fact, many producers that are reducing their herds bought them at high prices (by retaining heifer calves worth $100/cwt. or more as replacements) and are being forced to sell them at today's low prices.

Tax Implications

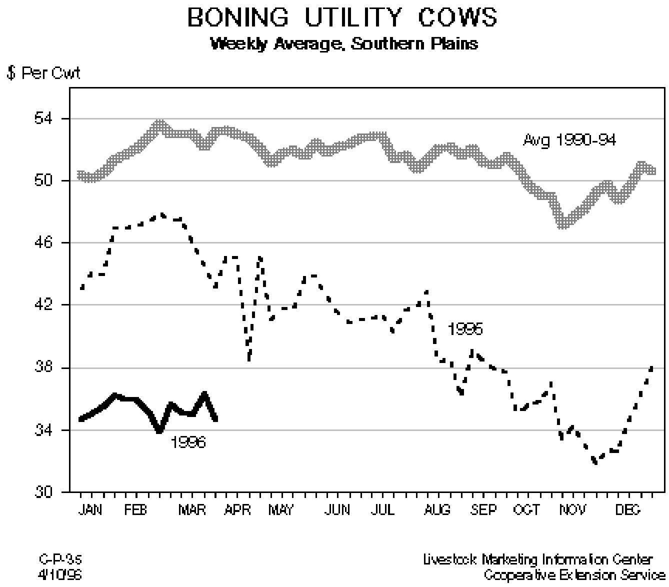
A sale of breeding animals can have significant tax consequences for operations already facing tight financial situations. Capital gain realized from the sale of the animals is subject to income tax. Capital gain is the gross sale price of livestock minus the expense of the sale. Federal taxes are paid on capital gains at rates of up to 28 percent, just like ordinary income. This means that in a year when a

Table 1.

Before Herd Reduction	Jones Ranch	Smith Ranch
Number of Cows	200	200
Variable Production Cost/cwt.	$50.00	$30.00
Fixed Production Cost/cwt.	$30.00	$50.00
Total Production Cost/cwt.	$80.00	$80.00
Production per Cow	4 cwt.	4 cwt.
Market Price/cwt.	$60.00	$60.00
Annual Return	($16,000)	($16,000)
Total Fixed Cost	$24,000	$40,000

Table 2.

After Herd Reduction	Jones Ranch	Smith Ranch
Number of Cows	100	100
Variable Production Cost/cwt.	$44.44	$26.67
Fixed Production Cost/cwt.	$33.89	$69.44
Total Production Cost/cwt.	$78.33	$96.11
Production per Cow	4.5 cwt	4.5 cwt.
Market Price/cwt.	$60.00	$60.00
Annual Return	($8,250)	($16,250)
Total Fixed Cost	$15,250	$31,250



substantial herd reduction occurs, the gain from selling your cows effectively increases your Federal taxable income, and may reduce your proceeds by up to 28 percent. Consult a tax professional to explore the income tax consequences of a herd reduction before you engage in any sales. Remember that state income taxes may also be incurred.

Investment Alternatives

Suppose you do sell part or all of your cow herd. Have you developed a plan for what to do with the sale proceeds? From a financial standpoint, you may have many options (or demands) on these funds. To gain the most benefit from the herd sale, funds must be invested wisely.

Pay Off Cow/Calf - Related Loans

Your first objective after a herd sale should be to pay off any loans directly related to the cows just sold. This might include loans obtained to purchase the cows or resources which used exclusively in cow/calf production. These loans were essentially made to allow you to operate a cow/calf "factory". They were structured to be repaid over a period of years because the "factory" was expected to operate over that same time period. If part or all of the "factory" is sold, then loans against it should be immediately repaid to the extent possible.

Loans outstanding which financed resources used in other cattle production enterprises may not be logical candidates for payoff. For example, suppose a land loan was obtained to finance the purchase of 160 acres of land for hay production. This hay land does not have to be used to support the cow/calf enterprise. It could be used for stocker cattle grazing, cash hay sales, or some other enterprise. Its alternative use suggests that a rule is needed to determine the best use of funds among competing investments. Such a rule is discussed in the section which follows.

Consider Other Alternatives

Funds remaining after cow/calf related loans are repaid should be allocated to their most profitable ends. The economic principle of equal marginal returns provides an operating rule which can be used to guide investment decisions. Basically, this principle states that the funds should be allocated among alternatives such that the rates of return in each alternative are maximized and about equal. The following example is used to illustrate this principle.

Suppose you've narrowed your investment alternatives to:

1. *Paying off an existing land loan,*
2. *Producing high-quality alfalfa hay for horse owners, and*
3. *Investing in the stock market through mutual funds.*

For up to $50,000 in investment, each offers the potential for an eight percent average return. The land loan return is in the form of interest saved, the alfalfa enterprise generates revenues that exceed costs, and the stock market offers capital gains and dividends. How should the $50,000 be invested in these three alternatives? Refer to Table 3 to answer this question.

The first and second $10,000 should be devoted to hay production, because it provides returns of 20 percent and 12 percent. The third and fourth $10,000 units should go to the stock market, to earn 10 percent and 9 percent returns. The final $10,000 should be used to pay down the land loan, as it saves 8 percent interest. The average return earned on these investments is 11.8 percent, considerably higher than investing in any single alternative. Of course, this example assumes that each alternative offers a similar level of risk. For risk levels that differ greatly, rates of return should be adjusted.

Table 3.

	Investment Alternatives		
	Pay Off Loan	Produce Alfalfa Hay	Stock Market Mutual Fund
First $10,000	8%	20%	10%
Second $10,000	8%	12%	9%
Third $10,000	8%	6%	7%
Fourth $10,000	8%	2%	6%
Fifth $10,000	8%	0%	8%
Average	8%	8%	8%

Summary

A herd reduction decision is a difficult one to make. This fact sheet has reviewed some of the economic and financial implications of a herd reduction, but there are many other factors to consider as well. Selling a herd that you've built up over 10 or 20 years can create a great deal of emotional stress and feelings of failure. Review your options carefully, and make sure the decisions you make contribute toward your long term goals. Postponing a sale until your equity is gone could lead to insolvency, foreclosure, or other tragic results. selling out now may enable you to buy back in the future.

Managing for Today's Cattle Market and Beyond

Farm/Ranch Information Systems

By
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Good management decisions in agriculture, as in any business, are based on good information. Without access to good information, making good decisions is much like trying to drive down an unmarked road. Without a centerline, well-defined shoulders, nor any roadsigns it would be difficult, if not downright hazardous to attempt to reach a specific destination. Accurate and reliable information can provide the signposts and indicators necessary for prudent decision-making.

While most operators would agree that adequate information is essential to a well-run business, few are willing to commit the resources necessary to ensure they have the best information possible. Times have changed. It is no longer enough to put in long hours behind the steering wheel or in the saddle to be successful. Today's successful operators must not only work hard but also work 'smart'. This requires the accurate, timely information and a commitment to spending adequate time in analysis. While this may be difficult during down-turns in commodity prices, it is all the more important where apparently small management decisions may have large unforeseen impacts.

Types of Information to Record

Once the decision has been made to develop or improve a farm/ranch information system, one might ask what information should be recorded. At first this question may appear to have a simple answer, however further consideration will show that the answer depends on the manager's need for information. It makes little sense to collect and record information that management has no intention of ever using. On the other hand, many times it is the uncollected information that is most useful in making complex management decisions.

Information can be collected and recorded for every resource on the farm/ranch—financial, livestock, wildlife, human, agronomic and natural resources. While resource documentation can be very general or more detailed, greater record keeping effort should be invested for critical resources. For example, on a western livestock ranch, winter feed may be a limiting resource. That is, winter feed is in short supply more often than other ranch resources. Keeping better records on the use of rangeland may provide enough information to allow the manager to develop strategies for improving range utilization and thereby reduce dependence on winter feed sources.

Sources of Information

Information needed for management decisions can be obtained from many different sources. Generally the best source of information, if available, are records kept by the farm/ranch itself. These records are generally more accurate and up-to-date than the information available from other sources. Below are some information sources you may want to consider using.

When available, an operation's own accounting records are usually the most helpful source of financial information. If the farm/ranch uses an accountant to prepare tax returns, this may be a good starting point for a financial records system. In addition, banks generally require financial statements and budget information before any loan is made. Another source for asset documentation may be the county assessor's office. They may be able to provide a detailed listing of all farm/ranch assets and their estimated market value. This can be quite useful when drafting a financial balance sheet for the first time.

University publications may also provide valuable information. Bulletins are compiled at many Land Grant Universities on the costs of production for different agricultural commodities. In addition, information may be available from the University or local farm management association on the financial structure and costs of production for farms or ranches in specific areas.

Records of livestock numbers are usually kept up-to-date and are readily available to most farm/ranch managers. However, breeding cow weights and calf weaning weights can be harder to determine. Old sales receipts might supply cull cow weights and/or calf weaning weights. A note of caution here, cull cows are often lighter than those retained in the herd. If all cows are assumed to weigh the same as the cull cows do and feed rations are formulated on that basis, the cow herd will likely receive inadequate feed. Body condition scores and other qualitative evaluations of cow condition can also be helpful in formulating feed rations and for evaluating herd performance.

Few farmers/ranchers keep records on wildlife numbers present on their operation. Those who allow or receive income from hunting may keep records of harvests, however. In addition to these records, state game & fish agency personnel may be able to provide estimates of game populations for lands managed by the operation. Finally, wildlife surveys are not difficult to conduct and may provide valuable estimates of forage consumption by wildlife and income potential from a wildlife enterprise.

Human resources are likely the area most difficult to obtain records for. However, simple, straight forward tools for inventorying this resource do exist. The local county extension office can likely help you get started on a program to better understand this resource. In addition, time scheduling packages are readily available that can make employee scheduling, as well as personal organization more easily accomplished.

Sources of information on the agronomic resources include the local Natural Resources Conservation Service (NRCS) office (formerly SCS), the Farm Service Agency (FSA) offices (formerly ASCS), and county Cooperative Extension Service office. In addition, service providers may also have records for services performed on your lands. A list of such providers might include fertilizer dealers, farm cooperative, fuel suppliers, herbicide/pesticide applicators, irrigation district office, conservation district office, soil testing lab, etc. One or more of these information sources may be helpful in reconstructing a crop history, soil fertility record, history of irrigation water use, or other important management information.

Natural resource information can also be obtained from many different sources. However, because it is gathered for a specific geographic location some adjustments may be necessary. For example, precipitation records are easily obtained for the nearest National Weather Service (NOAA) reporting station. However, depending on the proximity of the station to the operation, precipitation amounts can vary greatly. This can have implications for quantities of native forage species produced, amount of irrigation water needed, etc. Local NRCS offices can usually provide soil maps and aerial photos for most agricultural lands. These can be helpful in estimating type and quantity of forages available and corresponding management strategies. The county extension office may also be able to provide additional information on stocking rates, management strategies, and historic patterns of use.

Uses of Records

While keeping records accurate and up-to-date can require a large commitment of time and effort, it is the analysis of these records that makes the struggle worthwhile. Some of the uses of farm/ranch records include: legal and institutional uses, financial control and budgeting, and whole farm/ranch analysis and management.

The Internal Revenue Service (IRS) requires that sufficient records be kept to justify all income and expenses reported on income tax forms. While there are no legal requirements for records on non-corporate farms/ranches, such operations can be required to document all items of income and deductions. A complete, accurate record of the financial resource can be extremely helpful during an IRS examination. Also, some record of self-employment and employee earnings are required by law. Documentation of ‘basis’, the nontaxable share from the sale of an asset, is also required; it can be obtained from records of purchase price and date of purchase for capital assets. Other required records may include herbicide/pesticide application information, dates and number of head of livestock turned onto public lands, as well as records documenting vaccinations, implants, and feed additives.

Lenders like to see evidence of a good organization with sound management skills when extending credit to borrowers. Several things will be considered in making such a determination. You can expect the lender to request information which will include: evidence of good management and productivity for crop and livestock enterprises and standard financial statements such as a balance sheet, income statement, statement of net worth, and a cash-flow statement for the past year(s). These records and statements allow the lender to look not only at the collateral pledged, but to also evaluate the borrower’s repayment capacity. A complete, accurate set of records will provide the necessary information. In addition it will project a business-like, in-control image to the lender.

Just as lenders are concerned with cash flow in analyzing repayment capacities, agricultural managers should also be concerned with cash flow management. It is an important tool, not only in determining when and how much to borrow, but also in deciding when and how much to repay. Preparing a realistic cash flow budget should be regarded as a vital component of the annual record-keeping process. Preparing such a budget can help the manager work through various strategies on paper before it actually happens as the year unfolds, thus avoiding costly mistakes.

Perhaps the most important and often overlooked use of a farm/ranch record system is for analysis. A record system that meets income tax reporting and credit application needs provides virtually all the information needed for evaluating business performance. For example, good records provide the manager information on what variable and total costs of production are and whether the goals of the marketing plan and cash flow budget are being met. A thorough analysis of such records can supply information on strengths and weaknesses of the business, changes in business operations that worked and did not work, profitability of the business, and the financial position of the business. All of this information reflects on the performance of the farm/ranch unit.

If records have been compiled for limiting or critical resources, a whole farm/ranch analysis can be performed. Such an analysis can describe whether resources are being over or under utilized. This may also help management identify new opportunities for income. For example, if the forage resource was under utilized, there may be opportunities to lease out forage or to lease additional cows to harvest the excess. On the other hand, if forage was in short supply, perhaps the manager should consider strategies for obtaining additional forage, reducing the number of cows, or intensifying the management of the resource through rotational grazing. Thus, long term productivity of the resource is protected from damage caused by over use. Without a system for maintaining complete and accurate records, management decisions must be made based largely on secondary information and ‘gut feeling’.

Methods of Keeping Records

Many different methods are available for collecting resource information. There are any number of options from paper forms to be filled out by hand to computerized systems that store everything electronically. The best system is one that records, organizes, and reports the information in a timely manner in a form that is meaningful and easily analyzed. A system that is easy to use or is ‘user friendly’ is even better.

Financial records may have the most options for tracking and management. Systems for maintaining financial records extend from simple checkbook-type hand record systems for cash expenses to sophisticated computer-based double-entry accounting programs. New graphics-based computer operating systems and software that runs on them can help ease-the-way to adopting the latter. Furthermore, many software packages designed for the typical household or small business can be a valuable tool in an agricultural setting. The primary consideration when attempting to choose a record keeping system is whether the system will supply the information needed by the manager.

Many easy-to-use software packages collect only basic accounting information—information easily obtained from a checkbook register. Taking the time and effort to enter the information into the computer does not automatically mean the software will supply the information needed. On the other hand, if cash records are what management requires, it makes little sense to invest a lot of time and effort entering details that no one will use.

One of the attractive features of a hand record system is that it can be modified to fit a particular situation or can accommodate additional records without the high cost of purchased software or the requirement of learning to run a new computer program. In fact, for those who do not have a clear idea of the types of information they need, a hand record system is an inexpensive way to experiment until those needs are discovered.

For those unsure of what additional records they should keep or for those just starting out, many professionals are available to help. Cooperative Extension Service offices can assist in identifying alternative systems for keeping farm/ranch records, as well as a system for tracking personal finances. Many university publications are also available through these offices which can help in selecting the record keeping system best suited for various situations. If an accountant is used to prepare tax reports, they often have valuable insights into what will work best for their information needs. In addition, accountants who perform record keeping services for agricultural operations may have valuable insights into what a good system should provide. Finally, bankers, consultants, and other agency personnel can be helpful in identifying record systems to satisfy specific needs.

The final word on farm/ranch information systems is that they are essential to sound management decisions. Without accurate information, decisions are based on ‘gut feeling’ at best. More information is generally better than less. However, information that is available when it is needed easily outweighs information that takes hours or days to compile. Remember, without access to good information, making good decisions is like trying to drive down an unmarked road—a difficult, if not hazardous proposition.

Managing for Today's Cattle Market and Beyond

March 2002

Weather Related Sales of Livestock and Tax Implications

By
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Special tax treatment is generally available to producers that are forced to sell animals due to weather related events like drought and flooding. There are two basic tax treatments to defer income from these unusual sales. The first method allows for the deferral of funds for one year and requires that your area be designated as eligible for assistance by the federal government. The second or "involuntary conversion" option allows for the deferral of sales for up to two years, but only applies to breeding livestock. However, the weather severity criteria is not as great for this method since it does not require an area to be declared eligible for federal disaster assistance to be used. It is important to remember that only livestock sales beyond normal sales are eligible to be deferred for either special tax treatment.

Deferred Livestock Sales — Potentially All Livestock

Income from livestock sold in excess of normal sales, whether raised or purchased, may be deferred for up to one year if the following are satisfied:

1. Your principal business is farming or ranching.
2. Taxpayer utilizes the cash method of accounting.
3. Evidence that "excess livestock" sales are due to weather and not a sell-off that is beyond weather induced conditions. A three-year average is used to compute normal sales levels when making the calculation for "excess livestock" sold.
4. Your county or a neighboring county must be designated as eligible for federal disaster assistance. Designations made by the President of the United States, an agency of the Federal Government such as a Department of Agriculture agency (e.g., Farm Service Agency), or other Federal Agencies such as the Federal Emergency Management Agency or the Small Business Administration satisfy this requirement. The sale of livestock can occur before or after an area is designated a disaster area, as long as the weather event that caused the sale also caused the area to be designated as eligible for federal assistance.
5. You attach a statement to your tax return for the year of the sale with the following information:
   - A statement that you are making an election under I.R.C. section 451(e).
   - Evidence and explanation of conditions that forced your early sale (lack of water, feed, etc.) and the date, if known, that your area was designated eligible for federal disaster relief.

- A computation of the income to be postponed for each generic class of livestock (e.g., cattle, sheep, goats, etc.). These calculations would include information which specifies the number of each class of livestock sold in the preceding three years, the total number you sold this year, and the excess number sold because of weather related conditions (see the accompanying example for Deferred Livestock Sales).

The above statement and your tax return must be filed by the due date of the return, including extensions. If you filed your return on time for the year without making the 451(e) election, you can file an amended return within six months of the due date (excluding extensions). Attach the statement to the return and write "Filed pursuant to section 301.9100-2" at the top of the statement. If you are faced with weather related sales in more than one year, a separate election must be made for each year and there are special rules that prevent your choice in the first year from adversely affecting your choice in the second year.

Note that not all eligible excess livestock sale income needs to be deferred to the following tax year. That is, if prices are low and you expect to be in a zero or low marginal tax bracket, counting some of your weather induced sales as income for the current year may be to your advantage. You must keep in mind, however, that any benefits associated with feed assistance or indemnity payments have to be claimed for the tax year that they are received. It is conceivable that feed assistance combined with having to file an amended return of additional income could push one into a higher marginal tax bracket for a drought year than planned. Another advantage to the one-year postponement is that the tax basis for purchased replacements is not reduced by the amount of any postponed gain. Thus, if a raised cow is sold for $500 and a replacement is later purchased for $500, the entire $500 paid for the replacement is depreciable.

How much income is to be reported for the year of the sale or the following year must be accrued by the due date of the return for the tax year in which the drought sale occurred. Income from normal sales is reported on this year's Schedule F while excess sales are reported on next year's Schedule F. See the accompanying box (insert Box #1 here) for an example of the tax deferred tax treatment method. A disadvantage to this method is that you must rely on your area being declared eligible for federal disaster assistance. Also, the "involuntary conversion" tax treatment below for breeding animals may be preferred since it allows for drought induced gains to be deferred for two years or one year, beyond the one-year postponement described above.

Involuntary Conversion — Breeding Cattle

Gains from livestock sold as the result of a weather event such as a drought, for example, do not have to be recognized, if the proceeds are used to purchase replacement livestock within two years from the end of the tax year in which the sale takes place. An advantage to this treatment is that your area need not be declared a disaster area by the federal government. Basic rules of this treatment, similar to the deferred livestock sales method above include:

1. Drought induced sales in excess of a normal three-year average.
2. An equal or greater number of replacement livestock must be purchased within 2 years of the end of the tax year of sale.
3. No minimum holding period is required. That is, bred heifers that you may have just purchased last year qualify as breeding livestock.
4. Replacement livestock must be used for the same purpose.
5. It is not required that your ranch be declared as a federal disaster area, but evidence of your weather related sales must be provided. For example, newspaper clippings or rainfall reports for a drought are generally sufficient proof.
6. A computation of the number and kind of livestock sold by category and the accompanying gain realized from weather related sales must be provided (see the Involuntary Conversion example).

Gains and losses from breeding livestock sales are reported on Form 4797. You postpone gain by reporting your choice on your tax return for the year in which you receive the gain (insurance proceeds, sale of stock, other). The statement should include the date and details of the involuntary conversion, reimbursement received, and how you figured the gain. The replacement period ends two years after the close of the first tax year in which you realize any part of the gain from involuntary conversion.

After replacements are purchased, attach to your tax return the date replacements were purchased, cost of replacement animals, and the number and kind of replacements purchased. Careful consideration must be given to what the future intentions are for rebuilding your herd when opting for the involuntary conversion treatment. Raised replacements are not eligible for "replacement livestock." Thus, careful consideration needs to be given to the anticipated selling and buy-back replacement prices. In addition, property acquired as a gift or inheritance does not qualify as replacement property. Special rules may also apply if buying replacement property from a relative. Rules for ordinary gain or loss (Ch. 10, Farmers Tax Guide) apply if the breeding livestock sold are not replaced within two years.

Government payment assistance during or after a weather related event is a possibility through programs like the Livestock Assistance Program (LAP) and Livestock Indemnity Program administered by the Farm Service Agency. A county must have suffered a 40 percent or greater loss of available grazing for at least 3 consecutive months to be eligible for LAP assistance. Assistance is based on the value of feed calculated on a corn equivalent basis. Information needed to apply for LAP benefits include: 1) number and share of livestock owned, 2) acres, location and type of grass or forage used to support your livestock, 3) estimated percentage of your grazing loss, and 4) dates of any significant livestock inventory changes. Livestock Indemnity Assistance is possible for areas that receive a Presidential Disaster Declaration or requested a Secretarial Disaster Designation and received this status. This program provides partial reimbursement of livestock losses to eligible producers. Livestock Indemnity Program payments are not reduced to account for any insurance indemnity payments received from other sources. This is done so that the LAP does not discourage private means of insuring livestock losses.

Since every tax situation and ranch plan is different, no standard recommendation can be given as to whether the one-year deferred livestock sales is preferred to the two-year involuntary conversion. It is always advisable to consult with a reliable accountant and federal agency representatives. Close consultation and planning with a tax advisor or accountant is likely to pay dividends if you have or plan to make substantial weather related sales this year. Please refer to the Farmers Tax Guide (Publication 225, chapters 4 and 13) for a general explanation of weather related sale procedures or contact the IRS (1-800-829-1040) for more current and complete tax information. The Farmers Tax Guide along with other tax forms and publications are available on the Internet at the address of **http://www.irs.gov**. In addition, current information related to federal assistance from weather events can be found at the address of **http://www.fsa.usda.gov**.

Addendum: *Two Examples*

Example of Deferred Livestock Sales (election under I.R.C. 451 (e)):

Rancher Joe normally sells 100 yearlings in the fall every year, 13 cows and 2 bulls (most recent 3 year average). Due to the drought this year, Joe sold 100 yearlings in May along with 15 pairs (30 head). In June Joe sold 30 cows, 5 bulls, and 50 lightweight calves that were born earlier in the year. Normally, Joe doesn't sell any pairs or calves that are less than a year old. Sale prices were $275/head for the yearlings, $400 average for the 15 pairs sold, $325/head for the 30 cows sold, $600/head for each bull, and $150/head for the calves that were less than a year old. An election is made for each generic class of animals (e.g. cattle, sheep), not specific to an animal's age, sex, or breed. Thus, the average sale price for cattle is determined by dividing the total income received by the number of all cattle sold ($53,750 / 215 hd. = $250/hd.). This average is multiplied by the excess number sold due to drought (215-115=100) to give the "excess sales" amount. In this example, 115 hd. x $250/hd., or $28,750 in sales may be deferred for up to one year. The election of how much income to postpone must be made in the year of the drought induced sale.

Example of Involuntary Conversion (election under I.R.C. 1033 (e)):

Rancher Bob normally sells 20 cows and bulls from his beef herd every year but this year he sold 50, 30 more than normal due to the drought. The average selling price for all 50 head was $300/head. Thus, Bob defers the income of 30 head or $9,000 for this year if the cows were raised and have a zero basis. If in the following two years Bob buys only

25 cows to replace the 30 sold, a gain of $300/head for five head must be reported regardless of what was paid for the 25 replacements purchased. Bob would need to report an additional $1,500 ($300 x 5) of income to an amended return for the year in which the drought sales occurred and any additional taxes must be paid. If Bob purchased replacements for $400/head, then the tax basis for the 25 replacements would be $100 (replacement price minus the gain on the drought induced sale that wasn't taxed). But if Bob purchased 25 replacements for only $250/head then an additional $1,250 gain ($50/head x 25 head) would have to be filed to an amended tax return for the drought year.