

# Farm and Ranch Survival Kit

Working Together to Create a Hopeful Future For Family Farms



Issue 5

We call them **unavoidable**. Taxes, insurance, legal dilemmas. They may seem inevitable but with proper planning, we can manage these risks. This issue of your Farm and Ranch Survival Kit is a potpourri of information about those very subjects.

Many of you have felt the effects of the 2005 drought. This issue includes an article for livestock producers that may help you at tax time. Discuss it with your tax professional.

Could it be that you are over-insured? Go over your policies with the checklist in this issue and decide for yourself. Then consult with your insurance professional to make any needed changes.

Lastly, this may be the year to change your business structure. Sole proprietorships are the easiest but also the most risky; find out why in this issue. Day to day problems and interruptions often keep us from dealing with these important things. Make a promise to yourself that 2006 will be the year to review them.

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## Family Insurance Planning

An insurance program should be a part of every family's total financial plan. Before you can evaluate various insurance programs, you must understand the reasons for buying insurance and how to determine the amount and kind of insurance you need. Insurance is one way of protecting yourself against the risk of unexpected financial losses. It does not remove the risk, but it can partially compensate for losses incurred. Through the payment of premiums, you transfer the cost of a major loss from you to an insurance company.

Insurance operates on the principle of shared risk. A group of people pay in specified premiums to a common pool. Funds from the pool are used to cover individual losses. The amount of premium each individual pays is based on the frequency of past losses by the group, plus the costs of administration and selling, divided by the number in the group.

### Developing an Insurance Program

There are four basic steps in developing an insurance program to fit your situation:

1. Determine the risks you face.
2. Analyze the financial impact of the risk in your particular situation.
3. Determine how you should handle the risk.
4. Make a plan.

**1. Determine the risks you face.** Risks differ from situation to situation and will change throughout your lifetime. All insurance programs should be reviewed regularly. Situations are affected by occupation, size of household, savings, and income. Here are some common risks families and individuals face:

- Death of a household member, especially the wage earner.
- Total or partial disability of the wage earner or primary care provider.
- Loss of job for wage earner.
- Illness or accident in the family.
- Damage to your home by fire, wind, storm, etc.
- Liability for damage by your car.
- Liability for damage suffered by someone on your property.
- Damage to your car or other personal property.

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## Family Insurance Planning (continued 2)

**2. Analyze the financial impact of the risk.** Most families cannot afford insurance to cover all risks, so it becomes necessary to look at each potential risk and what effect each will have on the financial security of the family. Ask yourself some hard questions about potential risks:

- What are the chances of the risk occurring?
- How much of the cost could the family assume?
- If the risks occur, which would be the most difficult for the family to meet financially?
- How can insurance be used to cover the risk?

**3. Determine how to handle the risk.** There are three basic ways to handle any risk. You can take action to prevent the risk from happening. For example, you could make a change in health practices. You could begin using the seat belt in your car, or you could install a security system in your house. A second way of handling the risk is to keep the risk. Setting aside savings to cover the cost of dental care for the family is one example of keeping the risk. The third way is to transfer the risk through the use of insurance. The chart below can help you decide how to handle each risk and provide a guideline for deciding on the need for insurance.

Cost of Occurrence	Probability of Occurrence	
	Low	High
Low	Keep Risk 1	Keep Risk 2
High	Transfer Risk 3	Insurance too costly or not available 4

- A. In block number 1, the probability of the event's occurring is low, and the cost of each occurrence is low. Keep the risk; don't buy insurance.
- B. In block number 2, the probability of the event's happening is high, but the cost is low. Consider keeping the risk; set aside money for this loss in your emergency fund. Don't buy insurance.
- C. In block number 3, the probability of the event is low, but the cost is high. Transfer the risk; buy insurance.
- D. In block number 4, the probability of the event is high, and the cost of each occurrence is also high. No one will sell you insurance, or the cost of such insurance would be prohibitive. You are forced to keep the risk.

**4. Make a plan.** You are now ready to shop around for protection and for an agent. You know what your needs are and what you can afford to spend for insurance. Follow these steps in making a plan to meet your family's insurance needs:

- Review insurance policies you already have. Consider the coverage they provide in relation to your current situation and needs. Compare the coverage with the amount of the premiums.
- Assess all of your financial and human resources. What risks can you take action to prevent? What risks can you afford to keep? What risks will you need to transfer?
- Look at the insurance available. In general, when searching for an insurance company, you should choose a financially strong company. You can find *Best's Insurance Reports* and *Best's Life Reports* in most public libraries. A rule of thumb is to choose no company with a rating lower than "A," as its financial strength may be questionable.

## Family Insurance Planning (continued 3)

- You should also consider how quickly claims are settled. Your state Insurance Commissioner's officer can provide information on a company's financial strength. They can also tell you which firms have the greatest number of complaints registered against them. When comparing the differences in companies' complaint experience, remember to compare the number of contracts the company has in force. A small company with few complaints could actually be the most unsatisfactory when compared to larger companies, on the basis of complaints as a percent of policies.
- Find an insurance agent. A good agent is someone you can talk to, whose judgment you trust, and who explains insurance using terms you can understand. Work out a total plan for insurance. A good insurance agent can help you make good decisions. The agent should not decide which policies you should buy or how large they should be.

### Special Tips

- Know what insurance you have. Avoid double coverage.
- Avoid narrowly defined coverage such as a policy just for cancer or flight insurance.
- Select the highest deductible you can afford. Higher deductibles usually mean smaller premiums.
- Check out potential discounts, such as good grades for teenage drivers or special rates for nonsmokers.
- Comparison shop for new coverage or at renewal time.
- Consolidate coverage when possible. Fewer policies reduce the company's administrative costs, and the savings can be passed on to the consumer.
- Always read the policy before you buy. Check for exclusions and limitations.
- Buy through group policies when possible. Generally, group policies are less expensive because the insurance company has a contract with the group rather than with individuals.
- Pay premiums annually, if possible. One payment a year usually costs less.
- Review policies annually to be certain you have the coverage you need.

### Your Rights

As a consumer you have these rights:

- To cancel a policy or let it lapse at any time.
- To hire your own appraiser to establish the value of lost or damaged property.
- To know the types of personal information the insurance company collects about you and how the information is used.
- To know the reasons for cancellation.
- To correct any misinformation in insurance company files that may affect an underwriting decision.

Contact your agent or group insurance plan representative for questions about your policy.

*By Beverly Riggs Howell, Extension Family Economics and Management Specialist, Mississippi State University*



## Weather Related Sales of Livestock and Tax Implications

Special tax treatment is generally available to producers who 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.

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. A statement that you are making an election under I.R.C. section 451(e).
  - b. 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.
  - c. 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.

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 reported for the year of the sale or the following year must be accrued by the tax year due date 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. A disadvantage of 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.

## Weather Related Sales of Livestock and Tax Implications (continued)

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 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.

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.

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.

*Article written by Russell Tronstad, University of Arizona; C. Wilson Gray, University of Idaho; Lee Meyer, University of Kentucky.*



## Your Business Structure: Pros and Cons

Choosing a business structure is one of the first steps to setting up a business. Your business structure is the framework for how your business functions, how it is taxed and what your business liability is. Below are the five basic business structures and the pros and cons of each. An attorney specializing in corporate law can advise you on which business structure would be best your business.

### **Sole Proprietorship**

A sole proprietorship is a business of one without corporation or limited liability status. The individual represents the company legally and fully. Common proprietorships include part-time businesses, direct sellers, new start-ups, contractors, and consultants.

#### Advantages of a Sole Proprietorship

- Quicker tax preparation, simpler tax requirements
- Lower start-up costs
- Ease of money handling
- Owned and operated by you, sole decision-maker
- Easy to start

#### Disadvantages of a Sole Proprietorship

- Personally liable for business errors so personal assets are jeopardized
- Lack of financial controls
- Lonely at the top, may not have a successor to take over
- Difficult to raise capital

### **Business Partnership**

A partnership is when the business is owned by more than one individual. Partnerships can be comprised of two or more people, depending on how they are organized. Each partner is financially liable for the health of the business.

#### Advantages of a Partnership:

- Partners can pool resources for financial stability and increased profitability
- Taxes are relatively simple, individuals are taxed not the partnership
- Individuals can take advantage of each other's strengths
- Greater freedom from day to day tasks
- As with a Sole Proprietorship, partners are personally liable for business errors so personal assets are jeopardized

#### Disadvantages of a Partnership:

- Partners need to be able to communicate with each other
- Partners have legal liability for the actions of other partners
- A good partnership plan requires an exit strategy for each partner



## Your Business Structure: Pros and Cons (continued)

### Limited Liability Company

A limited liability company (LLC) is a type of business ownership combining several features of corporation and partnership. Since this form of business is not a corporation or a partnership, owners are called members not partners or shareholders.

#### Advantages of Limited Liability Company

- Limited Liability; owners of a LLC have the liability protection of a corporation.
- Flexible profit distribution
- No minutes are required as in a corporation
- Taxation is similar to that of a partnership or sole proprietorship
- Number of members are unlimited and may be individuals, corporations, or other LLC's

#### Disadvantages of Limited Liability Company

- Limited life; lifespan is limited by bankruptcy or death of a member
- Added complexity with more paperwork.
- Setting up a LLC is more difficult than a sole proprietorship or partnership.

### S Corporation

An S Corporation (Small Business Corporation) is a business elected for S Corporation Status through the IRS. This status allows the taxation of the company to be similar to a partnership or sole proprietor as opposed to paying taxes based on a corporate tax structure.

#### Advantages of a S Corporation Status

- No corporate tax
- Reduces taxable gains when the business is sold.
- Ability to write off start-up losses by applying them to your personal income.
- Liability Protection

#### Disadvantages of a S Corporation

- One class of stock
- Less attraction for outside investors
- Requires corporate meetings and company minutes.

### C Corporation

A corporation is an separate legal entity formed by you alone or in conjunction with other owners.

#### Advantages of a C Corporation

- Liability protection greater than other sole proprietorship or partnership.
- Corporate Taxes are often lower.
- Easier to raise money by selling shares.
- A business corporation value will be based on the business, not the owner, making it easy to sell the company.

#### Disadvantages of a C Corporation

- More costly and time consuming than other business types.
- Requires articles of incorporation, bylaws and Board of Directors.
- Normally need a lawyer to properly establish a corporation.
- Double taxation: the corporation pays tax and owners must pay additional tax on money received from corporation
- Difficult for shareholders of small, closely held corporations to sell shares if they want out of business.

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## Resources

### Web and Internet Resources

#### **About.com Small Business Information Guide**

Website rich with resource on operating a small business and clear articles on business structure.

<http://sbinformation.about.com/>

**The Farmers Tax Guide.** This Guide along with other tax forms and publications are available at

<http://www.irs.gov>.

#### **Western Center for Risk Management Online Library**

Articles detailing life and health insurance, legal considerations regarding farm partnerships and decision making.

<http://agecon.uwyo.edu/RiskMgt/HumanRisk/HUMANDEFAULT.htm>

#### **Farmland Trust**

Information about current farm policy and land conservation

<http://www.farmland.org/>

Small Business Administration, SBA Online Library

Publication #MP-25, *Selecting the Legal Structure for Your Business* is available as a downloadable document in Word or as a PDF file.

<http://www.sba.gov/library/pubs.html>

### Book and Print Resources

Bond, Larry; Dalsted, Norman and Willett, Gayle. **Federal Income Tax Management for Farmers and Ranchers. WREP0148**

Good tax planning is based on selecting a proper accounting period, the appropriate accounting method, and a good accounting system. This publication reviews selected income tax management principles and strategies relevant to the farmer and rancher, including fluctuating and stable income, capital gains, retirement funds, and other income and expenses. Supplemented with tables.

**Publisher: Western Regional Extension**

**Published: October 1995. 24 pages.**

**Price: \$1.50**

Schlosser, William E., Baumgartner, David M., Hanley, Donald P., with review by William L. Hoover. **Forest Taxes in Washington, EB1822**

If you own timber but hesitate to manage a small landholding for income, this guide will walk you through setting up tax accounts, record keeping, capital recovery, operating costs, and taxation of timber income. Examples provide further detail on allocating capital to basis, and handling expenses for brush and weed control, timber sales, and reforestation.

**Publisher: Washington State University**

**Published: June 1998. 32 pages.**

**Price: \$2.00 or Free PDF download available at**

<http://cru84.cahe.wsu.edu/cgi-bin/pubs/EB1822.html?id=hybPGAaF>