

Transferring Breeding Livestock

For some farms or ranches breeding livestock are an important part of transferring business ownership from the older generation to the younger generation (*AgDM File C4-80, Transferring Business Ownership, www.extension.iastate.edu/agdm/wholefarm/pdf/c4-80.pdf*). The methods used to transfer machinery also can be used for breeding livestock (*AgDM File A3-32, Transferring Ownership of Farm Machinery, www.extension.iastate.edu/agdm/crops/pdf/a3-32.pdf*). The tax and financial consequences are similar, but the need for replacement animals requires special considerations.

For breeding stock that were purchased by the older generation, the amount by which their sale price exceeds the original purchase price (if any) is taxed as capital gain. The amount by which the sale price exceeds the tax basis of the animals in the year of sale, up to their original purchase cost, gives rise to recaptured depreciation. If the sale price is below the current tax basis, a capital loss is generated.

Breeding livestock raised by the seller (older party) has a zero tax basis, so all the income from its sale (minus selling costs) is taxed as capital gain and is not subject to self-employment tax. To qualify as breeding stock, cattle and horses must have been held for breeding or dairy purposes for at least 24 months, and other species must have been held for at least 12 months. Breeding livestock falls into the 5-year property class under MACRS tax depreciation guidelines. The examples in this information file will assume that all breeding animals were raised on the farm or ranch.

Example 1. Breeding livestock outright sale

Inventory:			
40 beef cows at \$1,500	\$60,000		
8 yearling heifers at \$1,000	8,000		
Tax basis:			
Beef cows (raised)	0		
Yearling heifers (raised)	0		
Seller			
Sale price:	\$68,000		
Capital gain:	68,000	(68,000 - 0)	
Buyer			
Beginning basis:	\$68,000		
Depreciation in first-year:			
<i>non-family sale</i> ¹			
-- expensing:	\$30,000		
-- MACRS:	5,700	[(68,000-30,000) x .15]	
<i>family sale</i>			
-- expensing:	0		
-- MACRS:	\$10,200	(68,000 x .15)	

¹ Depreciation includes section 179 (e.g. \$30,000), plus MACRS depreciation using the 150% declining balance method.

Outright Sale

An outright sale of all the livestock is the simplest transfer procedure, but requires the most capital from the younger party and triggers tax consequences immediately (Example 1). The buyer can use the Section 179 expensing option to deduct some or all of the purchase cost in the year of the transaction if the parties are unrelated. However, sales between family members are not eligible for Section 179 treatment. The remaining portion of the purchase price can be depreciated as 5-year MACRS property. Purchasers who expect to be in a higher tax bracket in future years may want to defer deductions to later tax years.

Installment Sale

If an installment sale is used (Example 2), installments should be based on the value of the animals at the time of sale and should not be affected by subsequent changes in the size or value of the herd. If taxes are filed on the accrual accounting basis and breeding livestock is included in opening and closing inventories (rather than depreciated), all capital gain must be reported in the year of sale. The seller of purchased breeding cattle that have been depreciated for income tax purposes and are sold under an installment arrangement must recapture as ordinary income all depreciation that has been taken in the year of sale, even though the sale proceeds may be spread over several years. Under cash accounting, the installment sale of breeding stock is subject to the same related party rules discussed under transferring machinery (*AgDM File A3-32, Transferring Ownership of Farm Machinery*, www.extension.iastate.edu/agdm/crops/pdf/a3-32.pdf).

Example 2. Breeding livestock installment sale

Sale price:	\$68,000
Installment Terms	
-- term	5 years
-- principal	\$13,600 per year
-- interest	7% on unpaid balances
Seller	
Capital gain ¹	
-- non-family sale:	\$13,600 per year for 5 years
-- family sale:	68,000 in year of sale
Buyer	
Depreciation in first-year:	
<i>non-family sale</i> ²	
-- expensing	\$13,600 each year
-- MACRS	0
<i>family sale</i> ³	
-- expensing	0
-- MACRS	\$2,040 each year (13,600 x .15)

¹ Assumes cash basis taxpayer.

² Section 179 expensing.

³ MACRS 150% declining balance method.

Gradual Sale

Under a gradual sale, a portion of the breeding livestock is sold each year. The rate of transfer can be arranged to coincide with the normal culling cycle of the breeding animals, as shown in Example 3. When a mature animal is sold, the younger party supplies the replacements by buying them from an outside source, selecting them from her/his share of the offspring, or purchasing them from the older party's herd. The older party keeps the income from the cull animals that are sold. For tax purposes, income is reported for each animal in the tax year that it is sold, so careful records are important.

If the two parties farm together and income is divided according to the relative contribution of assets, the division of income should be recalculated each year as ownership of the breeding herd changes (*AgDM File C2-36, Beef Cow Joint Agreements*, www.extension.iastate.edu/agdm/wholefarm/pdf/c2-36.pdf).

Example 3. Breeding livestock gradual sale (purchased replacements)

Value of herd:	\$68,000
Annual culling rate:	20%
Cows culled per year:	8/year
Sale value (\$1,000/cow):	\$8,000
Replacements supplied by buyer:	8/year
Cost of replacements (\$1,000/cow)	\$8,000
Seller	
Capital gain ¹	\$8,000/year
Buyer	
Depreciation in first-year:	
<i>non-family sale</i> ²	
-- expensing	\$8,000/ year
-- MACRS	0
<i>family sale</i> ³	
-- expensing	0
-- MACRS	\$1,200/year (8,000 x .15)

¹ Assumes cash basis taxpayer.

² Section 179 expensing.

³ MACRS 150% declining balance method.

A gradual sale is probably not appropriate where a standard 50/50 livestock share lease is being used. In this case, the younger party would want to acquire ownership of half the breeding livestock immediately.

Lease

If the younger party has limited capital, leasing part or all of the breeding livestock for a period of time may be preferable to purchasing them. Lease payments should be large enough to provide the owner (older party) a competitive return on investment and pay for insurance, death loss, and other ownership costs. For enterprises with frequent sales, such as dairy or farrowing pigs, payments can be set up on a monthly schedule to match the sale periods. Lease payments may have to be adjusted according to the number of female animals in the herd each month, if this number fluctuates significantly.

There are several ways the replacement of culled breeding animals can be handled when the herd is leased.

1. The owner (older party) provides replacements from an outside source and receives all the income from selling cull animals (Example 4).

Example 4. Breeding livestock lease (owner supplies replacements)

Size of herd:	40 cows, 8 heifers
Value of herd:	\$68,000
Annual lease payment	\$6,800
Renter pays all operating costs.	

2. Replacements are selected from the offspring of the herd. The owner (older party) either pays the tenant (younger party) for the replacements or credits their value against the rent due.
3. The tenant (younger party) provides replacements from the offspring and gradually acquires ownership of the herd (Example 5). The tenant (younger party) pays rent on the remaining cows owned by the owner. Careful records should be kept of which animals are owned by each party.

The lease can continue indefinitely, a buy-out can be arranged after a period of time has passed, or the younger party can buy the herd gradually and lease the remainder of the animals. The lease payments would decrease each year as ownership of the herd is transferred to the younger party.

Example 5. Breeding livestock transfer under a lease, with gradual sale

Size of herd:	40 cows
Value of herd:	\$60,000
Lease payment:	10% of value of owner's herd
Culling rate:	20% annually

Renter supplies replacements, pays all operating costs.

<u>Year</u>	<u>Cows owned by owner</u>	<u>Value of cows</u>	<u>Lease Payment</u>	<u>Cows owned by tenant</u>	<u>Replacements supplied¹</u>
Now	40	\$60,000	\$6,000	0	0
1	32	48,000	4,800	8	8
2	24	36,000	3,600	16	8
3	16	24,000	2,400	24	8
4	8	12,000	1,200	32	8
5	0	0	0	40	8

¹ Replacements supplied at the beginning of each year.

Gifts

Breeding livestock also can be gifted, either gradually or all at once. The same tax treatment as for gifting machinery applies. Gifting also can be combined with a sale, gradual sale, or leasing agreement. Gifts with a value in excess of the annual gift tax exclusion between individuals may reduce the giver's estate tax exclusion. (AgDM File C4-23, **Federal Gift Taxes**, www.extension.iastate.edu/agdm/wholefarm/pdf/c4-23.pdf)

Labor Share

In situations where the younger party has little or no money to invest, he/she may receive a percent of the offspring in exchange for labor. The appropriate percent depends on the species of livestock, the costs involved, and the type of facilities used. In general, the share of offspring received each year should be equal to the percent of total production costs represented by the younger party's labor contribution. (AgDM File B1-21, **Livestock Enterprise Budgets for Iowa**, www.extension.iastate.edu/agdm/livestock/pdf/b1-21.pdf)

Additional resources on **Transition and Estate Planning** can be found by visiting the Ag Decision Maker website, www.extension.iastate.edu/agdm/wdbusiness.html.