



Ag Business Management

Informing farm families and ag businesses about management issues.

Drought and Your Debt

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Net income is necessary to provide for our family living, pay our income and social security taxes, and to repay our debt obligations. Net farm income may be the only source of net income for some farm families. Other farms may receive some of their net income from the farm, and the rest from non-farm sources. However it arrives, farm families are no different than any other family. We all need adequate net income.

The wage earner can experience a loss in net income due to employment changes, illness that keeps them out of the work force, and many other situations. Net farm income is affected by the climate, diseases, insects, market swings, employee issues and many other situations. What happens when our net income is cut short? We still need to live. We still need to pay our taxes. Our debt obligations do not go away. Will there be enough to go around? Is there anything that can be done?

Drought is a reality for many farm families in 2006. Crop and revenue insurance may soften the effect for some. Drought aid may be available in some counties, and may offer assistance for some farm families. There may be some cushioning of the harsh realities of drought, but those affected will feel the impact. If your farm is impacted by drought, what if anything can you do?

It is important to maintain the personal, social and professional contacts in your life. Communication and the support of others is necessary to keep a positive attitude, and to insure that one does not slip away into isolation and depression.

If we find that net income is smaller, can we adjust our living, our taxes and our debt obligations to ride through the slump?

Can we do anything to adjust our “cost of living”? Yes we can! Examine your personal budget. Identify those expenses that are for “needs”, and those that are for “wants”. A proper attitude, restraint and frugal shopping can assist many households. Some purchases can be postponed. Some travel can be eliminated. The entire family should participate. However, do maintain your medical insurance and your overall health.

Can we do anything about our “taxes”? Yes we can! If you are on the “Cash Method” of accounting for farm income taxes, you adjust your reported income and expenses every year to control your taxable income. This drought year is no exception. If your pattern is to sell much of the previous year’s production in the present tax year, your “short crop” year may not show up on your tax return until the following year. If your large crop from last year was sold in this drought year, you may want to consider pre-purchasing next years’ inputs (allowable amounts) to decrease your taxable net income. This may require borrowing on next year’s operating loan, so be sure to communicate well with your lender. Next year your expenses will be less (because you pre-paid them), but your income will be smaller as well, due to the short crop. If you are a cash method farmer in an area designated as eligible for assistance by the federal government, and because of the drought you sell more livestock than you normally would, you may be able to postpone the income from these additional animals until next year.

If you are an “Accrual Method” tax payer, you are taxed each year on your inventory. This generally gives you fewer ways to adjust your taxable income than the cash method farmer has. However, if you are impacted by drought, your inventory will be down, so you will be taxed on fewer dollars.

If farmers sell draft, breeding, or dairy purpose livestock (more than on a normal year) due to drought, flood or other weather-related conditions, treat the gain or loss of these additional animals as an involuntary conversion. If you will be replacing these animals, you can postpone reporting the gain within a specified period of time (replacement period). The replacement period of time begins at the time of sale, and ends 2 years after the close of the first tax year in which you realize any gain from the involuntary conversion. If the sale due to drought, flood or other weather-related conditions is in an area eligible for federal assistance, the replacement period is extended from 2 years to 4 years.

Communicate with your tax professional prior to the end of your taxable year, to discuss your options for adjusting your taxable income.

If we do all that we can to adjust our family living and taxable income, will we have enough remaining net income to service our “debt obligations”? Maybe, or maybe not. This will depend on the amount of obligations that exist.

Farmers’ loans generally fall into the categories of “short-term loans” (operating and feeder livestock purchase loans), and “term loans” that are structured with stated payments over a period of time. Operating loans exist so that crop inputs and other operating expenses can be paid on a timely basis. This loan supplements the cash flow of the farm operator’s own money, so the bills can be paid when due. If the operating loan is used only for crop inputs, the sale of the grown crop need not produce a profit in order to repay the loan. (We want to see a profit of course, but if the gross sale of the crop was equal to the total of the crop inputs, there would be no profit, but the dollars of sale would be able to repay the crop inputs.) However, if the operating loan includes advances for payments on other loans, or advances for family living, these advances are actually

advance draws on future farm profits, and will require net farm income (profit) to repay them. A loan to buy feeder livestock does not require profit from the livestock in order to repay the loan. (Profit is the sale amount that exceeds the livestock purchase, feed expense, and other related expenses. If the profit was zero, but the livestock sale covered their purchase, the feed, and the other expenses, the loan can be repaid.) Is it possible that the drought is so severe that the sale of the crop will not even cover the costs of putting in the crop? Yes, it certainly can! What can be done then? If your area is declared a disaster area, the disaster aid offered will likely be aimed at this very need. Low interest loans to refinance operating loans that can not be repaid as agreed, may be available, with payments structured over future years. This is good, in the sense that it gives immediate relief to the operating loan, by putting the repayment off into the future. The down side of this, is that you then have an additional term loan that will require additional future profits to repay it. Whether or not your area is in a declared disaster area, communicate with your lender to discuss options available to you. Your lender knows that you are in a drought. They are in a drought too. They are concerned about loan quality and repayment ability. As a credit customer, your loans are a valued asset of the lender. Their relationship with you is valued. The lender will normally be very interested in assisting you to structure your loans in a realistic way, so that you can continue your farm business in a profitable manner.

“Term Loans” are loans that are designed to be repaid over more than one year. Loans for equipment, breeding stock, facility improvements, etc. are usually structured for 3 to 7 or so years. These are generally labeled as “intermediate-term loans”. Loans for purchase of land, buildings, major facilities, etc. are often structured for repayments over 15 to 30 years. These are generally labeled as “long-term loans”. The principal portion of these intermediate and long-term loans should be repaid from net income (profits). The interest portion of these payments is a farm expense, and has already been counted as an expense, when calculating the net farm income. Is it possible to make loan payments if the profits are not there? Yes, but be aware of what is happening. Some times the term loan payment is advanced on the operating loan. As stated above, this is really an advance on future farm profits. There may be sufficient liquidity (relationship of current assets to current liabilities) to allow this, or it may be causing a problem. Some times the term loan payments are made by selling grain or livestock. As has been stated before, the “profit” should exist to make these payments. If the payments are made by the grain or livestock sale, there may be sufficient liquidity (relationship of current assets to current liabilities) to allow this, or it may be causing a problem. Is the sale of this grain or livestock already promised to be applied to an operating loan? What can be done when the repayment ability is suffering? Probably the most important thing that can be done is communicate with the lenders. Again, they most likely already know that you are struggling, and believe it or not, they may also be loosing sleep over how these loans will be serviced. Communicate with them, and do not wait for the loan to be past due. Remember, you have already promised to make the payments, and you likely pledged property as collateral on these loans. A good lender values you as a customer, and will realize that your survival and success is important to them, also. Bring them your concerns and your projections. The lender may be able to defer payments, or re-structure your loan. Be realistic in your promises.

Borrowing someone else's money to add to your capital, leverages your funds to control more assets. The goal of controlling more assets (land, equipment, livestock, etc.) is to enable you to be more profitable, to the extent that there will be profit left over after family living and taxes, so that your net worth will grow over time. This leveraging of funds has its rewards, and its risks. Leverage in concept, is not entirely different than using a wrench with a long handle to control a bolt. You can apply a lot more torque on the bolt, and control its rotation. However, if the bolt is turning and you are on the end of the wrench trying to hang on, the longer the handle, the faster the ride. With your capital being leveraged in profitable times, it allows you to progress much faster than if you were working with only your own funds. In difficult times, when the profits are not there to properly make the payments, and your financial condition is deteriorating, it will deteriorate at a faster pace. The more leverage you have (borrowed capital in relation to your own capital), the faster you progress in good times, and the faster you go the other way in bad times. Having excellent farm records and financial statements are fundamental in understanding your finances. Know where you are financially at all times. Understand your ratios and your trends. After all, it is your financial life.

Source for Tax Information: 2005 Publication 225 "Farmer's Tax Guide".