TAX IMPLICATIONS OF DROUGHT INDUCED LIVESTOCK SALES

By Paul H Gutierrez and Jerry Hawkes
New Mexico State University

If a producer is forced to sell livestock, in excess of normal levels due to shortages of water, feed or other consequences of drought, the income tax on the gain from the sale of those animals may be postponed. Producers have two distinct tax options available to them in this circumstance;

Tax Treatment #1, Code Section 451(e): The election to postpone reporting the taxable gain on the additional sales of any livestock for one year; or

Tax Treatment #2, Code Section 1033(e): The election to postpone, and altogether avoid, paying taxes on the gain from the sale of breeding, draft, or dairy animals if they are replaced within a specified time frame

Both these Tax Treatments require that drought sales exceed the normal level of sales. Eligibility for the two different treatments depends on the class of livestock sold and whether the federal government has designated your area as eligible for assistance. In the case of the latter, all 32 New Mexico counties received federal designation.

Tax Treatment #1, Code Section 451(e)—POTENTIALLY ALL LIVESTOCK

The deferred sales receipt method has the broadest class of animals that qualify. That is, only breeding livestock are eligible for the involuntary conversion tax method, which follows. Yearlings and even "sporting livestock" are potentially eligible for the deferred sales method described here. 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 (the taxpayer's) principal business is farming or ranching.
2. You utilize the cash method of accounting.
3. You state you are making an election under I.R.C. section 451 (e) and attach it to your drought-year return. You also attach a statement explaining the reasons that forced sales were necessary (lack of forage, water, feed, etc.).
4. You provide evidence that "excess livestock" sales are due to drought and not a sell-off that is beyond drought-induced conditions. A three-year average is used to compute normal sales levels when making the calculation for "excess livestock" sold.
5. Your county or a neighboring county is designated as eligible for federal disaster assistance. Drought designation may be made by the president, an agency of the federal government (e.g., the Federal Emergency Management Agency or the Small Business Administration), or a Department of Agriculture agency (e.g., Farm Service Agency). The sale of livestock can occur before or an area is designated a disaster area.
6. You total the number of animals sold this year and the number sold because of the drought. Any gain realized from weather-related sales must be provided. Income from normal sales is reported on this year's Schedule F while excess sales are reported on next year's Schedule F.

Livestock held for sale (e.g., steers, feeder heifers) can only qualify for tax treatment #1 or a one-year postponement in drought-induced income. Not all income needs to be deferred to the following year though. An advantage to Tax Treatment #1 is that some drought sale income can be taken as income for that year and some can be deferred to the following year. How much income is to be reported in the year of the sale or the following year must be decided by the due date of the return for the tax year in which the drought sale occurred.

Another advantage to this treatment is that the tax basis for purchased replacements is not reduced by the amount of the postponed gain. Thus, if a raised cow is sold for $700 and a replacement is later purchased for $700, the entire $700 paid for the replacement is depreciable. If prices are low and you expect to be in a zero or low marginal tax bracket, counting some if not all drought induced sales as income for the drought year may likely be your best alternative. Keep in mind that any drought-assisted aid will need to be declared as income for the tax year that monies are received regardless of the method used for reporting livestock sales. See below for an example of the deferred tax treatment method.

Example of Tax Treatment #1 [election under I.R.C. 451 (e)]

Every year in the fall, Rancher Gilbert normally sells 75 yearlings, 12 cows, and 1 bull (most recent 3-year average). Due to the drought this year, Gilbert sold 75 yearlings in May along with 12 pairs (24 head). In July, Gilbert sold 25 cows, 3 bulls, and 50 lightweight calves that were born earlier in the year. Normally, Gilbert doesn't sell any pairs or calves that are less than a year old.

Sale prices were $825/head for the yearlings, $750 average for the 15 pairs sold, $650/head for the 30 cows sold, $780/head for each bull, and $412/head for calves that were less than a year old.

Under Tax Treatment #1, 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 ($113,315 / 177 hd. = $640/hd.). This average is multiplied by the excess number sold (i.e., 177-88=89 head) due to drought to give the "excess sales." In this example, 89 hd. x $640/hd., or $56,960 in sales that may be deferred for up to one year.

The election of how much income to postpone must be made in the tax year of the drought sale. After accounting for drought assistance benefits and other income and expenses, which are often a lot higher in drought years, a plan should be devised for minimizing tax liabilities. The decision to buy breeding stock or retain more heifers in the following year needs to be considered in determining the amount of income to postpone for one year.

A disadvantage of Tax Treatment #1 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 to four years or one year beyond the one-year postponement described above. Code Section 451(e), provides for the one year postponement of gain on the sale of all classes of livestock.

Tax Treatment #2, Code Section 1033(e)—INVOLUNTARY CONVERSION, BREEDING CATTLE

Tax treatment #2 fits under the terminology of "involuntary conversion" in the tax guides. Gains from draft, breeding, or dairy animals sold as the result of a drought 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, many similar to Tax Treatment #1, include the following:

1. Your drought-induced sales must exceed a normal three-year average.
2. You must purchase replacement livestock within two years of the end of the tax year of sale. However, counties having Presidential disaster declaration my have a four years to replace livestock.
3. There is no minimum holding period. That is, bred heifers that you may have just purchased last year qualify as breeding livestock.
4. You must use replacement livestock for the same purpose. The tax basis of the replacement livestock is equal to the basis of the sold livestock plus an additional amount invested in the replacement livestock that exceeds the proceeds from the sale. An area need not be declared a federal disaster area, but there must be evidence that a drought occurred. For example, newspaper clippings or rainfall reports are generally sufficient proof. Government designation that the county is in a disaster area is sufficient and will allow for four year replacement period.
5. You must provide a computation of the number and kind of livestock by category and the accompanying gain realized from drought sales.

When you buy replacements, attach to the tax return the date replacements were purchased, the cost of replacement animals, and the number and kind of replacements. Carefully consider your future intentions for rebuilding your herd when opting for the involuntary conversion treatment. Raised replacements are not eligible for "replacement livestock." Also, attention needs to be given to the selling price and expected purchase price. Consider the example of involuntary conversion below.

<u>Example of Tax Treatment #2 [election under I.R.C. 1033 (e)]</u>

Rancher Casey normally sells 20 cows and bulls from her beef herd every year but this year she sells 50, 30 more than normal due to the drought. The average selling price for all 50 head is $675/head. Thus, Casey defers the income from 30 head or $20,250 for this year. The 30 head have a zero basis because the cows were ranch raised and a cash accounting system was used.

If in the following two years Casey buys only 25 cows to replace the 30 sold, at a purchase price of $1,000/head, or $25,000, the resulting tax basis, or depreciable basis for the 25 replacements would be $325 per head ($0-$1,000-$675, the tax basis of breeding animals sold, plus or minus the difference between the replacement price and the sale price). Furthermore, Casey's 25 head of replacement cows in valued costing in excess of the $20,250 deferred income would result in no taxable income from the earlier drought forced sale of cows.

If Casey purchased replacements for $875/head, or $21,875 the tax basis for the 25 replacements would be $200/hd., and again no taxable income from earlier drought forced sale. But if Casey purchased 25 replacements for $625/head, or $15,625 then an gain of $4,625 ($20,250 deferred-$15,625 replacement) would have to be filed to an amended tax return for the drought year and taxes paid on the gain. Not a likely situation in today's cattle market.

Keep in mind that any gains 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 a rancher into a higher marginal tax bracket for a drought year than planned.

Since every tax situation and ranch plan is different, no standard recommendation can be given as to whether the one-year postponement is preferred to the two-year involuntary conversion. Close consultation and planning with a tax advisor or accountant is likely to pay a heavy dividend if you have or plan to make substantial drought sales this year. Please refer to the Farmer's Tax Guide (Publication 225) or contact the IRS (1-800-829-1040) for more current and complete tax information.

The Farmer's Tax Guide along with other tax forms and publications are available on the Internet at http://www.irs.gov Current information related to drought-assisted aid programs can be found at http://www.fsa.usda.gov

Additional drought management resources can be found at http://aces.nmsu.edu/drought/

When there are adverse consequences due to weather related sales of livestock, there are two provisions in the law to help producers. This fact sheet explains both provisions and how to use them, with examples of each. http://www.ruraltax.org/files/uploads/Livestock%20Sales%20(RTE%202010-09).pdf – Fact sheet at Rural Tax Website -- **Weather Related Sales of Livestock:**