

Weather-Related Sales of Livestock

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Weather variability is one of the largest sources of risk in agricultural production. Congress recognizes the impact weather variability has on the livestock industry and the difficulty producers have in protecting themselves from this risk by implementing special tax provisions.

Two provisions are of particular interest.

- Code Section 451(e) deals with situations where a producer sells more livestock (including poultry) than they normally would have because of a drought, flood, or other weather-related condition and desires to postpone the recognizing the gain resulting from the disposal of the livestock until the following year.
- Code Section 1033(e) deals with the sale of livestock (other than poultry) in excess of normal that had been held for draft, breeding, or dairy purposes solely because of the drought, flood, or other weather-related condition, with the producer desiring to postpone reporting any gain and replacing the livestock at a later time. Thus both of these deferral provisions hinge on weather-related sales of livestock in excess of normal number of head.

Code Section 451(e) provides for the one year postponement of gain on the disposal of all classes of livestock (including poultry). The postponement is applicable only to the gain resulting from the livestock disposed of that is more than normal for that producer. To qualify for Section 451(e) the area must have been declared eligible for federal assistance. The sale of the livestock could have occurred earlier in the year prior to the designation as eligible for federal assistance; however, the weather-related condition that caused the federal assistance designation must also be the weather condition that caused the sale of livestock.

All of the following conditions must be met to qualify for postponing gain under the Code Sec. 451(e).

- Your principal trade or business is farming.
- You use the cash method of accounting.
- You can document your disposal of more livestock during the year than you normally would have, except for the weather-related condition.
- The weather-related condition caused the area to be designated as eligible for assistance by the federal government.

Example 1

Cowboy Rogers normally sells 100 head of raised beef calves each year. As a result of a drought, Cowboy sells 150 calves on July 7, 2005 realizing \$90,000 from the sale. On Aug. 10, 2005, as a result of the drought, the area was declared a disaster area eligible for federal assistance.

If Cowboy meets the requirements of Section 451(e), he can elect to postpone the gain (\$30,000) on the sale of the 50 head of calves (those he would not normally have sold during the current year) to 2006.

Attach a statement with your name and address to the return for the year of sale — including the following information for each class of livestock (hogs, sheep, cattle) for which you are electing to postpone gain.

- A statement that you are electing to postpone gain under Code Section 451(e).
- Evidence of the weather-related conditions that forced the early disposal.
- Date and information verifying area was designated as eligible for federal assistance. Number of animals sold in each of the 3 preceding years.
- Number of animals you would have normally sold this year in the absence of the weather-related condition.
- Total number of animals sold and the number sold because of the weather-related condition.
- A computation of the income to be postponed.

Code Section 1033(e) provides for the postponement of gain on the disposal of qualified livestock (poultry does not qualify for this provision) when the producer intends to replace the livestock at a later date. As with Section 451(e), only livestock sold in excess of the number you normally would sell under usual business practice, in the absence of weather-related conditions, are considered as qualifying involuntary conversions.

To postpone gain under this provision, replacement property must be acquired within a specified period of time. The replacement period begins on the date the livestock were sold or exchanged. The replacement period generally ends two years after the close of the tax year in which the involuntary conversion occurred. The replacement livestock must be used for the same purpose as those disposed — i.e., breeding stock must be replaced with breeding stock, and dairy cows with dairy cows.

The American Jobs Creation Act of 2004 added two new options available for taxpayers that have involuntary conversion of livestock. These new options are not only available now, but were made effective retroactively for tax years ending after Oct. 22, 2002. First, in areas designated as eligible for federal assistance, the replacement period under IRC 1033 is extended from two years to four years after the close of the year in which any part of the gain on conversion is realized. Thus two replacement periods are available under Section 1033:

- Two years if the area is not declared eligible for federal assistance.
- Four years if the area is declared eligible for federal assistance

Second, the Act provides that taxpayers may replace livestock with other farm property if, due to drought, flood, or other weather-related conditions, it is not feasible to reinvest the proceeds in property similar or related in use to the converted livestock. The "\$64,000 question" is what the Regulations will consider to qualify as "not feasible". Stay tuned!

Example 2

Wendy Roper normally sells 20 cows from her beef herd each year. In 2005 a severe hail storm reduced her hay crop and pasture yield to the extent she did not have enough forage to carry the normal herd through the winter.

Consequently, as a result of the hail storm she sold 60 raised cows during 2005 realizing \$60,000 from the sale.

If Wendy plans to replace the cows sold in 2005, the gain from 40 of the cows (those in excess of the cows normally sold each year) may be deferred and the gain will not have to be recognized if the proceeds are used to purchase replacement cows within two years of the end of the tax year of the sale.

If Wendy buys only 39 replacement cows during 2006 and 2007, \$1,000 of gain (for the cow not replaced) must be reported on her amended 2005 tax return regardless of the amount paid for the 39 replacement cows. Note: the item-for-item replacement rule does not apply to like-kind exchanges under Code Section 1031.

Example 3

Derry Barnes normally sells 20 cows from his dairy herd each year. In 2005 as a result of a drought he sells 30 cows, realizing a gain of \$30,000. As a result of the drought the area was declared eligible for federal assistance. Derry plans to replace to replace the dairy cows in subsequent years.

Since the drought caused the sale of extra cows and resulted in the area being designated as eligible for federal assistance, Derry has four year from the end of the tax year of sale to replace the 10 cows — deferring and avoiding recognition of the gain.

A statement with the following information for each class of livestock must be attached to the return in the year of disposal to elect postponement of the gain.

- A statement that you are electing to postpone gain under Code Section 1033(a).
- Evidence of the weather-related conditions that caused the disposal of the livestock.
- Number and description of animals sold.
- A computation of the amount of gain realized on the sale.
- Number of animals you would have normally sold under usual business practices.
- A computation of the income to be postponed.

Observations

- Section 1033(e) is not limited to cash basis taxpayers whose principal trade or business is farming.
- Taxpayers qualifying and electing the four year replacement period under Section 1033(e) have four years to evaluate their options regarding whether to replace the livestock or to amend the tax return for the year of disposal reporting the income that year or to elect Section 451(e) reporting the income in the year following the year of disposal.

Year(s) of replacement

Another statement is to be attached to the tax return for the year in which replacement property is acquired. The statement should contain detailed information on the replacement property and a computation of tax basis allocation.

An amended return (Form 1040X) must be filed for the tax year of the realized gain if replacement property is not acquired within the replacement period. Additionally, if fewer replacement animals are acquired during the replacement period, the proportional postponed gain on the animals not replaced must be reported as taxable gain on Form 1040X for the tax year the gain was realized.

The following are free references for further investigation into this topic.

- IRS Publication 225 *Farmer's Tax Guide*
- IRS Publication 544 *Sales and Other Dispositions of Assets*
- IRS Publication 547 *Casualties, Disasters and Thefts*

The Farmer's Tax Guide is available at most local MU Extension centers.

The publications are also available on the Web.

<http://www.irs.ustreas.gov/formspubs/index.html>

Related MU Extension publications

- FM6701, Missouri Farm Tax Record: Part 1, Cash Paid-Cash Received
<http://extension.missouri.edu/p/FM6701>
- FM6702, Missouri Farm Tax Record: Part 2, Four-Year Depreciation Records
<http://extension.missouri.edu/p/FM6702>
- NCR2, Income Tax Management for Farmers
- <http://extension.missouri.edu/p/NCR2>

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