Managing for
Today's Cattle Market
and Beyond

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Weather Related Sales of Livestock and Tax Implications

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Special tax treatment is generally available to producers that 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.

Deferred Livestock Sales — Potentially All Livestock

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

- 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 (see the accompanying example for Deferred Livestock Sales).

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 is to be reported for the year of the sale or the following year must be accrued by the due date of the return for the tax year 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. See the accompanying box (insert Box #1 here) for an example of the tax deferred tax treatment method. A disadvantage to 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.

Involuntary Conversion — Breeding Cattle

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 above 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 (see the Involuntary Conversion example).

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.

Government payment assistance during or after a weather related event is a possibility through programs like the Livestock Assistance Program (LAP) and Livestock Indemnity Program administered by the Farm Service Agency. A county must have suffered a 40 percent or greater loss of available grazing for at least 3 consecutive months to be eligible for LAP assistance. Assistance is based on the value of feed calculated on a corn equivalent basis. Information needed to apply for LAP benefits include: 1) number and share of livestock owned, 2) acres, location and type of grass or forage used to support your livestock, 3) estimated percentage of your grazing loss, and 4) dates of any significant livestock inventory changes. Livestock Indemnity Assistance is possible for areas that receive a Presidential Disaster Declaration or requested a Secretarial Disaster Designation and received this status. This program provides partial reimbursement of livestock losses to eligible producers. Livestock Indemnity Program payments are not reduced to account for any insurance indemnity payments received from other sources. This is done so that the LAP does not discourage private means of insuring livestock losses.

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. The Farmers Tax Guide along with other tax forms and publications are available on the Internet at the address of **http://www.irs.gov**. In addition, current information related to federal assistance from weather events can be found at the address of **http://www.fsa.usda.gov**.

Addendum: *Two Examples*

Example of Deferred Livestock Sales (election under I.R.C. 451 (e)):

Rancher Joe normally sells 100 yearlings in the fall every year, 13 cows and 2 bulls (most recent 3 year average). Due to the drought this year, Joe sold 100 yearlings in May along with 15 pairs (30 head). In June Joe sold 30 cows, 5 bulls, and 50 lightweight calves that were born earlier in the year. Normally, Joe doesn't sell any pairs or calves that are less than a year old. Sale prices were $275/head for the yearlings, $400 average for the 15 pairs sold, $325/head for the 30 cows sold, $600/head for each bull, and $150/head for the calves that were less than a year old. 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 ($53,750 / 215 hd. = $250/hd.). This average is multiplied by the excess number sold due to drought (215-115=100) to give the "excess sales" amount. In this example, 115 hd. x $250/hd., or $28,750 in sales may be deferred for up to one year. The election of how much income to postpone must be made in the year of the drought induced sale.

Example of Involuntary Conversion (election under I.R.C. 1033 (e)):

Rancher Bob normally sells 20 cows and bulls from his beef herd every year but this year he sold 50, 30 more than normal due to the drought. The average selling price for all 50 head was $300/head. Thus, Bob defers the income of 30 head or $9,000 for this year if the cows were raised and have a zero basis. If in the following two years Bob buys only

25 cows to replace the 30 sold, a gain of $300/head for five head must be reported regardless of what was paid for the 25 replacements purchased. Bob would need to report an additional $1,500 ($300 x 5) of income to an amended return for the year in which the drought sales occurred and any additional taxes must be paid. If Bob purchased replacements for $400/head, then the tax basis for the 25 replacements would be $100 (replacement price minus the gain on the drought induced sale that wasn't taxed). But if Bob purchased 25 replacements for only $250/head then an additional $1,250 gain ($50/head x 25 head) would have to be filed to an amended tax return for the drought year.