# Income Tax Issues of Weather-Related Sales of Livestock

If you must sell farm livestock (other than poultry) as a result of a weather condition (i.e. drought or flood), there are IRS rules from which you may benefit. Records of unusually large sales and documentation of weather conditions causing the sale will be needed if these rules are used. Under the Internal Revenue Code (IRC) there are two code sections that might provide taxation relief depending on the producer's situation and choice made.

**1. Two-year deferral of income from excess livestock sales, IRC Section 1033(e)**

This rule applies to adult animals held for breeding, dairy or draft purposes. Rules for deferring gains (sales price less basis, raised animals have zero basis) from livestock sales due to an involuntary conversion (forced or earlier than planned sale) because of a weather condition such as drought are found in IRC Section 1033(e). Briefly, this code section allows livestock producers to account for the excess sales (beyond normal numbers sold) and defer gains on those excess sales. Records and accounting become very important to determine which sales must be recognized and reported on the current year tax return versus those that are excess sales and may be deferred. Deferral using this option means producers report income from the excess animal sales as received on the election they make (see below), but this income is not taxed at that time. Then, provided replacement animals are purchased during the replacement period, tax is not paid on the gain resulting from the excess sale. Thus the earlier income from excess animal sales becomes a "non-taxed event." Note that these replacement animals should not be placed on depreciation.

The general rules for IRC Section 1033(e) are 1) the animals must be held for draft, breeding or dairy purposes, 2) the sale of these animals was due to a weather condition in the production location, 3) the livestock producer plans to replace the excess sales of livestock within two years with like-kind animals (i.e. beef cows for beef cows).

**Example:** Dusty Hay is a livestock producer who has a cow-calf operation. Dusty's breeding herd consists of 100 brood cows and 4 bulls. Due to a drought in 2007, the winter forage supplies are short and not available at a price he can afford. Dusty has a longstanding business practice to cull 10 cows and one bull per year from his herd and replace them either from his herd's heifer production or by purchasing them from purebred breeders. This year, due to the drought, Dusty decides to sell an additional 30 cows to take pressure off the dry pastures and short winter feed supplies.

Dusty is able to defer the tax consequence of the additional 30 cows under the provisions of IRC Section 1033(e). But he must replace the cows with cows and spend at least as much as he deferred. There is no requirement that a federal declaration of a weather condition be made in the area where Dusty's cattle are, only that a documented (by records, even farm records) weather condition exists. The two-year deferral can be extended to four years based on continuing weather conditions; see IRS Notice 2006-82, 2006-39 IRB for more detail.

**2. One-year deferral of livestock income due to weather conditions, IRC Section 451(e)**

Livestock producers can benefit from a second provision in the tax code for sales of animals due to weather conditions. This provision differs in two significant ways from above: 1) The area in which the producer operates his livestock business **must** be a federally declared disaster area due to weather conditions and 2) the livestock sold can be any livestock, including offspring (i.e. calves, lambs) that are normally sold as part of the farm operation. Two other conditions also apply, the individual's principal business must be farming as defined in IRC Section 6420(c)(3), which includes livestock husbandry, and the individual must use the cash method of accounting.

As with the involuntary conversion situation discussed previously, the farmer may defer the income from the excess sales of livestock due to the weather condition. The sale can take place either before or after the federal disaster area declaration, and the animals do not need to be actually raised or sold in the disaster area. The key point is that the same weather-related condition causes the sale of livestock coming from another location because of lack of feed.

**Example:** Dusty Hay, from the previous example, faces continuing drought conditions in his area. Recently his county was declared a federal disaster area due to the drought and is eligible for federal assistance. Dusty realizes that he cannot feed his 2007 calf crop over the winter. His normal business practice is to sell his fall calf crop in the calendar year after they were born. Dusty sold his 2006 calf crop in March of 2007; he now sells his 2007 calf crop in mid-September, effectively doubling calf sales this year.

Under IRC Section 451(e) Dusty can defer the recognition of (i.e. reporting of income from) the 2007 calf-crop sales (received in September) until 2008 (Dusty makes a book entry in his farm records for this sale in January of 2008). This allows his taxable income to reflect his long-held business practice. Dusty is not required to buy any replacements as the purpose is to "level" taxable income between two tax years.

Farmers wanting to defer excess livestock income must make elections (choices) on their current-year tax returns. The election to defer recognition of gain is made by attaching a statement to the tax return with the following:

- Election is made under which IRC code section,
- Evidence of weather-related conditions that forced the sale of excess livestock,
- A calculation of the gain realized on the sale but deferred to the subsequent year(s),
- The number and type of livestock sold or exchanged, and
- The number of livestock of each kind (i.e. breeding versus offspring) that **would have been** sold or exchanged under usual business practices.

A weather condition may persist from one year to the next, causing farmers to rethink prior year's plans. This may cause a change in the prior year's tax election. Farmers may change an IRC Section 451(e) election (on breeding, dairy or draft animals) to an IRC Section 1033(e) election and thereby gain up to three additional years before recognizing the income of deferred livestock sales. However, farmers may not change from an IRC Section 1033(e) to an IRC Section 451(e) election.

Farmers are encouraged to contact knowledgeable professional tax assistance for application of tax rules to their particular set of facts and circumstances.

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