Weather-Related Sales of Livestock

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Overview

I just returned from a speaking trip that took me through several states in the West. While many parts of Kansas have had plentiful rainfall this Spring and Summer, many parts of the West have not. Much of the West is struggling with drought and fire this summer and a smoky haze lingers over many areas.

Sometimes drought and other weather conditions can cause livestock owners to sell more livestock than normally would be sold in a particular year. When that happens, special tax rules can apply to address the additional income triggered by the excess sales.

Weather-related sales of livestock – it's the topic of today's post

Two Provisions

There are two statutory deferral strategies available to defer the income from excess livestock sold over normal business practice if the sale was on account of a weather-related condition.

Involuntary conversion. If a farmer sells livestock (other than poultry) held for draft, dairy or breeding purposes in excess of the number that would normally be sold during the time period, the sale or exchange of the excess number may be treated as a nontaxable involuntary conversion if the sale occurs because of drought, flood, fire or other weather-related condition. *I.R.C. §1033(e).*

The livestock sold or exchanged must be replaced within two years after the year in which proceeds were received with livestock similar or related in service or use (in other words, dairy cows for dairy cows, for example), and be held for the same purpose that the animals given were held. *Treas. Reg. §1.1033(e)-1(d).* This is why, for example, dairy cows can be replaced with dairy cows, but they can't be replaced with breeding animals. But, if the taxpayer can prove that it is not feasible to reinvest the proceeds in property similar or related in use, the proceeds can be reinvested in other property used for farming purposes (except real estate). Similarly, if it is not feasible to reinvest the proceeds from involuntarily converted livestock into other like-kind livestock *due to soil or other environmental contamination,* the proceeds can be invested into property that is not like-kind or real estate used for farming purposes. *I.R.C. §1033(f).*

The tax on the sale is triggered when the replacement animals are sold.

The two-year replacement period is extended to four years in areas designated as eligible for assistance by the federal government (i.e., by the President or any agency or department of the federal government). *I.R.C. §1033(e)(2)(A).* For example, if a farmer sells excess livestock in 2021, the replacement period begins in 2022 and runs through 2025.

Presumably, any livestock sales that occur *before* the designation of an area as eligible for federal assistance would also qualify for the extended replacement period if the drought, flood, or other weather-related conditions that caused the sale also caused the area to be so designated. The replacement property must be livestock that is similar or related in service or use to the animals disposed of. Also, the Treasury

Secretary has the authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than three years. *I.R.C. §1033(e)(2)(B).*

Note: *Notice 2006-82, I.R.B. 2006-39, 529*, IRS specified that the replacement period will be extended until the end of the taxpayer's first taxable year ending after the first "drought-free year" for the applicable region. "Drought-free year" means the first 12-month period that (1) ends on August 31; (2) ends in or after the last year of the taxpayer's four-year replacement period; and (3) does not include any weekly period for which exceptional, extreme or severe drought is reported for any location in the applicable region. "Applicable region" is defined as the county that experienced drought conditions on account of which the livestock was sold or exchanged and all contiguous counties. "Exceptional, extreme or severe drought is to be determined by reference to U.S. drought monitor maps which are accessible at http://www.drought.unl.edu/dm/archive.html. IRS also publishes, by the end of September every year, a list of counties for which extreme or severe drought was reported during the preceding 12 months. For 2020, the IRS issued Notice 2020-74, 2020-41 IRB on September 22, 2020, providing guidance on the replacement period under IRC §1033(e).

The election to defer the gain is made by attaching a statement to the return providing evidence of the weather-related condition that caused the early sale, the computation of the gain realized, the number and kind of livestock sold and the number and kind of livestock that would have been sold under normal business practices. The election can be made at any time within the normal statute of limitations for the period in which the gain is recognized, assuming that it is before the expiration of the period within which the converted property must be replaced. *Treas. Reg. §1.1033(e)-1(e).* If the election is filed and eligible replacement property is not acquired within the applicable replacement period (usually four years), an amended return for the year in which the gain was originally realized must be filed to report the gain. But, if the animals are replaced, for the tax year in which the livestock are replaced, the taxpayer should include information with the return that shows the purchase date of the replacement livestock, the cost of the replacement livestock and the number and kind of the replacement livestock. The election must be made on the return for the first tax year in which any part of the gain from the sale is realized. It's also very important for a taxpayer to maintain sufficient records to support the nonrecognition of gain.

Note: For livestock that are partnership property and are sold by the partnership, the election is the responsibility of the partnership. The partners do not individually make the election to defer recognizing the gain. *Rosefsky v. Comm'r, 599 F.2d 515 (2d Cir. 1979).*

If insurance proceeds are received that exceed the tax basis of the involuntarily converted animals, the excess is taxable gain that is also deferrable if an election is made to defer the gain and the livestock are replaced within the applicable timeframe. In that instance, the deferred amount is taxed at the time the replacement animals are sold.

Note: However, it may be advantageous from a tax standpoint for the rancher to report the gain on the animals in order to claim ordinary depreciation on the replacement animals.

Under I.R.C. §1033(a)(2)(C), the statutory period for the IRS to assess any deficiency for any tax year where part of the gain under the involuntary conversion rules is realized doesn't expire before three years from the date the taxpayer notifies the IRS of the replacement of the converted property or of an intention not to replace. If there is a deficiency, the IRS may assess the deficiency for up to three years from the notification. This means that the general three-year statute of limitations is extended. The effect of this is that if a livestock owner doesn't intend to replace the excess livestock when they are sold, the gain should be reported. This will avoid having to file an amended return in the future. Alternatively, the second provision – the one-year deferral provision could be utilized.

One-year deferral. Under the second provision, if farm and ranch taxpayers on the cash method of accounting are forced because of drought or other weather-related condition to dispose of livestock (raised or purchased animals that are held either for resale or for productive use) in excess of the number that would have been sold under usual business practices, they may be able to defer reporting the gain associated with the excess until the following taxable year. *I.R.C. §451(g).* In addition, the taxpayer's principal business must be farming in order to take advantage of this provision. In 1989, the IRS issued a very favorable ruling concerning what constitutes a farming business. *Priv. Ltr. Rul. 8928050, April 18, 1989.* In this ruling, a rancher had $121,000 a year gross income from ranching, and made $65,000 a year off the farm and it was determined that his principal business was farming where he devoted 750 to 1,000 hours per year to the ranch and his wife contributed about 300 hours. This ruling is a strong indication that taxpayers need not have all of their time on the farm in order to take advantage of this rule.

Deferral of income is limited to sales in excess of "usual business practices." Also, an election for one-year deferral is valid if made during the application replacement period for the livestock under I.R.C. § 1033(e).

Note: The gain to be postponed is equal to the total income realized from the sale of all livestock divided by the total head sold, with that result multiplied by the excess number of head sold because of the weather-related condition. The excess is determined by comparing the actual number of head sold to those that would have been sold under usual business practices in the absence of the weather condition. It is common to use the taxpayer's most recent three-year average in determining the number of livestock that would be sold under normal business practices. However, that is not the actual rule. Under Treas. Reg. §1.451-7(b) it is a facts circumstances test.

At the time the tax return is due for the year of the casualty, the livestock owner may not be sure of which election is the best one to make. In that event, a "protective" election can be made under I.R.C. §1033 for that tax year. If the livestock can be replaced within the applicable replacement period, the involuntary election can be revoked and the return for the casualty year can be amended to make the election to defer the gain for one year. In that instance, the return for the year after the casualty would also have to be amended to report the deferred gain.

Relatedly, a taxpayer can make an election under I.R.C. §451(g) until the four-year period for reinvestment of the property under I.R.C. §1033 expires. That means that if a livestock owner elects involuntary conversion treatment and fails to acquire the replacement livestock within the four-year period, the I.R.C. §451(g) election to defer the gain for one year can still be made. If that happens the livestock owner will have to file an amended return for the casualty year to make the I.R.C. §451(g) election and revoke the I.R.C. §1033(e) election, and the next year to report the gain deferred to that year.

Conclusion

These rules can be helpful for livestock owners dealing with drought and other weather-related conditions that have excess livestock sales. The two rules differ in terms of the type of livestock covered; the period within which to make the election; how the postponement works; the cause of the sale; whether a disaster need be declared; whether a repurchase of livestock is required; whether there is a carryover basis rule; and whether there is a replacement period.

Use the rule that works best for you.

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