BEEF USA
NATIONAL CATTLEMEN'S BEEF ASSOCIATION
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Q&A: Tax Options for Drought Sales of Livestock

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 options tax options available to them in this circumstance;

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

Code Section 451(e):

- Provides for the one year postponement of gain on the sale of all classes of livestock.

Q: What requirements must I meet as a producer?

A: In order to qualify for this election a producer must meet the following criteria:

- Their principal business must be farming.
- They must use the cash method of accounting.

Q: How do I make the election?

A: The 451(e) election must be made by the due date of the tax return for the tax year in which the sale occurred, and the following information should be attached to the statement:

- A declaration that the producer is taking an IRS Code Section 451(e) exemption.
- Evidence of the weather-related conditions that forced the sale of the animals.
- The number of animals sold under normal business practices during each of the past three years.
- The number of animals that would have been sold during the current tax year had the producer followed their normal business practices.
- Information verifying that the area was designated as eligible for federal disaster assistance, and that date at which that designation was received.
- Computations, consistent with IRS requirements, to show the amount of income that is being deferred until the next year.

Q: What if my county has not received a federal disaster declaration at this time?

A: In order for a producer to qualify for a 451(e) election, the area must have received a federal disaster declaration; however, it is not necessary that the sale of the livestock takes place after the declaration was received. The sale of the animals could have occurred prior to the area receiving a designation as eligible for federal disaster assistance, as long as the weather-related condition that caused the federal disaster designation was the same condition that forced sale of the livestock.

Q: What is an example of a situation where this election could be applied?

A: A cow/calf producer with 100 cows typically sells 25 of his calves after fall weaning while retaining the remaining 75 for back-grounding and sale the next Spring. This year, due to drought conditions, the producer has depleted feed stocks and is forced to sell all 100 calves immediately following weaning in the fall. This producer could postpone paying taxes on the gain from the sale of the additional 75 head until the next year.

Q: Is this the right choice for me?

A: There are a number of very important considerations that must be taken into account to accurately answer that question such as effects on depreciation and income averaging. This document is intended to aid producers in acquiring an understanding of their options, however, all producers should consult with their personal tax advisor/accountant in order to verify what strategies will work best for their operation.

Code Section 1033(E):

- Provides for the postponement of gain on the sale of breeding, draft, or dairy animals when the producer intends to replace them at a later time.

Q: What requirements must I meet as a producer?

A: In order to qualify for this election a producer must meet the following criteria:

- Their principal business must be farming.

Q: Is the 1033(e) election limited to cash-basis taxpayers?

A: No, a Section 1033(e) exemption is available to all taxpayers whose principal business is farming (unlike under Section 451(e)).

Q: How do I make the election?

A: The election to defer the payment of capital gains on the forced sale of livestock is made by demonstrating the involuntary conversion of those animals. This can be done by attaching the following information to the tax return for the year in which the sale of the animals occurred:

- A statement that the producer is electing to postpone gain under Code Section 1033(e).
- Evidence of the existence of the drought conditions that forced the producer to sell their livestock, and if applicable the date of federal disaster designation for that area.
- The number and kind of livestock that were sold.
- The number and kind of livestock that would have been sold should the producer have followed their normal business practices.
- A computation, consistent with IRS requirements, of the income that is being postponed.

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Q: How long do I have to replace the animals before I will be forced to pay capital gains?

A: Two different time frames can apply dependent upon the disaster declaration status of a producers' county.

- If the producers' area <u>*is*</u> eligible for federal disaster assistance, the replacement period begins on the date that the livestock were sold and ends <u>*four years*</u> after the close of the tax year in which the involuntary conversion took place.
- If the producer resides in an area that has <u>*not*</u> been declared eligible for disaster assistance, the replacement period begins on the date of the sale and ends <u>*two years*</u> after the close of the tax year in which the involuntary conversion occurred.

Q: Does that mean that I don't have to reside in a county that has been designated as eligible to receive federal disaster assistance in order to qualify for a 1033(e) election?

A: That is correct. Although the reinvestment time frame is two years shorter, producers whose county did not receive a federal disaster designation can still qualify for a 1033(e) election.

Q: What is an example of a situation where this election could be applied?

A: A cow/calf producer residing in a county that has been designated as eligible for federal disaster assistance customarily sells 20 cull cows every year, but due to the drought conditions he or she is forced to sell 60 head this year. The cows sold in excess of the normal number, 40 head, can be considered involuntary conversions. As such, the gain from the sale of those 40 head can be deferred, and will not have to be recognized, as long as the producer uses those proceeds to purchase replacement cows within 4 years of the end of the tax year in which the original animals were sold.

Q: What if the value of the replacements is different than the original animals?

A: In continuing with the example outlined above lets assume that the producer received $1000/hd for the 40 additional cows he or she was forced to sell in 2006. If this producer was to reinvest more than $40,000 in 40 cows in 2009, the excess would be his tax basis in those cows. However, if that producer reinvests less than $40,000 in 40 cows in 2009, the difference between the amount reinvested and the $40,000 must be reported as taxable income by amending the 2006 tax return (Form 1040X).

Q: What information must be filed for the year in which the animals are replaced?

A: The following information should be attached to the tax return for the year in which you replace the animals:

- The date the replacement animals were bought.
- The cost of the replacement animals.
- The number and kind of the replacement animals.
- A copy of the information you attached to the tax return from the year in which you claimed the involuntary conversion.

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Q: What if the drought condition still exists after four years have passed?

A: The Treasury Secretary has the discretion to extend the replacement period for breeding livestock beyond 4 years if the weather-related condition has persisted for longer than 3 years. The four year time frame for replacing animals that were sold from areas that had received federal disaster declarations was implemented as part of the American Jobs Creation Act of 2004, and was made retroactive to tax years ending after October 22, 2002. Thus, producers who were forced to sell their animals as a result of the drought in 2002, and that utilized a Section 1003(e) exemption, are now coming to the end of their reinvestment time frame. Under the current circumstances many regions of the country are experiencing severe drought and producers are facing the same, if not worse, drought conditions than they faced in 2002. NCBA recognizes this, and is working to have the reinvestment time frame extended for producers in the aforementioned situation.

Q: Can I reinvest in something other than livestock?

A: Producer 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 from the sale of the livestock in property similar to or related in use to the livestock. The difficult question is how the IRS will interpret "*feasibility*". Consult with your personal tax advisor for more information on this particular issue.

Q: Is this the right choice for me?

A: There are a number of very important considerations that must be taken into account to accurately answer that question such as effects on depreciation and income averaging. This document is intended to aid producers in acquiring an understanding of their options, however, all producers should consult with their personal tax advisor/accountant in order to verify what strategies will work best for their operation.

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Resources:

1. Hardin, M. Tax Consequences of Drought Sale of Livestock. *OSU Current Report CR-788, 0896*. Retrieved August 7, 2006, from http://www.oznet.ksu.edu/drought/drought/droughtsale.pdf.

2. Green, P. Weather-Related Sales of Livestock. *University of Missouri Drought Information.* Retrieved August 7, 2006, from http://agebb.missouri.edu/drought/taxlvst.htm.

3. United States Internal Revenue Service. *Farmers Tax Guide*. Retrieved August 7, 2006, from http://www.irs.gov/publications/p225/index.html.

4. United States Internal Revenue Service. *Publication 547: Casualties, Disasters, and Thefts.* Retrieved August 7, 2006, from http://www.irs.gov/pub/irs-pdf/p547.pdf.

5. United States Internal Revenue Service. *Publication 544: Sales and other Dispositions of Assets*. Retrieved on August 7, 2006, from http://www.irs.gov/pub/irs-pdf/p544.pdf.

6. United States Internal Revenue Service. *Sales Caused by Weather-Related Conditions*. Retrieved on August 7, 2006, from http://www.irs.gov/businesses/small/industries/article/0,,id=98990,00.html.

7. Cornell Law School, Legal Information Institute. *Title 26, Subtitle A, Chapter 1, Subchapter O, Part III, § 1033 Involuntary Conversions*. Retrieved August 7, 2006, from http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00001033----000-.html.

*More information on this topic can also be found at the Internal Revenue Service website: www.irs.gov or http://www.irs.gov/businesses/small/farmers/index.html.

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Summary of Tax Options for Drought Sales of Livestock:

Question	Section 451(e)	Section 1033(e)
What livestock qualifies?	All livestock	Breeding, draft, or dairy livestock
Must the county be eligible for Federal disaster assistance?	Yes	No, but the reinvestment timeframe is contingent upon the areas disaster declaration status
Do the animals have to be sold in the drought area?	No	No
What sales does the election apply to?	Sales in excess of normal business practices	Sales in excess of normal business practices
How does the election benefit me?	Postponing payment of income taxes on the sale for one year	Deferral of paying capital gains by carrying over basis, reinvestment timeframe applies.
Is replacement of the animals required?	No	Yes
What effects does the election have on basis?	N/A	Reduced by gain that is deferred
How long do I have to reinvest?	N/A	Two years if not eligible for federal disaster assistance; four years if eligible.
How long do I have to make the election?	Due date for the return for the tax year of the sale	Two years from the end of the taxable year of the sale