Tax Consequences of Weather Related Sale of Livestock

J C. Hobbs
Assistant Extension Specialist

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Often weather conditions have resulted in cattlemen having to sell a larger number of livestock than is the normal business practice. If you have sold livestock because of unfavorable weather conditions, take this article to your tax preparer. This information attempts to explain the tax rules that apply to weather related sales of livestock.

A farmer who sells livestock because of a shortage of water, grazing, feed production, or other consequences of a weather related condition may postpone the payment of income tax on the taxable gain from the sale. There are two separate and distinct tax treatments, both of which apply only to weather related sales of livestock in excess of normal business practice.

The election to postpone gain by repurchasing livestock within a two-year period applies to draft, breeding, or dairy animals that will be replaced within a two-year period. The election to postpone reporting the taxable gain for one year applies to all livestock.

Note: The two-year replacement period can be extended to four years if the area is eligible for assistance by the federal government. The Secretary of the Treasury can extend the replacement period for an even longer period of time if the weather condition continues for more than three years.

Election to Postpone Gain by Purchasing Replacement Animals

If livestock (other than poultry) held for any length of time for draft, breeding, or dairy (no sporting) purposes are sold because of a weather related condition, the gain realized on the sale does not have to be recognized if the proceeds are used to purchase replacement livestock within two years of the end of the tax year of the sale.

The new livestock must be used for the same purpose as the livestock sold. Therefore, dairy cows must be replaced with dairy cows. The taxpayer must show that weather caused the sale of more livestock than otherwise would have been sold in a typical year. For example, if the farmer normally culls or sells one-fifth of the herd each year, only the sales in excess of one-fifth will qualify for this provision. There is no requirement that the weather conditions cause an area to be declared a disaster area by the federal government. The farmer has a tax basis in the replacement livestock equal to the basis in the livestock sold plus any amount invested in the replacement livestock that is greater than the proceeds from the sale.

How to Make the Election

The election to defer the payment of tax on the gain by purchasing replacement livestock is made by not reporting the deferred gain on the tax return and by attaching a statement to the tax return showing all the details of the involuntary conversion, including:

a. Evidence of existence of the weather conditions that forced the sale or exchange of the livestock.
b. A computation of the amount of gain realized on the sale or exchange.
c. The number and kind of livestock sold or exchanged.
d. The number of livestock of each kind that would have been sold or exchanged under the usual business practice if the weather condition had not occurred.

Example 1

A taxpayer normally sells 15 cows from his beef herd each year. In 2011, drought conditions reduced his hay crop so that he did not have enough to carry his normal herd through the summer. Consequently, he sold 35 cows rather than 15 in 2011. He plans to purchase additional cows in 2012 to replace the extra 20 that were sold. How is this transaction reported for 2011?

Answer 1

Only 20 of the cows sold in 2011 qualify for the deferral of gain due to the drought. The taxpayer can elect to defer the gain by not reporting the gain on those 20 cows on his 2011 return, and attaching the following statement to the tax return:

Election under IRS Code Section 1033(e) to Postpone Recognition of Gain from Livestock Sold Because of Weather Conditions.

The drought conditions evidenced by the rainfall report attached to this statement caused the taxpayer to sell 35 head of beef cows rather than 15 head in 2011. The raised cows have a zero tax basis. The 35 cows sold for a total of $26,250. Taxpayer elects to defer the recognition of gain on the 20 extra head that were sold under IRS Code Section 1033(e). (20 / 35) x $26,250 = $15,000 of gain.

If the taxpayer reinvests $15,000 in replacement cows in 2012, he will have a zero tax basis in the replacement cows. If he reinvests more than $15,000 in the cows, the excess will be his tax basis in the cows. If he reinvests less than $15,000 in the cows, the excess of $15,000 over the amount reinvested must be reported as taxable income, by amending his 2011 income tax return. In addition to the tax owed, the farmer would owe interest on the additional tax.

The taxpayer should report the purchase of qualified replacement cows with his 2012 and/or 2013 return. If there is additional income for 2011, an amended 2011 return must be filed.

Election to Defer Income to Subsequent Tax Year

If any livestock is sold because of weather conditions, the taxpayer may be eligible for another exception to the general rule that the sale proceeds must be reported in the year they are received. This election applies to all livestock. This exception allows the taxpayer to postpone reporting the income by one year.

To qualify, the taxpayer must show that the livestock would normally have been sold in a subsequent year. Furthermore, a weather related condition that caused an area to be declared a disaster area must have caused the sale of livestock. It is not necessary that the livestock be raised or sold in the declared disaster area. The sale can take place before or after an area is declared a disaster area as long as the same disaster caused the sale.

The amount of income that can be postponed is computed as follows: Assume that because of weather, a taxpayer sold 500 head of calves in 2011 instead of the 300 she normally would have sold. She received $300,000 for the 500 head sold. She can postpone reporting the sale of only 200 calves. That amount is calculated by dividing the sale proceeds by the 500 calves sold and multiplying the result by the 200 for which she can postpone the proceeds. Therefore, $120,000 can be reported in 2012 rather than in 2011. ($300,000/500) x 200 = $120,000.

The election must be made by the due date of the return (including extensions) for the tax year in which the sale occurred. The election is made by attaching a statement to the return that includes the following information:

a. A declaration that the taxpayer is making an election under IRS Code Section 451(e).
b. Evidence of the existence of the weather conditions that forced the taxpayer's early sale or exchange of the livestock.
c. The total number of animals sold in each of the three preceding years.
d. The number of animals that would have been sold in the taxable year had the taxpayer followed his or her normal business practice in a typical year.
e. The total number of animals sold and the number sold because of weather during the taxable year.
f. A computation, pursuant to Reg. IRS Code Section 1.451-7(e) (the computation shown above), of the amount of income to be deferred for each such classification.

Present law allows sales of livestock due to any weather related condition, such as drought, hurricane, tornado, or flooding qualify for relief under IRS Code Section 451(e) or IRS Code Section 1033(e).

Revoking an Election to Defer Reporting of Weather Related Sales of Livestock

In the situation that breeding, dairy, or draft livestock are sold and the taxpayer determines that replacing them would be of greater benefit than postponing the gain until the following year the election can be revoked.

Example 2

In 2010, a taxpayer disposed of an unusually high number of dairy cows, due to drought conditions. On his 2010 tax return, he made an election under IRS Code Section 451(e) to include the income from the excess sales of livestock for 2010, the year following the year of actual sale. Later, in 2011, he decided to replace the excess dairy cows sold and asks if he can revoke the IRS Code Section 451(e) election and replace the involuntarily converted dairy cows under IRS Code Section 1033(e).

Answer 2

According to Letter Rulings 9127012, 9214021, and 9333032, a taxpayer can revoke the IRS Code Section 451(e) election only with the consent of the Commissioner of IRS. However, all taxpayers in the above rulings were allowed to do so. The taxpayers apparently can also then elect under IRS Code Section 1033(e) to replace the involuntarily converted animals within the two-year replacement period. Under IRS Code Section 1033(e), all of the details in connection with an involuntary conversion of property at a gain must be reported in the return of the year in which the gain is realized. However, all of those details were also supplied with the original IRS Code Section 451(e) election. Therefore, a taxpayer originally electing IRS Code Section 451(e) treatment has also complied with the information reporting under IRS Code Section 1033(e). Since there is no specific requirement that IRS Code Section 1033(e) be elected on a timely filed return (but only that the appropriate information be supplied), a taxpayer can apparently elect IRS Code Section 1033(e) treatment on an amended return.

Note: A letter ruling request may have to be filed to request permission for such a change. Thus, the taxpayer could likely change his IRS Code Section 451(e) election to an IRS Code Section 1033(e) election, if he filed a letter ruling request to do so. Alternately, the taxpayer might elect to request a determination letter from the District Director. A determination letter is apparently an option when the issue is the replacement of involuntarily converted property under IRS Code Section 1033, if the taxpayer has filed a return for the year in which the property was involuntarily converted (Rev. Proc. 95-1, 2006-1 IRB 9). This option would reduce the required user fee to $275, or a savings of $625.

Example 3

A taxpayer disposed of an abnormally high number of beef cows in 2010 due to drought conditions. On her 2010 tax return, she made an election under IRS Code Section

1033(e) to replace the involuntarily converted animals with the designated two-year time period. In 2011, she decides that she will not replace the beef cows. However, she would prefer to report the income from the drought sale in 2011, rather than amending her 2010 return, since her marginal tax rate was significantly higher in 2010 than in 2011. Can this taxpayer revoke the IRS Code Section 1033(e) election and elect the one-year deferral of sale reporting under IRS Code Section 451(e)?

Answer 3

Apparently the taxpayer cannot revoke the IRS Code Section 1033(e) election and adopt an IRS Code Section 451(e) election. An election under IRS Code Section 451(e) must be made by the due date of the return (including extensions) for the tax year in which the weather related sale occurred. Thus, if she did not replace the involuntarily converted beef cows within the designated time period, she would be required to amend her 2010 tax return and report the sales proceeds in that year.

Therefore, taxpayers who have the opportunity to elect either deferral method need to be careful in making the election. Once IRS Code Section 1033(e) treatment is elected and the due date of the return passes, IRS Code Section 451(e) treatment is no longer available. If, on the other hand, IRS Code Section 451(e) treatment is elected, it may only be revoked with permission, which may require a letter ruling request and a $900 fee. A second option is to request a determination letter, which has a cost of only $275. However, if permission to revoke IRS Code Section 451(e) treatment is granted, an IRS Code Section 1033(e) election on an amended return would defer any realized gain until the replacement property is sold.

Revoking a Drought Sale Election

Situation 1.

Original Election	*Can Revoke*	*New Election*
§451(e) One-Year Deferral	Yes	§1033(e) Purchase Replacements

WHY: A taxpayer that originally elected IRS Code Section 451(e) treatment has also complied with the information reporting requirements for electing IRS Code Section 1033(e) treatment. A taxpayer then can elect IRS Code Section 1033(e) treatment on an amended return.

Situation 2.

Original Election	*Can Revoke*	*New Election*
§1033(e) Purchase Replacements	Yes	§451(e) Not Available

WHY: IRS Code Section 451(e) Election must be made by original tax return due date. To change this election from IRS Code Section 1033(e) to IRS Code Section 451(e), a Letter Ruling request for permission to change and consent from the Commissioner of IRS may be required.

In the year that the animals are replaced, another statement must be attached to the income tax return. It needs to provide information about the number of animals replaced and a computation of the income tax basis allocations. If only a few of the animals are replaced, a similar statement must be attached to the return for that year as well.

If all or any part of the animals are not replaced, an amended return must be filed for the tax year that the original weather related sale occurred in order to report the income and pay any additional tax.

Summary of Weather Related Sale Rules for Livestock

	IRS Code Section 1033(e) Postpone Gain and Purchase Purchase Replacements	*Code Section 451(e) Defer Income to the Next Tax Year*
What livestock qualifies?	Draft, breeding, or dairy livestock	All livestock
Requirement of disaster area declaration?	No, but declaration increases replacement period to 4 years	Yes
Must livestock be in the affected area?	No	No
Must livestock be sold in the affected area?	No	No
Must weather have caused the sale?	Yes	Yes
Provision applies to: normal practice	Sales in excess of	Sales in excess of normal practice
Provision allows:	Deferral of gain by carrying over basis to replacements	Postponing recognition of income by one year
Is repurchase required?	Yes	No
What is the basis in replacement livestock?	Reduced by gain that is deferred	Not applicable
What is the period for replacing?	Two years from the end of the taxable year of sale or 4 years if area is eligible for federal assistance	Not applicable
What is the time limit for making the Election?	Two years from the end of the taxable year of sale.	Due date for return for year or sale for livestock held for resale and 4 years after the year of sale for draft, dairy, or breeding livestock.

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