EXTENSION

Weather-Related Sales of Livestock: Income Tax Management Issues

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Weather-Related Sales of Livestock

- Applies to sales of livestock due to weather-related conditions: flood, drought, or other weather-related condition causing a shortage of water and/or feed.
- Allows taxpayer to postpone recognition of income from the sale proceeds (avoids bunching of income).
- Desire is to help you to be able to discuss options with your tax advisor prior to filing.

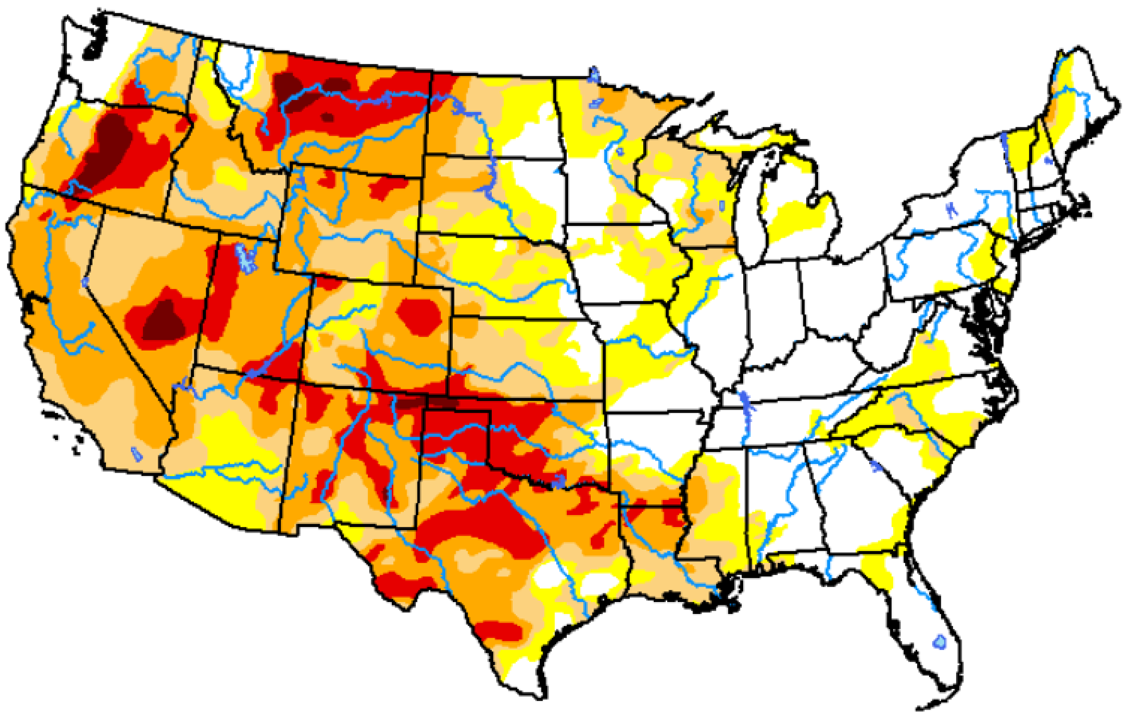
Sources for Drought and Disaster Information

- FEMA – Presidential declarations
- Farm Service Agency (FSA) – Secretary of Agriculture (Dept of Ag) declarations
- U. S. Drought Monitor – State and National drought intensity maps

Sec. of Ag Designations Map

- No maps available as of 2-4-2022
- Kentucky = 2 primary and 7 contiguous
  - Tornadoes
- Ohio = 1 primary and 7 contiguous
  - Excessive rainfall

2/1/2022 Drought Monitor Map



Intensity:

None

D0 Abnormally Dry

D1 Moderate Drought

D2 Severe Drought

D3 Extreme Drought

D4 Exceptional Drought

The Drought Monitor focuses on broad-scale conditions. Local conditions may vary. For more information on the Drought Monitor, go to https://droughtmonitor.unl.edu/About.aspx

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National Drought Mitigation Center

Two Different Tax Treatments

- Both tax treatments or rules apply to sales in excess of normal or usual business practice due to weather-related conditions.
- The first applies to sales of any livestock (**IRC § 451(g) Deferral of Income for 1 Year**).
- The second applies to sales of livestock (other than poultry) held for draft, breeding, or dairy purposes (**IRC § 1033(e) Involuntary Conversion**).
- References to share with your tax advisor.

Two Types of Taxable Income

- Ordinary Income
  - Sale of calves
  - Recapture of Depreciation from Purchased Breeding Livestock
- Capital Gain Income
  - Sale proceeds from Raised Breeding Livestock
  - Sale proceeds from Purchased Breeding Livestock in excess of purchase cost

1. Deferral of Income for 1 Year
IRC §451(g)

- *The drought, flood, or other weather-related condition must be of such severity that an area affecting the taxpayer's area is designated as eligible for Federal disaster assistance.*
- A taxpayer needs to show that the weather-related condition caused the sale of more animals than normal.
- Farmer (taxpayer) must use the cash method of accounting.

1. Deferral of Income for 1 Year
IRC §451(g)

- Applies to any livestock (including draft, breeding, or dairy animals) sold due to weather-related conditions.
- Sale proceeds (income) may be deferred to the next taxable year, however certain requirements **must be** met.

1. Deferral of Income for 1 Year
IRC §451(g)

Requirements that **must be** met by the taxpayer:

1. Principal business must be farming.
2. Must use the cash method of accounting.
3. Must show that the animals would normally have been sold in the following year.
4. The weather related condition that caused the area to be declared eligible for Federal assistance must have caused the sale.

1. Deferral of Income for 1 Year
IRC §451(g)

- The livestock <u>do not</u> have to be raised or sold in the declared disaster area, but the weather-related condition that caused an area to be declared eligible for federal assistance must have caused the early sale of the livestock.

1. Deferral of Income for 1 Year
IRC §451(g)

- The sale can take place <u>before</u> or <u>after</u> an area is declared eligible for federal assistance as long as the same weather-related condition caused the sale.
- Taxpayer's history is used to determine the number of animals that would have normally been sold compared to those sold prematurely.

1. Deferral of Income for 1 Year

IRC §451(g)

- The sale proceeds from those animals that were sold prematurely, can be deferred and reported as income in the year following the year of the sale.
- Example, animals would normally be sold in 2023. Due to shortage of pasture, animals were sold in 2022.

Example of Deferral For 1 Year

A rancher normally culls 20 head of cows annually. Due to drought conditions, he sells 30 head of cows.

He elects to defer recognition of income for 1 year for the 10 additional head of cows by attaching a statement to his tax showing that he normally sells 20 head annually, but due to weather-related conditions his county was declared a Federal disaster area thus he is electing to defer the income from the 10 cows to 2022.

1. Deferral of Income for 1 Year
IRC §451(g)

Questions before continuing.

2. Involuntary Conversion
IRC §1033(e)

- Must purchase replacement draft, breeding, or dairy livestock within a 2 year period. (example, for sales in 2022, must replace the livestock by end of 2024). This provision does not apply to poultry or market animals.
- Replacement period can be extended from 2 years to 4 years if the area has been declared eligible for disaster assistance by the Federal government or by one of its agencies.

2. Involuntary Conversion

IRC §1033(e)

- Livestock (draft, breeding, or dairy) held for any length of time and a weather-related condition caused the sale.
- Gain realized from the sale can be postponed if the sale proceeds are used to purchase replacement livestock within the time period previously described.
- Replacement animals must be used for the same purpose as those sold. (dairy for dairy and breeding for breeding)

2. Involuntary Conversion
IRC §1033(e)

- If exceptional, extreme, or severe drought persists, the replacement period is extended until the end of the taxpayer’s first tax year ending after the first drought free year for the applicable region. **(an IRS Notice is published every Sept. listing counties by state qualifying for the 1033(e) deferral treatment)**
- The applicable region is the county that experienced the drought condition and all contiguous counties to that county.

2. Involuntary Conversion

IRC §1033(e)

- A 2 year replacement period exists if the drought area does not receive a federal disaster declaration.
- A 4 year replacement period occurs when the drought area receives a federal disaster declaration.
- Secretary of the Treasury can further extend the replacement period if the drought persists for more than 3 years.

2. Involuntary Conversion
IRC §1033(e)

- There is no requirement that the weather-related conditions cause the area to be declared a disaster area by the Federal government for the involuntary conversion rules to apply.
- A taxpayer needs to show that the weather-related conditions caused the sale of more animals than normal.

2. Involuntary Conversion
IRC §1033(e)

To make the election to defer, attach a statement to the tax return showing:

- Evidence of the weather-related condition.
- Computation of the amount of gain realized.
- Number and kind of livestock sold.
- Number and kind of livestock that would have been sold under normal or usual business practices.

Example of Involuntary Conversion

A rancher normally culls 30 head of cows annually. Due to drought conditions in 2022, he sells 45 head of cows.

He can elect to defer recognition of income by attaching a statement to his tax return stating that he will be replacing the animals sold in excess of normal.

If he sells the 15 head for $50,000, he must buy at least $50,000 of replacement heifers and/or cows within the required time period.

Example of Involuntary Conversion (cont.)

If he spends less than $50,000 for replacements, he must amend the 2022 tax return and pay the additional tax due plus interest.

If he spends more than $50,000 for replacements, he must take the amount invested which is greater than $50,000, he will depreciate that amount on future tax returns.

If he spends exactly $50,000, he does nothing more.

Replacing the Cows

- Producer has 2 years to purchase the replacement cows unless drought continues.
- Must replace as many dollars as was sold to postpone all the gain until the new cows are sold.
- Repurchase can be staggered within the 2 year period.
- Must keep track of dollars spent and tax basis.

Replacing the Cows

Information needed for cows sold in excess of normal.

- Gross sale income of the cows.
- Remaining tax basis in these cows at the date of sale.
  - Raised cow: basis is typically zero.
  - Purchased cow: basis is purchase cost less the depreciation taken.
- Allocate the tax basis from the old cows to the new cows.

Tax Basis Explained

- Purchased Property: Your basis is the purchase price plus acquisition costs
- Inherited Property: Your basis is the Fair Market Value at the date of death of the decedent
- Property Received as a Gift: Your basis is the same basis that donor had at the time the gift was made
- Adjustments to Basis: Depreciation taken and/or Improvements made

Replacing the Cows

- Information needed to determine tax basis for the new cows:

1. Total cost of the new cows.
2. Sale value of the cows sold in excess of normal.
3. Tax basis of the cows sold in excess of normal.
4. Total number of new cows purchased.

Which Option to Select

- Not an easy answer.
- Everyone’s economic situation, tax situation, and goals will be different.
- You can change from a 451(g) election to a 1033(e) election for draft, breeding, and dairy animals. (cannot do the reverse of a 1033(e) to a 451(g) election)
- Consider the following points!

Points to Consider

- Your future personal and business goals:
  - Scale back the business.
  - Use the money from the cattle sales to get into or expand another farm enterprise.
  - Get fully back into the cow-calf enterprise.
  - Help someone else take over your farm.
  - Retire and never look back.
- Current and future income and expenses.
- Potential tax rate changes.

Which Method to Select?

Refer to RuralTax.org and Tax Topics: Weather-Related Sales of Livestock

Take the information to your tax preparer and have them evaluate the tax consequences of each alternative. (1033(e) Involuntary Conversion vs. 451(g) Deferral of Income for 1 Year)

Everyone’s situation will be different!!!

Talk to Your Tax Advisor

Items that could impact your decision.

- Farm versus Non-Farm Income
- Your Income Tax Bracket
- Income Averaging
- Disaster Payment Proceeds
- Crop Insurance Proceeds
- Prior year Net Operating Losses that have been carried forward

Questions and Comments

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