
INCOME TAX MANAGEMENT ALTERNATIVES FOR WEATHER-RELATED SALES OF LIVESTOCK

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INTRODUCTION

A "bone-dry" spring, coupled with a prolonged period of below normal rainfall, is causing significant problems in the Southeast. For livestock producers, especially cattlemen, these problems come in the form of insufficient pasture and forage feeds, and, in some cases, insufficient water supplies to maintain normal livestock numbers on the farm. When livestock producers have to sell animals in numbers in excess of their normal business practices, they realize additional current income. The Internal Revenue Code, however, offers livestock producers alternatives in their timing of recognizing the additional current income created by these sales under conditions of duress.

NATURAL DISASTER DECLARATION

On August 24, 2006, the Secretary of Agriculture issued a Secretarial Natural Disaster Declaration, due to losses caused by drought and excessive temperatures occurring beginning March 1, 2006, and continuing. The declaration designated 155 of Georgia's 159 counties. The four other Georgia counties (Fannin, Gilmer, Towns, and Union) are also eligible under the disaster declaration, because they are

contiguous to at least one of the 155 designated counties. Also eligible under the disaster declaration as contiguous counties in other states are:

- Alabama – Barbour, Cherokee, Cleburne, De Kalb, Henry, Houston, Jackson, Lee, Randolph, Russell
- Florida – Baker, Columbia, Gadsden, Hamilton, Jackson, Jefferson, Leon, Madison, Nassau
- North Carolina – Clay, Jackson, Macon
- South Carolina – Abbeville, Aiken, Allendale, Anderson, Barnwell, Edgefield, Hampton, Jasper, McCormick, Oconee
- Tennessee – Bradley, Hamilton, Marion, Polk

WEATHER-RELATED SALES OF LIVESTOCK

Two sections of the Internal Revenue Code offer potential alternatives in the timing of recognition of income from the sales of livestock in excess of the producer's normal business practice, when the excess sales are due to weather-related conditions.

INTERNAL REVENUE CODE SECTION 451(e)

Section 451(e) provides a one-year deferral of recognition of income from weather-related sales of all types (market, breeding, dairy, and draft) of livestock, provided that the weather-related conditions which caused the excess sales also results in a federal disaster declaration. There are additional requirements which must be met for a livestock producer to use the one-year income deferral:

- The taxpayer's principal business must be farming
- The taxpayer must use the cash method of accounting
- The taxpayer must show that the livestock would normally have been sold in a future year.

It is not required for the livestock to have been raised or sold in the disaster area, so long as the weather-related condition that caused the disaster declaration also caused the excess sales. Sales occurring before a disaster declaration are eligible for deferral, if the same weather-related conditions caused both the disaster declaration and the excess sales.

Example 1.

Joe Porterhouse is a beef producer with a 100 cow herd. His principal business is farming, and he uses the cash method of accounting. His normal business practices include:

- Culling 15 percent of his cows annually, and
- Backgrounding his calves over winter, rather than selling them at weaning.

Faced with a drastic reduction in quality and quantity of forage in his hay and pasture fields, and a diminishing water supply, on May 1

Joe sells 25 cows and 46 of his 92 new calves. He previously sold his prior year calves which he had backgrounded, along with 15 cull cows. On May 20, the Secretary of Agriculture declares Joe's county to be eligible for federal disaster assistance, due to extreme drought conditions, which have been determined to have existed since March 1.

Joe meets the conditions of Internal Revenue Code Section 451(e) for deferring the weather-related sale of 25 cows and 46 calves on May 1. His sales earlier in the care of cull cows and backgrounded calves do not qualify for deferral, since the sales are consistent with his normal business practices.

To make the deferral election, Joe must attach a statement to his federal income tax for the sale year. He must provide:

1. Evidence of the weather-related conditions that forced his excess sales
2. A computation of the amount of taxable income realized from the excess sales
3. The number and kind of livestock sold, and
4. The number of each kind of livestock that would have normally been sold.

Note: Joe includes all of his livestock sales for the year in item 3, and his normal sales in item 4.

INTERNAL REVENUE CODE SECTION 1033(e)

Section 1033(e) permits the deferral of gains realized from involuntary conversion, including sales due to weather-related conditions, of livestock, held for breeding, dairy, or

draft purposes. Gain is deferred by purchasing replacement livestock of the same kind, within a specified period. Sales of livestock held as inventory in the ordinary course of a farmer or rancher's trade or business (market livestock) are not eligible for deferral under Section 1033(e).

There are several significant differences in the eligibility requirements for Section 1033(e), compared to Section 451(e):

- Excess sales of market livestock are not eligible for Sec. 1033(e) deferral election
- The seller of the livestock is not required to have farming as his or her principal business, or to use cash basis accounting
- A federal disaster declaration is not required for Sec. 1033(e) eligibility, so long as excess sales of qualifying livestock are caused by weather-related conditions.

Deferral of Gain

Deferral of gain on the sale of qualified livestock is accomplished by purchasing replacement livestock of the same type. Generally, beef cows must be replaced with beef cows; dairy cows with dairy cows, etc. Qualifying replacement must be done on a dollars-per-head basis.

Example 2.

If Joe Porterhouse sold his 46 excess cows at \$750 per head, he must purchase at least 46 replacements, at a price of at least \$750 per head. If Joe purchases 46 replacements at a price of \$700 per head, he will have to amend his sale year income tax return to report the gain (of up to \$50 per head) which was not deferred through the purchase of replacements. Similarly, if Joe purchases only 40

replacements, he will be required to amend his sale year return to report and pay tax on gain resulting from the sale of the six cows which were not replaced.

Replacement Period

The normal replacement period permitted under Sec. 1033(e) is two years from the end of the tax year in which the excess sales occurred. If the weather-related conditions which caused the excess sales also resulted in a federal disaster declaration, the replacement period is extended to four years after the end of the excess sales tax year (for tax years ending after December 31, 2002).

The Secretary of the Treasury has discretion to further extend the replacement period on a regional basis if the weather-related condition that led to the disaster declaration continues for more than three years. Internal Revenue Service Notice 2006-82 identifies persistent drought as the weather related condition which would qualify for the additional extension of the replacement period.

In the case of persistent drought, the replacement period is extended until the end of the taxpayer's first taxable year ending after the first drought-free year for the region. The first drought-free year is deemed to be the first 12-month period that:

- Ends on August 31;
- Is in or after the last year of the taxpayer's four-year replacement period;
- And does not include any weekly period for which exceptional, extreme or severe drought is reported for any location in the region.

The Internal Revenue Service will consult with the National Drought Mitigation Center, and publish in September of each year a list of counties for which exceptional, extreme, or severe drought was reported during the preceding 12 months.

REPORTING WEATHER-RELATED SALES OF LIVESTOCK

Livestock producers in all of Georgia's 159 counties who sold livestock of all types in excess of their normal business practice due to the weather-related conditions identified in the August 24, 2006 natural disaster declaration are eligible for deferring the gain from those excess sales.

Market Livestock

For excess sales of market livestock, the one-year deferral in recognizing income under Internal Revenue Code Sec. 451(e) is the only alternative to reporting the weather-related sales in the sale year. Without a natural disaster declaration, no deferral in the recognition of gain from the sale of market livestock is permitted.

Breeding, Dairy, and Draft Livestock

Livestock producers who sold excess numbers of breeding, dairy or draft livestock due to weather-related conditions are eligible to defer the gain on the excess sales through the purchase of replacement animals, under the rules of Internal Revenue Code Sec. 1033(e). The one-year deferral of recognizing income under Internal Revenue Code Sec. 451(e) is also available to livestock producers who meet Sec. 451(e) requirements, since the weather-related conditions resulted in the issuance of a natural disaster declaration.

Livestock producers who meet the requirements for both Sec. 451(e) and Sec. 1033(e) should carefully consider their future plans before making an election. A Sec. 1033(e) election made on an amended return, but a Sec. 451(e) election can only be made on the tax return for the year of sale, unless the sales also qualify for the four year replacement period under Sec. 1033(e)(2). In this situation, the Sec. 451(e) election can be made on an amended return at any time during the four year replacement period.

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