Tax Relief for Cattle Producers Impacted by Natural Disaster

Updated August 2021

Cattle producers impacted by unfavorable weather-related conditions such as drought or flood may be eligible for federal tax relief under the Internal Revenue Code (IRC). Please note, this information is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice. However, cattle producers who believe they may be eligible for one of the options outlined below are encouraged to review this information with their tax preparer.

Under current tax law, there are two main provisions which attempt to cushion producers from the consequences of adverse weather-related livestock sales. These provisions apply only to those sales that are in excess of "normal sales" for the producer. However, each has slightly different requirements for eligibility, so producers should evaluate their circumstances to see which would be of greater tax benefit.

1. **IRC Section 1033:** Cattle producers can elect 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 or defer the gain into replacement property.
    a. Livestock sold in excess of usual business practices due to drought, flood or other weather-related conditions may similarly be replaced in a rollover manner under Sec. 1033(e).
    b. If involuntary sales occur because of weather-related conditions or soil or other environmental contamination and it is not feasible to reinvest in livestock, a broader definition of eligible replacement property applies under Sec. 1033(f).
    c. Additionally, livestock destroyed by disease may be replaced in a tax deferred manner under Sec. 1033(d) (also reviewed below).
2. **IRC Section 451(g):** Cattle producers using the cash method of accounting can elect to defer for one tax year the income of certain livestock sold due to weather-related conditions.

IRC Sec. 1033 – Involuntary Conversion of Draft or Breeding Animals

A livestock producer who sells more draft, breeding, or dairy animals than normal due to weather-related conditions may defer recognition of the gains for up to two years. This election applies only to the number of animals sold in excess of normal business practices. Declaration of a disaster area is not necessary, but the producer must be able to show that weather-related conditions forced the sale of more livestock than would normally be sold. Tax basis of the replacement livestock is equal to the basis of the livestock sold plus any additional amount invested in the replacement livestock that exceeds the proceeds from the sale.

Q: How long do I have to replace the animals before I will be forced to pay capital gains?
A: Different time frames can apply dependent upon the disaster declaration status and involuntary conversion election under Sec. 1033:

- In general, the purchase of replacement property under Section 1033 involuntary conversion rules must occur within **two years** after the close of the first year in which any gain is realized [Sec. 1033(a)(2)(B)].
    - This provision applies to gains on livestock sold on account of disease [Sec. 1033(d)].
    - The animals must be replaced within two years with other animals used for identical purposes. If the animals are not replaced, or if replacement cost is less than the gain from their sale, the difference must be reported as a gain for the sale year by amending the tax return. The return will be subject to additional tax and interest.
- The applicable replacement period for draft, breeding, or dairy livestock sold early on account of drought, flood, or other weather-related conditions is **four years** after the close of the first taxable year in which any part of the gain on conversion is realized [Sec. 1033(e)(2)].

- The taxpayer must establish that the sale would not have occurred but for the drought, flood, or weather-related conditions that resulted in the area being designated as eligible for federal assistance.
- The IRS is given authority on a regional basis to extend the replacement period if the weather-related conditions that resulted in the application of this provision continue for more than three years [Sec. 1033(e)(2)(B)].

Q: How do I make a Sec. 1033 election?
A: As referenced above, under 1033(a)-2(c)(2) and 1033(d), the election to defer gain under the involuntary conversion rules can be made at any time within the normal statute of limitations for the period in which the gain was recognized, assuming it is before the expiration of the period within which the converted property must be replaced. Under 1033(e), if the election is filed to defer gain and eligible replacement property is not acquired within the four-year replacement period, an amended return for the year in which the gain was originally realized must be filed to report the gain.

Q: What information is needed on your tax return in which any gain is first realized and then deferred under Sec. 1033?
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:

- Name, address, and ID number.
- Number and kind of livestock sold or exchanged.
- Number of livestock of each kind that would have been sold or exchanged under normal business circumstances (generally, the average number of animals sold over the three preceding years).
- The amount of gain realized on the sale or exchange.
- The amount of income to be postponed.

Q: What information is needed for livestock sold due to drought or weather-related conditions?
A: A producer must also provide evidence of the weather-related conditions that forced the sale or exchange of animals, and an explanation of how the sale is related to weather conditions. Keep in mind:

- The sale of livestock (other than poultry) held by a taxpayer for draft, dairy, or breeding purposes in excess of the number that would have been sold under the taxpayer's usual business practice is treated as an involuntary conversion if the early sale occurred solely on account of drought, flood, or a weather-related condition that resulted in the area being designated as eligible for federal assistance.
- While a sale or exchange of the livestock must be solely on account of the drought or weather conditions that affected the water, grazing, or other needs of the livestock, it is not necessary that the livestock were held in a drought or flood area, or that the actual sale occurred in a drought or flood area [Reg. 1.1033(e)-1(b)].
- The involuntary conversion treatment is limited to the livestock sold in excess of the number that would have been sold under the taxpayer's usual business practice [Reg. 1.1033(e)-1(c)].

Q: What information is needed for livestock destroyed by disease?
A: For livestock sold or exchanged because they have been exposed to disease, the election statement and tax return disclosure requirements for replacement of diseased livestock are the same as any involuntary conversion, except the taxpayer must recite the evidence that livestock were destroyed or sold because of disease [Reg. 1.1033(d)-1(b)]. Keep in mind:

- The disease need not be of epidemic proportions [Rev. Rul. 61-216]. However, the sale of a herd of beef cattle that developed the dwarf gene did not qualify because dwarfism in beef cattle is not a disease [Rev. Rul. 59-174].

- This diseased livestock rollover privilege applies to inventory or resale animals, in addition to breeding or productive animals.

Q: What information should be included on a tax return the year in which the livestock are replaced?
A: Producers are required to provide documentation of the following:

- 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.

Q: Does the value of the replacements need to be equal in value to the original animals?
A: In general, in a Sec. 1033 rollover, the replacement property must be similar or related in service or use.

- Historically, the regulations have required the replacement livestock to be functionally the same as the involuntarily converted livestock (i.e., held for the same useful purpose as the old). Thus, dairy cows should be replaced by dairy cows [Reg. 1.1033(e)-1(d)]. But breeding cattle may replace buffalo of the same sex [PLR 7903064].
- However, under Sec. 1033(f), a taxpayer is allowed to replace involuntarily converted livestock sold early due to drought, flood, or other weather-related conditions with other farm property (other than real property) if it is not feasible for the taxpayer to reinvest the proceeds in similar or related use livestock.

Q: What is an example of a situation where this election could be applied?
A: Utah State University Extension's RuralTax.org provides the following example:
Bo Vine normally sells 25 cows per year. This year Bo sells 40 cows because of weather induced limited forage and feed supplies. Gains from the sale of the 15 cows sold in excess of normal business practice would not be reported as income if Bo purchases replacement animals that cost as much or more within the next two tax years.

A. Bo sells 40 raised beef cows (with a $0 tax basis) for $50,000. The gain of $18,750 ($50,000 / 40 cows x 15 cows) is deferred. If Bo purchases the replacement cows for $18,750, the tax basis in the replacement animals would be zero. If the replacements cost $20,000, the tax basis in the replacement animals would be $1,250 ($20,000 - $18,750 of deferred gain). The $1,250 could then be depreciated over their MACRS depreciable life or expensed using the IRC Section 179 Expensing election.

B. Bo sells 40 purchased beef cows (with a remaining $16,000 tax basis) for $50,000. The gain of $18,750 ($50,000/40 cows x 15 cows) is deferred. If Bo purchases the replacement cows for $18,750, the tax basis in the replacement animals would be $16,000. If the replacements cost $21,000, the tax basis in the replacement animals would be $2,250 ($21,000 cost minus the $18,750 of gain deferred plus $16,000 remaining basis). The $2,250 could then be depreciated over their MACRS depreciable life or expensed using the IRC Section 179 Expensing election.

Q: Is the 1033 election limited to cash-basis taxpayers?
A: No, a Section 1033 exemption is available to all taxpayers whose principal business is farming (unlike under Section 451(g)).

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 determine what strategies will work best for their operation.

IRC Sec. 451(g) – One Year Deferral on Income

The gain from the sale of livestock sold early due to drought, flood, or other weather-related conditions may be deferred for one year. There are five conditions for eligibility:

1. The taxpayer's principal business is farming.
2. The taxpayer uses the cash method of accounting.
3. Under normal business practices, the sale would not have occurred in the current year except for the drought, flood, or other weather conditions.
4. The drought, flood, or other condition resulted in the area designated as eligible for assistance by the federal government.
5. Only livestock in excess of the number that normally would have been sold under usual business practices are eligible for the deferral.

It's important to note that livestock may be either raised or purchased animals and may be held either for resale (inventory livestock) or for productive use (depreciable livestock). Depreciable livestock includes dairy, breeding, draft, or sporting purpose animals.

Q: How do I make the election?
A: The 451(g) 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(g) exemption.
- Evidence of the weather-related conditions that forced the sale of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government.
- A statement explaining the relationship of the area affected by the weather-related condition of early sale or exchange of livestock.
- The number of animals sold 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 in the absence of weather-related conditions
- The total number of animals sold, and the number of animals sold because of weather-related conditions during the tax year.
- Computations, consistent with IRS requirements, to show the amount of income to be postponed for each class of livestock.

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(g) 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 if 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 several very important considerations that must be considered 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 to determine what strategies will work best for their operation.

Additional Resources:
Internal Revenue Service Publication 225 – Farmer's Tax Guide for use in preparing 2020 Returns: https://www.irs.gov/pub/irs-pdf/p225.pdf.

Rural Tax Education Website – The Rural Tax Education website is a source for information concerning agriculturally related income and deductions and self-employment tax. The website is available for farmers and ranchers, other agricultural producers, Extension educators, and anyone interested in learning about the tax side of the agricultural community. Members of the National Farm Income Tax Extension Committee are contributors for the website and the website is hosted by Utah State University Cooperative Extension. You can visit the website at www.ruraltax.org.

Much of the information found in this publication is also available via **RuralTax.org's** Weather-related Sales of Livestock (revised in April 2021) and through the **Agribusiness Blog: Farm CPA Today**, c/o Paul Neiffer – a principal with CliftonLarsonAllen, certified public accountant, and business advisor who specializes in income taxation, accounting services, and succession planning for farmers and agribusiness processors. Producers who are looking for professional tax guidance can contact Paul at Paul.Neiffer@claconnect.com.