

AGRICULTURAL ISSUES

AGI

ISSUE 1: WEATHER-RELATED SALES OF LIVESTOCK

Livestock producers who are forced to sell animals because of weather-related conditions, such as flood, drought, or other conditions that cause a shortage of water or feed, may be eligible to postpone recognition of income from the proceeds and avoid bunching of income.

The two different tax treatments apply only to weather-related sales of livestock in excess of normal business practices. The first applies to draft, breeding, or dairy animals that will be replaced within a 2-year period. The second applies to all livestock and allows a 1-year postponement of reporting the sales proceeds as taxable income.

Involuntary Conversion [I.R.C. § 1033(e)]

The sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes in excess of the number sold as usual or normal business practice is treated as an involuntary conversion if the livestock are sold or exchanged solely on account of drought, flood, or other weather-related conditions, I.R.C. § 1033(e).

If livestock (other than poultry) **held for any length of time** for draft, breeding, or dairy purposes is sold because of weather related conditions, the gain realized on the sale does not have to be recognized, if the proceeds are used to purchase replacement livestock within 2 years from the end of the tax year in which the sale takes place. The 2-year replacement period is extended to 4 years if the weather condition that caused the excess sales also caused an area to be eligible for assistance by the federal government and can be further extended by the Secretary of Treasury if the weather condition continues for more than 3 years [I.R.C. § 1033(e)(2)].

Persistent Drought

In Notice 2006-82, 2006-92 I.R.B. 529, the IRS announced that it will extend the replacement period for sales of livestock due to weather for taxpayers living in regions of extreme, exceptional or severe drought, based on maps produced by National Drought Mitigation Center. **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.** The first drought-free year for the applicable region is the first 12-month period ending on August 31 that meets both of the following criteria:

1. It ends in or after the last year of the taxpayer's 4-year replacement period, and

2. It does not include any weekly period for which exceptional, extreme, or severe drought is reported for any location in the applicable region.

The applicable region is the county that experienced the drought conditions on account of which the livestock was sold or exchanged and all counties that are contiguous to that county.

U.S. Drought Monitor Maps

A taxpayer may determine whether exceptional, extreme, or severe drought is reported for any location in the applicable region by reference to U.S. Drought Monitor maps archived at www.drought.unl.edu/dm/archive.html. The IRS, after consultation with the National Drought Mitigation Center, will publish in September of each year a list of counties for which exceptional, extreme, or severe drought was reported during the preceding 12 months. Taxpayers may also use this list to determine whether a 12-month period ending on August 31 of a calendar year includes any period for which exceptional, extreme, or severe drought is reported for a location in the applicable region.

The notice applies to tax years ending after September 25, 2006.

Example AGI.1 Extension of Replacement Period

Dusty Rhodes, a calendar year taxpayer, raises cattle in Sere County. In 2002, all of Dusty's cattle held for breeding purposes were sold solely on account of drought conditions in Sere County. Under Dusty's normal business practices, only 25% of his cattle held for breeding purposes would have been sold in 2002. In 2002, the Secretary of Agriculture designated Sere County as eligible for federal assistance on account of the drought conditions. Thus, 75% of Dusty's sale is treated as an involuntary conversion. Because Sere County is designated as being eligible for federal assistance on account of the drought conditions, Dusty's replacement period ends on December 31, 2006.

Under Notice 2006-82, Dusty's replacement period is extended until the end of his first taxable year ending after the first drought-free year for the applicable region. The applicable region is the county that experienced the drought conditions on account of which the livestock was sold (Sere County) and all counties contiguous to Sere County (Dry, Arid, Baked, and Parched counties).

For the 12-month period ending August 31, 2006, severe drought conditions were reported on U.S. Drought Monitor maps for all counties in the applicable region. For the 12-month period ending August 31, 2007, the only drought conditions reported for the applicable region on U.S. Drought Monitor maps were severe drought conditions for Parched County for the first week in September 2006. For the 12-month period ending August 31, 2008, U.S. Drought Monitor maps do not report drought conditions for any county in the applicable region.

Accordingly, the 12-month period ending August 31, 2008, is the first drought-free year for the applicable region, and Dusty's replacement period is extended through December 31, 2008 (the last day of his first taxable year ending after the first drought-free year for the applicable region).

[ENDOFEXAMPLE]

Practitioner Note—No Required Holding Period

There is no required holding period for this provision as there is in I.R.C. § 1231.

Generally, the new livestock purchased must be used for the same purpose as those sold because of weather-related conditions. Breeding stock must be replaced with breeding stock, and dairy cows with dairy cows. However, if the condition that caused the involuntary conversion also makes it infeasible to replace the livestock with similar livestock, then the livestock can be replaced with any property, including real property, used in the farming business [I.R.C. § 1033(f)].

The taxpayer must show the weather-related condition caused the sale of more livestock than would normally have been sold. Only the additional animals sold in excess of normal sales can be replaced without recognition of gain. If the taxpayer normally sells one-fifth of the herd each year, only the sales in excess of one-fifth will qualify for deferral. There is no requirement that the weather-related conditions cause an area to be declared a disaster area by the federal government. The taxpayer will have basis in the

replacement livestock equal to the basis in the livestock sold, plus any amount invested in the replacement livestock that exceeds the proceeds from the sale.

Election

The election to defer recognition of gain is made by attaching a statement to the tax return that includes the following information:

- Evidence of the weather-related conditions that forced the sale or exchange of the livestock
- A computation of the amount of gain realized on the sale or exchange
- The number and kind of livestock sold or exchanged
- The number of livestock of each kind that would have been sold or exchanged under usual business practices of the taxpayer

Deferral of Income for 1 Year [I.R.C. § 451(e)]

Cash-method farmers can elect to defer for 1 tax year the reporting of income from certain livestock sold on account of drought, flood, or other weather-related conditions. The drought, flood, or other weather-related condition must be of such severity that an area affecting the taxpayer area is designated eligible for federal assistance. To qualify for deferral, the taxpayer must show that he or she sold livestock in excess of the number that would ordinarily have been sold had there been no drought, flood, or other weather-related condition. Thus, this election applies only to sales in excess of normal or usual sales [I.R.C. §451(e)].

If **any** livestock are sold because of weather-related conditions, the taxpayer may be eligible for an exception to the general rule that the sales proceeds must be reported in the year received. To defer income to the next year, the following requirements must be met:

1. The taxpayer's principal business must be farming as defined in I.R.C. §6420(c)(3).
 1. The taxpayer must use the cash method of accounting.
 2. The taxpayer must show that the livestock would normally have been sold in the following year.
 3. The weather-related conditions that caused an area to be declared eligible for federal assistance area must have caused the sale of livestock.

It is not necessary that the livestock be raised or sold in the declared disaster area, just that the weather-related condition that caused an area to be declared eligible for federal assistance caused the sale of the livestock. Also, the sale can take place before or after an area is declared eligible for federal assistance as long as the same weather-related condition caused the sale.

The number of animals that would normally be sold is determined primarily from the taxpayer's past history. If the taxpayer usually holds all calves until the year after they are born before selling them, but was forced because of weather-related conditions to sell them in the year they were born, the proceeds from this sale may be reported in the year following the year of the sale.

Due Date of Election

The due date of the election depends on the classification of the livestock.

1. If the livestock is held for sale in the ordinary course of business, the election must be made by the due date of the return (including extensions) for the tax year in which the drought sale occurred.
2. If the livestock is held for draft, breeding or dairy purposes, then beginning with tax years for which the return is due after December 31, 2002, the election can be made any time in the 4-year

replacement period for the postponement of gain from sales caused by a disaster that resulted in a disaster area declaration under I.R.C. § 1033(e)(2).

Options for Deferring Income

The two weather-related sales of livestock tax provisions have similar but different requirements. Weather-related sales of breeding stock could qualify for either provision. Figure AGI.1 compares and contrasts the requirements and tax benefits. Affected taxpayers can determine which provision provides the greatest tax benefit.

Figure AGI.1 Comparison of Weather-Related Sales of Livestock Tax Consequences

Requirements for Weather-Related Sales of Livestock	Alternative Weather-Related Tax Provisions	
	Postpone gain by purchasing replacements [I.R.C. §1033(e)]	Defer income for 1 year [I.R.C. §451(e)]
Tax provisions provides for	Gain is deferred if replacement requirements are met within the next 2 (or 4) years.	Recognition of income is postponed by 1 year.
Tax provision is allowed only for	Sales in excess of normal practice	Sales in excess of normal practice
Qualifying livestock	Draft, breeding, or dairy livestock	All livestock
Requirement that area be designated eligible for federal assistance	No, but designation increases replacement period from 2 to 4 years	Yes
Weather-related condition must have caused the sale	Yes	Yes
Livestock must have been sold in the designated assistance area.	No	No
Livestock must be located in the designated assistance area	No	No
Purchase of replacement livestock required	Yes	No
Basis in replacement livestock	Must be reduced by the amount of gain deferred	N/A
Deadline for replacement	Generally 2 years after the year-end of the tax year of sale but 4 tax years after the year of sale if an area is designated eligible for federal assistance because of the condition that caused the sale	N/A
Deadline for making the election	2 years after the year-end of the tax year of sale	Generally, due date of tax return for year of sale, but 4 years after year of sale for sales that qualify for the 4-year replacement period under I.R.C. §1033(e)(2)