Drought Sales of Livestock

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Farming is a business that is difficult to manage. There are many factors beyond the control of the farmer. Weather is one of those factors. When the unusual occurs, the farmer must adjust. The government, in the form of income tax postponement, offers some help.

Farmers, like any other business, are required to pay tax on the net income they generate. One problem with farming is the variability in annual income; one year prices are up, the next they are down. Occasionally a major repair reduces income. Other times weather conditions force the sale of additional livestock increasing annual income.

When a farmer experiences an unusual increase in profit his income tax liability also increases. The increase may push the farmer into a higher tax bracket than usual. For example, using 2016 tax tables, if a farmer had an adjusted gross income (AGI) of $70,000 in 2016 and 2017, he would owe $19,145 in income taxes ($9,572.50 each year). However, if additional, unexpected sales increased his AGI to $140,000 in 2016 and zero in 2017, he would owe $26,542.25 in income taxes, an additional $7,397.25 in taxes for the same income because of timing differences.

The Internal Revenue Code offers the farmer two different options for spreading additional income because of weather-related sales over multiple years. The first is Section 451(e) Special Rule for Proceeds from Livestock Sold on Account of Drought, Flood, or Other Weather-Related Conditions. The second is Section 1033(e) Livestock Sold on Account of Drought, Flood or Other Weather-Related Conditions (part of Section 1033. Involuntary Conversion). Each section has different requirements.

There are three classes of livestock—purchased or raised for resale; purchased for draft, breeding or dairy; and raised for draft, breeding or dairy. The class of livestock determines which section should be used.

Livestock raised or purchased for resale are normally treated as “sales in the ordinary course of business” and generate ordinary income (as opposed to capital gain). The sale is reported on Schedule F. Livestock held for resale do not qualify for 1033 treatment.

Section 451(e) allows the postponement of income from the additional sales to the next year if the following qualifications are met. Farming must be the principal business; the cash method of accounting must be used; under usual business practices, the additional animals would not have been sold during the year except for the weather-related conditions; and the weather-related conditions caused an area to be designated as eligible for assistance by the federal government.

The livestock do not have to be raised or sold in the declared disaster area. They do have to be sold because of the weather-related condition that caused an area to be declared eligible for federal assistance.

To postpone gain, a statement must be attached to the return for the year of sale. The statement must include:

- An intention to postpone gain under Section 451(e);
- Evidence of the weather-related conditions that forced the early sale 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 conditions to the early sale;
- The number of animals sold in each of the three preceding year;
- The number of animals that would have been sold in the tax year had normal business practice been followed;
- The total number of animals sold and the number sold because of weather-related conditions; and
- A computation of the income to be postponed.

Suppose a farmer’s average AGI is $70,000. From the calculation above, his income tax liability would be $9,572.50. If the farmer sold an additional $20,000 of livestock in 2016, AGI of $90,000, because of a federally declared drought in his area and he did not claim the 451(e) relief his income tax liability in 2016 would be $14,042.25. Suppose his 2017 income was $50,000 (for a 2-year average of $70,000), then his 2017 tax liability would be $6,572.50 for a 2-year total of $20,614.75. If the farmer claimed the 451(e) relief and postponed the additional $20,000 of sales to 2017 his 2-year tax liability would have been $19,145.00. The savings are $1,469.75.

The tax bracket changes to 25% for married filing jointly at $75,301; so, the savings are the additional $14,699 ($90,000 - 75,301) taxed at 25% instead of 15%. If the farmers AGI had been only $50,000, an additional $20,000 would not have changed his tax bracket and the total tax would have been the same.

The result would have been different if the additional $20,000 had been raised breeding stock. Livestock used in a farm business generally qualify as Section 1231 property. That means gains are treated as capital instead of ordinary and losses are treated as ordinary instead of capital. If the $20,000 of capital gain had been deferred to 2017, the tax rate would have been zero. The long-term capital gains tax rate is 0%, 15% or 20% depending on the ordinary income tax bracket. Long-term means the property was held for at least one year (24 months for cattle and horses). For this example, at $50,000 of ordinary income and $20,000 of capital gains, the farmer is in the 15% ordinary income tax bracket which means his capital gains rate is 0%. The 2-year total tax would have been $16,145.00 (the same $9,572.50 for 2016 and $6,572.50 for 2017) or $3,000 less.

If the $20,000 of additional sales had been purchased breeding stock, the result would have been different from the two previous examples. Purchased livestock is a depreciable asset. Depreciation is not optional, the IRS calculates your taxes as if you claimed it whether you did or not. Suppose the animals had been purchased a few years ago for $21,000 and $12,000 of depreciations had been claimed. The basis in the animals would have been $9,000. The gain would have been $11,000. The entire gain is depreciation recapture under Section 1245 and is treated as ordinary income. Also, depreciation recapture cannot be deferred but must be repaid in the year of disposition. Income for 2016 would be $81,000 and income tax liability would be $11,792.25. There would be no tax liability for the $9,000 of basis; so, income for 2017 would be $50,000 and the total tax would be $18,364.75. Since the entire gain is depreciation recapture, none of the sales price can be postponed to the next year. The result depends on the basis in the assets sold.

If a farmer has to sell livestock because of weather-related conditions and qualifies for 451(e) treatment, he would get the most benefit from selling raised breeding livestock. The minimum benefit of claiming 451(e) relief for any class would be to spread the tax liability over two years instead of paying additional tax in the year of sale. The additional benefit would depend on the class of livestock and whether two or more tax income tax brackets were involved.

Section 1033 is for property that is compulsorily or involuntarily converted. It provides that if property is converted, within two years, to similar property, no gain will be recognized on the exchange.

Subparagraph (e) is a special rule for livestock, other than poultry, that are held for draft, breeding or dairy. The sale or exchange of livestock in excess of the number a farmer would have normally sold shall be treated as involuntarily converted if such livestock are sold or exchanged solely because of drought, flood or other weather-related conditions. It is not necessary that the area be eligible for federal assistance, but if federal assistance is available the replacement period lengthens from two years to four.

Continuing the example above, livestock held for resale, whether purchased or raised, and poultry do not qualify for Section 1033 treatment. If there is no federal assistance, the income must be claimed in the year of sale.

The raised livestock held for breeding in the example above would qualify for 1033 treatment. The basis in the livestock is $0 since the cost of raising the livestock was expensed in the year paid. If there was no federal declaration, 451(e) treatment would not be available. The question is, should you defer the gain or claim it in the year of sale? The sale of the breeding stock qualify for capital gains treatment regardless of the weather. For 2016 any amount of long-term gain (24 months for cattle and horses) when added to ordinary income that is less than $75,301 should be claimed in the year of sale since the capital gains rate would be zero. The ordinary income tax on the $70,000 is the same $9,572.50. If the entire $20,000 of long-term capital gain were recognized in the year of sale the additional tax would be $2,205.

A better strategy may be for the farmer to recognize $5,301 of gain since he would owe no tax on that amount. Deferring the tax under Section 1033 on the $14,699 would reduce the 2016 income taxes by $2,205. If the farmer purchased replacement stock in 2017 for $20,000 his basis would not be $20,000 paid but the substituted basis of $5,301. Section 1033 does not eliminate the tax, it only defers it to the next sale or exchange. The replacement stock could be sold in a year when the marginal, ordinary income tax rate was 15% so that no tax would be due on the sale of the capital assets.

Section 1033 provides the most benefit for purchased breeding stock. Normally depreciation recapture would be required in the year of sale, but that is not the case under 1033. Under 451(e), the $11,000 of depreciation recapture had to be claimed in the year of sale and could not be deferred. Under 1033, gain on the $20,000 sale would not be recognized. The basis of the replacement livestock would be adjusted to reflect the exchange. If replacement livestock were purchased for $22,000, the basis would be $11,000 ($9,000 substituted basis plus $2,000 additional investment. If only $18,000 was used to purchase replacement livestock, then the farmer would have to recognize $2,000 from the original sale and the basis would be the substituted basis of $9,000.

To elect 1033 treatment, the farmer would file a statement with his tax return for the year of sale and the year replacement property was purchased. The statement for the year of sale would include:

- Evidence of the weather-related conditions that forced the sale or exchange of the livestock;
- The gain realized on the sale or exchange;
- The number and kind of livestock sold or exchanged; and
- The number of livestock of each kind that would have been sold or exchanged under usual business practice.

The statement for the year replacement livestock was acquired would include the information above plus:

- The dates replacement livestock was purchased;
- The cost of the replacement livestock; and
- A description of the replacement livestock including the number and kind.

The sale of livestock because of weather-related conditions will increase income and tax liability. The Internal Revenue Code has two provisions that might allow the postponement of the recognition and thereby reduce the amount of income tax owed. The effect will be determined by the Code section used and the class of livestock. This article demonstrates the difference for a particular scenario. It is not meant to apply to a the reader's facts. A tax professional should be consulted to determine the effect in a particular situation.