Drought, Livestock, and Income Taxes

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Many Midwestern livestock producers have been adversely affected by weather conditions in 2012. Because of reduced feed supplies, some livestock producers have reduced their herd size through larger than normal sales of livestock in 2012. For example, because of a lack of forage, a cow-calf or dairy producer may cull heavily and sell more cows than usual in 2012. Other animals may have been sold earlier than they normally would have been sold. For example, a producer whose normal business practice is to carry calves through winter and sell them as yearlings may, because of a shortage of forage, have sold the 2012 calves at weaning.

In both cases, weather-related conditions could cause producers to have higher than normal taxable incomes in 2012 and lower than normal taxable incomes in 2013. Income tax law allows farmers affected by weather-related conditions to defer reporting of this income to even out their income and avoid potentially higher taxes. Farm income averaging, which was enacted after the weather-related provisions, is another alternative which could result in lower income taxes for producers in some situations. Effective tax management involves consideration of several tax years rather than minimizing this year's tax bill.

Weather-related Sales of Livestock

There are two provisions in tax law which attempt to cushion producers from the consequences of the weather-related sales of livestock. Livestock held for draft, breeding or dairy purposes and sold because of weather-related conditions are provided a two-year reinvestment period under the first provision (this replacement period can be extended if drought conditions persist). The second provision, which applies to all livestock (other than poultry), allows cash basis taxpayers whose primary trade or business is farming a deferral of receipts from sales in excess of normal business practice because of weather-related conditions resulting in a disaster area declaration. Both provisions apply only to those sales which are in excess of the normal business practice of the producer.

Sale with Replacement

The gain on the weather-forced sale of livestock held for draft, breeding or dairy (not sporting) purposes does not need to be reported as income if the proceeds are used to buy replacement livestock within two years after the end of the tax year of the year of sale. Although declaration of the area as a disaster area is not necessary, a producer must be able to show that weather-related conditions forced the sale of more livestock than would normally be sold. For example, a beef producer who normally sells five cows per year may sell 20 cows in 2012 because of limited forage and feed supplies. Gains from the sale of the extra 15 cows would not be reported as income if the producer purchased at least 15 replacement animals before the end of 2014. The new livestock must be used for the same purpose as the livestock which was sold. Thus, beef cows must be replaced with beef cows. Similarly, dairy cows must be replaced with dairy cows.

A producer's tax basis in the replacement livestock is equal to the basis in the livestock sold plus any additional amount invested in the replacement livestock that exceeds the proceeds from the sale. For example, a producer sells 20 raised beef cows (with a $0 tax basis) for $750 each. The gain of $11,250 (15 cows sold in excess of normal business practice X $750 sales price) is deferred. If the producer purchased 15 cows in 2014 for $1,000 each, the tax basis in each of the replacement animals would be $250 (the $1,000 cost minus the $750 proceeds from sale).

If a producer spends $11,250 and buys 15 cows before the end of 2014, the basis of the replacement animals will be $0, the same as the raised cows sold. If the producer spends less than $11,250 on the 15 replacement animals, the difference between what was spent and $11,250 must be reported as 2012 income. If less than 15 replacement cows are purchased, the gain from the animals not replaced must be reported as 2012 income regardless of the cost of the replacement animals. When filing an amended 2012 return, the producer may be subject to additional tax and interest on the tax.

To make the election under Section 1033(e) to defer recognition of gain, a producer does not report the gain and attaches a statement to the current year's tax return. The statement shows the following:

(1) Evidence of weather-related conditions which forced the sale of the livestock.
(2) Computation of the amount of gain realized on the sale.
(3) The number and kind of livestock sold.
(4) The number and kind of livestock that would have been sold as normal business practice without the weather-related sales.

Sale without Replacement

Producers who are forced to sell livestock because of weather-related conditions may be eligible for an exception to the rule the livestock-sale proceeds must be reported as income in the year they are received. This exception allows producers, whose principal business is farming, to postpone reporting these receipts as income for one year for both income and self-employment tax purposes. Although the livestock does not need to be located in a declared disaster area, there must be a relationship between the livestock and an area declared a disaster area. The animals can have been sold before or after the disaster area declaration. However, only the livestock sales in excess of a producer's normal business practice qualify for deferral.

A declaration must be attached to the tax return for the year in which the weather-related sale occurred. To make the election the statement should include the following:

(1) A declaration that the election is being made under Section 451(e).
(2) Evidence of the weather conditions which forced the early sale on the livestock and when the area was declared a disaster area.
(3) A statement explaining the relationship between the disaster area and early sale.
(4) The total number of animals sold in each of the three preceding years.
(5) The number of animals that would have been sold as normal business practice if the weather-related condition had not occurred.
(6) Total number of animals sold and the number sold because of the weather-related event during the tax year.

(7) Computation of the amount of income (see calculation below) to be deferred for each classification of livestock.

Let's look at another example. Suppose a producer normally farrows and feeds 2,000 pigs per year. Because of a drought, which caused the county in which the farm is located to be declared a disaster area, the farmer sells 1,000 pigs as feeder pigs in 2012 for $35 each rather than feeding them and selling them as market hogs in 2013. Under normal practice, no feeder pigs would be sold, so the proceeds from the sale of the 1,000 head can be deferred until 2013 ($35 per head X 1,000 feeder pigs = $35,000).

Further Information

For additional information on these tax provisions and details of the elections, see IRS Publication 225, *The Farmer's Tax Guide*. This publication is available on the IRS website at www.irs.gov. Search under Publication 225 in the publication search menu.

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