Income Tax Effects of Drought-Forced Sales of Livestock

By Jerry M. Hawkes

One of the obvious effects of a severe drought is that livestock must be liquidated in order to save the range and forage resources for future rehabilitation and use. While the fact that livestock must be sold under conditions that are much worse than normal and at a rate much higher than the normal replacement rate would seem to be punishment enough, most U.S. taxpayers are now conditioned to at least ask the question about what are the tax consequences of those sales. This question is always appropriate, because most of us now have come to understand, virtually every dollar that we receive is taxable unless the tax code says otherwise, and no dollar spent is deductible from taxable income unless the tax code says otherwise. That is not common wisdom, it is not common sense, it is the law! That principle is one of the first foundations upon which our income tax code is built.

When ranchers are forced to sell livestock because of drought conditions on their ranges, tax issues are not, and should not be, one of the major concerns. But, nevertheless, the question of the implications should always be asked before the action is taken, and a qualified tax advisor should be consulted to determine whether there is something you can do before the fact. Tax planning opportunities abound before an event; they seldom appear after the event.

If livestock have been or will soon be sold due to drought conditions, the tax code provides two options for tax treatment. Note right away, there are two options for how the sale price of the forced sales will be treated. There are no options for avoiding taxation altogether. The drought-related sale of livestock may be treated as an involuntary conversion or the gain from the sale may be postponed.

Involuntary Conversion

To qualify for treatment as an involuntary conversion simply means that the income from the drought-forced sale of livestock would be taxable on the tax return filed for the year 2011 tax year filed in the spring of 2012 (or the return filed for the 2012 tax year filed in 2013) for sales of livestock made in 2011. The following restrictions apply:

- Only livestock held for breeding, dairy, or draft purposes qualify. Any drought forced sales of calves or yearlings are taxable with the next tax return filed, regardless of the nature or intensity of the drought. If you have substantial drought-forced sales of market animals, choose the postponement alternative.

- Only livestock sold in excess of normal culling rates are eligible. If in the absence of drought 25 cows are normally culled, but 45 cows are culled in the drought year, only the gain from 20 cows could be deferred. Use Form 4797 numbers from previous years to establish the normal culling rates.
The livestock must be replaced by similar animals within the next two tax years. If replacements are not purchased within that time period, an amended return must be filed for the year of the sale, the gain reported, and any additional taxes paid. If the drought continues, preventing replacement, an extension of time to replace must be obtained in writing from the District Director of the IRS. Older cows may be replaced by younger cows, but should not be replaced by race horses.

If replacement animals are purchased at a price below what was received from the drought-induced sales, the difference is taxed as a gain by filing an amended return for the drought year. The tax basis (the amount that will be depreciated) of the replacement animal is equal to the price paid for that animal minus the gain on the drought-induced sale that was not taxed due to involuntary conversion treatment. For example, if the price received for a raised beef cow that was sold because of drought is $750 and a replacement is purchased for $750 or less, the tax basis on the replacement is zero. This means that there would be no depreciation deductions generated by the replacement.

**Postpone Gain from Sale**

Instead of treating drought-induced sales as an involuntary conversion, the gain may be deferred one year (gain will be reported on the 2011 tax return filed in 2012 for 2011 sales).

- Livestock held for breeding, dairy, or sporting purposes qualify as livestock held for sale (whether raised or purchased) qualify for a one-year postponement.

- Producers must be able to show that the sale would not have occurred under usual business circumstances (i.e., the drought had not occurred). The rules for sales in excess of normal would suffice.

- Drought-affected area must be an area eligible for federal assistance. However, the forced sales may have occurred before the area became eligible for federal assistance. A letter from an FSA representative can help establish the assistance declaration for your county.

- The tax basis for purchased replacement arrivals is not reduced by the amount of the postponed gain. Thus, if a raised cow is sold for $750 and a replacement is purchased for $750, the $750 paid for the replacement is depreciable.

**Making the Choice**

No simple recommendation is possible about which of the two choices will be to any individual’s advantage; except for such situations as if a large number of market animals are involved. Relative to a one-year postponement, opting for the involuntary conversion has the potential advantage of more than a one-year tax deferral on the gain and the disadvantage of limiting the tax basis (and depreciation deductions) to the excess (if any) of the replacement animal’s purchase price over the price received for the animal sold due to drought. Generally, a qualified tax preparer should work out both avenues and given the length of the drought, whether the drought continues next spring, whether the tax bill can be paid earlier, and the time value of money should all come into the analysis.

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