The drought in significant parts of the country during the summer of 2012 has raised a number of tax and law-related questions for farmers and ranchers. Those questions include the tax rules associated with sales of livestock on account of drought. The law contains special rules for farmers in this situation, but those rules can be complicated and must be followed to obtain any associated favorable treatment.

Involuntary Conversion Treatment
Two tax provisions are available for livestock owners to use in the event that livestock must be sold due to drought or other weather-related condition. Under the first provision, if a farmer on the cash basis sells livestock (other than poultry) held for draft, dairy or breeding purposes in excess of the number that would normally be sold during the time period, the sale or exchange of the excess number may be treated as a nontaxable involuntary conversion if the sale occurs because of drought, flood or other weather-related condition. The livestock sold or exchanged must be replaced within two years after the year in which proceeds were received with livestock similar or related in service or use. If it is not feasible to reinvest the proceeds in property similar or related in use, the proceeds can be reinvested in other property used for farming purposes (except real estate).

Note: The American Jobs Creation Act of 2004 altered the rules on reinvestment of the proceeds from the sale of draft, dairy or breeding livestock. For taxable years, with respect to which the due date of the return (without regard to extensions) is after December 31, 2002, the reinvestment rules for sales of livestock held for draft, dairy or breeding purposes were expanded to allow the reinvestment of proceeds in “other property...used for farming purposes” (except for investment in real property) where it is not feasible for the taxpayer to reinvest the proceeds in property similar or related in service or use. This provision, however, applies only to two-year reinvestment, not four-year reinvestment because that period for reinvestment is governed by the involuntary conversion rule, which is two years.

If the replacement property is livestock, the new livestock must be held for the same purpose as the animals disposed of because of the weather-related condition. In that event, the gain on the animals disposed of is not subject to tax. Instead, the gain is deferred until the replacement animals are sold or exchanged in a taxable transaction.

The two-year replacement period is extended to four years in areas designated as eligible for assistance by the federal government. Once the two-year replacement period is exceeded (if the longer period applies), the replacement property must be livestock that is similar or related in service or use to the animals disposed of. Also, the Treasury Secretary has the authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than three years.

To utilize the involuntary conversion rule, the livestock owner must attach a statement to the tax return for the year in which the animals were sold that shows evidence of the existence of the weather-related conditions that forced the sale. Also, the attachment must show a computation of the gain realized on the sale or exchange, and the number of livestock sold or exchanged in addition to the number of livestock of each kind that would have been sold under the usual business practice had there not been any weather-related event.
Note: The replacement of the livestock is to be reported on the tax returns of the following years. If reinvestment does not actually occur or there is not a full reinvestment, the tax return for the year of the weather-related conditions must be amended to report additional income in an amount equal to the amount that was not reinvested.

**One-year Deferral Treatment**

Under another provision, if a livestock owner on the cash method of accounting is forced because of drought or other weather-related condition to dispose of excess livestock, the owner can elect to have the gain on sale be deferred until the following taxable year.

Note: The deferral provision only applies to the excess livestock sold during the tax year at issue beyond what the livestock owner would have normally sold. In addition, the area must be declared a disaster area, but the livestock need not be raised or sold in the disaster area.

To be eligible for deferral, the taxpayer's principal business must be farming. But off-farm income is permissible. For example, the IRS has stated in one private letter ruling that a rancher with $121,000 for the tax year in gross income from ranching, and an additional $65,000 a year off-farm income, was still deemed to have a principal business of ranching. The rancher devoted 750 to 1,000 hours per year to the ranch, and his wife contributed about 300 hours.

A separate election form must be attached to the return, which must be filed on or before the due date of the return and must contain the following:

- Denote that an election is being made under I.R.C. §451(e);
- Show evidence of the weather-related conditions that forced the early sale, including the date the area was designated as eligible for federal assistance as a disaster area;
- An explanation of the relationship between the weather-related condition and the reason for the sale;
- The total number of animals sold in each of the three preceding years;
- The total number of animals that would have been sold under normal conditions;
- The total number of animals sold during the year and the number sold because of the weather-related conditions; and
- The amount to be deferred to the following year.

Deferral of income is limited to sales in excess of “usual business practices.” Thus, deferral is only available for the gain attributable to the excess number of livestock sold on account of the drought or weather-related condition over the number of livestock that the owner would normally sell during the tax year. Also, an election for one-year deferral is valid if made during the applicable replacement period for the livestock under I.R.C. § 1033(e). Similarly, a taxpayer can revoke a deferral election in favor of involuntary conversion treatment, but the converse is not possible.

Note: The deferral provision applies to all livestock held for resale (raised or feeders), as well as livestock used for draft, breeding, dairy or sporting purposes and livestock held for less than two years (cattle and horses) and less than one year for other livestock.

* This Information File is an excerpt from the Center for Ag Law and Taxation (CALT) article on Tax and Legal Issues Associated with the 2012 Drought, www.calt.iastate.edu/cropdrought.html. Visit the CALT website, www.calt.iastate.edu/, for more information and updates on tax related issues concerning weather-related livestock sales, the ability to defer crop insurance proceeds, and the inability to fill forward grain contracts due to lack of crop. Footnotes are not included.