Electing Internal Revenue Code 1033(e) to Defer Gains

Quick Notes...
- Proceeds from livestock sold due to drought may be deferred for four (4) years.
- Replacement property must generally be "similar or related in service or use" to the property sold.

Weather, particularly precipitation, greatly influences cattle production. Too much rain may cause flooding, reduced access to pastures, or areas of hay fields too wet to be harvested. Conversely, and quite common to much of the western U.S.A., is drought may cause management issues for livestock producers. Too little precipitation or precipitation occurring not at the right time will cause poor vegetative growth.

In cases of drought, livestock producers typically are forced to change management practices. Various strategies available to these producers include:

1. Feeding inventoried winter feed supplies,
2. Purchasing supplemental feed,
3. Moving the cattle to a part of the country with good pasture,
4. Early weaning and selling calves,
5. Early weaning calves and selling cows, and
6. Culling cow-calf pairs.

The first three management strategies effectively increase expenses, thus reducing profits. The latter three management strategies effectively increase revenues thus causing increased tax liabilities for the particular year.

There are generally two sections of the Internal Revenue Code that pertains to sale of animals because of weather-related conditions:

- IR Code 1033(e) pertains to the sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes. A weather related cause for such sales is considered to be an involuntary conversion.
- IR Code 451(e) pertains to all livestock and allows qualified tax payers to postpone recognition of gains from the sale of animals due to adverse weather-related conditions to the following tax year.

A farmer wanting to postpone gains allowed by either IR Code section must have farming as his principal trade or business use the cash method of accounting, and show that, under usual business practices, he would not have sold or exchanged the additional animals this year except for the weather-related condition.

Area of Weather Related Conditions
Internal Revenue Code 1033(e) concerns two primary categories of land with adverse

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weather-related conditions.

1. Area designated by the United States Secretary of Agriculture or President as "eligible for federal assistance." Such areas are typically by county and contiguous counties.
2. Areas with adverse weather-related conditions causing significant changes to stocking rates but not officially declared as eligible for federal assistance.

A farmer taxpayer may make a 1033(e) election to postpone recognition of revenues from sales of animals due to adverse weather-related conditions regardless of the area being officially declared as eligible for federal assistance. However, the replacement period is different.

Replacement Period

The gains realized from the sale of livestock (not poultry) held for any length of time for draft, breeding, or dairy (no sporting) purposes does not have to be recognized if the proceeds are used to purchase replacement animals within a specified period of time. The replacement period begins on the date the animals were sold. It generally ends two (2) years after the last day of the tax year in which the animals were sold.

However, if the land to have been grazed by the animals is within an area eligible for federal assistance, the replacement period is four (4) years after the last day of the tax year in which the animals were sold. The IRS may extend the replacement period on a regional basis if the weather-related conditions continue for longer than three (3) years.

It should be noted that for a farmer to make an election to postpone gains under IR Code 451(e), the area must be eligible for federal assistance.

Replacement Property

Replacement animals must be for the same purpose as the livestock sold. Therefore, beef cows must be replaced with at least the same number of beef females. Also, the same amount (or more) money must be spent to purchase the replacement animals.

However, there may be circumstances in which it is not practical to reinvest the sale proceeds in property similar or related in service and use to the livestock. In such cases, the sale proceeds may be reinvested in other property, except real property, used for farming purposes.

IR Code 1033(3) Election

A qualified farmer taxpayer may elect to defer recognition of the gains realized from sales of livestock due to drought by not reporting the deferred gain on the tax return and attaching a statement to the tax return showing all the details of the involuntary conversion. The details should include:

- Evidence of drought conditions forcing the sale or exchange of the livestock.
- The number, kind, and basis of the livestock sold or exchanged,
- The number of each kind of livestock that would have been sold or exchanged under normal business practices, and
- A computation of the amount of gain realized from the sale or exchange.

Example

A producer sells 75 beef cows in excess of normal business practice due to a drought in 2008. The land to have been grazed is in a county declared a disaster by the U.S. Secretary of Agriculture making the producer eligible for federal assistance. The cows were sold for $1,000 each and have zero basis (the cows were raised or "depreciated out", so the gains of $75,000 may be deferred.

If the producer purchases 75 breeding beef females before December 31, 2012 for $1,200, the tax basis of each replacement animal would be $200 ($1200 minus the $1000 sale proceeds).

If the producer spends less than $75,000 on the 75 replacement animals, the difference between what was spent and the $75,000 must be reported on the 2008 tax returns. If the producer purchases fewer than 75 replacement animals, the gains on the animals not replaced must be reported on the producer's 2008 tax return. In these cases, the producer will have to amend his 2008 tax return and be subject to any additional taxes and interest on the taxes owed. The producer's tax returns in the following years may also have to be amended.

A producer should contact his/her tax accountant to determine the effects of deferring gains from livestock sold and purchasing replacement property. Also, IRS Publication 225 – Farmer's Tax Guide – can provide additional information about making a 1033(e) election.

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