University of Idaho
College of Agriculture
Cooperative Extension Service
Agricultural Experiment Station

Current Information Series No. 413

October 1977

Income Tax Options For Drought Sales of Livestock

Under drought conditions, livestock producers must decide whether to sell part of their stock or face high bills for purchased feed. Income tax options for such sales may be an important consideration in that decision.

Under income tax law, gain from the sales of livestock held for draft, breeding or dairy purposes may be postponed. The length of time the tax can be deferred depends on which option the rancher selects, providing the necessary conditions are met. Additional information is provided in the 1977 Farmer's Tax Guide (see Chapters 4 and 14). The Guide is available through your County Extension Office. Livestock producers should also consult with their tax advisors.

Option 1: Treat As Involuntary Conversion

A forced sale may qualify as an involuntary conversion due to drought. The income from these sales is not taxable if replacement livestock, of similar type as those sold, are bought within the next two tax years. Ranchers also need to satisfy other conditions in order to take advantage of this tax law provision. For example, livestock sold or exchanged because of the drought must have been held for draft, breeding or dairy purposes. Forced sales of feeder cattle do not qualify.

Only the gains above normal sales can be included as a gain due to an involuntary conversion. If the rancher normally sells 30 beef cows but sold 50 because of the drought, only the proceeds from 20 animals would qualify.

Within two tax years, livestock sold must be replaced with similar livestock used for like purposes. A beef cow cannot replace a dairy cow. Also, any portion of the proceeds from the forced sales not expended on replacements must be included as taxable income.

The burden of proving the livestock were sold because of drought conditions rests with the rancher. Information on rainfall, feed production, rate of gain and any other evidence should support the claim. The Farmer's Tax Guide should be consulted for the information required when reporting gains from involuntary conversions.

Option 2: Pay the Tax on the Gain

Before electing the option of handling the sales as involuntary conversions, the rancher should also consider another alternative. If the cash method of reporting income and expenses is used, the animals purchased to replace the drought-sold cattle which were ranch-raised would have a zero cost "basis." Replacements are valued according to the "basis" on the livestock sold. With a zero basis, replacements would not be eligible for depreciation deductions and investment credit. Thus, it may be more beneficial in the long run to pay capital gains taxes on the sale and claim investment credit and depreciation rather than exempting the sale as an involuntary conversion due to drought.

Option 3: Defer the Tax One Year

This is a new option brought about by the Tax Reform Act of 1976, but it is limited to those areas that are designated as eligible for federal assistance. Ranchers reporting under the cash method may elect to defer their tax liability by one year for income arising from the sale or exchange of livestock sold because of drought. This treatment is limited to income from livestock that are sold or exchanged in excess of usual business practice and that would not have been sold except for the drought.

Thus, if the conditions are met, this year's income from drought sales may be included in next year's income. This would have the possible advantage of reducing the year-to-year variation in taxable income.

Ranchers have three options:

1. Elect to treat the sale as a tax-exempt involuntary conversion.
2. Pay tax on the gain from the forced sale.
3. Defer reporting the sales proceeds from the sale.

Comparing expected after-tax cash flows over the years until replacements are sold will help determine which alternative affords the greatest tax advantage.

Examples of How to Handle Sales As Involuntary Conversions

Assume:

- That you are reporting income on a calendar year basis for income tax purposes.
- That you sell 100 cows in 1977 for $150 each or $15,000 total.
- That you normally sell 20 percent of the herd each year.

Under these conditions, $3,000 (20 x $150) would be handled on your income tax return in the same manner as you have handled cow sales in the past and $12,000 (80 x $150) would be subject to recognition of gain.

Case 1: Assume that the stock was raised by you and the costs of raising were included in your expenses for the year in which they were actually paid. Therefore the entire $12,000 is gain.

If you do not replace the stock, the entire $12,000 would be included on your income tax for 1977 either in your original return or in an amended return.

If you buy replacement stock before the end of 1979 and they cost $12,000 or more, you would not pay tax on any of the gain.

If you buy replacement stock but it costs less than $12,000, the difference between the cost and the $12,000 would have to be included in your taxable income for 1977 in an amended return.

Case 2: Assume that you had purchased the stock and you have $100 per cow which has not been depreciated.

If you do not replace the stock, the difference between the sale proceeds — $12,000 and $8,000 (80 x $100) or $4,000 would have to be included in your return for 1977 either on the original or in an amended return.

If you buy replacement stock before the end of 1979 and they cost $12,000 or more, you would not pay tax on any of the gain.

If you buy replacement stock before the end of 1979 and they cost between $8,000 and $12,000, you would pay tax on the difference between the purchase price and $12,000.

If you buy replacement stock and they cost less than $8,000, you would include $4,000 gain in your amended 1977 tax return.

This publication was written by A. Gene Nelson and Manning H. Becker, Extension farm management specialists, Oregon State University. Printed in Idaho with permission of Oregon State University Cooperative Extension Service.

5 cents per copy

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