

## **The Impact of Income Tax Laws on the Sales of Livestock During Periods of Severe Drought**

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### **ABSTRACT**

Livestock producers were forced to sell their cattle and other livestock due to the drought conditions in 2008. These involuntary sales created significant income tax liabilities for the producers. However, in certain situations the producer can take advantage of relief provisions in the Internal Revenue Code which were enacted to reduce or eliminate these potential negative tax consequences. Some involuntary sales may qualify for tax deferral for at least one year and potentially a much longer period. Whether these tax provisions will provide any benefit to a producer depends on a detailed analysis of the specific circumstances of each case. This paper examines in detail the relevant tax laws including the Internal Revenue Code, Treasury Regulations, Internal Revenue Service rulings, and case law to determine whether there are ambiguities in the relevant laws that, when compared to other tax laws with similar purposes, could cause uncertainty in the application of these laws to common situations. The paper also sets forth the issues that should be considered when determining whether these tax laws will provide any benefit to a particular livestock producer. Based on a review of the existing laws and a comparison with other similar provisions, there are at least a few items that need clarification in order to provide the same level of clarity and certainty that exists with other provisions of tax law.

**KEY WORDS:** livestock, tax deferral, drought, gain, taxation

### **INTRODUCTION**

The current drought throughout much of the United States has caused farmers and ranchers to liquidate their herds in record numbers. According to the United States Department of Agriculture (USDA), the 90.8 million head of cattle in the U.S. as of January 2012 was 2% less than the 92.7 million inventory in January 2011. The national inventory decreased even further to 89.3 million in January 2013. In total, the cattle inventory has decreased 4% since the beginning of 2011, and the inventory in January 2013 is the lowest it has been since 1952 (NASS 2013). Oklahoma State University's Division of Agricultural Sciences and Natural Resources reported that feeder cattle sales

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in Oklahoma during July 2011, were up more than 50% from the same period in 2010 and cow and bull sales were up more than 200% (Oklahoma State University 2011).

Texas has been especially hard hit by the drought (Jervis 2011; Goodwyn 2011). In June 2011, the USDA designated 213 of 254 counties in Texas as primary natural disaster areas that qualified for federal aid as a result of the drought (USDA 2011). During the 12-month period ending in February 2013, the U.S. Drought Monitor reported at least some period of exceptional, extreme, or severe drought for all 254 Texas counties (U.S. Drought Monitor 2013). The agricultural losses due to the 2011 drought in Texas were estimated to be \$7.62 billion, with \$3.23 billion of that from livestock losses (Fannin 2012). In addition, Texas' cattle inventory has decreased significantly. In 2011, the overall number of cattle in Texas dropped by nearly 1.5 million, with 660,000 of that reduction being from beef cattle (NASS 2012). The overall Texas cattle inventory decreased another 600,000 in 2012, with 550,000 of that being a reduction in beef cattle (NASS 2013). The national drought has also impacted many states across the country (University of Arkansas 2012; AgWeek 2011).

The duration and severity of the drought have created uncertainty regarding future farming and ranching operations. Long-term recovery from the diminished livestock herds is a primary issue. In particular, some farmers and ranchers will be faced with the decision of whether to re-enter the market, when to do so, and to what degree. Undoubtedly, these decisions will be based on fundamental economic principles regarding whether the potential profit from continuing or starting a new ranching operation will be sufficient to justify the costs and risks involved (Lacy 2011). If cattle prices rise over time - which they may, given the decreased supply that results from current liquidations and increasing slaughter rates (Galbraith 2011), rising inflation, and increased world demand for beef - then the buying power of today's sales proceeds will be diminished and the ability to restart a sustainable operation may be affected (Texas 2011).

One of many difficult issues producers face during this period of uncertainty involves difficult tax decisions surrounding the liquidation of livestock. This paper addresses some provisions of the Internal Revenue Code (the "Code") that affect a farmer or rancher's decisions regarding the sale of livestock and the purchase of new livestock if and when current drought conditions subside.

## **METHODS AND MATERIALS**

This paper provides an overview of the federal income tax treatment of livestock sales under existing tax laws. After providing a general overview, the author gives a more detailed analysis of Internal Revenue Code Sections 1033 and 451, two provisions that may allow farmers and ranchers to defer all or a portion of the gain recognized on livestock sales due to recent drought conditions. When compared to other similar provisions of the Code, Sections 1033 and 451 leave some important questions unanswered and other sources of authority do not provide any additional guidance. This paper discusses a few significant aspects of Code Sections 1033 and 451 and the related rules that need clarification in order to provide guidance for different situations that may arise. The paper also offers suggestions for how to clarify those ambiguities by identifying specific changes that could be made to make these laws consistent with

similar provisions of the Code and discusses issues that farmers and ranchers must consider when determining whether it would be beneficial to utilize these tax deferral provisions.

## RESULTS

**Gain from the sale of livestock.** Generally, when an asset is sold the difference between the amount realized on the sale and the seller's adjusted basis in the asset is recognized as gain (I.R.C. § 1001(a)). The amount realized on the sale is equal to the amount of money received plus the value of any property (other than money) received and the amount of any liabilities of the seller that are discharged as a result of the transaction (I.R.C. § 1001(b)). An owner's tax basis in property is generally equal to the cost of acquiring the property, subject to certain special rules and adjustments (I.R.C. 1012(a)). If a sale results in a realized gain, the gain is included in the owner's taxable income unless there is a specific exception that allows him to defer or eliminate the gain (I.R.C. § 1001(c)).

Most family livestock producers and farmers have a zero basis in their livestock because the costs of raising the animals are deducted and not added to the livestock's basis (Treas. Reg. § 1.162-12(a)). If the farmer is a corporation or partnership that is required to use the accrual method of accounting, then Code Section 263A requires capitalizing certain costs, which would increase the tax basis in the livestock. Code section 447 requires corporate farmers to use the accrual method of accounting, unless the corporation has not had gross receipts in excess of \$25,000,000 in any taxable year after 1985 (I.R.C. § 447(a) and (d)). However, when livestock is purchased, the basis is equal to the amount paid for the livestock (I.R.C. § 1012(a)). For producers whose herds consist of raised livestock with zero basis, the sale of a significant portion of a herd could result in substantial taxable gains. Furthermore, even if a herd is made of purchased livestock, unless the livestock was bought within the previous two or three years the gain will likely be substantial because of depreciation deductions that have significantly reduced the tax basis in the livestock. Depending on the year the livestock was purchased, the entire basis could be depreciated in the first year under the bonus depreciation provisions of Code Section 179. In addition, the depreciation recovery period for most livestock is between three and seven years, so basis is reduced quickly by depreciation.

Taxable gain is subject to tax at either ordinary income rates or reduced capital gain rates, depending on the circumstances. Gains from the sales of capital assets held for more than one year are currently taxed at a maximum rate of 15% (I.R.C. § 1(h)(1)(C)). The capital gains rate was set to revert back to 20% at the end of 2010, but the lower rate was extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The maximum capital gain rate will increase to 20% if the "Bush tax cuts" are not extended again after 2012. The maximum individual tax rate on ordinary income and gains from the sale of capital assets held for less than one year is 35% (I.R.C. § 1(i)(2)). The maximum ordinary income rate will increase to 39.6% if not extended again after 2012.

The Code defines a capital asset by describing what it is not. Section 1221 of the Code states that a capital asset means property held by the taxpayer (whether or not connected with a trade or business), but does not include:

- i. stock in trade;

- ii. inventory;
- iii. property held primarily for sale to customers;
- iv. depreciable property used in a business;
- v. real property used in a business;
- vi. certain intellectual property;
- vii. accounts receivable acquired in the ordinary course of business;
- viii. certain publications of the United States government;
- ix. hedging transactions; and
- x. supplies used by the taxpayer in the ordinary course of business (I.R.C. § 1221(a)).

Assets that do not qualify as capital assets are generally not eligible for the preferential capital gains rate when sold. For farmers and ranchers, cattle and other livestock do not qualify as capital assets because they are either held primarily for sale to customers or are depreciable property used in a business.

However, there is an additional provision that may treat gains from the sale of livestock as capital gains. Code Section 1231 provides that if section 1231 gains for any taxable year exceed section 1231 losses for that year then such gains and losses are treated as long-term capital gains and losses (I.R.C. § 1231(a)(1)). However, any gain that results from depreciation recapture will be subject to tax at ordinary income rates (I.R.C. § 1245(a)(1)). If 1231 gains do not exceed 1231 losses, then they are treated as ordinary gains and losses (I.R.C. § 1231(a)(2)). “Section 1231 gains” are gains from the sale of property used in a trade or business or from the involuntary conversion of such property, and “section 1231 losses” are losses resulting from the sales of such property (I.R.C. § 1231(a)(3)). For purposes of these rules, only certain property qualifies as being used in a trade or business. That property includes any personal property that is (i) used in a trade or business, (ii) subject to depreciation under Code Section 167, and (iii) held for more than one year, but does not include property that is inventory or held primarily for sale to customers or certain intellectual property and government publications (I.R.C. § 1231(b)(1)). The term also includes real property used in a trade or business and held for more than one year. In addition, the term includes specific types of livestock. Cattle and horses held for more than two years for draft, breeding, dairy, or sporting purposes are covered as is other livestock held for more than one year for the same purpose (I.R.C. § 1231(b)(3)). However, poultry do not qualify for Section 1231 treatment.

Therefore, livestock held for draft, breeding, dairy, or sporting purposes may qualify for capital gain treatment under Section 1231, but livestock held primarily for sale to customers does not qualify for capital gain treatment under either the capital asset test or Section 1231. The determination of whether livestock is held for draft, breeding, dairy, or sporting purposes is based on the facts and circumstances of each case (Treas. Reg. § 1.1231-2(b)). This issue has been litigated many times and the cases illustrate the importance of keeping accurate records regarding farming and ranching operations (Bales 1989; A. Duda 1977).

**Potential tax deferral.** For many producers, additional taxable income will not create a tax liability because there are sufficient losses and deductions to offset the gain. However, for those faced with the possibility of a current income tax liability resulting from livestock sales, there are several options for deferring tax payments. The availability

of these deferral provisions and which options may be better suited for a particular farm or ranch operation depend on the circumstances in each case and the different.

**Section 1033 of the Internal Revenue Code.** This Code section provides that if property is involuntarily converted into money and subsequently reinvested in similar property within a specified time period then no gain or loss is recognized on the transaction (I.R.C. § 1033(a)(1)). Generally, this provision applies to condemnation proceedings where all or a portion of some real estate is condemned or seized by a government entity and the land owner is compensated for any land taken. In such a case, the landowner is not required to recognize taxable gain if the proceeds are invested in other real estate within a specified replacement period (I.R.C. § 1033(a)(2)).

This special deferral provision also applies to the sale of livestock as a result of drought, flooding, or other weather-related conditions (I.R.C. § 1033(e)). Only livestock (other than poultry) held for draft, breeding, or dairy purposes qualify for this treatment (I.R.C. § 1033(e)(1)). If a taxpayer sells more qualifying livestock solely due to drought or other weather conditions than he would have under normal business practices, then the gain from the sale of “extra” livestock can be deferred under Code Section 1033(e). It is not necessary that the livestock be held or sold in the affected area, but the sale must be solely on account of weather-related conditions that affected “the water, grazing, or other requirements of livestock so as to necessitate their sale” (Treas. Reg. § 1.1033(e)-1(b)).

In order to qualify for deferral, a taxpayer generally must purchase replacement livestock within the replacement period discussed below. Replacement livestock should be similar or related in service or use to the livestock that was sold (Treas. Reg. § 1.1033(e)-1(d)). That is, the new livestock must be held for the same purpose as the old livestock. For example, dairy cows can be replaced with dairy cows, but they cannot be replaced with draft or breeding animals. The rules under Code Section 1033 do not specify whether replacement livestock must be the same sex as the livestock that was involuntarily converted. However, the like-kind exchange provisions of Code Section 1031 specifically provide that the exchange of one sex of livestock for the other sex is not an exchange of like-kind property (I.R.C. § 1031(e)). A lack of specificity in Section 1033 provisions suggests that the replacement livestock need not be the same sex as converted livestock as long as the use and purpose is the same.

In addition, if because of drought, flooding, or other weather-related conditions it is not feasible for the taxpayer to reinvest his proceeds from involuntarily converted livestock in new similar livestock, he may purchase other property used in farming (including real estate) and qualify for tax deferral (I.R.C. § 1033(f)). The taxpayer’s basis in replacement property is the same as the basis in the involuntarily converted property, decreased by the amount of money that was not reinvested in replacement property and any loss recognized on the involuntary conversion (I.R.C. § 1033(b)(1)). Tax basis is increased by the amount of any gain recognized on the conversion. If replacement property cost exceeds the involuntary conversion proceeds, then the basis is increased by such excess cost (I.R.C. § 1012(a)).

If livestock sales meet the requirements set forth above, then the taxpayer must reinvest the proceeds in qualifying replacement property (either livestock or other farm property as discussed above) within a specified replacement period. Generally, the replacement period is two years from the end of the tax year in which the livestock were sold due to adverse weather conditions (I.R.C. § 1033(a)(2)(B)). If the area affected by

weather has been designated as eligible for disaster assistance from the Federal Government, then the replacement period for livestock is four years (I.R.C. § 1033(e)(2)(A)). However, when replacing livestock with other farm equipment the replacement period is always two years. In 2006, the IRS issued a notice that extends the replacement period for livestock sold on account of drought, flooding, or other weather-related conditions until the end of the first year ending after the “first drought-free year for the applicable region” (IRS Notice 2006). With respect to individual taxpayers, the first drought-free year for the applicable region is the first twelve-month period that (i) ends on August 31, (ii) ends in or after the last year of the taxpayer’s standard four-year replacement period, and (iii) does not include any weekly period for which exceptional, extreme, or severe drought is reported for any location in the applicable region (IRS Notice 2006). In September of each year, the IRS publishes a notice that includes a list of counties in which extreme drought conditions were reported for any period during the previous twelve months. If the taxpayer’s region is listed in the notice, then his replacement period is extended pursuant to the rule outlined in the notice (IRS Notice 2010). The 2010 IRS Notice included 31 states with at least one county that qualified for an extended replacement period.

The following hypothetical example helps illustrate the replacement period rules. Mr. Smith is a calendar year taxpayer and raises cattle for breeding in Kendall County, Texas. In July 2006, Mr. Smith sold 40 cows due to the drought (he would not have sold any if it were not for the drought). At the time of the sale, Kendall County qualified for assistance from the Federal government because of the drought conditions. As a result, Mr. Smith had until December 31, 2010, to purchase replacement cows. However, in September 2010, the IRS released a notice that listed Kendall County as one of the regions in which extreme drought was reported, thus extending the replacement period. In September of 2011 and 2012, the IRS notice did not list Kendall County as one of the severe drought regions. At that point, Mr. Smith has to purchase his replacement cows by December 31, 2012, in order to qualify for the relief of Section 1033.

A taxpayer who desires to take advantage of this deferral provision should report the details of the involuntary conversion on the return for the taxable year in which the conversion took place (i.e. the year the sales were finalized and the proceeds received) (Treas. Reg. § 1.1033(a)-2(c)(2)). The report should include the following:

- i. Evidence of the drought conditions which forced livestock sales;
- ii. A computation of the amount of gain realized on the sale;
- iii. The number and kind of livestock sold; and
- iv. The number of livestock of each kind that would have been sold under usual business practice in the absence of drought conditions (Treas. Reg. § 1.1033(e)-1(e)).

**Deferring some or all of the gain.** Only the amount of gain that the taxpayer desires to recognize currently as a result of the involuntary conversion should be included in the gross income on that return. The taxpayer reports the details of the purchase of replacement livestock on the return for the year in which replacement livestock is purchased (Treas. Reg. § 1.1033(a)-2(c)(2)). If the taxpayer fails to purchase replacement property or only uses a portion of the involuntary conversion proceeds for such property, then he must amend the return on which the original involuntary conversion of livestock was reported and pay any resulting taxes. In addition, if the taxpayer originally reported

gain from the involuntary conversion but later decides to apply Code Section 1033 to defer that gain, he should file a tax refund claim (Treas. Reg. § 1.1033(a)-2(c)(2)).

**Another potential deferral provision is Code Section 451.** This Code section allows farm and ranch taxpayers who use the cash method of accounting to defer to the following tax year the gain from the sale of certain livestock due to drought or other weather-related conditions (I.R.C. § 451(e)(1)). Once made, this election is irrevocable unless the taxpayer obtains IRS consent. This election may be made only by individuals whose principal trade or business is farming (I.R.C. § 451(e)(2)) and is not available with respect to livestock held for draft, dairy, breeding, or sporting purposes for more than twelve months (twenty-four months in the case of cattle and horses) (Treas. Reg. § 1.451-7(a)). Just as with the deferral under Code Section 1033, this elective provision is available only to the extent that the number of livestock sold exceeds the number that would have been sold under normal business practices. In addition, sales must be solely on account of drought or other weather-related conditions, and the affected area must have been designated as eligible for assistance by the Federal government (Treas. Reg. § 1.451-7(a)). If a sale occurs before the area is designated for Federal assistance, the sale can still qualify under Section 451 if the sale occurred as a result of weather conditions that caused the area to become eligible for Federal assistance. Again, it is not necessary that the livestock be raised or sold in the affected area, but the taxpayer must be able to show that the sales occurred because of weather conditions that affected the water, grazing, or other requirements of the livestock so as to necessitate a liquidation (Treas. Reg. § 1.451-7(c)(1)).

Generally, taxpayers must make the Section 451(e) deferral election prior to the due date for filing the income tax return for the taxable year in which the sales occurred (Treas. Reg. § 1.451-7(g)). However, if the sale would qualify for the extended replacement period under Code Section 1033(e)(2), then the Section 451 election is valid if made prior to the replacement period expiration (generally, two years from the end of the year in which the sale occurred, but possibly longer in severe drought situations) set forth in Section 1033(e)(2) (I.R.C. § 451(e)(3)). The practical effect of this rule is that the Section 451 election does not have to be made until the end of the extended replacement period under Section 1033(e)(2) because all sales that qualify for Section 451 treatment would also qualify for the extended replacement period under Section 1033(e)(2). Code Section 1033(e)(2) extends the replacement period from two to four years if the area has been designated as eligible for Federal assistance. Given that Section 451 applies only when the drought caused an area to be eligible for Federal assistance, any sale that qualifies for Section 451 deferral would satisfy the requirements of Section 1033(e)(2).

**Need for clarification.** The application of the rules outlined above is relatively straightforward. However, there are several issues that are unclear and warrant additional guidance. First, given the anticipated severity and duration of the current drought that affects nearly the entire country, it is important to understand what qualifies as replacement livestock under the Code Section 1033(e) deferral rules. As currently drafted, the Code and Treasury Regulations require that replacement livestock be of similar or related use or service and be “functionally the same as” the livestock that was sold. That is, the new livestock must be held for the same purpose as the old livestock. Treasury Regulations indicate that livestock held for breeding cannot be replaced with

livestock held for draft or dairy purposes, but, presumably, a taxpayer could replace hogs held for breeding with cows held for breeding. However, the Code, IRS rulings and publications, and case law do not provide a clear answer to this question.

The like-kind exchange rules of Code Section 1031 could provide guidance in clarifying what qualifies as replacement livestock. Under Section 1031, property held for investment or use in a trade or business can be exchanged for “property of like kind which is to be held either for productive use in a trade or business or for investment” without recognizing gain or loss on the transaction. Whether two properties are like kind depends on the nature or character of the property, not their grade or quality (Treas. Reg. § 1031(a)-1(b)). As a result, real estate exchanges are a common use of the 1031 exchange rules because of the ability to exchange one type of real estate for another. For example, the following exchanges qualify as like-kind exchanges of real estate: city real estate exchanged for a farm (Treas. Reg. § 1031(a)-1(c)); gold mines exchanged for coal mines (Peabody 2006); perpetual water rights exchanged for farm land (PLR 2004); and a fee simple interest in real estate for a lease with more than a thirty-year remaining term (Treas. Reg. § 1031(a)-1(c)).

The types of real estate that can be exchanged in a 1031 transaction have little in common other than being real estate held for investment or business use. The real estate need not consist of the same rights, be held for the same purpose, or produce (or have the potential to produce) the same type of income. Nonetheless, those properties are considered like-kind for purposes of Section 1031 and can be exchanged without the recognition of gain or loss.

Applying a similarly broad characterization to livestock held for breeding, draft, or dairy purposes would provide comparable flexibility when replacing livestock that were sold due to drought or other weather-related conditions. The Code refers to livestock as the broad category to which the section applies, and then narrows the application by limiting it to livestock held for breeding, draft, or dairy. Therefore, because cows and goats are both livestock, a rancher should be permitted to exchange cows for goats, as long as the new livestock is held for the same purpose as the old livestock.

In addition, there are good policy reasons for allowing the exchange of different types of livestock. For example, due to the recent drought severity, certain forms of farming or ranching may not be sustainable in areas that have historically been used for that purpose. Therefore, good policy would permit farmers to change the kind of livestock they raise to a type better suited for the new conditions of drought-affected areas. This type of exchange satisfies the plain language of the Code and Regulations so long as the livestock are used for the same purpose, but it is not clear what position the IRS would take on this issue.

Assuming that different livestock cannot be used to replace the involuntarily converted livestock under Code Section 1033 provisions, it could also be argued that extreme drought conditions that make a different type of livestock more suitable for particular environments make it not feasible for the taxpayer to reinvest the proceeds in the same type of livestock that was sold due to the drought. In that case, the purchase of a different type of livestock may qualify as “other property used for farming purposes” so that Code Section 1033(f) would treat the other property as similar to the livestock that was sold. This could even apply to livestock used for other purposes so long as it is utilized for “farming purposes,” which has not been defined. Attempting to fall within



Code Section 1033(f) provisions would require the taxpayer to show that the purchase of similar livestock was not feasible due to drought or other weather conditions, something that may be difficult or impossible, particularly if other farmers and ranchers in the area continue to raise the same type of livestock that the taxpayer sold due to drought.

The language of Code Section 1033 and the applicable Regulations also leave room for IRS interpretation. When given the opportunity to do so in the past, the IRS has made reasonable and rationale changes to the application of livestock exchange rules. For example, in 2006, the IRS realized that it did not make sense to require the purchase of replacement livestock if the drought or other weather conditions that caused the involuntary conversion still existed. As a result, the IRS issued a notice that extends the replacement period until after the extreme drought conditions have ended. This extension was made pursuant to specific statutory authority that allowed additional extensions when appropriate based on weather-related conditions I.R.C. § 1033(e)(2)(B)). There is no similar authority for determining the type of exchanges that qualify for deferral under Code Section 1033, but the IRS could reasonably interpret Section 1033 to provide that different types of livestock can qualify 1033 treatment under the circumstances described above.

**Practical planning.** Conventional wisdom suggests that tax deferral is the next best thing to tax elimination and a taxpayer should not recognize taxable income now in order to provide for future deductions. That thought process may lead many farmers and ranchers to take advantage of the deferral provisions discussed above when they are forced to sell livestock as a result of drought conditions. However, a careful analysis should be made to ensure that tax deferral is the best choice. In some cases, recognizing taxable gain now may be the preferred option.<sup>1</sup>

For example, a farmer might have significant net operating loss (NOL) carryovers that will expire at the end of the current tax year. In that case, recognizing gain now may allow him to use those expiring NOLs that would otherwise be wasted. As noted previously, it is not ideal to offset capital gains with ordinary losses and deductions, but it could be worth it to recognize the gain now in order to use the expiring NOLs.

It is also important to determine whether current and future sales will create ordinary income or capital gain. If a rancher sells twenty cows that he raised for breeding which have a zero tax basis, then the resulting gain will be a Section 1231 gain and could result in capital gain treatment if the Section 1231 gains exceed the Section 1231 losses for the year. If the rancher has sufficient deductions or losses to offset the current gain, then no tax will be due and he may decide it is not necessary to use the deferral provisions under Code Section 1033(e) or Section 451.

When a rancher buys cows to replenish his breeding program, he will get a tax basis equal to the cost of the replacement cows. He will be entitled to take depreciation deductions with respect to the cows (either by electing to expense the cost of the

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<sup>1</sup> For a general discussion of situations in which tax-able transactions may be more efficient than tax-free transactions, see Timothy J. Devetski, *Avoiding a Tax-Free Transaction: When Taxable is Tax Efficient*, 5 HOUS. BUS. & TAX L.J. 90 (2005).

replacement cows pursuant to Code Section 179 or through the standard annual depreciation deductions determined under Code Sections 167 and 168), and if the new cows are sold in the future the rancher will likely have a zero basis at the time of sale due to depreciation deductions. This will result in all or a portion of the gain from the sale of his depreciated cattle being taxed as ordinary income due to the depreciation recapture rules. By choosing not to use the 1033(e) deferral provisions, the rancher will recognize capital gain now but may not have any current tax liability because of potential offsetting deductions. In the future, he will be entitled to depreciation deductions with respect to the replacement cows, but the resulting gain from the sale of the cows will be taxed as ordinary income.

In addition, the capital gains and ordinary income tax rates are set to increase after 2012. If a rancher believes that rate increases will occur, then he might recognize gain now and pay tax at potentially lower rates. A thorough analysis should be done to review current and anticipated income and other tax attributes to determine whether to elect the available deferral provisions. In any event, Code Section 1033 provides great flexibility in applying the provisions so that a taxpayer can effectively change its election at any time during the replacement period. For most sales that occur now, this means the taxpayer has at least four years to decide whether deferring the gain is the best choice, and in some cases the decision period may be extended even longer. However, the decision to defer gain under Code Section 451 may need to be made prior to the due date of the return for the taxable year in which the sales occurred.

## CONCLUSION

Drought conditions continue to affect United States agriculture, forcing many farmers and ranchers to sell more livestock than is typical during a given time period. Some producers may face substantial federal income tax liabilities resulting from these "forced" sales. However, the Code contains two deferral provisions that allow for the deferral of resulting gains. Code section 451 allows taxpayers to defer the gain to the next taxable year. The other provision (Code section 1033) lets taxpayers defer the gain for more than one year (and possibly up to four years or more) and to invest the resulting proceeds in replacement livestock that are similar in use to the livestock sold. While the provisions are straight-forward, there are some issues that need clarification, including what type of livestock qualifies as replacement property. These issues will surely be tested in the coming years as severe drought conditions cause some ranchers to seek unconventional methods of applying the Code's deferral provisions, and additional guidance may be warranted to help these taxpayers. As these issues are presented to the IRS and courts for decision, additional research will be required to analyze the decisions and determine whether the existing deficiencies have been addressed and whether additional changes are necessary.

In addition, affected farmers and ranchers will need to determine whether the deferral provisions are the best option for them. In most cases, electing either provision will likely be beneficial. However, it is important to perform a detailed analysis of the facts and circumstances in each case.

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