Agricultural Law Press

Publisher/Editor
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Issue Contents

Agricultural Law Digest

Volume 29, No. 20 October 19, 2018 ISSN 1051-2780

Weather-Related Sales of Livestock Eligible for Deferral of Gain

by Robert P. Achenbach, Jr.*

The IRS has published *Notice 2018-79*[1] that provides guidance regarding an extension of the replacement period under I.R.C. § 1033(e) for some livestock sold on account of drought in 2018 in specified counties listed in the Notice. The Notice provides farmers and ranchers one method of deferring gain for four or more years from the forced sale of livestock due to weather-related conditions. A one-year deferral method is also discussed below.

Involuntary Conversion of Livestock Due to Weather-Related Conditions

I.R.C. § 1033(a) generally provides for nonrecognition of gain when property is involuntarily converted and replaced with property that is similar or related in service or use.[2] I.R.C. § 1033(e)(1) provides that a sale or exchange of livestock (other than poultry) held by a taxpayer for draft, breeding, or dairy purposes in excess of the number that would be sold following the taxpayer's usual business practices is treated as an involuntary conversion if the livestock is sold or exchanged solely on account of drought, flood, or other weather-related conditions. Sales of other livestock, such as those raised for slaughter or held for sporting purposes, are not eligible

If a sale or exchange of livestock is treated as an involuntary conversion under I.R.C. § 1033(e)(1) and is made solely on account of drought, flood, or other weather-related conditions that result in the area being designated as eligible for assistance by the federal government, I.R.C. § 1033(e)(2)(A) provides that the replacement period ends four years after the close of the first taxable year in which any part of the gain from the conversion is realized. Note that it is not necessary for the livestock to have been held in the designated disaster area, but the sale must have been solely on account of weather-related conditions, the existence of which affected the water, grazing or other requirements of the livestock.[3]

Replacement Period of Livestock Sold Due to Drought

The Secretary of the Treasury may extend the four-year replacement period on a regional basis for such additional time as the Secretary determines appropriate if drought conditions that resulted in the area being designated as eligible for assistance by the federal government continue for more than three years.[4]

A 2006 Notice[5] provides guidance for additional extensions of the replacement period under I.R.C. § 1033(e)(2)(B). If a sale or exchange of livestock is treated as an involuntary conversion on account of drought and the taxpayer's replacement period is determined under I.R.C. § 1033(e)(2)(A), the replacement period will be extended under I.R.C. § 1033(e)(2)(B) and *Notice 2006-82*[6] until the end of the taxpayer's first taxable year ending after the first drought-free year for the applicable region. For this purpose, the first drought-free year for the applicable region is the first 12-month period that (1) ends August 31; (2) ends in or after the last year of the taxpayer's four-year replacement period determined

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* Publisher and editor of the Agricultural Law Press.

Agricultural Law Digest is published by the Agricultural Law Press, 735 N. Maple Hill Rd., Kelso, WA 98626 (ph 360-200-5666), bimonthly except June and December. Annual subscription $90 by e-mail. http://www.agrilawpress.com Printed on recycled paper.

under § 1033(e)(2)(A); and (3) does not include any weekly period for which exceptional, extreme, or severe drought is reported for any location in the applicable region. The applicable region is the county that experienced the drought conditions on account of which the livestock was sold or exchanged and all counties that are contiguous to that county.

A taxpayer may determine whether exceptional, extreme, or severe drought is reported for any location in the applicable region by reference to U.S. Drought Monitor maps that are produced on a weekly basis by the National Drought Mitigation Center.[7] In addition, *Notice 2006-82*[8] provides that the IRS will publish in September of each year a list of counties, districts, cities, or parishes (hereinafter "counties") for which exceptional, extreme, or severe drought was reported during the preceding 12 months. Taxpayers may use this list instead of U.S. Drought Monitor maps to determine whether exceptional, extreme, or severe drought has been reported for any location in the applicable region. The annual list contains the counties for which exceptional, extreme, or severe drought was reported during the 12-month period ending August 31 of the prior tax year. Under *Notice 2006-82*,[9] the 12-month period ending on August 31, is not a drought-free year for an applicable region that includes any county on this list.

The most recent Notice[10] provides that, for a taxpayer who qualified for a four-year replacement period for livestock sold or exchanged on account of drought and whose replacement period is scheduled to expire at the end of 2018 (or, in the case of a fiscal year taxpayer, at the end of the taxable year that includes August 31, 2018), the replacement period will be extended under I.R.C. § 1033(e)(2) and *Notice 2006-82* if the applicable region includes any county on this list. This extension will continue until the end of the taxpayer's first taxable year ending after a drought-free year for the applicable region.

One Year Deferment of Gain

I.R.C. § 451(g)[11] provides that for taxable years beginning after December 31, 1975, a taxpayer whose principal trade or business[12] is farming (within the meaning of § 6420 (c)(3)) and who reports taxable income on the cash receipts and disbursements method of accounting may elect to defer for one year a certain portion of income resulting from the sale of livestock because of drought.

The income which may be deferred is the amount of gain realized during the taxable year from the sale or exchange of that number of livestock sold or exchanged solely on account of a drought which caused an area to be designated as eligible for assistance by the federal government.[13] That number is equal to the excess of the number of livestock sold or exchanged over the number which would have been sold or exchanged had the taxpayer followed its usual business practices in the absence of such drought.[14]

To qualify under Section 451(g), the livestock need not be raised, and the sale or exchange need not take place, in a drought area.[15] However, the sale or exchange of the livestock must occur solely on account of drought conditions, the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange. Eligibility for the deferment is not lost if all or a portion of the excess number of animals were sold or exchanged before an area becomes eligible for federal assistance, so long as the drought which caused such dispositions also caused the area to be designated as eligible for federal assistance.[16]

Principal Trade or Business of Farming. A 1989 letter ruling[17] involved a taxpayer who owned and operated a cattle ranch and was employed full time off the ranch. Over the prior five years, the taxpayer spent between 750-1000 hours per year on the ranch and the taxpayer's spouse spent 200-300 hours per year on the ranch. Over the prior three years, the ranch generated average annual gross income of $121,000 per year and the taxpayer's employment produced an average of $65,000 in wages per year. The ranch was located within an area designated as eligible for federal assistance because of drought and the taxpayer showed sales of cattle resulting from that drought. The issue was whether the taxpayer's ranch was the taxpayer's principal business. Although the IRS did not provide any guidelines for determining whether a business was the taxpayer's principal business, the IRS held that the facts of this ruling demonstrated that the taxpayer's principal business was farming for purposes of I.R.C. § 451. The IRS noted that the ranch gross income was about two-thirds of the total average income and that the time spent on the activity by the taxpayer and spouse showed material participation in the ranch activity.

Thus, it appears that eligibility for Section 451 deferment of gain from sales of livestock because of drought requires (1) meeting the definition of a trade or business,[18] (2) having more than 50 percent of gross income from farming, and (3) establishing material participation[19] in the farm or ranch activity by the taxpayer in order to demonstrate that the ranch is the taxpayer's principal trade or business.

Election. The Section 451 election must be made by the due date for filing the income tax return (determined with regard to any extensions of time granted the taxpayer for filing such return) for the taxable year in which the early sale of livestock occurs.[20] The election must be made separately for each taxable year to which it is to apply.[21]

The election may be revoked only with the approval of the Commissioner.[22]

ENDNOTES

[1] I.R.B. 2018-42.

[2] See generally 1 Harl, *Farm Income Tax Manual*, § 2.14 (2018); Harl, *Agricultural Law*, § 27.06 (2018).

[3] Treas Reg § 1.1033(e)-1(b).

[4] I.R.C. § 1033(e)(2)(B). I.R.C. § 1033(e)(2) is effective for any taxable year with respect to which the due date (without regard to extensions) for a taxpayer's return is after December 31, 2002.

[5] Notice 2006-82, 2006-2 C.B. 529.

[6] 2006-2 C.B. 529.

[7] U.S. Drought Monitor maps are archived at http://www.droughtmonitor.unl.edu/Maps/MapArchive.aspx.

[8] 2006-2 C.B. 529.

[9] 2006-2 C.B. 529.

[10] Notice 2018-79,I.R.B. 2018-42. For the notices with the lists of past years, see 1 Harl, *Farm Income Tax Manual*, § 2.14 (2018); Harl, *Agricultural Law*, § 27.06 (2018).

[11] I.R.C. § 451(f) was changed to I.R.C. § 451(g) by Pub. L. No. 115-97, § 13221, 131 Stat. 2113 (2018).

[12] See Ltr. Rul. 8928050, April 18, 1989 discussed below.

[13] Treas. Reg. § 1.451-7(e).

[14] *Id*.

[15] Treas. Reg. § 1.451-7(c)(1).

[16] Treas. Reg. § 1.451-7(c)(2).

[17] Ltr. 8928050, April, 18, 1989.

[18] See Achenbach and Harl, "What Does It Take to be Conducting a Ranching Activity for Profit," 29 *Ag. L. Dig.* 57 (2018); Achenbach, "Passing Hobby Loss Test Does Not Insure Deductibility of Ranch Losses," 29 *Ag. L. Dig.* 97 (2018).

[19] For discussion of material participation under the passive

activity rules, see Harl, *Agricultural Law*, § 30.08 (2018).

[20] Treas. Reg. § 1.451-7(g).

[21] Treas. Reg. § 1.451-7(g): "[The election] must be made by attaching a statement to the return or an amended return for such taxable year. The statement shall include the name and address of the taxpayer and shall set forth the following information for each classification of livestock for which the election is made:

(1) A declaration that the taxpayer is making an election under section 451(e);
(2) Evidence of the existence of the drought conditions which forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the Federal Government as a result of the drought conditions.
(3) A statement explaining the relationship of the drought area to the taxpayer's early sale or exchange of the livestock;
(4) The total number of animals sold in each of the three preceding years;
(5) The number of animals which would have been sold in the taxable year had the taxpayer followed its normal business practice in the absence of drought;
(6) The total number of animals sold, and the number sold on account of drought, during the taxable year; and
(7) A computation, pursuant to paragraph (e) of this section, of the amount of income to be deferred for each such classification."

[22] Treas. Reg. § 1.451-7(h).

CASES, REGULATIONS AND STATUTES

ANIMALS

HORSES. At the time of the accident, the plaintiff was 13 years old and had been taking riding lessons for two years from the defendant. The accident occurred during a "free ride" when the plaintiff was allowed to ride a horse without instruction and when the defendant was not present. The plaintiff was inured when plaintiff fell to the ground during a dismount and the horse stepped on the plaintiff. The defendant obtained summary judgment at trial based on immunity under the New Hampshire equine liability statute, N.H. Stat. § 508:19 *et seq*. Section 508:19(II) provides in part that " . . . an equine activity sponsor, an equine professional, or any other person engaged in an equine activity, shall not be liable for an injury or the death of a participant resulting from the inherent risks of equine activities and, except as provided in paragraph III of this section, no participant's representative shall make any claim against, maintain an action against, or recover from any other person for injury, loss, damage, or death of a participant resulting from any of the inherent risks of equine activities. . . ." Section 508:19(III) provides a exceptions ". . . if the equine activity sponsor, equine professional, or person: . . . (b) Provided the equine and failed to make reasonable and prudent efforts to determine the ability of the participant to engage safely in the equine activity. . . . (d) Commits an act or omission that constitutes willful or wanton disregard for the safety of the participant, and that act or omission caused the injury." The plaintiff argued that, because the defendant was not present during the free ride, there existed an issue of material fact for the jury to determine whether the defendant was subject to either exception. On appeal, the court held that (1) the plaintiff failed to establish any proximate cause between the defendant's absence and the injury and (2) the plaintiff failed to establish that the defendant could have reasonably foreseen the accident or injury. The trial and appellate courts found that the injury was within the risks inherent in equine activities and covered by the equine activity statute. **Franciosa v. Hidden Pond Farm, Inc., 2018 N.H. LEXIS 174 (N.H. 2018)**.

BANKRUPTCY

CHAPTER 12

CONVERSION. The debtor filed for Chapter 12 in December 2017 and filed a proposed plan. A secured creditor challenged the debtor's eligibility for Chapter 12 and the debtor responded by seeking a conversion of the case to Chapter 11. The creditor objected to the conversion, arguing that (1) there was no authority for converting a Chapter 12 case, although the creditor acknowledged that the debtor could dismiss the Chapter 12 case and refile for Chapter 11; (2) the conversion would be prejudicial to creditors; and (3) conversion would be inequitable. The debtor argued that, because the conversion could be accomplished by dismissal and refiling, the court had the discretion to allow the conversion and that conversion would cause less delay and be less prejudicial to all parties. The court noted that, although a farmer may not be forced to convert to Chapter 7, 11 or 13, (see Sections 706, 1112 and 1307) there is is no provision preventing a farm debtor from converting to Chapter 7, 11 or 13. In addition, there is no Bankruptcy Code provision authorizing a Chapter 12 debtor to convert the case to another chapter. The court acknowledged a split among the courts ruling on the issue but the court agreed with the cases holding that the Bankruptcy Court had the discretion to allow a Chapter 12 debtor to convert to Chapter 11. The court went on to cite Section 1208(e) which states "Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter . . . unless the debtor may be a debtor under such chapter." The court held that Section 1208(e) authorizes conversion to any other Bankruptcy Code chapter so long as the debtor is eligible for that new chapter filing. The court pointed out that the same result would occur under a dismissal of the Chapter 12 case and a refiling under Chapter 7 which is allowed. As to the prejudicial effect of a conversion, the court noted that conversion would avoid the Section 362(c)(3) provision terminating the automatic stay after 30 days if a refiling of a dismissed case occurs within one year of the dismissal. The court held that the prejudicial effect of losing the Section 363(c)(3) provision would be minimal in this case