Livestock Sales — Understanding Tax Impacts

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How farm livestock sales records are kept and the reporting of sales of livestock on an income tax return can have a major impact on taxes owed. Correctly reporting sales that qualify for capital gains treatment can reduce both income and self-employment taxes. This document reviews the different types of livestock sales and tax impact of the sales. Additional information can be found in IRS publication 225 – Farmer's Tax Guide.

Types of Livestock Sales

Generally there are two types of livestock sales: sales from livestock which are primarily held and sold as market animals and livestock held for breeding, draft and milking purposes.

Sales of Livestock

An animal raised or purchased with the objective to sell the animal (market livestock), means the animal is not intended to become breeding livestock (breeding livestock covered later). The income from the sale of market livestock is ordinary income reported on Schedule F (Profit or Loss from Farming) and Form 1040. Ordinary income tax rates will apply, and the income is subject to self-employment tax.

Income from the sales of livestock held for breeding, draft or milking purposes is not reported on Schedule F and is not subject to self-employment tax. Income from these sales is reported on Form 4797 (Sales of Business Property) and any remaining cost basis is deducted to calculate the net gain or loss. Gains and losses from the sales of livestock held for breeding, draft or milking purposes may be short-term or long-term, depending on how long the animal was held and the amount of any depreciation that was previously allowed. Long-term capital gains are generally taxed at lower rates than ordinary income.

Keeping records sufficient to accurately track and communicate sales of these types of animals to one's income tax preparer may reduce taxes owed.

Livestock Raised for Sale

Income from cattle, sheep, swine or other market animals which are intended to be sold after raising or purchase is generally ordinary income. Raised animals have zero cost or basis as the expense of raising were deducted as they were raised. The cost of any selling expenses is subtracted from the selling price of the raised animal to determine the net income from the sale.

Example 1. Farmer A raised a group of calves to 500 pounds each. When these calves are sold, the income is reported on Schedule F, line 2 (Sales of livestock, produce, grains, and other products you raised). The marketing expenses and transportation costs of selling the animals are deducted as farm expenses on Schedule F.

Livestock Purchased for Resale

The net income from purchased animals is determined by subtracting the cost of the animal and the selling expenses from the sales price.

Example 2. Farmer B purchased a group of calves at 250 pounds each and sold them when they reached 500 pounds. The income from the sale is reported on Schedule F line 1a (Sales of livestock and other resale items). The cost of the calves when purchased is reported on Schedule F, line 1b (cost or other basis of livestock or other items). The difference is reported on Schedule F, line 1c. Other expenses incurred in the feeding, care, marketing and transportation are deducted as farm expenses on Schedule F.

Breeding, Draft and Milking Livestock Sales

The term "breeding livestock" will be used to describe sales of all livestock held for breeding, draft and milking purposes. The reporting and tax treatment of income from breeding livestock depends on the following factors:

1. Whether the animal was raised or purchased;
2. How long the animal was held for breeding purposes (see holding period below); and
3. Whether the sale resulted in a gain or loss.

Cattle sales are used as examples in this discussion; however, the rules are similar for other types of livestock.

Holding Period

The length of time the animal is held on the farm determines whether the sale qualifies as a long-term capital gain. Generally, the holding period is 24 months for cattle and horses and 12 months for other livestock. For any livestock not held for the required holding period, the gain or loss is ordinary and is reported on Form 4797 using either Part II or Part III dependent upon facts and circumstances.

Other observations:

1. There are some exceptions to the holding period rules for situations like weather-related sales of livestock (an involuntary conversion).
2. If an animal (like a heifer) is raised with the intent to use as breeding livestock and it is determined the animal is sterile and the animal is sold within a reasonable time, it would be considered breeding livestock.
3. A farmer who is selling an entire herd of animals generally could consider the younger animals that would have become breeding livestock as such for tax purposes.

Raised Breeding Livestock

A farmer has no cost (basis) in a raised animal since the expenses of raising the animal were deducted while it was being raised. The sale of the breeding livestock may result in a taxable capital gain. The sale of the raised breeding livestock is reported on Form 4797 Part I if the holding period is met. Income reported on Form 4797 is not subject to self-employment tax. These sales include cows and heifers raised for breeding purposes, raised bulls and other raised cull breeding animal sales.

Example 3. Farmer C sold a four-year-old raised cow for $1,100. The expenses of the sale are $125, and these are deducted from the gross sales price to arrive at a gain of $975. This gain is a treated as a long-term gain under Internal Revenue Code (IRC) section 1231 rules since the cow was held at least 24 months and is not subject to self-employment tax. This gain would be combined with other section 1231 gains and losses to determine net gains and losses for the year. Under IRC section 1231 net long-term gains are taxed at the generally lower capital gains tax rates; net losses, under section 1231, are treated as ordinary losses.

Purchased Breeding Livestock

Depending on the purchase and selling price of purchased breeding livestock and the amount of allowable depreciation, the sale of purchased livestock could result in either a taxable gain or loss. Purchased breeding animals can be depreciated like other assets used in a business. The gain or loss is calculated by subtracting adjusted tax basis (ATB) from the sales price. Gains on the sale of purchased breeding livestock to the extent of allowable depreciation are considered ordinary gains and taxed as ordinary income; this is referred to as depreciation recapture.

Example 4. Farmer D sold a cow purchased four years ago. The cow was purchased for $1,300 and sold for $1,250. The amount of depreciation taken was $867, and the expense of the sale was $125. The gain from the sale of the purchased cow is calculated as follows:

Gross Selling Price	$1,250
Original Cost	$1,300
Add Expense of Sale	+ 125
Less Allowable Depreciation	- 867
Adjusted Tax Basis	$ 558
Gain Realized	$ 692

The expense of the sale ($125) is added to the original cost ($1,300), and the amount of depreciation taken on the cow ($867) is subtracted to arrive at the adjusted tax basis of the cow ($558). The adjusted basis is subtracted from the gross selling price to determine the gain of $692. Since this is the sale of depreciable property (1245 property), the gain is calculated on Form 4797 Part III and subsequently transferred to Part II, Line 13, and is an ordinary gain because the entire gain is depreciation recapture. If this animal was sold at a loss, it is reported on Form 4797 Part I because the holding period was met.

Importance of Proper Reporting

If Farmer D had mistakenly reported the sale of the cow for $1,250 on Schedule F as raised livestock with no basis, the entire amount would be considered ordinary income and would also be subject to self-employment tax. Depending on the farmer's adjusted taxable income from all sources, if the farmer is in the 10 percent tax bracket, the total payment of income and self-employment tax (15.3 percent) in this case could be about $300. [(10 percent + 15.3 percent) x 1,250]

In years where a farm has an overall loss, improper reporting reduces the farm loss and could increase taxes owed.

Summary

Farmers should maintain careful records separating sales of market livestock from sales of breeding livestock. Breeding livestock should be further separated by whether they were raised or purchased. Keeping good records helps farmers minimize their tax burden and helps their tax preparer to have the information needed to complete a correct tax return.

References

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