The 2012 Drought and Income Tax Deferral of Crop Insurance and/or Disaster Payments

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Overview

The drought in significant parts of the corn-belt during the summer of 2012 has raised familiar questions about deferability of crop insurance proceeds. The issue is especially important for those farmers that have a history of reporting crop income in the year after the year of harvest. The Internal Revenue Code allows deferability of crop insurance proceeds if certain requirements are satisfied.

For a cash basis taxpayer, proceeds from insurance, such as from hail or fire coverage on growing crops, are includible in gross income in the year that they are actually or constructively received.[1] In essence, destruction or damage to crops and receipt of insurance proceeds are treated as a "sale" of the crop. Under a special provision, taxpayers on the cash method of accounting may elect to include crop insurance and disaster payments in income in the taxable year following the year of the crop loss if it is the taxpayer's practice to report income from the sale of the crop in the later year.[2] The provision covers payments made because of damage to crops or the inability to plant crops. Also the deferral provision applies to federal payments received for drought, flood or "any other natural disaster."

Deferability and Payment Trigger Under Policy

A significant issue is whether the deferral provision also applies to new types of crop insurance such as Revenue Protection (RP), Revenue Protection with Harvest Price Exclusion (RPHPE), Yield Protection (YP) and Group Revenue Protection (GRP).[3] As mentioned above, to be deferrable, payment under an insurance policy must have been made as a result of damage to crops or the inability to plant crops. Other than the statutory language that makes prevented planting payments eligible for the one-year deferral, the IRS position is that agreements with insurance companies providing for payments without

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regard to actual losses of the insured, do not constitute insurance payments for the destruction of or damage to crops.[4] Thus, payments made under types of crop insurance that are not directly associated with an insured's actual loss, but are instead tied to low yields and/or low prices, may not qualify for deferral depending upon the type of insurance involved. For example, payments made under policies where yield loss triggers payment will, at least in part, qualify for deferral. Other types of policies may not hinge payment on physical damage or destruction to crop.

If a crop insurance payment is based on both crop loss and price loss from a revenue-based insurance policy, only the portion intended to reimburse the farmer for crop loss is deferrable. The portion payable because of a decline in market price is not deferrable and is income in the year the payment is received.

Consider the following example:

EXAMPLE 1:

Al Beback took out an insurance policy (RP) on his corn crop. Under the terms of the policy the approved corn yield was set at 170 bushels/acre, and the base price for corn was set at $6.50/bushel. At harvest, the price of corn was $5.75/bushel. Al's insurance coverage level was set at 75 percent, and his yield was 100 bushels/acre. Al's final revenue guarantee under the policy is 170 bushels x $6.50 x .75 = $828.75/acre. Al's calculated revenue is his actual yield (100 bushels/acre) multiplied by the harvest price ($5.75/bushel) which equals $575/acre. Al's insurance proceeds is the guaranteed amount ($828.75/acre) less the calculated revenue ($575/acre), or $253.75/acre. His yield loss is the 170 bushel/acre approved yield less his actual yield of 100 bushels/acre, or 70 bushels/acre. Multiplied by the harvest price of $5.75/bushel, the result is a physical loss of $402.50/acre. Al's price loss is computed by taking the base price of $6.50/bushel less the harvest price of $5.75/bushel, or $.75/bushel. When multiplied by the actual yield of 100 bushels/acre, the result is $75/acre.

So, to summarize, Al has the following:

    Total loss (per acre): $402.50 (physical loss) + $75 (price loss) = $477.50
    Physical loss as percentage of total loss: 402.50/477.50 = .8429
    Insurance payment: $253.75/acre
    Insurance payment attributable to physical loss (which is deferrable): $253.75 x .8429 = $213.89/acre
    Portion of insurance payment that is not deferrable: $253.75 – 213.89 = $39.86

If harvest price *exceeds* the base price, consider the following example:

EXAMPLE 2:

The facts are the same as in the previous example, except that the harvest price of corn was $7.50/bushel. Al's final revenue guarantee under the policy is 170 bushels/acre x $7.50 x .75 = $956.25/acre. Al's calculated revenue is his actual yield (100 bushels/acre) multiplied by the harvest price ($7.50/bushel) which equals $750.00/acre. Al's insurance proceeds are the guaranteed amount ($956.25/acre) less the calculated revenue ($750.00), or $206.25/acre. His yield loss is the 70 bushels/acre which is then multiplied by the harvest price of $7.50/bushel, for a physical loss of $525/acre. Al's price loss is zero because the harvest price exceeded the base price.

So, to summarize, Al has the following:

    Total loss (per acre): $525.00 (physical loss) + $0.00 (price loss)
    Physical loss as percentage of total loss: $525/525 = 1.00
    Insurance payment: $206.25/acre
    Insurance payment attributable to physical loss (which is deferrable): $206.25 x 1.00 = $206.25/acre
    Portion of insurance payment that is not deferrable: $206.25 – 206.25 = $0.00

Observation: Normally, if the price of crop at the time of harvest *exceeds* the base price, the physical loss will constitute 100 percent of the total loss, and the *entire* insurance payment will be deferrable. However, if insurance proceeds for physical loss to crops are collected *before* the harvest price is determined and

the harvest price ultimately exceeds the base price, any additional payment attributable to the price difference could be deemed by IRS to be attributable to revenue loss that would not be eligible for deferral.

Note: For policies not based on physical loss (such as a GRP), payments received are not deferrable. The same holds true for an Average Crop Revenue Election (ACRE) payment because it is received after the end of the marketing year and in a year after the year the crop at issue is produced. *There is no additional ability to defer income to a later year if it is actually received in a year following the year of crop loss.*

Other Requirements

Deferability of crop insurance proceeds requires the taxpayer to make an election on the tax return.[5] The election is made by attaching a separate, signed statement to the return for the year of damage or destruction or by filing an amended return, which includes the name and address of the taxpayer along with a declaration that the taxpayer is making an election. The following should be included on the attached statement:

The taxpayer's name and address along with a declaration that the taxpayer is making a deferral election;

Identification of the specific crop or crops destroyed or damage;

A statement that it is the taxpayer's normal business practice to report income derived from the crops that were destroyed or damaged in the taxpayer's gross income for a tax year following the tax year of damage or destruction;

Note: On this point, the taxpayer must establish a history of reporting more than 50 percent of the crop sales in the subsequent year.[6] *If multiple crops are involved, the 50 percent test must be satisfied with respect to each crop.*

A description of the cause of the destruction or damage of the crops;

The date or dates on which the destruction or damage occurred;

The total amount of payments received from payors such as insurance companies and government agencies (with itemization per crop and per payor).

Conclusion

The ability to defer crop insurance proceeds is an important planning tool for many farmers when weather interferes with normal crop production and marketing expectations. If the requirements can be satisfied, deferral can allow consistency in income tax reporting of insurance proceeds (and disaster assistance payments). Even if the technical requirements cannot be satisfied, deferral can still be accomplished if the insurance proceeds for a current year's crop are not received until the following year.

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[1]For taxpayers on the accrual method, payment is taxable in the year received.

[2] I.R.C. ?451(d).

[3] RP utilizes Chicago Board of Trade (CBOT) futures market prices and the farmer's actual historical yields to compute the level of revenue coverage and the

policy guarantee. The projected price is set during February in accordance with the monthly average new-crop futures prices for corn (utilizing a December futures contract) or soybeans (utilizing a November futures contract). The harvest price is pegged by averaging the new crop futures prices during October

(for corn and soybeans). The revenue guarantee under the policy is computed by multiplying the greater of the projected price or harvest price by the farmer's actual production history. That result is then multiplied by the coverage level under the policy (typically between 50 and 85 percent). GRP is policy where the guarantee and actual production history is based on county yields, with payment under the policy being the lost bushels multiplied by the February futures price. YP is a policy where the guarantee and the actual is based on farm-level yields, with the payment under the policy set at the lost bushels multiplied by the February futures price.

[4] I.R.S. Notice 89-55, 1989-1 C.B. 698.

[5] The election covers the insurance proceeds attributable to all crops representing a trade or business. Treas. Reg. ?1.451-6(a)(2). Also, deferral is "all or nothing." A taxpayer may not elect to defer only a portion of the insurance proceeds to the following year. Rev. Rul. 74-145, 1974-1, C.B. 113.

[6] See Nelson v. Comr., 130 T.C. 70 (2008), aff'd., 568 F.3d 662 (8th Cir. 2009).(8th Cir. 2009).