
1307 6th St. SW #1, Mason City, IA 50401 | **P:** 641-424-4170 | **F:** 641-424-5613 July **2019**



## SPECIAL RULE FOR TAXING CROP INSURANCE AND DISASTER PAYMENTS

Generally, cash basis farmers must include proceeds from crop insurance and federal disaster programs in gross income for the tax year during which they receive the payments. IRC § 451(f), however, provides a special deferral provision for insurance proceeds received as a result of "destruction or damage to crops." Farmers who meet the requirements of the statute may elect to include the proceeds in gross income for the tax year following the destruction or damage. This one-year deferral protects farmers from recognizing excessive income in one year when their regular practice would have been to sell the crop in the following tax year.

The one-year deferral election only applies to proceeds received during the taxable year of the destruction or damage. Proceeds received the following taxable year must be included in gross income for the taxable year of receipt.

**Application to "Destruction or Damage"**

The special IRC § 451(f) deferral election applies to "insurance proceeds" received as a result of "destruction or damage to crops." It also applies to disaster payments received from the federal government under the Agricultural Act of 1949 and the Disaster Assistance Act of 1988. Treas. Reg. § 1.451-6(a) has extended this election to apply to all federal payments received as a result of destruction or damage to crops caused by drought, flood, or any other natural disaster, or the inability to plant crops because of such a natural disaster (prevented planting payments). Pursuant to this regulation, such payments are treated as insurance proceeds received as a result of destruction or damage to crops.

Taxpayers who otherwise qualify may elect to defer payments received in 2019 under the Additional Supplemental Appropriations for Disaster Relief Act of 2019, if the payment is made for damage to crops or the inability to plant crops because of a natural disaster. The Disaster Relief Act parenthetically includes milk, on-farm stored commodities, and harvested adulterated wine and grapes in its definition of "crops." It is thus arguable that payments made to compensate farmers for damage or destruction to these "crops" may be eligible for deferral if all other requirements can be established. No current guidance addresses this issue. Producers may not defer market facilitation program payments made in 2019. These are not payments for damage or destruction, but compensation for price damage caused by trade disruptions.

**Qualifying for the Election**

To qualify for the deferral election, a farmer must:

- Report income on the cash receipts and disbursements method of accounting (cash-basis)
- Establish that under normal business practice, income from the crops would have been included in gross income for any taxable year following the tax year of the destruction or damage

Neither the statute nor the regulations specify for how long a farmer must have been engaged in a pattern of sales activity to establish a "normal business practice."

**All or Nothing**

The election to defer recognition of income until the following tax year is an all or nothing election for each trade or business. In other words, taxpayers who have a history of selling 40 percent of their grain in the year of harvest and 60 percent of their grain in the following year cannot allocate income recognition between two years to simulate their normal business practice. Instead, they must either elect to defer all proceeds or none of them. The same rule applies to disaster payments and crop insurance proceeds. Farmers making a deferral election must defer income recognition for all proceeds attributable to loss or damage to their crops, unless the payments flow from separate trades or businesses.

Likewise, farmers receiving payments for destruction of or damage to multiple crops generally must make a single election for all proceeds, unless each crop represents a separate trade or business.

**Substantial Portion of the Income**
To establish a normal business practice, a taxpayer to establish that he or she would have reported *more than 50 percent* of the income from the damaged or destroyed crops in the year following the damage or destruction. This "substantial portion" test was applied by a federal appeals court to disallow a deferral election where a taxpayer (*Nelson*) would have reported 65 percent of his income from the sale of his sugar beet crop in the year of harvest and 35 percent in the following year.

**Multiple Crops**
For farmers receiving insurance payments for multiple crops, the "substantial portion" test applies to the crops for which they are receiving insurance payments. It does not apply to crops for which they are not receiving an insurance or disaster payment. Furthermore, the *Nelson* court held that a farmer seeking to take advantage of deferral when two or more crops are damaged "must first establish qualification for such deferral. In other words, a farmer seeking to defer insurance proceeds from damage to two or more crops must show *as to any of the individual crops* the customary practice was to defer more than fifty percent of the income."

This interpretation by the Eighth Circuit suggests that deferral is only available if regular practice is to report more than 50 percent in the year following harvest. Outside of the Eighth Circuit, a reasonable interpretation is that farmers may aggregate the historical sales proceeds from the crops for which they receive disaster payments when determining whether the "more than 50 percent" test is met for the trade or business. They may not, however, include in that aggregation sales proceeds from crops for which no insurance payments were received.

**Example One – Deferral Eligibility**
James received $12,000 in 2019 for prevented planting crop insurance coverage for his soybean crop. He also received $8,000 in disaster assistance payments for damage to his corn crop. He operates his farm as a single trade or business. James normally sells both his corn and soybeans in the year following harvest.

**Question One**
Can James elect to report the $8,000 in disaster payments in 2020, but report the $12,000 in crop insurance in 2019?

**Answer One**
No. Because James has a single trade or business, he must elect deferral for both crops or for neither crop. It does not matter that one payment was "disaster aid" and one payment was crop insurance. They are both treated as crop insurance and must be treated as one payment.

**Question Two**
Assume James has historically received substantially similar income from his corn crop and his soybean crop. He has, however, generally sold 40 percent of his corn crop in the year of harvest and 65 percent of his soybean crop in the year after harvest. Would James be eligible to defer recognition of his crop insurance and proceeds to 2020?

**Answer Two**
Under the Eighth Circuit Court of Appeals' interpretation in *Nelson*, no. The court in that case stated that the "more than 50 percent test" had to be met *for each crop* for which an insurance payment was being made. Outside of the Eighth Circuit (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota) the answer is maybe. Because James has a normal business practice of selling, in the aggregate, more than 50 percent of his crop in the year following harvest, he may argue that the "substantial portion" test is met and elect to defer all insurance and disaster proceeds for both crops to 2020. IRS has provided no guidance to specifically address this question.

**Question Three**
Suppose James planted soybeans through his own sole proprietorship, but received the disaster payment for the corn crop through a partnership in which he is a 50 percent partner. Can James elect to report his $8,000 in disaster payments in 2019, even if his partnership elects to defer income recognition for its crop insurance proceeds to 2020?

**Answer Three**
Yes. Since these are separate trades or businesses, they must make separate election decisions and those elections may be different.

**Making the Election**
To make the election, the taxpayer must attach a separate, signed statement to the taxpayer's return or amended return for the taxable year of destruction or damage. The statement must include the following:

- Name and address of taxpayer (or duly authorized representative)
- Declaration that the taxpayer is making an election under section 451(f) (the regulation references the provision 451(d) because it was

issued before the code was renumbered by the Tax Cuts and Jobs Act)
- Identification of the specific crop or crops damaged
- Declaration that under the taxpayer's normal business practice, the income derived from the crops which were destroyed or damaged would have been included in gross income for a taxable year following the taxable year of the destruction or damage
- The cause of the destruction or damage of the crops and the date or dates on which such destruction or damage occurred
- The total amount of payments received from insurance carriers, itemized with respect to each specific crop and with respect to the date each payment was received
- The name(s) of the insurance carrier or carriers from whom the payments were received

Once an election is made, it cannot be revoked absent consent by the district director. Requests for consent to revocation should be made through a letter to the district director for the district in which the taxpayer is required to file his return. It should set forth the taxpayer's name, address, ID number, the year for which the revocation is requested, and the reason for the request.

**Revenue Protection Insurance and Deferral**
To qualify for the election, the payment must have been made for "destruction or damage" to crops. This means that the taxpayer must suffer an actual loss due to this destruction or damage. Notice 89-55, 1989-1 C.B. 696. Payments made under insurance policies that provide coverage for reduced revenue or losses unrelated to destruction or damage do not qualify for deferral.

Most farmers, however, are covered under revenue protection policies that provide combined coverage for revenue losses and disaster losses. In this case, farmers must determine which portion of any indemnity payment is attributable to lost revenue and which portion is due to crop loss caused by destruction or damage. Because IRS has never provided guidance on this issue, taxpayers are left to make an allocation using a reasonable method.

The 2018 IRS Publication 225 states that deferral isn't permitted for proceeds received from revenue insurance policies. It is not believed that this is guidance from IRS suggesting that deferral of payments from a revenue insurance policy attributable to damage or destruction is not allowed. Rather, it appears to be an overgeneralized statement of the principle that payments for loss of revenue are not deferrable. Publication 225 also suggests that producers can elect to defer some, but not all insurance proceeds received in a given year. It is expected that the 2019 Publication 225 will clarify.

**Example Two – Allocating Between Payments Eligible and Ineligible for Deferral**
Jenna uses the cash method of accounting and usually sells her corn the year following harvest. In 2019, her 300-acre farm was flooded and her corn crop was largely destroyed. Her revenue protection policy paid her claim in 2019 on the following terms:

**Indemnity Payment**
Approved Yield: 180 bushels per acre
Coverage Level: 65 percent
Base Price: $4.00
Harvest Price: $4.10
Actual Yield: 50 bushels per acre
Guaranteed amount = 180 x 4.00 x .65 x 300 acres = $140,400
Calculated revenue = 50 x 4.10 x 300 = $61,500
Insurance Payment = $78,900

**Deferral Eligibility Calculation**
Yield loss (from destruction or damage) = 130 x 4.10 = 533 x 300 = $159,900
Price loss (from market decline) = (Base price – harvest price) = 0
Indemnity = **$78,900 (all eligible for deferral)**

***Change in Harvest Price***
Now assume a harvest price of $3.50, instead of $4.10.

**Indemnity Payment**
Approved Yield: 180 bushels per acre
Coverage Level: 65 percent
Base Price: $4.00
Harvest Price: $3.50
Actual Yield: 50 bushels per acre
Guaranteed amount = 180 x 4.00 x .65 x 300 acres = $140,400
Calculated revenue = 50 x 3.50 x 300 = $52,500
Insurance Payment = $87,900

**Deferral Eligibility Calculation**
Yield loss (from destruction or damage) = 130 x 3.50 = 455 x 300 = $136,500
Price loss (from market decline) = ((4.00-3.50) x 50 x 300) = $7,500
Total revenue loss = $144,000
Loss from damage = 94.79 percent
Indemnity = $87,900

**Amount eligible for deferral = .9479 x $87,900 = $83,322**

## NEWS COMING SOON ON SYNGENTA CLAIMS, BUT NO PAYMENTS IN 2019

A June 18 update posted to the Syngenta settlement claims administration page states that eligible class members will receive notices of determination showing their "compensable recovery quantities" as early as July. This is the number of bushels for which they can recover, not the amount of the payment to which they are entitled. Those claimants who provided insufficient information in their claims are receiving notices of rejection this month. These claimants can respond to the notice with an attempt to cure the deficiency. Final rejection notices will issue by the end of August. Producers can appeal a final rejection with the special master, and notices of determination will issue in October, with final appeals being resolved by December of 2019.

After that time, the claims administrator can finally issue a preliminary report to the district court, explaining the number of class members who submitted proper claims and the compensable recovery quantity for each of those class members. The special master will then resolve any appeals to the report, and the claims administrator will submit its final report to the court for approval. It is then that the actual dollar value of a producer's claim can be determined.

Based upon this schedule, the notice states that payments will issue February 2020 ***at the earliest***. Actual timing of the payments will depend on the above claims determination appeal process, as well as the resolution of a pending appeal challenging the fairness of the settlement. Several class members objected to the final settlement, and the district court overruled their objection. The class members appealed to the United States Court of Appeals for the Tenth Circuit and filed their opening brief on May 30, 2019. Final payments cannot be made until that appeal is resolved.

The notice also clarifies that attorney fee disputes and appeals will not delay the timing of the payments to class members.

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