Are Crop Insurance Proceeds Deferrable for Tax Purposes?

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Overview

There still seems to be a misunderstanding among some farmer about the tax deferability of crop insurance proceeds. I have seen several comments recently on social media by farmers communicating with each other stating to the effect that crop insurance is always deferable. That is not correct. With today's post, I sort through the proper way to determine whether the receipt of crop insurance is deferable for income tax purposes.

The income tax deferability of crop insurance – it's the topic of today's post.

In General

The proceeds from insurance coverage on growing crops are includible in gross income in the year actually or constructively received. In effect, destruction or damage to crops and receipt of insurance proceeds are treated as a "sale" of the crop. But taxpayers on the cash method of accounting may elect to include crop insurance and disaster payments in income in the taxable year *following the crop loss* if it is the taxpayer's practice to report income from sale of the crop in the later year. *I.R.C. §451(d).* A "practice" requires that the taxpayer establish that a substantial part of the crops (more than 50 percent) has been carried over into the following year. *Rev. Rul. 74-145, 1974-1 C.B. 113.* Eligible payments are those made because of damage to crops or the inability to plant crops. The deferral provision applies to federal payments received for drought, flood or "any other natural disaster."

Summary: Deferability is possible if the farmer is on the cash method of accounting and has a practice of deferring the reporting of crop income. Payments eligible for deferral are payments for crop damage, payments for inability to plant and payments for damage on account of "any other natural disaster." The insurance payment must be received in the year of the crop loss. If payment is received the year after the crop loss, it is not deferable to the next year.

Details

Election. The election is made by attaching a separate, signed statement to the income tax return for the tax year of damage or destruction or by filing an amended return, and it covers insurance proceeds attributable to all crops representing a trade or business.

Multiple crops. If multiple crops are involved, the "substantial portion" test must be met with respect to each crop if each crop is associated with a separate business of the taxpayer. Otherwise, the 50 percent text is computed in the aggregate if the crops are reported as part of a single business. Also, a taxpayer may not elect to defer only a portion of the insurance proceeds to the following year.

Revenue and yield policies. 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 Risk Plan (GRP). 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 oneyear deferral, the IRS position as stated in Notice 89-55, 1989-1 C.B. 698 is that agreements with insurance companies providing for payments without regard to actual losses of the insured, *do not constitute insurance payments* for the destruction of or damage to crops. Accordingly, payments made under the 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, RP policies insure producers against yield losses due to natural causes such as drought, rain, hail, wind, frost, insects and disease, as well as revenue losses tied to the difference between harvest price and a projected price.

Summary: *Only the portion attributable to physical damage or destruction to a crop is eligible for deferral.* RPHPE, YP and GRP policies tie payment to price and/or yield and amounts paid under such policies are less likely to qualify for deferral.

Correct Approach

While the IRS has not specified in regulations the appropriate manner to be utilized in determining the deferrable and non-deferrable portions, the following is believed to be an acceptable approach:

Consider the following example:

Al 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 physical 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 approved yield of 170 bushels/acre, the result is $127.50/acre.

So, to summarize, Al has the following:

- Total loss: (1) anticipated income/acre [170 bushels/acre @ $6.50/ bushel = $1105/acre] less (2) actual result [100 bushels/acre @ $5.75/acre = $575.00] for a result of $530.00/acre.
- Physical loss: 70 bushels/acre x $5.75/bushel harvest price = $402.50/acre
- Price loss: 170 bushels/acre x $.75/bushel = $127.50
- Physical loss as percentage of total loss: $402.50/530 = .7594
- Insurance payment: $253.75/acre
- Insurance payment attributable to physical loss (which is deferrable): $253.75 x .7594 = $192.70/acre
- Portion of insurance payment that is not deferrable: $253.75 – $192.70 = $61.05/acre

But what if the harvest price exceeds the base price? Then the above example can be modified as follows:

Assume now 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

Conclusion

Crop insurance will be an important component of income for many farmers this year due to drought. Make sure you understand the rules for deferability. Take the advice you receive on social media or at the café or coffee shop with a grain of salt.

On a related point, Emergency Relief Payments received in 2022 are not deferable. Those payments were for loss sustained in either 2020 or 2021.