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An Agricultural Law Research Note

Proper Handling of Disaster Payments, Crop Insurance and Livestock Sold On Account of Weather

by

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In 2002, adverse weather conditions caused crop and livestock losses in many parts of the country. The western United States was hit particularly hard. Several income tax rules are designed to soften the blow by allowing preferential treatment of gains and losses realized as a result of weather-related conditions.

Disaster Payments and Crop Insurance

One-year deferral rule. For farmers on the cash-method of accounting, there is an exception to the general rule that payments must be reported in the year of receipt. The exception allows the farmer to postpone reporting a payment for one year.[1] Generally, the rule applies when crops cannot be planted or are damaged or destroyed by a natural disaster such as a drought or flood. Under the statutory language, the exception applies to crop insurance proceeds, disaster payments received from the federal government under the Agricultural Act of 1949, as amended, and disaster payments received under the Disaster Assistance Act of 1988. Under the regulatory language, the provision applies to all federal payments received after December 31, 1973, for losses due to a natural disaster.[2]

To qualify for the exception, a taxpayer must be able to show that under the taxpayer's normal business practice the income from the crop for which the payment is received would have been reported in a year following the year of the receipt of the payment. Taxpayers qualifying for the exception have the option of reporting the payment as income in the year it is received or as income in the following year. One-year deferral is available by election. The election to postpone reporting the payment as income covers all crops from a farm. A separate election must be made for each farming business of a taxpayer. For purposes of this provision, separate businesses are defined as those for which the taxpayer keeps separate books and is allowed to use different methods of accounting. In general, the businesses are required to be separate and distinct.

If a disaster payment or crop insurance is received for two different crops and the crops are normally marketed in different years, the IRS has ruled that if a producer normally sells 50 percent of *all* crops in the year following the year of harvest, than *all* insurance payments would be postponed until the following year if the election under I.R.C. §451(d) is made.[3] However, in a later notice, the IRS stated that insurance proceeds and disaster payments can be postponed "if the taxpayer establishes that, under its normal business practice, income from the crops would have been reported in the year following the year of destruction or damage."[4] That language can be interpreted as saying that insurance and disaster

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[1] I.R.C. §451(d). The provision does not allow the taxpayer to accelerate reporting the payment if the payment is received the year after a loss.

[2] Treas. Reg. §1.451-6(a).

[3] Rev. Rul. 74-145, 1974-1 C.B. 113.

[4] I.R.S. Notice 89-55, 1989-1 C.B. 696.

payments received from crops that are normally marketed in the year of harvest cannot be postponed even if the election is made. The Notice creates an ambiguity in the election requirements, but does not specifically overrule the earlier IRS ruling on the matter.

How to make the election. The election takes the form of a statement attached to the return (or amended return) for the tax year in which the payment was received. The statement must include the taxpayer's name and address, a statement that the taxpayer is making an election under I.R.C. §451(d), identification of the specific crop or crops destroyed or damaged, and a statement that it is the taxpayer's normal business practice to report the income from the crops that were destroyed or damaged in income for a tax year following the tax year of the destruction or damage. The statement must also name the cause of destruction or damage of crops and the date or dates on which such destruction or damage occurred. In addition, the statement must list the total amount of payments received from insurance carriers, itemized with respect to each specific crop, the date each payment was received, and the names of the insurance carriers from which payments were received.

Sales of Livestock Due to Weather

If a farmer sells livestock because of a shortage of water, grazing or other consequences of a weather-related condition, the recognition of the proceeds from the sale may be postponed. There are two different tax treatments, both of which apply only to weather-related sales in excess of normal business practice. The first treatment applies to draft, breeding, or dairy animals that will be replaced within a two-year period. The second applies to all livestock and allows a one-year postponement of the reporting of the sales proceeds.

Election to postpone gain by purchasing replacement animals. If livestock (other than poultry) held for any length of time for draft, breeding or dairy (not sporting) purposes is sold because of weather-related conditions, the gain realized on the sale does not have to be recognized if the proceeds are used to purchase replacement livestock within two years of the end of the tax year of the sale.[5] The new livestock must be used for the same purpose as the livestock that was sold,[6] and the taxpayer must show that weather caused the sale of more livestock than would have been sold without the weather-related conditions.[7] There is no requirement that the weather-related conditions cause an area to be declared a disaster area by the federal government. The taxpayer's basis in the replacement livestock equals the basis in the livestock sold, plus any amount invested in the replacement livestock that exceeds the proceeds from the sale.

The election to defer the recognition of gain by reducing the basis of the replacement livestock is made by not reporting the deferred gain on the tax return and by attaching a statement to the tax return showing all the details of the involuntary conversion. The statement must include evidence of the weather-related conditions that forced the sale or exchange of the livestock, a computation of the amount of gain realized on the sale or exchange, the number and kind of livestock sold or exchanged, and the number of livestock of each kind that would have been sold or exchanged under the usual business practice in the absence of the weather-related conditions.

Example:

> Slim Pickens normally sells 30 cows from his beef herd each year. In 2002, drought conditions reduced his hay crop to such an extent that he will not have enough hay to carry his normal herd through the winter. As a result, Slim sold 50 cows rather than 30 in 2002. He plans to purchase an additional 20

[5] I.R.C. §1033(e). Legislation has been proposed that would extend the replacement period to four years. S. 665, 108th Cong., 1st Sess. (2003).

[6] For example, dairy cows must be replaced with dairy cows.

[7] If the farmer normally sells one-fifth of the herd each year, for example, only the sales in excess of one-fifth will qualify for this provision.

cows in 2003 to replace the extra 20 that were sold. How will Slim report the sale of the 50 cows on his 2002 return if he sold them for a total of $28,750?

Only 20 of the cows sold in 2002 qualify for the deferral of gain due to the drought. Slim can elect to defer the gain by not reporting the gain on those 20 cows on his 2002 return, and attaching a statement to the return. The raised cows have a zero basis, and the amount of gain deferred is $11,500 [(20/50) x $28,750 = $11,500].

If Slim reinvests less than $11,500 on 20 replacement cows in 2003, he will have a zero basis in the replacement cows and must report the excess of $11,500 over the amount reinvested by amending his 2002 tax return. If he reinvests more than $11,500 in 20 cows, the excess will be his basis in the cows.

Election to defer income to a subsequent tax year. For livestock sold on account of drought, the taxpayer may be eligible for another exception to the general rule that the sales proceeds must be reported in the year they are received. This exception applies to all livestock and allows the taxpayer to postpone reporting the income for one year if certain requirements are satisfied.[8] To use the deferral provision, the taxpayer's principal business must be farming, the taxpayer must be on the cash method of accounting, the livestock normally would be sold in a subsequent year, and a drought resulting in an area's being declared a disaster must cause the sale of livestock.[9]

The amount of income that can be postponed can be illustrated as follows:

Example:

Jim Beam normally sells 200 head of raised cattle each year. Due to drought conditions, Jim sells 300 head during 2002, realizing $90,000 from the sale of the 300 head. On August 24, 2002, as a result of the drought, the affected area was declared a disaster area eligible for federal assistance. The income that Jim may elect to postpone until 2003 is determined as follows:

$$\frac{\text{Total income from sale}}{\text{Total number sold}} \times \text{Excess number sold} = \text{Postponed income}$$

$$\frac{\$90{,}000}{300} \times 100 \text{ head} = \$30{,}000$$

Jim may elect to postpone $30,000 of income until 2003. The $60,000 that would have normally been received in 2002 must be reported on Jim's 2002 Schedule F.

The election must be made by the due date of the return (including extensions) for the tax year in which the drought sale occurred. The election is made by attaching a statement to the return that includes a declaration that the taxpayer is making an election under I.R.C. § 451(e); evidence of the existence of drought conditions that 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. The statement must also include an explanation of the relationship of the designated drought area to the taxpayer's early sale or exchange of the livestock, the total number of animals sold in each of the three preceding years, and the number of animals that would have been sold in the taxable year had the taxpayer

[8] I.R.C. §451(e). Legislation has been proposed that would extend the deferral period to two years if the sale is on account of weather-related conditions or federal land management agency policy or action. S. 2762; H.R. 5227, 107th Cong., 2d Sess. (2002).

[9] On this point, it is not necessary that the livestock be raised or sold in the declared disaster area. The sale can occur before or after an area is declared a disaster area as long as the same disaster caused the sale.

followed normal business practice in the absence of drought.[10] In addition, the statement must specify the total number of animals sold, the number sold on account of drought during the taxable year, and show a computation of the amount of income to be deferred for each such classification.

SUMMARY OF WEATHER-RELATED SALE RULES FOR LIVESTOCK

	Postponement of Gain and Purchase Of Replacement Animals	Defer Income To Next Tax Year
Qualifying livestock	Draft, breeding or dairy livestock	All livestock
Disaster area declaration?	No	Yes
Livestock in disaster area?	No	No
Livestock sold in disaster area?	No	No
Must weather cause the sale?	Yes	Yes
Applicability of provision	Sales in excess of normal business practices	Sales in excess of normal business practices
What provision allows	Deferral of gain by carrying over basis	Deferral of gain by carrying over basis
Is a repurchase required?	Yes	No
Basis in replacement livestock	Reduced by deferred gain	Not applicable
Period for replacement	Two years from end of tax year of sale	Not applicable
Time limit for making election	Two years from end of tax year of sale	Due date for return for year of sale

Revoking an Election to Defer Reporting of Weather-related Livestock Livestock Sales

If a livestock owner sells an excess number of livestock due to weather-related conditions in 2002 and makes an election on the 2002 tax return to defer the reporting of the excess amount until 2003, but then in 2003 decides to replace the excess number sold can the livestock owner revoke the deferral election and elect the two-year replacement provision? The IRS has ruled that such a move is possible only with the consent of the IRS Commissioner.[11] However, it is not possible to revoke a two-year postponement election and elect the one-year deferral provision because a two-year replacement election can be made on an amended return, but the one-year deferral election must be made by the due date for the original tax return.

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[10] The number of animals that would have been sold under usual business practices in the absence of drought is determined primarily by the past history of the farmer. For example, if a farmer generally holds all calves until the year after they were born before selling them but was forced because of drought conditions to sell them in the year they were born, the sale proceeds may be reported in the year following the year of the sale.

[11] Priv. Ltr. Ruls. 9127012 (Mar. 25, 1991); 9214021 (Jan. 6, 1992). A letter ruling request may have to be filed to request permission for such a change.

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