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Handling Income Under Drought Provisions

by Neil E. Harl*

The widespread drought in 1988 and the dry conditions in some areas in 1989 have focused great deal of attention on how income should be reported under the various drought provisions.

Crop insurance proceeds and federal disaster payments. As a general rule, proceeds from insurance, including hail, fire and all-risk crop insurance, are includable 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.

Under a special provision, taxpayers on the cash method of accounting may elect to include crop insurance payments in the year following the crop loss if, under the taxpayer's practice, income from sale of the crop would have been reported in the following year. Federal disaster payments are also deferable to the following year if payments are made under the Agricultural Act of 1949 or Title II of the Disaster Assistance Act of 1988. A 1988 amendment added the latter provision to enable payments under the Disaster Assistance Act of 1988 to be deferred. An amendment that would have allowed deferral of benefits under the

Disaster Assistance Act of 1989 was introduced but was not enacted in 1989. There is a slim chance of enactment in 1990, retroactive to 1989, but passage seems unlikely. Therefore, the only way to defer payments under the 1989 act was to delay the application for benefits so that payments would be received in 1990. Applications can be filed through April 2, 1990.

A taxpayer may not elect to defer only a portion of the crop insurance proceeds or disaster benefits to the following year. Under a 1974 revenue ruling, IRS held that if a taxpayer could establish that a substantial part of the crops would have been reported in the following year, the taxpayer was eligible to elect to defer. If that election is made, all amounts must be deferred.

As a general rule, crop insurance and disaster payments must be treated the same if received in the same taxable year and both are eligible for deferral. Because benefits under the Disaster Assistance Act of 1989 are not eligible for deferral, taxpayers should nonetheless be able to elect to defer crop insurance proceeds.

Agreements with insurance companies providing for payments without regard to actual crop losses do not constitute insurance payments for destruction of or damage to crops and do not qualify for the one-year deferral.

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

Deferral for livestock sales. Farm and ranch taxpayers on the cash method of accounting who are forced because of drought to dispose of livestock may be able to defer reporting the gain until the following taxable year. To be eligible for deferral, the taxpayer's principal business must be farming. In a 1989 letter ruling, a rancher grossing an average of $121,000 and earning $65,000 per year in an off-farm job was eligible to defer. In that situation, the taxpayer devoted 750-1,000 hours per year to the ranch and the spouse contributed about 300 hours.

The taxpayer must establish that, under the taxpayer's usual business practice, the sale or exchange would not have occurred but for the drought conditions and the drought conditions must have resulted in the area being designated for assistance by an agency of the federal government. The livestock need not be raised or sold in the drought area; however, the sale must have occurred solely on account of drought conditions in the designated area that affected the water, grazing or other requirements of the livestock so as to necessitate the sale.

The deferral of income is limited to sales in excess of "usual business practices" and, through December 31, 1987, did not apply to livestock held for draft, dairy, breeding or sporting purposes. After 1987, livestock held for draft, dairy, breeding or sporting purposes are eligible for the one-year deferral.

The election is made by attaching
a statement to the income tax return or an amended return for the year in which the early sale of livestock occurs and must be made within the time for filing the return including extensions. The election must contain—

(1) a statement that an election is being made, (2) evidence of the existence of drought conditions which forced the early sale or exchange of the livestock and the date, if known, on which the area was designated as eligible for federal assistance as a result of drought conditions (the sale can occur before drought designation); (3) a statement explaining the relationship of the drought area to the taxpayer’s early sale or exchange of the livestock; (4) the total number of animals sold in each of the three preceding years; (5) the number of animals that would have been sold or exchanged under usual business practices.

The livestock sold or exchanged must be replaced within the replacement period (two years after the year in which the proceeds were received) with livestock similar or related in service or use to the livestock sold because of the drought; the new livestock must be held for the same purpose of the animals disposed of because of the drought.

All of the details of the disposition of the livestock are to be reported in the return for the taxable year when proceeds are received. The taxpayer is to include evidence of the existence of drought conditions which forced the disposition of the livestock, a computation of the gain involved, the number and kind of livestock sold or exchanged and the number that would have been sold or exchanged under usual business practices in the absence of drought.

Federal feed assistance programs. Some guidance has been provided for handling benefits received under the federal feed assistance programs.

- Feed expenditures incurred as a result of drought for which the taxpayer had received prior authorization for partial reimbursement before the feed costs were incurred are not deductible; the remaining portion of feed expenditures for which reimbursement is not available is deductible. The federal reimbursements are not includible in income.

- If prior authorization is not obtained, benefit amounts are included in gross income with an offsetting feed deduction.

- For donated feed, the fair market value is included in gross income with an offsetting feed deduction allowed.

- Feed assistance program benefits are not deferrable under the one-year deferral rule.

FOOTNOTES

1. Treas. Reg. § 1.61-4(c).
2. I.R.C. § 451(d).
3. I.R.C. § 451(d), as amended by TAMRA 1988, Sec. 6033.
8. Id.
10. Id.
11. Id.
12. Treas. Reg. § 1.451-6(b).
20. I.R.C. § 451(e), as amended by TAMRA Sec. 6030.
21. Treas. Reg. § 1.451-7(g).
23. I.R.C. § 1033(e).
24. Treas. Reg. § 1.1033(e)-1(b).
25. Treas. Reg. § 1.1033(e)-1(d).
28. Id.
30. Id.
31. Id.