Taxation of Crop Insurance and Disaster Payments

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Weather variability is one of the largest sources of risk in agricultural production. Not surprisingly, weather is probably right at the top of the list with market prices – for the most frequently discussed topics of farmers. Congress, recognizing the impact of weather variability on crop production and the resulting variability of farm income implemented a special tax provision dealing with crop insurance and disaster payments.

Code Section 451(d) provides that under certain circumstances crop producers reporting on the cash method of accounting may elect to report crop insurance and disaster payments as income of the tax year following the year of crop destruction or damage. To qualify for this election, the taxpayer must establish that the income from the destroyed or damaged crop would have been included in income for a taxable year following the year of destruction or damage under their normal business practices.

Crop disaster program payments received from the federal government qualify for Code Section 451(d) election if a natural disaster prevented a farmer from planting crops, or destroyed or damaged crops that had already been planted.

Example: Fred Farmer operates a grain farm and uses the cash method of accounting. During 2012 Fred Farmer received the following amounts of crop insurance proceeds for the damage caused to his growing crops by a June 17th hail storm: corn $75,000, soybeans $40,000, and wheat $5,000.

If Fred can establish that under normal business practices he would have reported a substantial amount of the income from the 2012 crops in a subsequent tax year – he may report the insurance proceeds as 2012 income or he can elect to defer the entire $120,000 of insurance proceeds to 2013.

Some Observations:

- Substantial portion of the crop is considered to be more than fifty percent.

- Since the insurance proceeds in the example above are attributable to crops representing a single trade or business, John may elect to defer all or none of the insurance proceeds. He may not allocate a portion of the proceeds to each of the two years.

- Taxpayers receiving insurance proceeds in the tax year following the tax year of destruction or damage, include the proceeds as income in the year of receipt without needing to make the Section 451(d) election.

- To qualify for deferral, the insured must suffer an actual loss to their crop. An important note with this point is that insurance proceeds from revenue based crop insurance must document the loss was due to actual damage or destruction to their crop, rather than due to a reduced market price.

Given this year's dry weather, a large volume of insurance claims are expected be filed this year, communicate with your insurance agent regarding when your claim will be settled – this year or next year. Given you have to recognize all or defer all the crop insurance and disaster payments, consulting with a professional tax advisor prior to the end of your tax year – could pay substantial dividends.