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Tax and Legal Issues Associated With The 2012 Drought

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Overview

The drought in significant parts of the country during the summer of 2012 has raised a number of tax and law-related questions for farmers and ranchers. Those questions involve the ability to defer crop insurance proceeds, the tax rules associated with sales of livestock on account of drought, and the inability to fill forward grain contracts due to lack of crop. The law contains special rules for farmers in each situation, but those rules can be complicated and must be followed to obtain any associated favorable treatment.

Deferral of Crop Insurance Proceeds

For a cash basis taxpayer, proceeds from insurance, such as from hail or fire coverage on growing crops, are includible in gross income in the year that they are actually or constructively received.[1] In essence, 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 and disaster payments in income in the taxable year following the year of the crop loss if it is the taxpayer's practice to report income from the sale of the crop in the later year.[2] The provision covers payments made because of damage to crops or the inability to plant crops. Also the deferral provision applies to federal payments received for drought, flood or "any other natural disaster."

Deferability and Payment Trigger Under Policy. 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 Revenue Protection (GRP).[3] 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 one-year deferral, the IRS position 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.[4] Thus, payments made under 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, payments made under MPCI contracts, MVP and RC will likely qualify for deferral because an insured yield loss triggers payment. CRC, RA and IP requires an insurable yield loss if the market price increases. Thus, deferral eligibility is tied to whether payment was caused by crop damage or destruction resulting in yield loss or whether payment was triggered regardless of yield loss.

If a crop insurance payment is based on both crop loss and price loss from a revenue-based insurance policy, only the portion intended to reimburse the farmer for crop loss is deferrable.

The portion payable because of a decline in market price is not deferrable and is income in the year the payment is received.

Consider the following example:

EXAMPLE 1:

Al Beback 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

If harvest price *exceeds* the base price, consider the following example:

EXAMPLE 2:

The facts are the same as in the previous example, except 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

Observation: Normally, if the price of crop at the time of harvest *exceeds* the base price, the physical loss will constitute 100 percent of the total loss, and the *entire* insurance payment will be deferrable. However, if insurance proceeds for physical loss to crops are collected *before* the harvest price is determined and the harvest price ultimately exceeds the base price, any additional payment attributable to the price difference could be deemed by IRS to be attributable to revenue loss that would not be eligible for deferral.

Note: For policies not based on physical loss (such as a GRP), payments received are not deferrable. The same holds true for an Average Crop Revenue Election (ACRE) payment because it is received after the end of the marketing year and in a year after the year the crop at issue is produced. *There is no additional ability to defer income to a later year if it is actually received in a year following the year of crop loss.*

Other Requirements. Deferability of crop insurance proceeds requires the taxpayer to make an election on the tax return.[5] The election is made by attaching a separate, signed statement to the return for the year of damage or destruction or by filing an amended return, which includes the name and address of the taxpayer along with a declaration that the taxpayer is making an election. The following should be included on the attached statement:

- The taxpayer's name and address along with a declaration that the taxpayer is making a deferral election;
- Identification of the specific crop or crops destroyed or damage;
- A statement that it is the taxpayer's normal business practice to report income derived from the crops that were destroyed or damaged in the taxpayer's gross income for a tax year following the tax year of damage or destruction;

Note: On this point, the taxpayer must establish a history of reporting more than 50 percent of the crop sales in the subsequent year.[6] *If multiple crops are involved, the 50 percent test must be satisfied with respect to each crop.*

- A description of the cause of the destruction or damage of the crops;
- The date or dates on which the destruction or damage occurred;
- The total amount of payments received from payors such as insurance companies and government agencies (with itemization per crop and per payor).

The ability to defer crop insurance proceeds is an important planning tool for many farmers when weather interferes with normal crop production and marketing expectations. If the requirements can be satisfied, deferral can allow consistency in income tax reporting of insurance proceeds (and disaster assistance payments). Even if the technical requirements cannot be satisfied, deferral can still be accomplished if the insurance proceeds for a current year's crop are not received until the following year

Hedging of Crop Insurance

A significant issue is whether crop insurance proceeds can be part of a hedging program. Under the regulations, a hedge is a transaction entered into in the normal course of the taxpayer's trade or business primarily to manage risk of price chances or currency fluctuations with respect to ordinary property that the taxpayer holds. Thus, the key determination as to whether a transaction constitutes a hedge is whether it reduces the risk of price change. A farmer with crop insurance is guaranteed a particular amount of revenue per acre which is a combination of actual production and insurance. The farmer 's yield risk at the time of planting is associated with the difference between actual production and the insured amount. However, if the crop is a growing crop that becomes subject to a prolonged and intensifying drought, the farmer 's risk becomes exclusively price risk due to crop insurance loss calculations that use a

price established during October. Thus, a farmer that takes a position on the Board of Trade could eliminate the price risk and the transaction could be considered part of the farmer 's overall program to reduce price risk in actual crops and those crops covered by insurance. The resulting gain or loss would be an ordinary loss under the rules governing hedges.

Tax Treatment of Court Judgments

A farmer that is found in breach of a cash forward grain contract will be ordered to pay "cover" damages. Generally, a payment made by a taxpayer pursuant to a court judgment (or settlement) are deductible as a business expense if the claim arises from acts the taxpayer performs in the ordinary course of the taxpayer's business.[7] Thus, in cases involving breaches of forward grain contracts by farmers, cover damages are paid to compensate the buyer for the actual damage or harm that the farmer's breach caused and would be deductible by the farmer.

Weather-Related Sales of Livestock

Involuntary conversion treatment. Two tax provisions are available for livestock owners to use in the event that livestock must be sold due to drought or other weather-related condition. Under the first provision, if a farmer on the cash basis sells livestock (other than poultry) held for draft, dairy or breeding purposes in excess of the number that would normally be sold during the time period, the sale or exchange of the excess number may be treated as a nontaxable involuntary conversion if the sale occurs because of drought, flood or other weather-related condition.[8] The livestock sold or exchanged must be replaced within two years after the year in which proceeds were received with livestock similar or related in service or use. But, if it is not feasible to reinvest the proceeds in property similar or related in use, the proceeds can be reinvested in other property used for farming purposes (except real estate).

Note: The American Jobs Creation Act of 2004 altered the rules on reinvestment of the proceeds from the sale of draft, dairy or breeding livestock. For taxable years with respect to which the due date of the return (without regard to extensions) is after December 31, 2002, the reinvestment rules for sales of livestock held for draft, dairy or breeding purposes were expanded to allow the reinvestment of proceeds in "other "property…used for farming purposes" (except for investment in real property) where it is not feasible for the taxpayer to reinvest the proceeds in property similar or related in service or use. This provision, however, applies only to two-year reinvestment, not four-year reinvestment because that period for reinvestment is governed by the involuntary conversion rule, which is two years.[9]

If the replacement property is livestock, the new livestock must be held for the same purpose as the animals disposed of because of the weather-related condition.[10] In that event, the gain on the animals disposed of is not subject to tax. Instead, the gain is deferred until the replacement animals are sold or exchanged in a taxable transaction.

The two year replacement period is extended to four years in areas designated as eligible for assistance by the federal government.[11] Once the two-year replacement period is exceeded (if the longer period applies), the replacement property must be livestock that is similar or related in service or use to the animals disposed of. Also, the Treasury Secretary has the authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than three years.[12]

To utilize the involuntary conversion rule, the livestock owner must attach a statement to the tax return for the year in which the animals were sold that shows evidence of the existence of the weather-related conditions that forced the sale. Also, the attachment must show a computation of the gain realized on the sale or exchange, and the number of livestock sold or exchanged in addition to the number of livestock of each kind that would have been sold under the usual

business practice had there not been any weather-related event.

Note: The replacement of the livestock is to be reported on the tax returns of the following years. If reinvestment does not actually occur or there is not a full reinvestment, the tax return for the year of the weather-related conditions must be amended to report additional income in an amount equal to the amount that was not reinvested.

One-year deferral treatment. Under another provision, if a livestock owner on the cash method of accounting is forced because of drought or other weather-related condition to dispose of excess livestock, the owner can elect to have the gain on sale be deferred until the following taxable year.[13]

Note: The deferral provision only applies to the excess livestock sold during the tax year at issue beyond what the livestock owner would have normally sold. In addition, the area must be declared a disaster area, but the livestock need not be raised or sold in the disaster area

To be eligible for deferral, the taxpayer's principal business must be farming. But, off-farm income is permissible. For example, the IRS has stated in one private letter ruling that a rancher with $121,000 for the tax year in gross income from ranching, and an additional $65,000 a year off-farm income was still deemed to have a principal business of ranching. The rancher devoted 750 to 1,000 hours per year to the ranch and his wife contributed about 300 hours.[14]

A separate election form must be attached to the return which must be filed on or before the due date of the return and must contain the following:

- Denote that an election is being made under I.R.C. §451(e);
- Show evidence of the weather-related conditions that forced the early sale including the date the area was designated as eligible for federal assistance as a disaster area;[15]
- An explanation of the relationship between the weather-related condition and the reason for the sale;
- The total number of animals sold in each of the three preceding years;
- That total number of animals that would have been sold under normal conditions;
- The total number of animals sold during the year and the number sold because of the weather-related conditions; and
- The amount to be deferred to the following year.

Deferral of income is limited to sales in excess of "usual business practices." Thus, deferral is only available for the gain attributable to the excess number of livestock sold on account of the drought or weather-related condition over the number of livestock that the owner would normally sell during the tax year. Also, an election for one-year deferral is valid if made during the applicable replacement period for the livestock under I.R.C. § 1033(e). Similarly, a taxpayer can revoke a deferral election in favor of involuntary conversion treatment, but the converse is not possible.

Note: The deferral provision applies to all livestock held for resale (raised or feeders) as well as livestock used for draft, breeding, dairy or sporting purposes, and livestock held for less than two years (cattle and horses) and less than one year for other livestock.

Contract-Related Issues[16]

Unsigned contracts. Weather problems can also cause legal issues with respect to cash-forward grain contracts if insufficient grain is available to satisfy the amount required to be delivered under the contract at the time specified for delivery. A contract for the sale of goods worth $500 or more is generally not enforceable unless there is some writing signed by the party against whom enforcement is sought sufficient to indicate that the contract had been made between the parties. This is known as the "Statute of Frauds" requirement. For contracts between merchants, it is common for one

merchant to send the other merchant a letter of confirmation, or a pre-printed form contract. This confirmation will be signed by the party who sent it, thus leaving one party at the other party's mercy. The Uniform Commercial Code (UCC) remedies this situation by providing that unwritten contracts between merchants are enforceable if a writing in confirmation of the contract is received within a reasonable time unless written notice of objection to the contents of the writing is given within ten days.[17] Thus, the effect of this "merchants" exception is to take away from a merchant who receives a writing in confirmation of a contract the statute of frauds defense if the merchant does not object to the confirmation.

Example 3:
In December of 2011, Albert Black, a Kansas wheat farmer, telephoned his local elevator for a price quote. During their telephone conversation, Albert and the elevator agreed that Albert would sell the elevator 25,000 bushels of Grade #1 wheat (60# test weight) at the December price next July, with performance to be completed no later than July 31, 2012. The elevator sent Albert a written confirmation asking that it be signed and returned within ten days. Albert did not sign the written confirmation. Because of poor growing conditions and a resulting small wheat crop, the July 2012 wheat price was substantially higher than the December 2011 price. Albert refused to perform in accordance with the forward contract, preferring instead to sell his wheat crop at the higher current market price. The elevator sued to enforce the forward contract. As a defense, Albert asserted the UCC statute of frauds.

If Albert is a merchant with respect to the kind of goods contemplated in the forward contract (wheat), Albert will be bound by the oral contract entered into over the telephone with the elevator in December of 20011. If it is determined that Albert is not a merchant, the elevator might be able to recover if it can establish that it changed its position in reliance on Albert's conduct, that Albert knew or reasonably should have known the elevator would sell the forward contract, or can demonstrate that nonperformance by Albert was based on Albert's desire to benefit from a higher market price.

As illustrated by the above example, a significant consideration is whether a particular farmer or rancher is a merchant. A "merchant" is defined as one who deals in goods of the kind being sold, or one who by occupation holds himself or herself out as having knowledge or skill peculiar to either the goods involved or the practice of buying and selling such goods. Courts are divided on the issue of whether a farmer or rancher is a merchant, with the outcome depending on the jurisdiction and the facts of the particular case.[18] Unfortunately, in many instances, farmers and ranchers cannot know with certainty whether they are merchants without becoming involved in legal action on the issue.

Courts consider several factors in determining whether a particular farmer is a merchant. These factors include (1) the length of time the farmer has been engaged in marketing products on the farm; (2) the degree of business skill demonstrated in transactions with other parties; (3) the farmer's awareness of the operation and existence of farm markets; and (4) the farmer's past experience with or knowledge of the customs and practices unique to the marketing of the product sold.

Commercial impracticability. A seller is excused from timely delivery of goods if performance becomes commercially impractical because of unforeseen circumstances. However, if a farmer fails to deliver a crop because drought, hail or other weather has destroyed it, the farmer is generally not excused from performance unless the contract called for the crop to be grown on a specified geographic area (such as a 160-acre tract) and weather damage reduces the amount available for delivery.[19]

Calculation of damages. The traditional measure of damages for a seller's total breach of contract is the difference between the market price and the contract price.[20] The UCC retains this rule,[21] but also allows an aggrieved buyer to

"cover" by making a good faith purchase or contract to purchase substitute goods without unreasonable delay.[22] The buyer that covers is entitled to recover from the seller the difference between the cost of cover and the contract price.[23]

Example 4:
Assume the same facts as set forth in Example 3 except that Albert Black signed and returned within ten days of receipt the written confirmation sent by the elevator. Assume that the December 2011 price for wheat was $5.50 per bushel. Because of poor growing conditions, Albert's wheat crop only yielded 17,500 bushels which Albert delivered to the elevator pursuant to the forward contract. Will Albert be excused from delivery of the additional 7,500 bushels of wheat as required under the forward contract? Likewise, what, if any, is the elevator's remedy? Assume the July 2012 market wheat price is $6.45 per bushel.

Albert will be excused from delivery of the additional 7,500 bushels of wheat as required under the forward contract only if the forward contract legally described the land on which the crop was to be grown and it was clear that Albert was selling the output of that tract. However, even if the contract does specifically describe the acres where the crop is to be grown, Albert will be required to deliver whatever he produces. He will only be relieved from the shortfall. As for the elevator's remedy, the elevator will be able to "cover" by taking the difference between the July 2004 market wheat price and the December 2003 price times the number of bushels of shortfall (7,500 x $.95 = $7,125). That amount can be charged to the seller.

Most of the agricultural cases concerning "covering" focus on the difference between the goods purchased as cover and the goods called for in the contract (cover goods must be like-kind substitutes), and the timeframe within which cover was carried out (there must be no unreasonable delay). In general, when a seller repudiates a forward contract before delivery is required, the buyer is entitled to the difference between the contract price and the price of the goods on the date of repudiation if it is commercially reasonable for the buyer to cover at that time. If it is not commercially reasonable to cover at the time of repudiation, cover occurs at the time specified in the contract for delivery at the then prevailing market price for the cover goods.

Conclusion

The 2012 drought is creating significant stress on producers in the affected areas. But, certain tax provisions can be utilized to reduce the impact. Also, understanding the rules surrounding forward grain contracts can be beneficial if the drought causes insufficient grain to be available to meet contract requirements.

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[1] For taxpayers on the accrual method, payment is taxable in the year received.

[2] I.R.C. §451(d).

[3] RP utilizes Chicago Board of Trade (CBOT) futures market prices and the farmer's actual historical yields to compute the level of revenue coverage and the policy guarantee. The projected price is set during February in accordance with the monthly average new-crop futures prices for corn (utilizing a December futures contract) or soybeans (utilizing a November futures contract). The harvest price is pegged by averaging the new crop futures prices during October (for corn and soybeans). The revenue guarantee under the policy is computed by multiplying the greater of the projected price or harvest price by the farmer's actual production history. That result is then multiplied by the coverage level under the policy (typically between 50 and 85 percent). GRP is policy where the guarantee and actual production history is based on county yields, with payment under the policy being the lost bushels multiplied by the February futures price. YP is a policy where the revenue guarantee and the actual production history is based on farm-level yields, with the payment under the policy set at the lost bushels multiplied by the February futures price.

[4] I.R.S. Notice 89-55, 1989-1 C.B. 698.

[5] The election covers the insurance proceeds attributable to all crops representing a trade or business. Treas. Reg. §1.451-6(a)(2). Also, deferral is "all or nothing." A taxpayer may not elect to defer only a portion of the insurance proceeds to the following year. Rev. Rul. 74-145, 1974-1, C.B. 113.
[6] See Nelson v. Comr., 130 T.C. 70 (2008), *aff'd*, 568 F.3d 662 (8th Cir. 2009).
[7] I.R.C. §162.
[8] I.R.C. §1033(e). The animals will qualify for involuntary conversion treatment regardless of how long the taxpayer has held them. In other words, there is no 12-month or 24-month test (for cattle and horses) that must be satisfied.
[9] This result is reached by reading I.R.C. §1033(a) in conjunction with I.R.C. §1033(f) and I.R.C. §1033(a)(2)(B)(i).
[10] Treas. Reg. § 1.1033(e)-1(d).
[11] In other words, there is no requirement that the area be declared a drought or disaster area if livestock is replaced within two years.
[12] The replacement period will be extended until the end of the taxpayer's first taxable year ending after the first "drought-free year" for the applicable region. "Drought-free year" means the first 12-month period that (1) ends on August 31; (2) ends in or after the last year of the taxpayer's four-year replacement period; and (3) does not include any weekly period for which exceptional, extreme or severe drought is reported for any location in the applicable region. "Applicable region" is defined as the county that experienced drought conditions on account of which the livestock was sold or exchanged and all contiguous counties. "Exceptional, extreme or severe drought is to be determined by reference to U.S. drought monitor maps which are accessible at http://www.drought.unl.edu/dm/archive.html. By the end of September of each year, IRS publishes a list of counties for which extreme or severe drought was reported during the preceding 12 months.
[13] I.R.C. §451(e).
[14] This ruling is a strong indication that taxpayers need not have all of their time on the farm in order to take advantage of this rule.
[15] The sale can occur before the designation is made.
[16] This section is drawn from McEowen, Roger A., *Principles of Agricultural Law*, Chapter 2, Release 31 (August, 2012), McEowen, P.L.C., Ankeny, Iowa.
[17] UCC § 2-201(2).
[18] *See, e.g.* Huprich v. Bitto, 667 So.2d 685 (Ala. 1995) (farmer not liable for breach of an implied warranty of merchantability; court held that farmer was not a merchant because farmer made only occasional sales of corn and did not perform additional marketing activities). But see Smith v. General Mills, Inc., 968 P. 2d 723 (Mont. 1998) (Farmer determined to be merchant unable to raise statue of frauds as defense of contract; farmer had operative knowledge of grain marketing system and understood factors influencing grain prices); Brooks Cotton Co., Inc. v. Wilbine, No. W2011-01415-COA-R9-CV, 2012 Tenn. App. LEXIS 262 (Tenn. Ct. App. Apr. 23, 2012) (experienced commercial farmers could fall within definition of "merchant" for purposes of exception to Statue of Frauds; lower court decision reversed and case remanded for trial because fact question presented regarding whether farmer was merchant which could not be resolved on summary judgment motion).
[19] UCC § 2-615, Comment 9. *See* Clark v. Wallace County Cooperative Equity Exchange, 267 Kan. 754, 986 P.2d 391 (1999).
[20] *See, e.g.*, Tongish v. Thomas, 251 Kan. 728, 840 P.2d 471 (1992) (seller breached contract to sell sunflower seeds to buyer; buyer recovered damages for difference in market price and contract price).
[21] UCC § 2-713(1).
[22] UCC § 2-712(1).
[23] UCC § 2-712(2).