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Eighth Circuit Affirms Tax Court - Crop Insurance Proceeds Not Deferrable

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Overview

Crop insurance and disaster payments are normally reported as income in the year of receipt. However, operators and share-rent landlords on the cash method of accounting may elect to defer crop insurance proceeds and federal disaster payments to the year after the year of the destruction or damage to the crops.[1] While the statute does not expressly require a farmer to have a practice of deferring *all* crop income to the following year to be eligible to defer receipt of crop insurance or disaster payment, the IRS has interpreted the statute to require a "substantial amount" of the crop to be deferred before the taxpayer is eligible to defer crop insurance or disaster insurance proceeds. But what does "substantial amount" mean? IRS has generally interpreted the phrase as meaning more than 50 percent. That interpretation was tested in this case.

> **Note:** Both crop insurance and disaster payments must be treated the same way if received in the same taxable year. Neither need be deferred, even though the taxpayer is eligible, and both can be deferred if the taxpayer elects. But it is not possible to defer one and not the other if received in the same taxable year. Of course, if received in different taxable years, the payments can be treated differently.

Facts of the Case

In this case, two related family farming partnerships and their partners were not allowed to defer reporting federal crop insurance proceeds associated with the loss of a sugar beet crop until the year following receipt. The partnerships had a history of reporting the income from the crops not on the basis of when the partnerships sold the crops, receive the proceeds, or realize the income from the crops, but rather on the basis of a formula that resulted in 65 percent of the income realized from the sale of the crops in the year of harvest and 35 percent in the year after harvest. The 2001 sugar beet crops were destroyed and the partnerships reported the full amount of crop insurance proceeds received in 2001 on their 2002 returns along with elections made under I.R.C. §451(d) to defer the crop insurance proceeds. IRS disallowed the deferral on the basis that the partnerships did not have a history of deferring a *substantial* portion of the crop income, and assessed penalties. The partnerships argued that 35 percent was "substantial" and, in the alternative, that they could defer the insurance proceeds because their entire farming operations deferred more than 50 percent of the combined income derived from all crop production.

The Tax Court[2] noted that the stated legislative purpose for the deferral set forth in the statute was to avoid the hardship of farmers having to pay income tax on two years' worth of income relating to their crops.[3] This distortion occurs, for example, when cash method farmers who normally report income from the sale of their crops in the year following crop production, also receive crop insurance proceeds in that same year. Thus, the farmer would normally have included the proceeds from the sale of the prior year's crop in income, and without the deferral, the farmer would also have to include the insurance proceeds covering the current year's destroyed crop.

As indicated above, limited guidance on this treatment is contained in Treas. Reg. §1.451-6(a)(1) and Rev. Rul. 74-145.[4] Rev. Rul. 74-145 involved a situation where the taxpayer had a history of deferring more than 50 percent of crop income to the following year. IRS ruled that constituted a "substantial portion" of the taxpayer's crop income, and allowed deferral of all of the crop insurance proceeds for the destroyed crop. Neither the Regulation nor the Revenue Ruling, however, clearly indicates whether the deferral election is available to farmers who customarily defer all of their crop income or only a portion of the income. The Revenue Ruling only points toward a "substantial portion" test. The Tax Court noted that the legislative history behind the statute illustrated the Congressional intent that the statute apply only in those situations where farmers do not receive *any* income from current year crops until sale in the following year. But, the Tax Court noted that IRS had interpreted the statute more liberally to allow deferral in those situations where the taxpayer had a history of deferring a substantial portion of the crop. Here, the court reasoned that taxpayers' history of deferring only 35 percent of the crop income was not substantial enough to support the deferral of all the crop insurance proceeds received. To have held otherwise, the court reasoned would have further distorted the income reported for the two years at issue.

But, in light of the ambiguity of the statute and the prior IRS interpretation of the statute, the Tax Court held that the taxpayers acted with reasonable cause and in good faith in deferring all of the crop insurance proceeds to 2002. As such, the taxpayers were not liable for the accuracy-related penalty under I.R.C. §6664(c)(1).

Eighth Circuit Opinion

On appeal, the United States Court of Appeals for the Eighth Circuit affirmed.[5] The court noted that the statute could be read as allowing a taxpayer to defer crop insurance proceeds if the taxpayer's customary practice is to defer *any* portion of the income from the damaged crops to a subsequent tax year. Conversely, the court noted that the statute could be read as allowing deferral only when *all* of the income from the crops would have been deferred. But, given the legislative history behind the statute indicating a Congressional intent to limit the impact of a farm taxpayer having to report two years worth of income in one year, the court concluded that the "substantial portion" test of Rev. Rul. 74-145 was reasonable and entitled to deference.

The court also pointed out that had deferral been allowed, (and it's 100 percent deferral if the election to defer is made), the taxpayers would have only reported 35 percent of the beet income in 2001, but then would have reported 165 percent of their beet income in 2002. That would have created a bunching of income problem in 2002 – the precise problem that the Congress sought to *avoid* by providing for the election. So, based on the particular facts of the case, Rev. Rul. 74-145 avoided a result at odds with Congressional intent and was a reasonable construction of the statute.

The court also rejected the taxpayer's argument that they were entitled to make the election because, in the aggregate, they deferred more than 50 percent of their entire crop production income. On that point, Treas. Reg. §1.451-6(a)(2) specifies that a farmer who receives crop insurance proceeds from *two or more damaged crops*, and elects to defer insurance proceeds, can defer *all* insurance proceeds attributable to crops constituting a single trade or business. But, the court noted the regulation didn't apply to the taxpayer because they only received crop insurance on a single crop – the beet crop. In any event, the court noted that when a farmer sustains damage to multiple crops, to be eligible for deferral, the farmer must meet the "substantial portion" (more than 50 percent) test *with respect to each crop.*

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[1] I.R.C. §451(d).
[2] Nelson, *et al*. v. Com'r., 130 T.C. 70 (2008).
[3] See S. Rep. No. 91-552, at 106-107 (1969).
[4] 1974-1 C.B. 113.
[5] Nelson v. Com'r., No. 08-2912 (8th Cir. Jun. 10, 2009).