

INTERNAL REVENUE SERVICE

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UIL 451.23-00

[REDACTED]

Attn: [REDACTED]

Dear [REDACTED]:

I am responding to your letter of March 22, 2004, to Commissioner Everson. You wrote on behalf of your constituent, [REDACTED], who asked about certain rules concerning the deferral of crop insurance proceeds. Specifically, she inquired about the rule that if a taxpayer receives both federal crop insurance and private crop insurance proceeds as a result of destruction or damage to crops, the taxpayer cannot defer one type of insurance proceeds but not the other type if those amounts are attributable to crops representing a single trade or business. [REDACTED]'s letter mentioned that she had been told that this rule was a recent change to the regulations. Robert Basso of my staff called [REDACTED] of your staff to discuss this matter, and they agreed that a conference call among Mr. Basso, [REDACTED], and [REDACTED] would be appropriate.

The conference call was held on April 14, 2004. They discussed not only [REDACTED]'s specific issue but also the broader issues concerning the deferral of crop insurance proceeds and disaster payments, including the statutory and regulatory provisions allowing this deferral. Mr. Basso explained that the specific rule [REDACTED] described has been in effect since 1971. He also explained that it was based on section 451(d) of the Internal Revenue Code (the Code) and that legislation would be required to change it. At the conclusion of the conference call, it was agreed that our written response to your office would also contain information about the statutory and regulatory provisions discussed.

In general, a taxpayer must include any item of gross income in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, that amount is to be properly accounted for as of a

different period. See section 451(a) of the Code. Most individual farmers use the cash receipts and disbursements method of accounting. Under the cash receipts and disbursements method of accounting, generally they must include an amount in gross income when actually or constructively received. See sections 1.451-1 and 1.451-2 of the Income Tax Regulations (the regulations).

The following special rule applies for crop insurance proceeds and disaster payments:

In the case of insurance proceeds received as a result of destruction or damage to crops, a taxpayer reporting on the cash receipts and disbursements method of accounting may elect to include such proceeds in income for the taxable year following the taxable year of destruction or damage, if he establishes that, under his practice, income from such crops would have been reported in a following taxable year. For purposes of the preceding sentence, payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988, as a result of (1) destruction or damage to crops caused by drought, flood, or any other natural disaster, or (2) the inability to plant crops because of such a natural disaster shall be treated as insurance proceeds received as a result of destruction or damage to crops. An election under this subsection for any taxable year shall be made at such time and in such manner as the Secretary prescribes. (Section 451(d) of the Code.)

A taxpayer cannot use section 451(d) to defer income from insurance or disaster payments into the following year unless the taxpayer would have reported more than 50% of the income from the destroyed or damaged crops in the following year under normal business practice. See Rev. Rul. 74-145, 1974-1 C.B. 113.

Section 451(d) of the Code was originally enacted in 1969 to ease hardships caused under prior law when a farmer had to report crop insurance proceeds in the year received even though the farmer under normal circumstances would not have reported income from the crop until the following year.¹ See section 215(a) of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, 573 (1969); H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. 299 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 106-107 (1969). As originally enacted, section 451(d) applied to crop insurance proceeds, but not to disaster payments.

In 1976, section 451(d) was expanded to include disaster payments received under the Agricultural Act of 1949, as amended. See section 2102(a) of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1900 (1976). The legislative history describes

¹ In our research, we located a document titled "A History of the Crop Insurance Program" on the website of the U.S. Department of Agriculture at www.rma.usda.gov/aboutrma/history.html (copy enclosed). That document states that federal crop insurance was first authorized during the 1930s and that participation in the program increased significantly during the 1990s.

how a 1973 amendment to the Agricultural Act of 1949 provided for disaster payments to farmers, but such payments were not treated as insurance proceeds under section 451(d) of the Code because no premiums were paid by the farmers. See H.R. Rep. No. 658, 94th Cong., 2nd Sess. 330-331 (1975); S. Rep. No. 938, 94th Cong., 2nd Sess. 398-399 (1976). In 1988, section 451(d) was again expanded to include payments received under title II of the Disaster Assistance Act of 1988. See section 6033(a) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3695 (1988). Section 451(d) has not been amended since 1988.²

In 1989, the Disaster Assistance Act of 1989 (Pub. L. No. 101-82, 103 Stat. 564) was enacted to provide disaster relief payments to farmers, but without any corresponding amendment to section 451(d) of the Code. Consequently, whether section 451(d) treatment was available to farmers receiving these payments was questionable. In response, temporary regulations were written making it clear that federal disaster payments made under statutes other than those specifically listed in section 451(d) were also covered provided the farmers received the payments as a result of destruction or damage to crops caused by drought, flood, or any other natural disaster, or the inability to plant crops because of such a natural disaster. See 55 Fed. Reg. 7,316 (March 1, 1990). These regulations were made final as section 1.451-6(a)(1), and still provide that federal payments received as a result of destruction or damage to crops caused by drought, flood, or any other natural disaster, or the inability to plant crops because of such a natural disaster, shall be treated as insurance proceeds received as a result of destruction or damage to crops. See 57 Fed. Reg. 38,594 (August 26, 1992).

Unfortunately, many farmers filed their 1989 income tax returns without the guidance provided by the temporary regulations. Consequently, some farmers deferred crop insurance proceeds but not federal disaster payments received under title I of the Disaster Assistance Act of 1989. This was a problem because the regulations do not permit a taxpayer to defer crop insurance proceeds but not disaster payments, or vice versa, if such amounts were attributable to crops representing a single trade or business. In the case of a taxpayer who receives insurance proceeds as a result of the destruction of, or damage to, two or more specific crops, if such proceeds may be included in gross income for the taxable year following the taxable year of such destruction or damage, and if such taxpayer makes a section 451(d) election with respect to any portion of such proceeds, then such election will be deemed to cover all such proceeds that are attributable to crops representing a single trade or business under section 446(d) of the Code. See section 1.451-6(a)(2) of the regulations. This regulation has been in effect since 1971. See 36 Fed. Reg. 5,215 (March 18, 1971), as corrected by 36 Fed. Reg. 5,339 (March 20, 1971).

² We have reviewed the provisions of the Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134 (2002) (the 2002 Act), as we said we would during the conference call. Subtitle A of title X of the 2002 Act covers crop insurance. The 2002 Act did not make any changes to the tax rules concerning the deferral of crop insurance proceeds.

In Notice 90-28, 1990-1 C.B. 339, the Internal Revenue Service addressed the problem. The Notice informed farmers that they could elect to defer crop insurance proceeds under section 451(d) without also deferring federal disaster payments made under the Disaster Assistance Act of 1989, but only for a tax year ending before April 1, 1990. The purpose of this one-time modification of the general rule was to eliminate the need for many farmers to file amended returns. The Notice specifically mentioned that while the Notice allows an election to defer insurance proceeds but not federal disaster payments, it does not allow an election to defer federal disaster payments but not insurance proceeds.

As mentioned above, a taxpayer cannot defer crop insurance proceeds but not disaster payments, or vice versa, if such amounts are attributable to crops representing a single trade or business. See section 1.451-6(a)(2) of the regulations. Also, the regulations do not permit a taxpayer who grows different types of crops to defer crop insurance proceeds for only one type of crop but not others if such insurance proceeds are attributable to crops representing a single trade or business. Furthermore, if a taxpayer receives both federal crop insurance and private crop insurance proceeds as a result of destruction or damage to crops, the taxpayer cannot defer one type of insurance proceeds but not the other type if such amounts are attributable to crops representing a single trade or business. This regulatory rule is in accord with section 451(d) of the Code, which does not make a distinction between federal crop insurance proceeds and private crop insurance proceeds.

I hope this information is helpful. If you or your staff need further assistance, please contact me or [REDACTED] at [REDACTED].

Sincerely,

CHRISTOPHER F. KANE
Chief, Branch 3
Office of Associate Chief Counsel
(Income Tax and Accounting)

Enclosure