

Crop Insurance Indemnities: Some Tax Considerations for 2013

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Corn and soybean yields for most Indiana producers are higher in 2013 than they were in 2012, but crop prices are lower. A number of producers may also have crop insurance indemnities from 2012 crops which have not yet been reported as income. Producers may have additional crop insurance indemnities for damages to their 2013 crops. Although there are some provisions which provide flexibility for producers, tax law and regulations have not kept up with changes in the crop insurance products. This article reviews the tax treatment of a number of common situations and suggests possible procedures to be used.

Deferral of Income

Crop insurance indemnities are generally included in income of the year in which the indemnities are received. However, a producer whose normal business practice is to sell their crop in the year following the year of production can make an election (See Pub. 225, *The Farmer's Tax Guide*, p. 11) to defer reporting indemnities until the year following the year of production. There are some restrictions on the election.

1. The election covers payments for all crops from a farm. There are conflicting views on how this is interpreted. IRS has taken the position that if a producer normally sold 50% of all crops in a year following the year of production, then all of the crop loss payments could be postponed until the following year. [Rev. Rul. 74-145, 1974-1 C.B. 113]. The instructions for Schedule F (Form 1040) suggest any or all of the payments may be postponed.
2. Only indemnities for a producer's physical loss of production are eligible for deferral. The indemnities associated with revenue-based insurance may need to be allocated between the yield and price effects as discussed later.
3. The indemnities from the county-based Group Risk Plan (GRP) and Group Risk Income Plan (GRIP) would not be eligible because they are not linked to a producer's actual loss.

Some producers may have received prevented planting payments if they were unable to plant a crop consistent with good farming practices. Payments for replanting may also be made if the planted acreage has a poor stand. These payments would generally be reported as income for the year in which they were received, but could be deferred by an election as discussed above.

Acceleration of Income

Indemnities cannot be reported as income before they are actually or constructively received. An indemnity received in 2013 for a 2012 crop would be reported an income in 2013, regardless of when the producer normally sells the crop. Because of the very large number of crop insurance claims filed for 2012, there was a significant increase in the time needed for insurance companies to process a claim.

Furthermore, a 2012 insurance claims of over \$200,000 required a 3-year audit of the producer before the claim for 2012 losses could be paid. Although these situations are due to factors beyond a producer's control, current tax law has no provisions that would permit reporting of indemnities as income before they were received.

Crop insurance proceeds paid in the year following the year of harvest must be reported as income when received. With the county-based insurances, Group Risk Plan (GRP) and Group Risk Income Plan (GRIP), yields and indemnities for corn, soybeans and most other crops are not determined until the year following the year of production. This is the tax treatment even if the producer's normal business practice is to sell the crops in the year of harvest. There is no provision that would allow an acceleration of reporting. As previously discussed, this would also apply to delayed indemnity payments under crop and revenue insurance.

Producers can file amended tax returns within 3 years of when the return was filed or within two years from when the tax was paid, whichever is later. Although many farmers file and pay their taxes by March 1 to avoid estimated taxes, their filing deadline is April 15. Filing amended returns to take advantage of farm income averaging, and making careful use of additional first year depreciation and Section 179 expensing may provide more flexibility in managing income over several years.

Tip: In 2012 the prices of the 2012 December corn and November soybean futures used to determine insurance guarantees and indemnities increased sharply. The price of December corn futures averaged \$5.68 in February and \$7.50 in October. The price of November soybean futures prices increased from \$12.55 to \$15.39 over the same period. Almost all of the 2012 losses were due to low yields (physical losses) of corn and soybeans.

Calculation of Physical/Yield Losses

For crop insurance covering only physical losses of production (e.g., Yield Protection Plan and Group Risk Plan), determination of the loss is relatively straight forward. Let's look at a soybean producer in 2013 with an Actual Production History (APH) yield of 50 bushels per acre. The projected price of 2013 soybeans, based on the November soybean futures was \$12.87 per bushel.

Example 1:

Approved yield (APH) is 50 bushels per acre
Projected price of soybeans is \$12.87 per bushel
Insurance coverage level is 75%
Actual yield of 45 bushels per acre

The final revenue guarantee level is $50 \text{ bushels} \times \$12.87 \times 75\% = \$482.63$ per acre.

Calculated revenue is the $45 \text{ bushel actual yield} \times \$12.87 \text{ projected price} = \579.15 per acre.

Because the calculated revenue for actual production (\$579.15) is larger than the insurance guarantee (\$482.63), there is no indemnity. No indemnities would be paid until actual yields were less than 37.5 bushels per acre.

Calculation of Revenue Losses

Other crop insurance policies provide coverage for decreases in both yields and prices (e.g., Revenue Protection). Farmers have shifted to insurance products based on revenue rather than yield alone. Over 95% of both the corn and soybeans acreages that were insured by yield or revenue insurances were insured for revenue coverage.

Let's look at a corn producer in 2013 with an APH yield of 160 bushels per acre. The projected price of corn is based on the average closing price of the December corn futures during the month of February. The harvest price of corn is based on the average closing price of the December corn futures during October. The revenue guarantee is based on the higher of the price of December corn futures in February or November. In 2013, the February price was \$5.65 and the November price was \$4.39 for a decline of about 22.3% percent. If a producer had insured at the 75% coverage level, an indemnity could be determined as illustrated in Example 2.

Example 2:

APH yield is 160 bushels of corn per acre
 Projected price of corn is \$5.65 per bushel
 Harvest price of corn is \$4.39 per bushel
 Insurance coverage level is 75%
 Actual yield of 150 bushels per acre

The revenue guarantee level, based on November futures prices in February, is
 $160 \text{ bushels} \times \$5.65 \times 75\% = \$678.00 \text{ per acre}$

The revenue guarantee, based on the November futures price in October, is
 $160 \text{ bushels} \times \$4.39 \times 75\% \text{ per acre} = \561.92

Calculated revenue for actual production of 150 bushels at the \$4.39 harvest price is
 $150 \text{ bushels} \times \$4.39 = \$658.50$

Indemnity is the higher revenue guarantee minus actual revenue
 $\$678.00 - \$658.50 = \$19.50 \text{ per acre.}$

Allocation of Losses

As discussed above, only an insurance indemnity based on a physical loss of production is eligible for the reporting deferral. Payments received from crop insurance companies may not report the allocation between physical and price losses. Example 3 illustrates one procedure to determine the amount of the insurance payment due to the decline in yields of corn (physical loss).

Example 3:

Approved yield is 160 bushels per acre
 Projected price of corn is \$4.06 per bushel
 Harvest price of corn is \$3.80 per bushel
 Insurance coverage level is 75%
 Actual yield is 75 bushels per acre

The final revenue guarantee level is $160 \text{ bushels} \times \$4.06 \times 75\% = \$487.20$ per acre.

Calculated revenue is $75 \text{ bushel actual yield} \times \$3.80 \text{ harvest price} = \285.00 per acre

Insurance proceeds are computed as follows: $\$487.20 \text{ guarantee} - \$285.00 \text{ calculated} = \202.20 per acre indemnity

Yield loss is $160 \text{ bushel approved yield} - 75 \text{ actual yield} = 85 \text{ bushels per acre}$

Value of physical loss per acre is computed as: $85 \text{ bushel yield loss} \times \$3.80 \text{ harvest price} = \323 per acre

Price loss is $\$4.06 - 3.80 = \0.26 per bushel $\times 75 \text{ actual yield} = \19.50 per acre

Total loss is $\$323.00 + \$19.50 = \$342.50$ per acre

Physical loss is $\$323.00 / \$342.50 = 94.31\%$ of total loss

Payment per acre due to physical loss is computed as follows: $94.31\% \text{ physical loss} \times \$202.20 \text{ insurance proceeds} = \190.69 per acre

Based on this procedure, \$190.69 per acre of insurance payment would be eligible for possible deferral as the value of the physical loss. The remaining \$11.51 per acre of the insurance payment would be due to the price decline of the December corn futures and is not eligible for possible deferral.

Implications

Changes in farm policy and commodity prices which have been high by historical standards have led to substantial increases in producers' use of crop insurance in their risk management programs.

Understanding the basics of the various types of the insurance is critical now and is likely to be even more so in the future. As noted above, tax policy treats yield and revenue products differently. In addition to tax policy differences, producers should compare premiums and potential payoffs between yield and revenue crop insurance products.