

Tax Implications of Tobacco Quota Buyout

by

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Overview

Tobacco quota buyout payments, beginning in 2005 and ending in 2014, have important income tax implications for tobacco producers and quota owners. A general awareness of the tax effects is an important step in making some decisions in 2005 about receiving the payments and in managing the tax impact for this and future years. Producers and quota owners need to work closely with their accountant, tax preparer, lender, or other professional advisers in 2005 to determine the specific tax impact on their individual situation.

The tax issues are different for producers receiving the \$3 production payment and quota holders receiving the \$7 quota payment. A general guiding principle is that income from the buyout payments retains the character of the income or asset it is replacing. Thus, the \$3 production payment will be taxed as ordinary business income while the \$7 quota payment will be taxed as capital gain income. The tax rates and reporting rules are substantially different for each.

Production Payment (\$3) Tax Issues

The tax implications for the production payments to producers are relatively simple and straight forward. Payments will be treated as ordinary business income (*Schedule F for most producers*) in the year payments are received (*even if they are no longer farming in the year of payment*). That income is subject to:

- Self-employment (FICA) tax at the 15.3% (14.13% adjusted) rate up to \$90,000 of net farm income; 2.9% of net farm income above \$90,000 (in 2005).
- Federal tax at ordinary rates of 10, 15, 25, 28, 30, or 35% in 2005.
- State tax at ordinary rates in 2005 of 6, 7, 7.75, or 8.25% in North Carolina (*rates will vary and other rules may apply in other states*).

Thus, the amount of tax will vary widely among individual producers depending on the amount of payment received and the amount of other taxable income in a given year. The combined tax rate could be as low as 30% and as high as 51%; individuals should consult with their tax preparers to determine the rate more precisely for their status. (*Note: farm income averaging may be useful in lowering the effective tax rate.*)

Beyond the applicable tax rate, producers should also consider two other tax implications.

- Effect of production payments on social security benefits
- Effect of taking a lump sum payment in 2005.

Because the producer payment is earned income, it may reduce the eligible benefit for individuals taking early social security—generally between ages 62 to 65—which may affect the decision on when to begin drawing social security. Taking a lump sum in 2005 and declaring income from the production payment in only one year may be advantageous in this respect for some. For others, a lump sum may result in such a higher tax rate in 2005 that it would be a significant disadvantage. Whether or not a lump sum payment in 2005 has tax advantages or disadvantages will vary among individual situations. Recipients of production payments should work closely with a professional financial adviser in making decisions about taking a lump sum payment or taking social security early.

Quota Holder Payment (\$7) Tax Issues

Tax issues and planning for quota owners are more complicated, requiring more knowledge, information and work by recipients. Although the tobacco buyout legislation does not specifically address all of these issues, the following points can be made based on legal characteristics of quota and tax guidelines previously followed by the Internal Revenue Service regarding tobacco quota and other similar assets.

First, tobacco quota is an interest in land (real property) because it is assigned to farms and attached to land. Since quota is used in the trade or business of farming, or in the rental of farm assets, it qualifies as a

Section 1231 asset if it was owned for over one year. Thus, the following tax treatments apply to quota payments from the buyout:

- Payments are not subject to self-employment (FICA) tax.
- Only the portion of the payment which is a gain above the cost basis of the quota is taxed as a capital gain.
- Gains are taxed at federal capital gains tax rates of 5, 10, or 15%, not at ordinary tax rates.
- Gains do not qualify for farm income averaging (*since gains are not "farm income"*)
- Capital gain income does not affect social security benefits.
- State taxes apply according to individual state tax rates (6, 7, 7.5 or 8.25% in North Carolina in 2005).

While the tax rate on quota payments can still vary among individuals, the rates are much lower than for production payments. For a North Carolina taxpayer, the combined federal and state tax rate on the capital gain portion could be as low as 11% or as high as 23%.

Capital gains tax treatment of quota holder payments implies some other important issues that individuals must consider. Each of these requires individual-specific information, planning, and decisions which recipients should work through with their tax preparer, accountant, financial adviser, etc., as soon as possible in 2005 (*i.e., don't wait until the 2006 tax season for doing 2005 tax returns to work through these tax issues.*) Three preliminary issues that are pertinent to quota holders merit additional attention at this point.

- Determining the tax basis of quota.
- Considering a like-kind exchange to defer the tax.
- Evaluating the effect of taking a lump-sum payment in 2005.

Quota Basis

The taxable capital gain portion of the quota buyout payment is the total amount received minus the total cost basis in quota acquired over time. There are basically three ways to have acquired quota, and the rules for establishing a basis are different for each.

- Quota purchased—most often the basis is the amount of cash paid. If property was exchanged for the quota in addition to cash, the value of the property or its basis must be added to the cash amount. If the quota was at some time incorrectly amortized (depreciated) or taken as a business expense, the basis must be reduced by those amounts.
- Quota received by inheritance—the basis is the fair market value (FMV) of the quota on the date it was inherited.
- Quota received as a gift—the basis is whatever the basis was of the person making the gift.

While these rules for establishing basis are simple and straight forward, determining the correct dollar amount for each is not so easy for many quota holders.

One complication arises when quota was acquired as part of an entire land purchase. At the time that the land was purchased, the amount paid for the quota attached to the land should have been established separate from the land itself. Likewise, if the quota and land was inherited, the FMV of the quota should have been recorded separate from the FMV of the land and other assets. In either case, if the quota and land values were not separated at the time of acquisition, the quota holder faces a challenge in retroactively determining what was paid for quota and what was paid for the land, or what the FMV of each was at the time of inheritance.

In the case of a gift, the previous owner's basis in the quota should have been recorded as part of the gift transaction. If not, the current quota holder must somehow determine what that basis was.

What if no precise records of quota basis were made or if records are unavailable? Quota owners must make a good faith effort to calculate a basis value from historical information pertinent to their individual situation. In other words, they cannot simply pick a number that looks reasonable or "guess" at what the basis could be. There is no specific methodology for doing this, but information from county records, real estate appraisers, government agencies and other sources may be useful to the quota holder in working with his/her professional adviser on this issue. In the absence of adequate records or a good faith effort to establish a record of basis, the IRS default position is that the basis is zero. With a zero basis, the entire quota buyout payment will be the taxable capital gain. It will be advantageous to quota holders to complete the work of determining their basis as soon as possible in 2005 before trying to evaluate their tax situation and before making any other long-term decisions about their buyout payments.

Example: Esther Holder inherited a 200 acre farm in 1986 with 40,000 pounds of quota attached, which was appraised at a FMV of \$300,000 (\$1,500 per acre). Unfortunately, the estate settlement documents did not make an allocation at the time between the land and the quota. Historical sources indicate that tobacco quota had a value of \$1.25 per pound in 1986 which would be a \$50,000 basis through inheritance of this lot of quota that Esther now owns. That would leave a residual basis of \$250,000 in the 200 acres of land at \$1,250 per acre. Further research indicates that \$1,250 per acre is consistent with the average value of farmland without quota in her county in 1986. Thus, Esther's calculation of her quota basis appears to be a reasonable good faith effort. *(Note: When using indirect historical data to calculate quota basis, it is prudent to err on the conservative side. Also, if in the example above Esther had purchased the farm instead of inheriting it, a similar approach for deriving the quota basis would be applicable.)*

In determining quota basis, owners should think in terms of owning different "lots" of quota instead of pounds. The basis should be determined for each lot rather than for each pound owned. The reason is because the number of pounds owned in a particular lot when the quota was obtained is most likely different than the number of pounds of 2002 effective quota upon which the buyout is based. While the basis per pound of a lot has not changed, the basis per pound has; thinking in terms of a basis-per-pound can lead to confusion. The basis for all of the separate lots owned should be combined and applied against the total buyout amount received to determine the capital gains.

Example: Leif Green purchased quota Lot A of 30,000 pounds in 1989 for \$1.50 per pound or \$45,000 for the entire lot. Leif inherited quota Lot B in 1998 of 20,000 pounds which had a Fair Market Value of \$3.00 per pound or \$60,000 total at the time of inheritance. He also received a small amount of quota as a gift from his father when he began farming in 1981; this Lot C of 5,000 pounds has a basis of \$1.00 per pound or \$5,000 total, the amount his father paid for it when he purchased it in 1962. Leif, who owns 55,000 pounds with a combined total basis of \$110,000, will receive buyout payments on 30,000 pounds, the amount of his 2002 effective quota base, at \$7.00 per pound for a total buyout payment of \$210,000. Thus, Leif's taxable capital gain will be \$100,000—the buyout amount minus his total basis.

Like-Kind Exchange to Defer the Capital Gains Tax

Some quota holders may want to seriously consider a method for deferring the tax on all or part of their buyout payment through a simultaneous exchange of their payment for like-kind property. In this process, the basis and capital gains from their quota rolls over into the property being purchased, and the tax consequence is delayed (deferred) until that property is sold. While the details of a like-kind exchange are somewhat complex and require the professional assistance of the quota owner's tax preparer, accountant, real estate broker, lawyer, etc., the following discussion covers the basic concepts which need to be initially considered.

The tobacco buyout legislation is silent about and the IRS has not yet issued a specific ruling about whether or not Section 1031 of the Revenue Code on like-kind exchanges applies to quota buyout payments. Nonetheless, it can be reasonably argued that tobacco quota does qualify for Section 1031 treatment since it is an interest in land and is real property exchangeable for other real property. Previous IRS rulings have allowed for a like-kind exchange of an interest in land for other real property.

If a quota holder wants to complete a like-kind exchange in order to defer the capital gains tax, three specific rules must be followed.

- Like-kind category of replacement property.
- Qualified intermediary to hold payment funds until transactions are completed.
- Time limits for completion of transactions.

To qualify as a nontaxable (deferred) exchange, tobacco quota, as an asset used in a trade or businesses, can only be exchanged for another asset used in a trade or business which must also be an interest in land. Thus, an exchange for other farmland, timber, or real rental property such as an apartment building would, for example, qualify. An exchange for a personal residence, a vacation home, machinery or livestock, for example, would not qualify.

In the exchange process, money from the buyout payment(s) must be held by a qualified intermediary (*similar to but not exactly like an escrow agent*) until the money is used to purchase the replacement property for which the quota is being exchanged. In other words, the quota owner cannot receive the payments and have use of those funds.

Strict time limits for completing the exchange must also be met. First, the quota owner must identify and clearly describe in writing the replacement property being purchased within **45 days** after the date the quota ownership is transferred to the government. The replacement property must be received (i.e., transactions completed) within **180 days** after that transfer date. (*Note: A time limit less than the 180 day maximum could apply in some instances; this limit should be checked for by a tax preparer.*)

An important question which arises from these time limit rules is “On what date is quota ownership transferred?” A specific definition of that date has not yet been issued by the IRS nor specified in the legislation. Until the transfer date is more clearly defined, two reasonable arguments can be made. One, the transfer date is when the quota holder signs up for the buyout program, sometime between March 14, 2005 and June 17, 2005. (*The effect of late sign-ups after June 17 is unclear.*) On the other hand, it could be reasonably argued that the transfer date is when consideration is exchanged, which would be the date the first buyout payment is received, sometime between June and September, 2005. Until IRS or other legislation establishes a ruling on the date of transfer, quota holders entering into a like-kind exchange, along with their tax preparer or legal adviser, will have to make their best good-faith judgment on this matter. With an exchange date sometime in 2005, the quota holder will probably have to take a lump-sum payment from another private party in 2005 through a securitized assignment of future buyout payments in order to meet the time limit rules.

Obviously, the like-kind exchange is not something a quota holder can decide or complete without the help of third-party professionals. And the window of time for making such a decision is limited and will require action soon in 2005 by quota holders.

Lump-Sum Payment

Buyout payments from the government to both producers and quota holders will be made in equal installments over 10 years. As an installment “sale” contract, the tax liability of buyout payments will be spread out over 10 years. However, two exceptions to the installment and treatment of tax liability may arise.

First, the taxpayer can “elect out” and report the entire amount of income in the year of sale/transfer, which would be 2005. The entire tax liability accrues to 2005, and future payments are tax free, except for the amount of implied interest received in years 2006-2014. This election may be advantageous to some taxpayers, although most will probably choose to keep installment treatment of taxes on the buyout.

A more likely exception is for quota holders and producers who choose to take a lump-sum in 2005 of the nine buyout payments for 2006-2014. In this case, individuals receive a discounted amount in 2005 from a private party by assigning all future payments through a securitized contract. Because the quota owner or producer is receiving all of the funds from the buyout in 2005, all taxes also accrue to the 2005 tax year. However, only the amount actually received in the lump sum is taxable, not the entire buyout amount. For example, George Grower will receive \$100,000 from the buyout. He receives \$10,000 from the government as the 2005 payment and he receives a lump-sum payment from XYZ Financial Institution of \$67,000 in 2005 for the remaining \$90,000 portion. George will owe taxes on \$77,000, the total cash amount received in 2005.

The decision to take a lump-sum payment involves several economic and personal considerations. The income tax consequence in 2005 is a major consideration which individuals should discuss thoroughly with their tax preparer and other financial advisers as soon as possible in order to make an informed decision about whether or not to take a lump-sum. The advisability and advantages or disadvantages for doing so will vary with each individual.

New Information

Additional information and clarifications on tax implications of the tobacco quota buyout may become available in the coming months. Quota holders and producers should stay informed beyond the information written here as they make decisions in 2005.