Tax Consequences of the 2002 Farm Bill Mandated Peanut Quota Buyout

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Introduction

There have been various government programs to assist farmers since the 1930s. Peanuts have been produced under a quota system since 1938. Farmers have received quota in the past based on historical production at the beginning of the "peanut program", have purchased peanut quota, have received quota as a gift, or have inherited quota from an estate.

On May 13, 2002, President George W. Bush signed The Farm Security and Rural Investment Act of 2002 (Farm Bill 2002), which drastically changes policy regulating peanut production in the United States. Most importantly, the peanut quota system of production was abolished, and quota holders are to be paid $0.55 per pound for each pound of quota owned. Payment can be received as a lump sum this year or in equal payments over 5 years. This buyout of peanut quota raises several income tax issues. IRS has ruled that the sale of quota held for more than one year and used the business of growing peanuts qualifies for a capital gain tax rate, of 10 or 20% and is not subject to the 15.3% self-employment tax. If a peanut quota holder elects to receive the payments over 5 years, a portion of the payment will be treated as unstated interest and taxable at ordinary income tax rates.

Peanut Quota: What is it for Tax Purposes?

Peanut quota, like tobacco quota, is an interest in land for tax purposes and, therefore, not depreciable or amortizable. [Wenzel v. Commissioner, Tax Court Memo 1991-166].

Peanut quotas are assigned to farms, that is, they are attached to land. Quotas and allotments cannot exist without being attached to land (except for some unusual situations such as eminent domain and forfeiture pools). Federal law defines the term "quota" to mean, "The pounds allocated to a farm for a commodity as prescribed in the applicable commodity regulations." Peanut quota can be transferred from one farm to another. The new owner of the quota must "attach" the quota to land that he or she owns. The "attachment" of peanut quota is done through the new owner's Farm Service Agency (FSA) office.

There are certain restrictions that govern these transfers. The amount of quota that can be transferred is some or all that is assigned to the farm. Transfers can be either temporary (for the crop year only) or permanent. Temporary transfers are by lease; permanent transfers are by sale. Although quotas may be transferred, it is clear that permitted transfers are between farms. This means that quotas may be detached from the land of one farm and reattached to the land of another. The new peanut base must be attached to land by contacting the local Farm Service Agency before March 31, 2003.

Why is Basis Important?

Owners of peanut quota must pay tax to the extent that the peanut quota buyout payments exceed tax basis. In other words: (pounds of quota times .55 cents less tax basis equals taxable gain). Basis is good because, if you have basis - you don't pay tax.

Basis of Purchased Quota

Farmers who have purchased quota should have a relatively simple task in determining the basis of that quota. Generally, basis will be what the farmer paid for the quota "lot." The cost basis is reduced by subsequent deductions, such as amortization.

Example 1. Joe Smith purchased 5,000 pounds of peanut quota from his maiden aunt in 1997 for $0.50 per pound.

Question 1. What is the basis of the quota Joe bought?

Answer 1. $2,500 is the cost basis of the quota. Joe should retain a record of this purchase in his permanent farm records.

Question 2. If the Secretary of Agriculture changes the national peanut quota, does the basis of Joe's quota change?

Answer 2. No. For the quota "lot" that Joe bought from his aunt, the basis does not change; it remains $2,500. However, the basis per pound of the "lot" will change as quota increases or decreases.

Question 3. If quota has gone down 5% since 1997, what is the basis per pound of Joe's quota?

Answer 3. Joe's basis per pound is now $0.5263 per pound ($2,500/4,750 pounds) an increase of 2.63 cents per pound.

The basis of peanut quota that was purchased with land is the portion of the purchase price that is allocated to the peanut quota based on the relative fair market value of the peanut quota and the land. If the quota and land were purchased years ago and no allocation was made, farmers could use historic price data to determine the relative values of the land and quota. If the peanut quota was purchased in a separate transaction, the basis is the purchase price.

Basis should be recorded in permanent records of the farm business.

Basis of Peanut Quota Received as an Inheritance

Farmers, who receive assets as a bequest or inheritance from a decedent, have a basis equal to the fair market value (FMV) of the asset on the date of death of the decedent or six months after the date of death if the alternate valuation date is elected. Assets, such as peanut quota, that are inherited are deemed to have a "long-term" holding period upon receipt from the estate.

Example 2. Jim Jones inherited land and peanut quota attached to that land from his father, Jim Sr. The land was valued in the estate at $50,000 and the quota was valued at $3,000.

Question 4. What is Jim's basis in peanut quota he inherited from his father's estate?

Answer 4. The basis is $3,000 for the "lot" of quota and is deemed to have a "long-term" holding period.

Basis of Peanut Quota Received as a Gift

Farmers who receive assets, such as peanut quota, as a gift, have the donor's carryover basis in the asset increased by the portion of gift taxes attributable to the appreciation in value of the property. There is not a "step-up" to the FMV of the gift on the date of the gift. However, there is a "step-down" in basis if the FMV of the asset is below the donor's basis on the date of the gift. Further, the donor is not allowed a deduction for the "loss" on the property on the date of transfer. The amount that is the difference between the donor's basis and FMV is suspended; and when the asset is disposed of, the "loss" that was disallowed is added to the remaining basis of the asset to calculate gain, but not loss.

Example 3. Jim Jones, from Example 2, receives the farm and peanut quota as a gift from his father Jim Sr. When Jim Sr. purchased the land and quota, he allocated $20,000 of the $21,500 purchase price to the land and $1,500 of the purchase price to the peanut quota. Jim Sr. did not owe any gift taxes.

Question 5. What is Jim's basis in the peanut quota?

Answer 5. Jim has a carry-over basis from Jim Sr., which is $1,500. Jim should make a note of this basis in his permanent farm records.

Adjusted Basis of Peanut Quota

If farmers have incorrectly taken amortization deductions for the peanut quota purchased after August 10, 1993, the basis of their quota is adjusted by the amount of amortization taken. Quota basis may also be adjusted due to other factors such as changes made by USDA or inheritance.

Example 4. John Nutt bought peanut quota in January of 1994 for $10,000. John amortized his quota for one year due to the confusion surrounding the intangible life issue when Congress created the 15-year life for intangibles. John deducted $333 of amortization on his 1994 tax return. In 1995 John stopped deducting the amortization expense for peanut quota.

Question 6. What is John's basis in his peanut quota?

Answer 6. The adjusted basis, due to the amortization deduction taken, is $9,667.

Calculating and Reporting Gain or Loss of Peanut Quota Buy back

Under Farm Bill 2002, farmers who are owners of peanut quota will receive payment for their quota. The payment may be received as a lump-sum payment of $0.55 per pound or $0.11 per pound over 5 years. In order to make management decisions relative to their business, farmer's need to calculate the gain or loss triggered by the "buyout" of peanut quota. The buyout will be based on the number of pounds quota owners held in 2001.

Since farmers can choose to receive payment for their quota in a lump sum or installment payments over 5 years they should compute the tax consequence of each before choosing.

Example 5. John Nutt, from Example 4, has a total of 100,000 pounds of quota in 2001, all of which qualifies for the long-term holding period. Assume that John received his peanut quota when the program began and his tax basis is zero. John is in the 27% federal income tax bracket and is also subject to a state income tax rate of 7%. John elects to take a lump-sum payment.

Question 7. Will John have a gain on the sale of the quota?

Answer 7. Yes. The quota payment is $0.55 per pound; the tax basis is zero, so John will recognize $0.55 per pound gain or $55,000 total gain.

Question 8. How will John report the gain?

Answer 8. John will report the gain on Part I of Form 4797. If John has a net Internal Revenue Code Section §1231 gain, the gain will flow to Schedule D (Form 1040) as a long-term capital gain. At the margin, the federal tax will be $11,000 ($55,000 x 20%) and the state tax will be $7000, assuming 7% state income rate. (See Table 1, federal income tax rates for the different filing status and levels of taxable income).

Tax Consequences of Installment Sale Reporting

Installment sales are defined as a disposition of property where at least one payment is received after the close of the taxpayer's tax year in which the sale of the asset occurs. The language in Farm Bill 2002 clearly states that payment of the peanut quota buyout is to occur over a period of 5 years with annual installment payments.

Example 6. John Nutt, from the above example, anticipates that over the next five years he will be in the 15% federal income tax rate and subject to the 7% state income tax rate. He elects to take payments over the 5-year period to prevent going into the 27% tax bracket.

Question 9. What is the tax savings that John will receive by electing the installment payment option?

Answer 9. Since John is in the 15% tax bracket, his long-term capital gains rate will be 10 percent (or 8% if held for over 5 years); therefore he reduces his total tax on the peanut quota buyout from $11,000 to $5,500.

Question 10. Is John required to report any of the payments as unstated interest?

Answer 10. Yes. The peanut quota buyout agreement does not require a discount to receive the payments in a lump sum and does not allow interest to be paid if the 5 year payout is elected. Because there is no stated interest in an installment contract, IRS requires that unstated interest be computed and reported as ordinary income.

Question 11. How is the unstated interest computed?

Answer 11. There is total unstated interest under the contract if:

1. The sum of all payments (other than interest payments) due under the contract more than six months after the date of the sale or exchange exceeds;
2. The sum of (a) the present value of all payments due more than six months after the date of the sale or exchange, and (b) the present value of all interest payments due under the contract.

Example 7. John Nutt from example 6 above would receive a lump sum payment of $55,000. The present value of the five annual $11,000 payments using a 4.93% discount rate is $47,716.54. Thus, $7,283.46 would be reported as interest income not eligible for capital gain. If the interest is taxed at 15% ordinary income tax rate rather than 10% capital gain rate, the $5,500 installment sale tax savings would be reduced buy $364 to $5,136.

Question 12. Should John consider taking the lump sum even if it causes him to pay a higher tax?

Answer 12. Yes. John should consider the time value of money of receiving the lump-sum payment versus the installment sale.

Question 13. If John receives the peanut quota buyout as installment payments over 5 years, does he recognize any recapture on the sale of peanut quota in the year of the first payment?

Answer 13. Since the peanut quota is an interest in land and has not been depreciated or amortized, there is no recapture to recognize in the first year of the installment sale. If the quota had been incorrectly amortized in a prior year like example 4, the amortization amount would be reported as ordinary income in the first year of the installment sale.

Planning Pointer:

Obviously, this is a simplified example for illustrative purposes. Taxpayers in the trade or business of farming have options to manage their tax liabilities. The prepayment of expenses is one such means that would help to reduce the tax liability of the current year.

Example 8. Dick Wilson inherited a farm from his great-uncle Dan Wilson with a 10,000-pound peanut quota attached. Dan's estate valued the land at $45,000 and the quota at $5,000 at the time of his death. These were the values reported on the federal estate tax return and became Dick's basis. Since that time the peanut quota has been reduced by 10%. Dick held 9,000 pounds of quota in 2001. Dick elects to receive a lump-sum payment for his peanut quota as allowed under the buyout provisions of Farm Bill 2002.

Question 14. What is the taxable consequence of the quota buyout to Dick?

Answer 14. Dick's basis in his peanut quota is $5,000. He will receive $4,950 as a lump-sum payment. Therefore, Dick will have a loss of $50. If the quota is considered a capital asset, he will report the loss on Part I of Form 4797. If he has a net capital loss, the loss will offset ordinary income. If the quota is considered ordinary income, the loss will be reported on schedule F.

Planning Pointer:

This example illustrates the need to establish the basis of peanut quota as there may not be any taxable gain to recognize and the loss may offset other capital gains or, if none exist, ordinary income is reduced.

Deferral of Peanut Quota Buyout Gains

Taxpayers who realize a gain from the peanut quota buyout may be able to defer recognition of the gain. Internal Revenue Code Section 1031 may, depending on circumstances, provide farmers with statutory authority to defer capital gains.

Deferral of Gain using Internal Revenue Code Section 1031, Like-kind Exchange

IRS has ruled (Notice 2002-67) that peanut quota is an interest in land. However, in this notice, IRS offers no guidance as to whether peanut quota could qualify for a like-kind exchange. Peanut quota is similar to development rights which can be exchanged for other interest in land including fee simple interests under the like-kind exchange rules. IRS letter rulings: 9851039, 9232030, and 9215049 have given taxpayers approval for the exchange of development rights of property for fee simple interests in other real estate. Likewise, a scenic conservation easement (a property right) can be exchanged for a fee interest in land. (IRS Letter Ruling 9621012).

Therefore, following the logic of these four letter rulings, peanut quota can be exchanged for land in a like-kind exchange, if all the rules are followed.

1. A qualified intermediary or escrow agent must hold the money paid for the relinquished property until it is used to purchase the replacement property. The seller must never have legal right or access to the money; and
2. Strict time limits must be met:
   a. The property to be acquired in the exchange must be identified within 45 days of the beginning of the transaction.
   b. The property to be acquired in the exchange must be closed 180 days from the beginning of the transaction (or by the due date of the return for the tax year in which the trade occurs). **Caution:** Taxpayers should consider professional assistance to ensure compliance with the complex tax and exchange rules.

Section 1309(e) of Farm Bill 2002 states that section 8(g) of the Soil Conservation and Domestic Allotment Act (SCDA) apply to assignments of payments.

"Payment that may be made to a producer under this section may be assigned only in accordance with regulations issued by the Secretary. This subsection shall not authorize any suit against or impose any liability on the Secretary, any disbursing agent, or any agency of the United States if payment is made to the producer without regard to the existence of any such assignment." [16 U.S.C. §590h(g)]

If the farmer can arrange for the payment of peanut quota to be assigned to a qualified intermediary or a qualified escrow agent such that the farmer does not have "constructive receipt," then the buyout may qualify for a like-kind exchange. FSA Form CCC-36 can be used to assign the peanut quota buyout.

Example 9. Mary Johnson will receive $100,000 for peanut quota she owns under the provisions of the peanut quota buyout. Mary has determined that she has only a $5,000 basis in the quota. Mary also plans to buy a neighboring farm for $100,000. Mary is interested in deferring the $95,000 gain on her quota buyout.

Question 15. Can Mary defer her gain using like-kind exchange?

Answer 15. The peanut quota is an interest in land and has been used in Mary's farming business during past years to allow for the marketing of produced peanuts. By following the like-kind exchange rules, Mary can defer recognizing gain (paying tax) on the peanut quota buyout.

Question 16. What property qualifies as like-kind under Internal Revenue Code Section §1031?

Answer 16. Since the peanut quota is an interest in real property, the acquired property must also be real property or an interest in real property. It could be held for use in a business (such as farmland) or held for investment. The acquired property cannot be personal property such as farm machinery.

Caution: If IRS takes the position that the deemed sale of peanut quota occurred on May 13th, 2002, the day the 2002 Farm Bill was signed, then the 45 day identification requirement could not be met.

Question 17. Can Mary disagree with IRS? Would she be subject to penalties?

Answer 17. If Mary believes the sale occurred on the day she received payment from FSA; she can defer gain on the peanut quota by purchasing replacement property and meeting the above requirements. If Mary also attaches Form 8275, Disclosure Statement, that fully discloses all the facts of the transaction to IRS and Mary's legal basis for his position, neither Mary nor her tax preparer would be subject to penalties. If Mary is later audited and looses, she will owe only the tax and interest. (Currently the IRS interest rate for underpayment of tax is 6%).

Deferral of Gain Using Internal Revenue Code Section §1033: Involuntary Conversion

Under the 2002 Farm Bill language, it clearly states that the quota buyout is for the "...loss of value of the quota on account of the repeal of the marketing quota program for peanuts..." [Farm Bill 2002 § 1309(b)(1)]. Since peanut quota is an interest in land and farmers who are quota holders had no individual control over the actions of Congress in writing Farm Bill 2002, it could be argued that quota buyout is an involuntary conversion of an interest in land. However, IRS has ruled that <u>peanut quota payments do not qualify for involuntary conversion</u>. Condemnation of property that will be used as a public good (Example: farmland condemned for a public highway) can qualify as an involuntary conversion. But, since peanut quota is not a public good, involuntary conversion tax treatment is not allowed.

Conclusion and Summary

The peanut quota buyout under Farm Bill 2002 provides opportunities and pitfalls to owners of peanut quota. Quota owners must establish their basis in the quota to calculate the gain or loss realized from the buyout. IRS has ruled that peanut quota is considered a capital asset eligible for favorable capital gain treatment and is not subject to self-employment tax. Farmers have a choice to receive the payment, 55 cents per pound, as a lump sum this year or in equal payments over 5 years. If the payments are spread over 5 years a portion of the payment must be treated as unstated interest taxed at ordinary income rates. The IRS ruling specifically prohibits treating the peanut quota buyout as an involuntary conversion, but is silent as to whether like-kind exchange treatment is allowed.

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