

Tax Consequences of Gold Kist Conversion

Members of Gold Kist meet in September to vote whether to convert the farm cooperative to a publicly traded corporation. The conversion would have major income tax consequences for its equity holders. The following summarizes the tax treatment of the conversion to current and former members of Gold Kist Cooperative. The full opinion, as prepared by Alston & Bird LLP and filed with the Securities Exchange Commission, can be found on the web at sec.gov. This information is included in a disclosure statement-prospectus provided to each member. A brief background of Gold Kist's actions and patronage dividends is given first, and some suggested action points follow.

Background

Farmers who purchase supplies or sell products through a cooperative may receive income in the form of patronage dividends. If at least 20% of the income is issued by check, the remainder may be retained by the cooperative as a qualified written notice of allocation. The entire amount is reported to the farmer on Form 1099-PATR. The farmer reports the income on Schedule F, Lines 5a and 5b.

Some patronage dividends issued by Gold Kist in 1984 and 1987 included qualified written notices of allocation. Since 1988, Gold Kist has issued less than 20% of the income by check. The remainder has been retained as notified nonqualified patronage dividends. Taxpayers are not required to report nonqualified patronage dividends until they are distributed.

Gold Kist's Board of Directors announced in June its desire to convert from a cooperative to a for-profit corporation. Pending approval by its membership, Gold Kist will be merged into a newly formed corporation called Gold Kist Holdings Inc. The conversion not only requires approval by Gold Kist members but the completion of an initial public offering of common stock by Gold Kist Holdings.

In the initial public offering, the corporation expects to offer 18 million shares of the common stock of Gold Kist Holdings. Proceeds from this offering are expected to be used to provide cash to Gold Kist members in connection with the conversion, repay certain indebtedness, and cover general corporate purposes.

Over 16,000 farmers in five states are affected. This includes past and current poultry and swine growers, past pecan and peanut growers, and farmers who purchased supplies from Gold Kist Cooperative stores.

Tax Consequences of Conversion

If Gold Kist converts to a corporation, equity holders will be given cash and stock in exchange for their retained patronage dividends. Equity holders with total patronage equity accounts under \$10,000 will be paid out entirely in cash prior to the conversion. The nonqualified patronage equity will be reported on Form 1099-PATR for 2004 and should be reported on Schedule F, Lines 5a and 5b.

Equity holders with patronage accounts of \$10,000 or more may elect to receive nonqualified patronage equity in cash instead of stock. They may request a percentage or dollar amount of the nonqualified patronage equity. Gold Kist will prorate the amount distributed if equity holders request more cash than is available. The remaining nonqualified patronage equity and all qualified patronage equity will be converted to stock in Gold Kist Holdings Inc. The nonqualified patronage dividends distributed in cash will be reported on Form 1099-PATR for 2004.

Stock received by equity holders in the conversion will not be taxed until it is sold. Gold Kist "intends to qualify as a reorganization pursuant to section 368(a) of the Internal Revenue Code." The conversion of equity to stock would not be taxable. Basis in stock will be zero for nonqualified equity and the actual (face) amount of qualified equity. Separate accounts will be established by New Gold Kist for stock received in exchange for each type of equity. Gain from the sale of stock should be long-term capital gain for the patronage equity held more than one year. Gold Kist is providing all members with a Patronage Equity Report listing the dollar amounts earned by year and whether it is qualified or nonqualified.

Marjolaine A. Butler, IRS Senior Tax Specialist - Taxpayer Education and Communication, makes the following observation: "Assuming the Gold Kist conversion meets federal requirement for a tax-free reorganization, receipt of stock for your retained patronage dividend will not be taxable until the new stock is sold. When the new stock is sold it will be treated as the sale of a capital asset. The gain on the sale of a capital asset has federal tax advantages, but losses on the sale of a capital asset have restrictions on the amount of loss deductible."

Gold Kist expects the initial public offering to generate additional value that will be distributed to members as a "premium." This member interest represents part of the sale of each equity holder's ownership in the company after the conversion. The distribution will be made in cash and stock. Gold Kist expects that any additional stock distributed will be treated as a conversion of equity to stock. Basis of the member interest will be zero.

It is the opinion of Alston and Bird LLP that member interest distributed as cash will be treated as a stock redemption. In most cases it will be considered a qualified dividend. Member interest distributed in cash would qualify as a long-term capital gain if it reduces the individual's total remaining equity in New Gold Kist by more than 80%. For example, an equity holder with \$10,000 converted equity and member interest receives \$2,100 in cash after the conversion. The cash would qualify as a long-term capital gain.

The prospectus points out that the Internal Revenue Service has never addressed the issue of cash received in conversion of a cooperative to a cooperation. The IRS could take the position that all cash received for nonqualified patronage equity would be treated as patronage dividends.

Fractional shares of New Gold Kist stock will be distributed in cash and would be treated as capital gain.

Certain restrictions are placed on members concerning selling New Gold Kist stock. Generally, equity holders may sell up to 50% of stock received for patronage equity nine months after conversion. They are free from restrictions one year after the conversion. Gold Kist may elect to make another stock offering as early as six months after conversion. Members may be invited to participate in the sale by including up to 50% of their stock offering.

Action Points

- Instruct clients in completing Form W-9 to avoid backup withholding. Gold Kist should receive Form W-9 by **September 15, 2004**.
- Consider meeting with clients to estimate the tax consequences of electing to receive cash for nonqualified patronage equity. Gold Kist should receive Requests for Redemption of nonqualified patronage equity by **September 15, 2004**.

A typical broiler operation with four broiler houses could have \$300,000 or more nonqualified equity built up since 1988. Receiving 20% in cash will likely push the taxpayer into the next tax bracket.

Consider the average broiler operation participating in Alabama's Farm Analysis program for example. The average farm has a four-house broiler operation, beef cattle, and some custom work income. There is about \$46,000 in off-farm income with taxes withheld. The family has one child under 17 and they use the standard deduction.

State, Federal, and self-employment taxes would be about \$4,800 if this farmer elected to receive no cash. The farm is in the 15% Federal tax bracket. Electing to receive up to \$12,000 cash keeps the farm in this bracket and total taxes increase to \$8,690.

Electing to receive between \$12,000 and \$76,250 in cash moves the taxpayer to the 25% tax bracket. Total taxes would be about \$35,250 on \$76,250 in cash. The additional taxes would require 40% of the cash received.

Section 179 expensing, bonus depreciation, income tax averaging, and other tax strategies may be used on an individual basis to reduce or eliminate the tax consequences of receiving cash.

- Calculate the stock price that would equal net cash received if the equity was taken in cash. What stock price would yield the same net amount as cash?

Assume the farmer illustrated above elects to receive \$60,000 in cash. The tax liability takes 40% of the cash received, leaving the farmer with \$35,894. Electing to take the \$60,000 as stock and selling it for \$49,050 yields the same net after-tax amount of cash. Gold Kist estimates the initial stock price will be about \$15 per share. In this example, the farmer could sell his stock for 80% of the initial stock price, or \$12 per share, and still net the same amount. This assumes the stock qualifies for the 15% long-term capital gains rate.

- Determine whether estimated state and federal tax payments are required.
- Help the farmer consider other factors. How will the cash be used - for capital improvements, debt repayment, operating expenses, family living? What are the prospects for the new stock? The conversion initially restricts the timing of stock sales. No consideration of the time value of money has been given in these examples.

The tax consequences of conversion to Gold Kist grower/members is a complicated issue, and tax liability will differ for each Gold Kist member. Gold Kist's board of directors recommends that each member seek guidance from a tax professional. Tax preparers have the opportunity to counsel clients in making informed decisions and tax management strategies. By estimating tax liability now, members can make plans to reduce their overall tax burden.

The preceding summary is intended for educational purposes only. Consult your tax advisor.
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