

Tax Issues of Peanut Quota Buyout

Guido van der Hoeven, Extension Specialist
Department of Agricultural and Resource Economics
NC State University
919.515.9071
email: guido_vdh@ncsu.edu
and
Philip E. Harris, Professor
Department of Agricultural and Applied Economics
University of Wisconsin-Madison

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Introduction

There have been various government programs to assist farming taxpayers since the 1930's. 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" or have purchased peanut quota from individuals who no longer needed or wanted quota.

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. This buyout of peanut quota raises several income tax issues.

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, TC Memo 1991-166, I.R.C. §167, I.R.C. §197(e)(2)] For purchases after August 10, 1993 I.R.C. §197 was amended to provide a statutory life for certain intangibles. [Omnibus Reconciliation Act of 1993]

There was confusion in 1993 as to whether peanut quota and tobacco quota qualified for a 15-year amortizable life as an intangible capital asset. This confusion resulted because the United States Department of Agriculture (USDA) issued the quota, and I.R.C. § 197 specifically states that "a license, permit, or other right granted by a government unit" is a §197 asset that qualifies for 15 year amortization. In 1996, IRS clearly stated that peanut and tobacco quotas are interests in land and therefore, cannot be amortized under I.R.C. §197. [Rev. Rul. 66-58, IRS Memorandum from Paul Kugler, Assistant Chief Counsel, Nov. 12, 1996]

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 like eminent domain and forfeiture pools). 7 CFR §719.2 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. [See *McClung v. Thompson*, 401 F.2d 253 (CA-8, 1968); *Bryant v. Peckinpaugh*, 400 S.E. 2d 201 (VA, 1991); and *Combustion Engineering, Inc. v. Morris*, 271 S.E. 2d 813 (GA, 1980.)

Since it is an interest in land, peanut quota is real property used in the trade or business. Consequently, it is I.R.C. §1231 property if it is held for more than a year [I.R.C. §1231(b)(1)]. That means gains and losses from the peanut quota buyout are netted with other I.R.C. §1231 gains and losses. If the result is a net I.R.C. §1231 gain, that gain is treated as long-term capital gain. If the result is a net I.R.C. §1231 loss, that loss is treated as an ordinary loss.

IRS Position

On October 1, 2002, the IRS issued Notice 2002-67, in which it discussed the income and self-employment tax consequences of the peanut quota buyout. The Notice makes the following points.

- a. The peanut quota is an I.R.C. §1231 asset if the owner meets the purpose and holding period requirements of I.R.C. §1231
- b. The buyout payment is not self-employment income
- c. The owner of the quota can use the installment method to report gain from the buyout if the payments are received in more than one tax year
- d. The gain or loss resulting from the buyout does not qualify for farm income averaging
- e. The payments are subject to information reporting
- f. The buyout is non an involuntary conversion (See discussion below for an argument that the buyout is an involuntary conversion)

The Notice does not discuss whether the buyout will qualify for a like-kind exchange under I.R.C. §1031 as discussed below.

Determination of Basis in Peanut Quota

Taxpayers must determine the basis or adjusted basis of the peanut quota to calculate their gain or loss from the quota buyout.

Peanut quotas are measured in pounds and are sold in large quantities or “lots”. The Secretary of Agriculture announces annually the national quota for peanut production. The Secretary uses a formula to make the annual quota calculation. The quota can increase, decrease or remain unchanged from the previous year. For taxpayers, their quota amount may likewise change. Typically peanut producers speak in terms of “owning so many pounds of quota”. This is something of a misnomer. These quota owners own “lots” of quota.

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 fair market value of the peanut quota and the land. 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 from Purchase of Quota

Taxpayers who have purchased quota should have a relatively simple task in determining the basis of that quota. Generally basis will be what the taxpayer paid for the quota "lot". The cost basis is reduced by subsequent deductions, such as amortization of quota purchased after August 10, 1993.

Example 1. *P. Nutt Butter 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 P. Nutt bought?

Answer 1. \$2,500 is the cost basis of the quota. P. Nutt 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 P. Nutt's quota change?

Answer 2. No. For the quota "lot" that P. Nutt 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 P. Nutt's quota?

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

Basis of Peanut Quota Received as an Inheritance

Taxpayers 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 date of death of the decedent (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. [I.R.C. §1223(11)]

Example 2. *Roasted Nutt inherited land and peanut quota attached to that land from his father when his father died. The land was valued in the estate at \$50,000 and the quota was valued at \$3,000.*

Question 4. What is Roasted'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

Taxpayers 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 remaining basis of the asset to calculate gain, but not loss.

Example 3. *Roasted Nutt, from Example 2, receives the farm and peanut quota as a gift from his father Oily. When Oily 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. Oily did not owe any gift taxes.*

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

Answer 5. Roasted has a carryover basis from Oily, which is \$1,500. Roasted should make a note of this basis in his permanent farm records.

Adjusted Basis of Peanut Quota

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

Question 6. What is Spanish'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 Buyback

Under Farm Bill 2002, taxpayers who are quota owners of peanut quota will receive payment for the quota that is being bought out. The payment may be received as a lump-sum payment of \$0.55 per pound or \$0.11 per pound over 5 years [The Farm Security and Rural Investment Act of 2002 §1309(c)(1) &(2)]. In order to make management decisions relative to their business, taxpayer'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 taxpayers can choose to receive payment for quota in lump-sum or installment over 5 years they should calculate the tax consequence of each before choosing.

Example 5. *Spanish 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. The basis of this quota has been determined to be \$45,000. Spanish is in the 27% federal income tax bracket and is also subject to a state income tax rate of 6%. Spanish elects to take a lump-sum payment.*

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

Answer 7. Yes. The quota is to be bought at \$0.55 per pound; the basis is \$0.45 per pound so Spanish will recognize \$0.10 per pound gain or \$10,000 total gain.

Question 8. How will Spanish report the gain?

Answer 8. Spanish will report the gain on Part I of Form 4797. If Spanish has a net I.R.C. §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 \$2,000 (\$10,000 x 20%) and the state tax will be \$600, assuming 6% state income rate.

Example 6. *Spanish 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 6% 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 Spanish will receive as a result in making this decision?

Answer 9. Since Spanish 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 by \$1,000 (or \$1,200).

Question 10. Should Spanish consider taking the lump sum even if it causes him to pay a higher tax?

Answer 10. Yes. Spanish should consider the time-value-of money of receiving the lump-sum payment versus the installment sale.

Question 11. If Spanish 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 11. 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.[I.R.C. § 453(i)]

Note:

Under I.R.C. § 453(b)(1) installment sales are defined as a disposition of property where at least one payment is received after the close of the taxpayers' 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.

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 7. *Mixed Nutt inherited a farm from his great-uncle Wahl Nutt with a 10,000-pound peanut quota attached. Wahl'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 Mixed's basis. Since that time, the peanut quota has been reduced by 10%. Mixed held 9,000 pounds of quota in 2001. Mixed elects to receive a lump-sum payment, for his peanut quota, as allowed under the buyout provisions of Farm Bill 2002.*

Question 12. What is the taxable consequence of the quota buyout to Mixed?

Answer 12. Mixed's basis in his peanut quota is \$5,000. He will receive \$4,950 as a lump-sum payment. Therefore, Mixed will have a loss of \$50. Since the quota is an I.R.C. §1231 asset, he reports the loss on Part I of Form 4797. If he has a net I.R.C. §1231 loss, the loss will offset ordinary income.

Note.

Quota owners who rent out their quota, are in the trade or business of renting. Therefore, their gains or losses are also I.R.C. §1231 gains or losses, not I.R.C. §1221.

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 capital gains don't exist, ordinary income is offset.

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. I.R.C. §1031 or §1033 may (depending on circumstances) provide taxpayers with statutory authority to defer gain.

Deferral of gain using I.R.C. §1031: Like-kind exchange

Taxpayers can argue that peanut quota is an interest in land that qualifies for the like-kind exchange rules of I.R.C. §1231.

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 under the I.R.C. §1031, like-kind exchange, if all the rules are followed.

There are two primary rules that must be followed:

1. The money paid for the relinquished property must be held by a qualified intermediary until it is used to purchase the replacement property, 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, [I.R.C. §1031(a)(3)(A)]
 - 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). [I.R.C. § 1031(a)(3)(b)(I)d(ii)].

Note:

Tax practitioners and their clients should follow closely the rules for like-kind exchange as found in I.R.C. § 1031. Further, Rev. Proc. 2000-37 allows for the “reverse like-kind exchange”.

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 (see quote from USC below as referenced in section 8 of SCDA).

“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 taxpayer can arrange for the payment of peanut quota to be assigned to a qualified intermediary in a qualified escrow account such that the taxpayer does not have “constructive receipt”, then the buy-out may qualify for a like-kind exchange.

Example 8. *Cash U. Nutt will receive \$100,000 for peanut quota he owns under the provisions of the peanut quota buyout. Cash has determined that he has only \$5,000 basis in the quota. Cash also plans to buy a neighboring farm for \$100,000. Cash is interested in deferring the \$95,000 gain on his quota buyout.*

Question 13. Can Cash defer his gain using a §1031, like kind exchange?

Answer 13. The peanut quota is an interest in land and has been used in Cash’s farming business during past years to allow for the marketing of produced peanuts. The buyout, as stated in the Farm Bill 2002, is to compensate for the loss of value of the quota. Cash must construct the like-kind exchange following the codified rules found in I.R.C. §1031. By using a §1031 like-kind exchange Cash defers recognizing the gain on the peanut quota.

Question 14. What property qualifies as like-kind under I.R.C. §1031?

Answer 14. 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 held for use in a business (such as farmland) or held for investment. The acquired property cannot be personal property such as farm machinery.

Deferral of Gain Using I.R.C. §1033: Involuntary Conversion

I.R.C. §1033, allows taxpayers to defer gain realized on an involuntary conversion of property if the property is replaced with property that is like-kind. The replacement property must be acquired within three years (for real property) following the close of the tax year in which the conversion occurred. [I.R.C. §1033(g)4]. This extended length time period (as compared to I.R.C. §1031) may help taxpayers who want to defer gain on a conversion but are unable to acquire the replacement property in the short time frame.

Like-kind property is defined under I.R.C. §1033 as "...property held for productive use in trade or business or for investment...compulsorily or involuntarily converted, property is like is of like kind to be held either for productive use in trade or business or for investment...shall be treated as property similar or related in service or use to the property so converted." [I.R.C. §1033(g)(1)]

Since peanut quota is an interest in land and taxpayers who are quota holders had no individual control over the actions of Congress in writing Farm Bill 2002, the quota buyout is an involuntary conversion of an interest in land. Taxpayers, therefore, have three years under I.R.C. §1033 to acquire replacement property and defer any gain recognized by the peanut quota buyout. Quota holders, then, could purchase farmland or additional newly established peanut base to defer the gain, if any, realized from the peanut quota buy out.

Example 9. *Mack A. Daymia under Farm Bill 2002 will receive \$100,000 for his peanut quota. Mack is unable to determine basis in his quota, therefore is facing 100% gain. Mack is unable to locate farmland that he will be able to purchase within 180 days. Mack wants to defer the gain that is triggered by the quota buyout.*

Question 15. Can Mack use I.R.C. §1033 to defer gain on the quota that is being bought out?

Answer 15. Yes, Mack can use I.R.C. §1033 to defer his gain for up to three years following the close of the tax year in which the buyout takes place. Mack must replace the quota with other property similar or related in service or use for the purposes of §1033. Farmland will qualify for this purpose.

Question 16. If Mack is unable to purchase land in the required time period, what must he do?

Answer 16. Mack must amend his tax return for the year of the buyout and recognize the gain and pay the additional tax with interest.

Question 17. Could Mack buy timberland for investment purposes instead of farmland to defer the gain from the quota buyout?

Answer 17. Under a very liberal interpretation of I.R.C. §1033(g)(1) an interest in land held for the purpose of trade or business (farming) might be exchanged for real estate held for investment (timberland) purposes.

Note:

Under review, IRS most likely would disallow the position that farmland and timberland would qualify for exchange under I.R.C. §1033.

Question 18. Can Mack use the proceeds from the peanut **quota buyout and purchase a rental duplex and qualify under I.R.C. §1033 to defer the gain?**

Answer 18. No. The quota and the rental duplex are not like-kind property for the purposes of I.R.C. §1033. Mack cannot grow agricultural products in a rental duplex, thus there is no farming trade or business.

Note:

Quota buyout proceeds exchanged for a rental business property would work under I.R.C. §1031 like-kind exchange rules, but as illustrated above will not work under I.R.C. §1033. The definition for “like-kind” and property similar or related in service or use is narrower for I.R.C. §1033.

Conclusion and Summary

The peanut quota buyout under Farm Bill 2002 provides opportunity and pitfalls to owners of peanut quota. The owner of the quota must establish his or her basis in the quota to calculate the gain or loss realized from the buyout. Taxpayers can arguably elect to defer the realized gain by using either I.R.C. §1031 or I.R.C. §1033. Under I.R.C. § 1033 taxpayers have more time to acquire replacement property for the peanut quota.

Disclaimer:

Information provided is for educational purposes only: nothing herein constitutes the provision of legal advice or accounting services. Taxpayers should contact their tax practitioner relative to their circumstances in regards to these issues. The above discussion is based on information currently available. IRS rulings and regulations in the future may change the applications described.