

Tax Reporting of Buyout Payments for Amortized Tobacco Quota

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Questions are being raised regarding the tax reporting of buyout payments received in 2005 of tobacco quota that was amortized or depreciated following purchase in the past. Amortization or depreciation of tobacco quota was done in error as tobacco quota is an interest in land (IRS Notice 2005-57); land is never depreciated or amortized.

However, some former tobacco quota owners did amortize or depreciate purchased quota. The tax treatment of the buyout receipts that relate to these specific pounds will mean that the amortization must be recaptured and taxed at ordinary income tax rates not capital gains rates. IRS Notice 2005-57 discusses this circumstance on pages 4 and 5 of the notice.

Example: In the 1980's and 1990's Dusty Furrow purchased \$200,000 of tobacco quota for use in his farming business. Dusty, wanting a near-term tax benefit, amortized (in error) his purchases (quota purchases should have been allocated to a capital account). In 2005, the year of the first payment of the tobacco quota buyout, Dusty's cost basis of his quota was zero. Dusty had 85,000 pounds of quota that was bought out. His total buyout is \$595,000 (85,000 x \$7.00) payable in ten equal installments.

Question 1. How does Dusty report the buyout payments that will be paid in ten equal installments?

Answer 1. Dusty will report \$200,000 of amortization recapture on Form 4797 Part III. The recapture will be taxed at ordinary income tax rates, not capital gains. This is true if Dusty takes his buyout payments as installments. He must realize and recognize the tax on the entire \$200,000 regardless if he receives only the first payment (1/10th of the total buyout).

Question 2. How might this requirement affect the balance (\$395,000) Dusty is to receive?

Answer 2. The balance, \$395,000, will be treated as a capital gain. Tax reporting will become more complicated because of the incorrect amortization taken in prior years. Since Dusty chose to take his payments as installments, he must report the installment sale on Form 6252. To correctly calculate the capital gains, Dusty must account for imputed or unstated interest as a reduction of capital gains (see discussion in *Tobacco Quota Buyout Tax Considerations*). Once the calculation of the capital gains is made and the gross profit percentage determined, each subsequent payment is multiplied by the gross profit percentage to determine the payment's capital gain. The annual installment's capital gain or loss then flows to the Part I of Form 4797 and becomes part of the calculation of IRC § 1231 gains or losses. If a net gain results then the capital gains portion of the installment sale will flow to Schedule D. If a loss was triggered, it is treated as an ordinary loss not subject to the capital loss rules since Dusty used the tobacco quota in his farming business.