

2004 Tobacco Quota Buyout and Potential Tax Consequences and Planning Opportunities

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The 108th Congress passed H.R. 4520, The American Jobs Creation Act of 2004, on October 11, 2004 when the Senate followed the House in passing the bill. This Act includes the tobacco buyout for tobacco quota holders and payments to producers of leaf tobacco. Therefore, once the President signs the legislation, the tobacco buyout is a reality, owners of tobacco quota need to be aware of the various tax consequences that will affect recipients of buyout dollars.

With the tobacco quota buyout a reality, tax consequences that will affect taxpayers (quota owners and growers) in the tobacco industry include: income, self-employment (social security), and capital gains taxes. The taxpayer's relationship to the quota will determine the tax consequence the taxpayer will face. This paper attempts to explain tax issues that may affect taxpayers owning and renting tobacco quota. Further, this paper proposes actions that may be taken by taxpayers to minimize or defer the tax burden that may occur. First, taxpayers must have an understanding of what kind of asset tobacco quota is for tax purposes.

Tobacco quota for tax purposes

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 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 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]

Tobacco 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." Tobacco 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 tobacco 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, tobacco 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 tobacco 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 relative to Peanuts: A lesson for Tobacco

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 (to quota owners) 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, and
- f. The buyout is not an involuntary conversion.

The author believes that IRS will follow the precedent set above relative to the tobacco quota buyout (in a personal conversation with IRS personnel October 14, 2004 this seems to be the case).

Tax Issues of Tobacco Quota Buyout

As the tobacco quota buyout is now reality, taxpayers will need to determine the tax consequence that is pertinent to their relationship to the quota. That relationship is as owner or lessee of tobacco quota. Lessee issues will be discussed first.

LESSEE TAX ISSUES

As a lessee, the taxpayer does not own tobacco quota, but has the right to produce and market tobacco since tobacco quota is rented. Since the quota buyout passed, there are provisions for lessees to receive a payment for the loss of this right to market and grow tobacco. This payment [\$3.00 per pound, H.R. 4520 Sec. 623(d)(1)(A)] is a replacement of tobacco income and will be subject to income tax as well as self-employment tax. This is consistent to the treatment of Phase 2 payments under the General Tobacco Settlement of several years ago.

Example 1. *Dusty Leif rents 10,000 pounds of tobacco quota from his widowed neighbor, Ima Lone. Under the current proposal, as enacted, Dusty will receive \$30,000 in total from the tobacco quota buyout. This income is subject to income tax (federal and state) and self-employment tax. Assuming that Dusty is in the 25% federal income tax bracket, 7% state income tax bracket, and 15.3% for self-employment tax; Dusty will pay*

47.3 percent of his payment in tax over the period of time payments (ten years) are received or \$14,190 in total. Dusty's payments are not treated as capital gains since he does not own the quota and materially and actively participates in the production of tobacco. These tobacco quota payments will be reported on Dusty's Schedule F (Form 1040).

TOBACCO QUOTA OWNER TAX ISSUES

Tobacco quota owners must determine the basis or adjusted basis of the tobacco quota in order to calculate their gain or loss for federal and state tax purposes should a tobacco quota buyout occur.

Tobacco quotas are measured in pounds and are sold in large quantities or "lots". The Secretary of Agriculture announces annually the national quota for tobacco 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 tobacco producers speak in terms of owning so many "pounds" of quota. This is something of a misnomer. These quota owners own "lots" of quota.

There are generally three ways an individual can acquire tobacco quota and basis in the quota. Those ways are: by **purchase**, by **inheritance** or by **gift**. Basis may also be "adjusted" if there has been a change to the basis value, for example, by amortization of quota basis.

What is the basis of quota acquired by PURCHASE?

Quota owners who have purchased quota should have a relatively simple task in determining the basis of that quota. Generally, basis will be what the quota owner paid for the quota "lot" ("lot" means total pounds involved in the particular purchase).

Example 2. Leif Brown purchased 5,000 pounds of tobacco quota from his maiden aunt in 1997 for \$2.00 per pound.

Question. What is the basis of the quota Leif bought?

Answer. \$10,000 is the cost basis of the quota. Leif should retain a record of this purchase in his permanent farm records.

Question. If the Secretary of Agriculture changes the national tobacco quota, does the basis of Leif's quota change?

Answer. No. For the quota "lot" that Leif bought from his aunt, the basis does not change; it remains \$10,000. However, the basis per pound in the "lot" will change as quota increases or decreases.

Question. If quota has gone down 50% (2500 pounds) since 1997, what is the basis per pound of Leif's quota?

Answer. Leif's basis in the "lot" remains \$10,000, however, the basis per pound is now \$4.00 (\$10,000/2500 pounds) an increase of \$2.00 per pound. Leif still paid \$10,000 for the original "lot" therefore, it does not change.

What is the basis of quota acquired by INHERITANCE?

Quota owners 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 tobacco quota, that are inherited qualify for long-term capital gain (loss) treatment for income tax purposes. [I.R.C. §1223(11)]

Example 3. *Sam Jones inherited land and 7,500 pounds of tobacco 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 \$15,000.*

Question. What is Sam's basis in tobacco quota he inherited from his father's estate?

Answer. The basis is \$15,000 for the "lot" of quota (\$2.00 per pound) and is deemed to have a "long-term" holding period.

Question. What if the land and quota was inherited but the quota was not valued as a separate asset. What is the basis of the quota?

Answer. The quota owner needs to make an allocation for the value of the quota. Example 4, below, illustrates how this allocation might be made. In this case, the year of the death is important to look to, as assets are allowed to be "stepped up" to fair market value on the date of death. A similar method is used to calculate the basis as described in the discussion of Example 6.

What is the basis of quota acquired by GIFT?

Quota owners who receive assets, such as tobacco 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.

Example 4. *Sam Jones, from Example 3, receives the farm and tobacco quota as a gift from his father Bill. When Bill purchased the land and quota, he allocated \$20,000 of the \$23,600 purchase price to the land and \$3,600 of the purchase price to the tobacco quota. Bill did not owe any gift taxes.*

Question. What is Sam's basis in the tobacco quota?

Answer. Sam has a carryover basis from Bill, which is \$3,600. Sam should make a note of this basis in his permanent farm records.

If Quota has been amortized, for example, what is the ADJUSTED BASIS?

If quota owners have incorrectly taken amortization deductions for the tobacco 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 5. *Bob Smith bought tobacco quota in January of 1994 for \$10,000. Bob amortized his quota for one year due to the confusion surrounding the intangible life issue when Congress created the 15-year life for intangible assets. Bob deducted \$333*

of amortization on his 1994 tax return. In 1995, Bob stopped taking the amortization expense for tobacco quota.

Question. What is Bob's basis in his tobacco quota?

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

What is quota basis if there are NO RECORDS?

If quota owners do not have records, but acquired the quota from other than the US Government when it was originally assigned (1938), how then is basis determined? Quota owners **may be** able to allocate a value to basis from historical records. These records might come from permanent farm records, but where allocation to quota was not made at the time of purchase. Historical records might be obtained from the county appraiser's office, real estate transaction records for a county, or from research sources such as USDA, NCDA or Extension Service.

Quota owners attempting to calculate a basis value without actual data must remember the three general methods of acquiring basis and **NOT** simply pick a number. A **good faith effort** on the part of the quota holder must be made. If an historical data set is available, quota holders may be able to **extrapolate** a value of tobacco quota many years after the quota was acquired.

See the list below for sources providing historical data that may help in the calculation of basis.

Example 6. *Dyrt Clodd bought a 100 acre farm in 1976 in Aggie County. Dyrt paid \$1,850 per acre for the land and attached quota for a total of \$185,000. Quota attached was 800 lbs per acre. Unfortunately Dyrt did not make an allocation at the time of purchase between the land and the quota. Dyrt may receive a buyout of his tobacco quota; Dyrt wants to determine his basis for income tax planning and future possible tax reporting.*

Question. How can Dyrt determine his basis in his tobacco quota 28 years after the purchase of the farm?

Answer. Dyrt knows what was paid for the land, \$1,850 per acre. If research indicates that in 1976 the value of tobacco quota was \$800 per acre (\$1.00 per pound) he may be able to defend a basis allocation of \$80,000 (\$800 per acre x 100 acres) since he in fact purchased land in 1976 and historical records support the \$1.00 per pound quota value.

Question. Where did Dyrt get the historical data?

Answer. Dyrt obtained the data from his county appraiser's office at the Aggie county seat. The office had historical records of land with and land without tobacco quota. If the appraiser's office does not have records then other information sources as listed below might also provide similar data for a basis calculation.

<p>Caution: Quota holders must apply a good faith effort in determining the basis of tobacco quota when records for the farm are missing. When using third party historical data to calculate basis of tobacco quota erring on the side of conservatism is prudent.</p>
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Sources that may provide data:

Farm Real Estate Values in the United States by County 1850 – 1982. USDA, ERS Statistical Bulletin 751, Published March 1987.
County Appraisers Office of Local County
Historical records from Real Estate agencies

Once taxpayers, who are quota owners, have determined their bases in the tobacco quota tax planning may begin. The remainder of this paper investigates tax issues relative to tobacco quota owners and possible outcomes as decisions are made by taxpayers.

As discussed above, tobacco quota is an interest in land and therefore an I.R.C. §1231 asset held in the trade or business of tobacco farming or renting of tobacco quota. Reportedly, there are 76,000 tobacco quota holders in North Carolina and several thousands more in other states; and they are interested in the possible tax outcomes of a tobacco buyout. Buyout payments are to be made over 10 years at \$0.70 per pound per year based on 2002 quota amounts. [H.R. 4520 Sec. 622 (e)(1)(A) and (B)]

Example 7. Heeza Holder owns 25,000 pounds of tobacco quota. Under the legislation, Heeza would receive \$175,000 (25,000 lbs x \$7/lb). Assuming that Heeza's income tax bracket is 25%, state income tax bracket is 7% his tax liability is calculated as follows.

Tobacco quota, being an I.R.C. §1231 asset, is treated as a capital gain item; therefore, maximum federal tax is the capital gains rate of 15%. Heeza has determined that his basis in the quota is \$30,000. Therefore, total gain on the buyout payments is \$145,000. Total tax paid over the ten year payout period amounts to \$31,900 in total or \$3,190 per year (\$145,000 x 22%, this amount pro-rated over 10 years).

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

Taxpayers can argue that tobacco quota is an interest in land that qualifies for the like-kind exchange rules of I.R.C. §1031. Tobacco quota is similar to development rights, which can be exchanged for other interests 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, tobacco 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 tobacco 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. *Golden Leif will receive \$100,000 for tobacco quota he owns under the provisions of the tobacco quota buyout. Golden has determined that he has only \$5,000 basis in the quota. Golden also plans to buy a neighboring farm for \$100,000. Golden is interested in deferring the \$95,000 gain on his quota buyout.*

Question 1. Can Golden defer his gain using a §1031 like-kind exchange?

Answer 1. The tobacco quota is an interest in land and has been used in Golden’s farming business during past years to allow for the marketing of produced tobaccos. The buyout, as stated in the H.R. 4520, is to compensate for the loss of value of the quota. Golden must construct the like-kind exchange following the codified rules found in I.R.C. §1031. By using a §1031 like-kind exchange Golden defers recognizing the gain on the tobacco quota.

Question 2. What property qualifies as like-kind under I.R.C. §1031?

Answer 2. Since the tobacco 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.

<p>Note: Practitioners and their clients should consult with knowledgeable advisors before entering in such an arrangement to learn about the tax benefits accruing to the taxpayer’s specific situation.</p>
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Disclaimer:

Information provided is for educational purposes only: nothing herein constitutes the provision of legal advice or accounting services. Quota owners should contact their tax practitioner relative to their circumstances in regards to these issues. IRS may issue rules and regulations providing guidance with regard to the tobacco quota buyout.