

INCOME TAX IMPLICATIONS OF THE PEANUT QUOTA “BUYOUT”

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Introduction

Peanut marketing “quotas” are considered by the Internal Revenue Service to be an “interest in land.” As such, the cost or other basis of peanut quota is not generally recoverable through amortization, depreciation, or expense in the year of acquisition, but instead, must be held in an asset account until the quota is disposed of.

The Farm Security and Rural Investment Act of 2002 (2002 Farm Bill) contains provisions which dramatically change U. S. policy toward domestic production and marketing of peanuts. As a part of this new legislation, peanut quota holders are to be paid 55 cents per pound for each pound of quota held. The language of the legislation states plainly that the payment is “...for the lost value of quota...,” rather than for income lost due to the elimination of the quota program. It is clear from this language that Congress’s intent is for the Farm Service Agency of the United States Department of Agriculture to “buy back” peanut marketing quota.

Basis

Since the “buy back” amounts to the disposition of an asset, either one used in a trade or business (if held by a producer) or one held for investment or the production of income (if held by a non-producer) it is essential for quota holders to know their cost or other basis in the peanut quota pounds. Any taxable gain or loss resulting from the elimination of the quota in exchange for the 55 cents per pound payment will be determined by comparing the payment received to the quota owner’s basis.

For income tax reporting purposes, basis is the “book” value of an asset in the hands of its current owner. An individual receives basis in an asset in an asset in one of three ways; by purchase, by gift during lifetime of the giver, or by testamentary gift through transfer from a decedent’s estate.

Purchase

Peanut production quotas have generally been purchased by the pound, but the purchases have generally been in large quantities or “blocks.” It has been virtually impossible to purchase one pound of peanut quota. In the view of the Internal Revenue Service, basis in purchased peanut quota is considered to be the total amount expended to secure the “block” acquired.

Gift

A recipient’s basis in property received by gift is generally the basis of the property when it was

in the hands of the donor. Unlike property received from the estate of a decedent, there is no “step up” of basis to current fair market value. The only exception to this rule is when the fair market value of the property gifted is **less** than the donor’s basis. In this situation, the recipient’s basis is the property’s fair market value at the time of transfer, and the donor is not permitted any loss. Instead, the difference between the donor’s basis and the fair market value at the time of the gift is carried forward, and when the property is finally disposed of, any gain will be reduced, or any loss increased, by the “loss” disallowed at the time the gift was made.

Testamentary Gift

A recipient’s basis in property received via testament or transfer from a decedent’s estate is given a basis equal to the fair market value of the asset at the time of death. Property received via testamentary gift, other than livestock, is considered to meet the holding period requirement for long-term capital gain tax treatment in the hands of the recipient, regardless of how long it is actually held.

Adjusted Basis

The adjusted basis of an asset is its original basis, plus any subsequent increases, if any, and less any decreases due to permitted cost recovery methods such as amortization, depletion or depreciation. When an asset is disposed of, the initial basis, the adjusted basis and the nature of any basis adjustments must be known to correctly compute the gain or loss, and income tax impact on the disposition. As stated at the beginning of this paper, peanut production quotas are considered by the Internal Revenue Service to be an interest in land, and therefore, are ineligible for any basis adjustment through amortization, depletion or depreciation. Therefore, the **dollar value** of a “block” of peanut quota should not change from the time of acquisition to the time of disposition.

In 1993 and 1994, however, a period of confusion existed when the Internal Revenue Service revised Internal Revenue Code Section 197, which relates to the tax treatment of intangibles. The new Sec. 197, effective August 10, 1993, provided an amortization deduction for specifically defined intangible assets over a 15 year period beginning with the month the asset was acquired. The language of new Code Sec. 197 stated that eligible intangibles included: “a license, permit, or other right granted by a government unit.” Since peanut and tobacco quotas and milk bases were created by a government unit, some parties assumed that such assets acquired on or after August 10, 1993 were eligible for amortization under Sec. 197. In 1995, however, the Internal Revenue Service clarified their position on Code Sec. 197, and restated that peanut and tobacco quotas were interests in land, and therefore, not eligible for amortization under Code Sec. 197. In the mean time, however, some purchases of peanut and tobacco quota were being amortized. In some cases, when this practice was begun on a quota purchase, it was not abandoned, despite the clarification of the Internal Revenue Service position on the issue.

In this case, both the original basis and the adjusted basis will need to be known to correctly compute and tax any gain or loss on the quota “buy back.”

Computing Gain or Loss

To correctly compute the tax gain or loss resulting from the peanut quota “buy back,” the quota holder will need to know his or her initial basis, and if applicable, adjusted basis and the nature of any basis adjustments. In all situations other than those limited cases where quota basis has been amortized following the revision of I.R.C. Sec. 197, the quota holder’s initial basis will be the current basis for gain or loss computation.

In determining the gain or loss resulting from the “buy back,” the dollar basis is the important item of information. If George A. purchased 100,000 of peanut quota in 1996 at a price of 40¢ per pound, his basis in that “block” of quota is \$40,000. If adjustments by the Secretary of Agriculture have subsequently reduced that “block” of quota to 80,000 pounds, his basis in the “block” is still \$40,000, but it is now 50¢ per pound. When George reports the “buyout” of his quota, he will report \$44,000 of sales proceeds (40,000 lbs x 55¢), reduced by \$40,000 basis recovered, leaving \$4,000 of gain. George’s recovery of his \$40,000 basis is not taxed. Since George held the quota for more than one year, his gain is a long-term capital gain, subject to Federal tax at a maximum rate of 20 percent, plus his applicable state income tax rate.

For some quota holders, the 55 cent “buy back” payment will leave them with a loss. Caroline inherited 400,000 pounds of quota when her father died in 1997. The fair market value of the quota at the time of her father’s death was 50 cents per pound, giving her a basis of \$200,000. Subsequent quota reductions have left her holding 320,000 of quota, with her total basis continuing to be \$200,000, but now 62.5¢ per pound. The 55¢ buyout payment will leave her with a long-term capital loss of \$24,000, or 7.5¢ per pound. Caroline has used her quota as a part of her material participation in peanut production, so the quota is considered to be an asset used in a trade or business under Section 1231 asset under the Internal Revenue Code. I.R.C. Sec. 1231 permits gains from the disposition of such assets to be treated as capital gains, while losses are treated as ordinary losses. Under I.R.C. 1231 Caroline will be able to claim the entire \$24,000 loss as an ordinary loss, deductible against any other income on her tax return.

Virginia, Caroline’s sister, also inherited 400,000 pounds of quota in 1997. Virginia is not involved in peanut farming, but has always rented her quota to her sister. Her quota is not considered to be a Sec. 1231 asset, but instead is treated as an I.R.C. Sec. 1221 asset held for investment or for the production of income. Because of this, Virginia’s \$24,000 loss is considered to be a long-term capital loss. Long-term capital losses can only be used to offset long-term capital gain income, except that \$3,000 of long-term capital losses in excess of long-term capital gains may be deducted annually. If Virginia has less than \$21,000 in long-term capital gain income in the year she takes the “buy back” payment, she will have to carry at least some part of her loss forward to the next tax year, for deduction under the same rules. If Virginia’s long-term capital gains are \$12,000, she will be able to deduct \$15,000 (\$12,000 plus \$3,000 excess) of her loss in the current year, and she will be required to carry the remaining \$9,000 loss forward to the next tax year. If in that year she has no long-term capital gain income, she will be permitted to deduct only \$3,000 of long-term capital loss, whether from her loss carryover, or from losses sustained in that tax year, and the balance will again be carried forward.

Al A. Bama purchased 60,000 pounds of peanut quota to use in peanut production in his farm business in January 1994 at a price of 60 cents per pound, giving him an initial basis of \$36,000. Believing that peanut quota was included in the definition of amortizable intangibles under new I.R.C. Sec. 197, he began recovering his basis over 180 months (15 years), beginning in the month of purchase. Through April 2002 his amortization expense was \$20,000, leaving him with an adjusted basis of \$16,000. Quota reductions since the time of his purchase left him with 45,000 of quota at the time of the “buy back,” giving him a payment of \$24,750. Al’s payment will be taxed as follows:

1. Sixteen thousand dollars (\$16,000) will be a non-taxable recovery of his adjusted basis.
2. The remaining \$8,750 will be taxed as ordinary income at the applicable ordinary income tax rate for the year in which he takes his payment. This amount is taxed as ordinary income since it is a recapture of amortization expense, which was treated as ordinary expense at the time it was claimed.

Determining Basis

Knowing your cost or other basis in peanut quota is essential to correct tax reporting of peanut quota “buyout” payments. Determining basis in peanut quota may be a challenge for some quota holders.

It is possible for a few quota holders to have a zero (\$0.00) basis in their quota. This would be the case for a quota holder who was an original recipient of peanut production allotment, which was converted to quota in the 1970's. The peanut production allotment was assigned to farms by USDA, at no cost to the receiving farmers. Thus, some quota holders may have a zero basis, making their entire “buyout” payment a long-term capital gain item of income.

Some quota holders received possession of their quota through inheritance. If the value of the quota was not determined separately from the value of farm land at the time of the death which created the inheritance, the quota holder should make an effort to determine what the fair market value would have been. This might be accomplished by accessing records on sales of quota for cash at time and in the locality of the quota inherited, or by accessing records of sales of comparable land at the same time and in the same area which were sold without quota.

It will be the taxpayer’s responsibility to prove the accuracy of any information reported on his or her income tax return, so time spent now to accurately determine basis in peanut quota will be rewarded by both the knowledge that only the correct amount of tax, if any, is paid when the “buyout” is reported, and by the assurance that the information provided on the tax return is accurate and truthful.