

Termination of Tobacco Quotas and Price Support Programs

Notice 2005-51

PURPOSE

This notice provides answers to frequently asked questions regarding the tax treatment of federal payments made pursuant to § 622 of the Fair and Equitable Tobacco Reform Act of 2004, Title VI of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1521-36 (2004) (the Act).

BACKGROUND

Sections 611 and 612 of the Act terminate the tobacco marketing quota program and the tobacco price support program. Section 622 of the Act provides that the United States Department of Agriculture (USDA) will offer to enter into a contract with an eligible tobacco quota holder (Owner) under which the Owner may receive total payments of \$7 per pound of quota in 10 equal annual payments in fiscal years 2005 through 2014 (Owner Payments) in exchange for the termination of the tobacco marketing quotas and related price support. Section 622 does not provide for stated interest on payments due under the contracts.

For federal income tax purposes, Owner Payments are the proceeds from a sale of the Owner's tobacco quota as of the effective date applicable to the Owner. The effective date applicable to an Owner is the earlier of (1) June 30, 2005, for flue-cured tobacco and September 30, 2005, for all other types of tobacco, or (2) the date on which an Owner and USDA enter into a contract for Owner Payments with respect to the quota.

QUESTIONS AND ANSWERS

Q-1. Are Owner Payments received under the Act subject to federal income tax?

A-1. Yes, Owner Payments are subject to federal income tax. If the amounts received by the Owner are more than the Owner's adjusted basis in the quota, the Owner has a taxable gain; if the Owner receives less than the Owner's adjusted ba-

sis, the Owner has a loss that may be deductible for tax purposes if the requirements for deduction under § 165 of the Internal Revenue Code are satisfied. In determining an Owner's gain or loss, the amount received for the quota does not include any amount treated as interest for federal tax purposes. See Q&A-7 for help in determining whether any portion of an Owner Payment is treated as interest for federal tax purposes.

Q-2. How does an Owner determine the adjusted basis of a quota?

A-2. The adjusted basis of a quota is determined differently depending upon how the Owner acquired the quota.

- An Owner who holds a quota that is derived from an original grant by the federal government has a basis of zero in the quota.
- The basis of a purchased quota is the price the Owner paid for it.
- Generally an Owner who received a quota as a gift has the same basis in the quota as the person who gave the quota to the Owner. Under certain circumstances, the basis is increased by an amount related to the amount of gift tax paid. If the basis is greater than the fair market value of the quota at the time of the gift, the basis for determining loss is that fair market value.
- The basis of a quota that an Owner inherited generally is the fair market value of the quota at the time of the decedent's death.

The basis of a tobacco quota is not subject to adjustment through amortization, depletion, or depreciation. However, if an Owner improperly has deducted any amount for these purposes, the Owner must reduce the basis by the amount deducted before determining the Owner's gain or loss. A similar reduction in the basis of a quota must be made for any amount previously deducted as a loss because of a reduction in the number of pounds of tobacco allowable under the quota. If an Owner purchased a quota and deducted the entire cost in the year of purchase, then the Owner's basis in the quota is zero.

Q-3. If an Owner has a gain and reports Owner Payments under the installment method, when must the gain be included in income?

A-3. The installment method may be used to report gain if an Owner receives at least one Owner Payment after the close of the Owner's taxable year that includes the effective date applicable to the Owner. The amount of the gain is the excess of the total amount of Owner Payments to be received, reduced by any amount treated as interest, over the Owner's adjusted basis in the quota. Under the installment method, a proportionate amount of the gain is taken into account in each year in which an Owner Payment is received. See the instructions for Form 6252, *Installment Sale Income*.

Q-4. If an Owner has a gain and elects not to report Owner Payments under the installment method, when must the gain be included in income?

A-4. The Owner must report the entire gain on the Owner's federal income tax return for the taxable year that includes the effective date applicable to the Owner.

Q-5. Is the gain or loss with respect to a quota ordinary or capital gain or loss?

A-5. Whether the gain or loss with respect to a quota is ordinary or capital depends on how the Owner used the quota.

- If an Owner used a quota in the trade or business of farming and, on the effective date applicable to the Owner, the Owner's holding period for the quota was more than one year, then the transaction is reported under § 1231 on Form 4797, *Sales of Business Property*. If an Owner has no other § 1231 transactions reportable on Form 4797, any gain is treated as long-term capital gain and any loss is treated as ordinary loss. Even if an Owner has other reportable § 1231 transactions, the net result of all § 1231 transactions reported generally is either long-term capital gain or ordinary loss. See the instructions for Form 4797 for more detailed information.
- If an Owner held a quota for investment purposes, or for the production of income, but did not use the quota in

a trade or business, any gain or loss is capital gain or loss.

Under certain circumstances, some or all of the gain must be recharacterized and reported as ordinary income. If an Owner previously deducted (1) the cost of acquiring a quota, (2) amounts for amortization, depletion, or depreciation, or (3) amounts to reflect a reduction in the quota pounds, any gain is taxed as ordinary income up to the amount previously deducted. The Owner must report this amount of ordinary income on the Owner's return for the taxable year that includes the effective date applicable to the Owner, even if the Owner uses the installment method to report the remainder of the gain.

Q-6. Are Owner Payments received under the Act subject to Self-Employment Contributions Act (SECA) tax (see § 1402)?

A-6. No.

Q-7. Is any portion of an Owner Payment treated as interest for federal tax purposes?

A-7. (a) If the total amount to be paid under a contract does not exceed \$3,000, no portion of an Owner Payment is treated as interest for federal tax purposes.

(b) If § 483 applies to a contract, a portion of each Owner Payment (other than an Owner Payment due within six months of the effective date applicable to the Owner) is treated as interest for federal tax purposes. For example, § 483 generally applies to a contract if the total amount to be paid under the contract does not exceed \$250,000 or if a cash method election is made under §§ 1274A and 1.1274A-1(c). A contract is eligible for the cash method election only if the total amount to be paid under the contract does not exceed the inflation-adjusted amount for a cash method debt instrument (\$3,202,100 for 2005).

(c) In all situations not described in (a) or (b) above, a portion of each Owner Payment is treated as interest for federal tax purposes under § 1274.

(d) In general, to determine the amount of an Owner Payment that is treated as interest, see § 483 or § 1274, whichever is applicable, and the regulations thereunder. You may wish to consult a tax advisor for assistance in determining the portion of an Owner Payment that is treated as interest and the taxable year in which the interest is includible in income.

Q-8. Does an individual Owner's gain or loss from Owner Payments qualify for farm income averaging?

A-8. No. A tobacco quota is considered an interest in land, and farm income averaging is not available for gain or loss arising from the sale or other disposition of land.

Q-9. Are Owner Payments subject to information reporting?

A-9. Yes. Because a tobacco quota is considered an interest in land, the total amount received under a contract by an owner in a taxable year generally will be reported by USDA on Form 1099-S, *Proceeds From Real Estate Transactions*, if the amount is \$600 or more. In addition, any portion of an Owner Payment treated as interest for federal tax purposes generally will be reported by USDA on Form 1099-INT, *Interest Income*, if the total amount of interest received in a taxable year is \$600 or more.

Q-10. Is the termination of a tobacco quota under the Act an involuntary conversion of the quota?

A-10. No.

Q-11. May an Owner enter into a like-kind exchange of a quota?

A-11. Yes. An Owner may postpone reporting the gain or loss from the termination of a quota by entering into a like-kind exchange if the Owner complies with the requirements of § 1031 and the regulations thereunder. For purposes of § 1031, the date on which an Owner is deemed to relinquish a quota is the effective date applicable to the Owner.

SUBSEQUENT GUIDANCE

Section 623 of the Act provides that USDA will offer to enter into a contract with an eligible tobacco producer (Grower) under which the Grower may receive total payments of up to \$3 per pound of quota in 10 equal annual payments in fiscal years 2005 through 2014 (Grower Payments) in exchange for the termination of the tobacco marketing quotas and related price support. Grower Payments are determined by reference to the amount of quota under which the Grower produced (or planted) tobacco during the 2002, 2003, and 2004 tobacco marketing years and are prorated based on the number of years that the Grower produced (or planted) quota tobacco during those

years. The federal tax treatment of Grower Payments is expected to be addressed in subsequent guidance.

DRAFTING INFORMATION

The principal author of this notice is Marnette M. Myers of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding Q&A-7 of this notice, contact Pamela Lew of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 622-3950 (not a toll-free call). For further information regarding the remainder of this notice, contact Ms. Myers at (202) 622-4920 (not a toll-free call).