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Tobacco Buyout

Tax Implications of the Tobacco Quota Buyout

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The tobacco buyout legislation eliminates the federal tobacco program. In exchange, tobacco producers will be paid $3 per pound of quota tobacco grown, and owners of quota will be paid $7 per pound of quota owned. The payments, which will be distributed over ten years in equal, annual installments have important income tax implications for tobacco producers and quota owners.

Recipients of buyout payments need to work closely with their accountant, tax preparer, lender, or other professional advisers in 2005 to determine the specific tax impact on their individual situation. Tax issues, rates and reporting rules are different for producers receiving the $3 production payment and quota holders receiving the $7 quota payment. The $3 production payment will be taxed as ordinary business income while the $7 quota payment will be taxed as capital gain income.

Production Payment ($3) Tax Issues

The tax implications for the production payments to producers are simple and straight forward. Payments will be treated as ordinary business income in the year payments are received and will be subject to the following taxes: self-employment (FICA) tax at 15.3%; federal tax at ordinary tax rates (10% to 35% in 2005); and North Carolina state tax at ordinary tax rates (6% to 8.25% in 2005). The amount of tax will vary widely among individual producers depending on their individual situation. The combined tax rate could be as low as 30% or as high as 51%.

Beyond the applicable tax rate, producers should also consider the effect of production payments on social security benefits and the effect of taking a lump-sum payment in 2005. Because the producer payment is earned income, it may reduce the eligible benefit for individuals taking early social security. Taking a lump sum in 2005 has tax advantages or disadvantages that will vary among individual situations. Recipients of production payments should work closely with a professional financial adviser in making decisions about taking a lump sum payment or taking social security early.

Quota Holder Payment ($7) Tax Issues

Tax issues and planning for quota owners are more complicated, requiring more knowledge, information and work by recipients. Tobacco quota, which is an interest in land, qualifies as a Section 1231 asset with unique tax treatment.

- Payments are not subject to self-employment (FICA) tax.
- Only the portion of the payment which is a gain above the cost basis of the quota is taxed as a capital gain.
- Gains are taxed at federal capital gains tax rates of 5, 10, or 15%.
- Gains do not qualify for farm income averaging (since gains are not "farm income")
- Capital gain income does not affect social security benefits.
- State taxes apply according to individual state tax rates (6% to 8.25% in NC).

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Eleven Questions to Answer Before Investing Your Tobacco Buyout Money

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Individuals receiving money from the tobacco buyout program must decide what to do with the money. Here are answers to eleven important investment questions that will help guide your decision.

1. How much risk are you willing to take?

Many will answer "none," but at the same time will want to earn a high return on their money. Unfortunately, this attitude ignores the iron rule of investing: making more money on an investment generally required taking more risk. So first you need to decide how much risk to take.

Your acceptable level of risk is determined by a number of factors, including your age, your need to have ready access to your money, and the amount of money you have to invest. In general, the older you are, the more you need access to your money; and the smaller the amount you have to invest, the less risk you'll want to take.

Two recommended ways of managing risk and increasing your investment earnings are *diversification* and *buy and hold*. Diversification means investing in several investments with different risk levels. Buy and hold means keeping investments for a long time period, expecting that any losses will eventually be recovered over several years.

2. Do you have expensive debt?

If the answer to this question is yes, then an excellent way to effectively earn a high return on your money is to pay down that debt. When you reduce debt by a dollar, you are saving, and thus essentially earning, the interest rate charged on that debt. For example, paying off a $1000 credit card debt on which you are charged 18% is like earning 18% on that money. On the other hand, if you have a mortgage loan charging 4%, paying down on that debt only earns 4% on your money.

3. Are fees charged on the investment?

Fees can be charged on investments in many ways - when you initially invest money, while your money is invested, and when you withdraw your money from the investment. These fees reduce your investment earnings. Investment fees vary between investments and investment companies. Always ask what you'll be earning <u>after</u> subtracting the fees.

4. What kind of investment returns do you want?

Investments can earn money in three different ways: by paying a regular amount of income as interest or dividends; by having the investment increase in value over time; or by a combination of the two. Which payment type is best depends on your particular circumstances. If you need regular income from your investments for living expenses, then investments paying regular income or dividends may be best. Alternatively, if regular income isn't important, then investments which grow in value and only pay when they're sold may be a better choice. There are also tax advantages to these kinds of investments. The third investment type, which blends the two forms of payments, is a compromise.

5. Are fixed or variable interest rates better?

Many investments, such as certificates of deposit and bonds, pay a stated interest rate. However, with these interest rates, there is the choice between *locking in* the rate for a long period of time, or allowing the rate to *float*, or vary, over time. Which is better?

Unfortunately, there is no set answer. If you knew with certainty that future interest rates earned by investors were going to drop, then you would want to lock-in today's relatively high rate. On the other hand, if you were sure interest rates would rise in the future, then a floating interest rate would be preferred. One option is to invest in a mix of fixed and floating interest rates.

6. Are stocks too risky?

The stock market continually rises and falls, and trends are very difficult to predict. This is even more true for individual stocks. Yet over long periods of time, the stock market does rise.

One way to deal with the risk of buying individual stocks is to buy *indexed stock funds* instead. These funds purchase a varied collection of stocks that represent the entire stock market. With stock index funds, you still bear the risks of the whole stock market, but you avoid much of the risk tied to individual stocks.

7. Should you invest in mutual funds?

Mutual funds are a *way* of investing, not a *type* of investment. Mutual funds collect money from many investors, they hire a professional manager, and then the manager makes the specific investment decisions. With most mutual funds, you can withdraw money anytime you want.

A critical question to ask about any mutual fund is, what specific investments will the manager buy? The fund's prospectus describes what stocks and bonds the mutual fund invests in; it will provide you with information about the fund's risk and earnings potential. Never assume a mutual fund's past investment performance is a perfect predictor of how it will do in the future.

8. Should you look for tax-favored investments?

If some of your tobacco buyout money is classified as earnings (for example, $3 production payments), you may want to consider some of the tax-favored investments geared to saving for retirement. The major ones are the regular IRA, the Roth IRA and the SEP account (see IRS publications 560 and 590 for eligibility and investment rules).

However, keep in mind two important issues regarding these investments. First, in most cases your money will be "tied up" in the investments until you reach age 59 ½. There are substantial penalties for withdrawing money before then. Second, these investments are still only a tax-treatment. You still must decide where specifically to put the money, like stocks, bonds, certificates of deposit, etc.

Other tax-favored investments outside of retirement programs pay periodic income that is federally tax-free. Municipal bonds are an example. However, the interest rate these investments earn is also lower than for comparable taxable investments. Generally, the higher your income, the more likely these investments will be a good idea for you.

9. Can certain kinds of spending be investments?

Don't forget that spending that allows you or your business to be more productive is really an investment. Examples include education, training and purchases of technology and equipment. Work with an accountant or business manager to estimate the investment return on such expenditures.

10. Should you pay attention to investment predictions?

It's easy to make predictions about investments, but it's much harder to be correct about them. The performance of investments is tied to the economy, and the economy is very unpredictable – even for professional economists and financial experts. So a healthy dose of skepticism is important when considering investment forecasts, especially very optimistic ones.

11. Should you use an investment professional?

There are many types of investment professionals available for you to hire, and you may want to use one for advice with your buyout funds. Before engaging an investment professional, carefully consider several questions. What is the advisor's education and training? Does the advisor provide information on all kinds of investments or only for certain types? How is the advisor compensated? The options are a flat fee versus a percentage of the investment returns. Finally, talk to current and former clients of the advisor for their views on the value of the advisor's services.

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While the tax rate on quota payments can still vary among individuals, the rates are much lower than for production payments. For a North Carolina taxpayer, the combined federal and state tax rate on the capital gain portion could be as low as 11% or as high as 23%.

Capital gains tax treatment of quota holder payments implies some other important issues that individuals must consider and work through with their tax preparer or financial adviser as soon as possible in 2005 Three issues merit particular attention:

- Determining the *tax basis* of quota.
- Considering a *like-kind exchange* to defer the tax.
- Evaluating the effect of taking a *lump-sum payment* in 2005.

For more information on these issues, visit www.cals.ncsu.edu:8050/advancement/tobaccobuyout.

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