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The Lump-Sum Payment Option in the Tobacco Quota Buyout

Arnold W. Oltmans, *Associate Professor and Extension Economist*

The tobacco buyout legislation signed into law October 22, 2004 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 will be distributed over ten years in equal annual installments.

The legislation provides for both producers and quota owners to receive a lump-sum payment in 2005 instead of yearly payments. In deciding whether or not to take a lump-sum payment, growers and owners need to be aware of several important issues. These include the procedure for setting up a lump-sum option, the tax implications of the two choices, and the financial advantages or disadvantages of a lump-sum payment. This issue of the *NC State Economist* discusses these topics in detail.

Procedure for Setting up a Lump-Sum Payment

A quota holder or tobacco producer can enter into an agreement with a private party to receive a lump-sum payment from that party (*not* the government agency issuing the buyout payments) in return for the rights to future payments. This is known as *securitization* of the buyout payment contract. Securitization is different from taking out a loan and assigning future payments to a lender. Under securitization, a buyout recipient transfers all rights from the buyout contract to the private party by executing a *successor-in-interest* contract with the private party and the Commodity Credit Corporation (CCC). These contract forms are available from USDA service centers and explain how to transfer buyout payments from the CCC to another party. Only the last nine of the ten buyout payments, beginning with the 2006 payment, are eligible for a lump-sum payment. The first payment in 2005 will be paid directly to the quota owner or producer. Payments two through ten, scheduled to be paid in January of each succeeding year through 2014, will go directly to the private party named in the contract.

A quota owner or producer may do a successor-in-interest contract at any time during the buyout period after the first payment. All of the last nine payments do not have to be taken as a lump sum in 2005. For example, a quota owner could take payments two through four directly from the CCC in years 2006, 2007, and 2008. Then in 2008 he or she could do a successor-in-interest contract for payments five to ten and receive a lump sum for those payments in 2008, completing a *partial* instead of a *full* lump sum. This flexibility may be especially helpful to quota holders or producers in managing their tax liability, and it gives them another tool for planning and managing their financial situation. This assumes, however, that a market will still exist for lump-sum offers after 2005. Financial institutions may not be willing to make offers on partial securitizations of less than nine payments in a future year, which makes the availability of this partial lump-sum option in the future less certain than doing a full lump sum in 2005.

Tax Implications of a Lump-sum Payment

If the quota owner or producer receives the full lump sum - nine payments in 2005 - taxes are also due on the total amount in 2005. For many taxpayers this will result in a substantial increase in taxable income in 2005 and also an increase in the buyout payment tax rate. Some taxpayers on the other hand – most likely growers receiving the $3 per pound payment whose net farm income per year is below the wage base ceiling for self-employment tax – may find that a full lump-sum payment results in a lower tax rate in 2005 than if they take annual payments over the remaining nine-year period.

Although a lower tax rate is possible, the majority of taxpayers should think in terms of paying a higher tax rate if they take a full lump-sum payment in 2005. For this reason, recipients may want to consider waiting to do a partial lump sum in a later year. The tax effect will vary widely dependent upon the type of buyout payment (i.e., $3 per pound producer vs. $7 per pound quota owner payments), the amount of payment, basis in the quota, amount of other taxable income, filing status (single, married, etc.), and other individual factors. To get the exact amount of tax that will be due from a lump sum compared to receiving the buyout in yearly installments, recipients must consult with their tax preparer about their individual situation. The amount of difference in tax payable is an important piece of information needed to make an informed decision about whether or not to take a lump-sum payment.

An additional consequence, while not a tax per se, of the producer portion ($3) of the buyout is the impact on social security benefits. Because the producer payment is earned income, it may affect the amount of benefit that an individual taking early social security, before their full retirement age, will receive from age 62 to 65. Taking a lump sum before age 62 may be an advantage in this respect instead of receiving producer payments in the 62-65 age years. Or, taking a lump sum between ages 62-65 may suggest that a producer should wait until the full retirement age of 65 before drawing social security. Or, producers drawing early social security benefits may want to take direct payments from the CCC through age 65 and do a partial lump sum of the remaining payments after age 65.

Financial Return from a Lump-Sum Payment

One key question a buyout recipient will have about a lump sum offer is, "How do I know whether or not I am getting a good deal from the private party offering me a lump-sum? How much should that lump-sum be?" The answer varies depending on other financial factors for each individual, but the following guidelines can be a useful starting point for interpreting a lump-sum offer.

Assuming a recipient has an offer of a lump-sum payment to be received in October 2005, Table 1 can be used to see the interest rate the private party making the lump-sum offer is effectively charging. In financial circles this is referred to as the *discount rate*, since the private party must discount the full face amount of the buyout contract. No one will offer to pay the full amount in 2005 for payments that will be spread out over the next nine years. So, the lump-sum offer will be for a percentage of the face amount. That percentage can be converted into an implied interest rate that the private party is charging the recipient.

After determining the approximate interest rate being charged in the lump-sum offer, the next question is whether or not that interest rate is too high. The following rule of thumb can help to evaluate the offer. If the recipient can invest the lump-sum amount at a rate of return *greater than* the implied interest rate in the offer, then the lump-sum offer is financially advantageous to the recipient; if not, then the offer is not.

The CCC has established a maximum discount rate that can be charged in a lump-sum, successor-in-interest contract. That rate equals the prime rate plus two percentage points (rounded to the nearest whole number.) At the current prime rate, the maximum rate would be either 7% or 8%, and offers would have a minimum lump-sum percentage of about 73% to 76%. These rates can change over time however and may be different at the time a specific lump-sum offer is made.

Table 1: Approximate Discount Rate from Lump-Sum Offers

Lump-Sum as a % of Interest Payment	Implied Interest Rate
85.2%	4.0%
83.5%	4.5%
81.9%	5.0%
80.4%	5.5%
78.9%	6.0%
77.5%	6.5%
76.2%	7.0%
74.8%	7.5%
73.5%	8.0%
72.3%	8.5%
71.1%	9.0%
69.9%	9.5%
68.7%	10.0%

Of course, there are financial reasons other than the interest rate to consider in evaluating a lump-sum offer. The lump sum may be a useful source of financial liquidity. It may simplify estate planning or making gifts to others. A lump sum may enable the recipient to do things that could not be done otherwise. On the other hand, receiving a large sum of money all in one year may result in wasteful spending more easily than if it was received as installments spread over nine years.

The previous discussion and Table 1 only look at the lump-sum offer on a before-tax basis, so any final decision should be made on an after-tax basis as discussed earlier. The after-tax effect is too variable and complex for a full discussion of an after-tax analysis in this article. However, quota holders and growers considering a lump-sum payment should realize that if a lump sum increases the tax rate on the buyout payments, the rate of return needed to make a lump sum financially advantageous will be substantially higher than the implied rates in Table 1 and higher than the rule of thumb above suggests. The after-tax consequences need to be discussed and analyzed with the recipient's tax preparer or other financial adviser who can apply the analysis to their individual financial situation.

Lump-Sum Option in a Like-Kind Exchange

Perhaps the greatest advantage of taking a lump-sum payment is its use in a tax-deferred, like-kind exchange of the quota holder's payment for other property. This option, available only to quota owners, involves rolling over the basis and capital gains from quota payments into the property being purchased. This allows the tax consequence of the buyout payment to be deferred until the property is sold.

Details of a like-kind exchange are somewhat complex and require the professional assistance of the quota owner's financial advisers. The window of time for making such a decision is limited and will require action in 2005 by quota holders.

Assignment of Payments to Secure a Loan

The lump-sum payment set up through a successor-in-interest contract is not the same thing as taking out a loan from a lender based on the assignment of future payments to the lender. With a loan and assignment, the tobacco grower or quota holder continues to be the holder (owner) of the buyout contract even though future checks will be written to the lender named in the assignment. Thus, for tax purposes the grower or quota holder will still be the official recipient of income in future years, and will pay taxes in installments for each year from 2005-2014.

This may be an option that some buyout recipients will want to consider. One advantage is that the recipient can receive cash up front in

2005 through the loan without paying all of the taxes in 2005. Only the 2005 payment will be taxable; the cash received from the loan in 2005 is not taxable (as is the case with any type of loan). A disadvantage is that taxes will have to be paid in future years as buyout payments are made, even though the grower or quota holder who has assigned the payments to the lender will not receive any cash with which to pay the taxes.

Conclusion

Individuals interested in taking a lump sum should work closely with their tax preparer and other financial advisers before making a decision, since the tax effects and financial returns will vary widely according to each individual's situation. Additional information and clarifications on the lump-sum payment option may become available in the coming months. Buyout recipients should stay informed beyond the information written here as they make decisions in 2005.

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North Carolina Cooperative Extension Service
North Carolina State University
Agricultural and Resource Economics
Box 8109
Raleigh, North Carolina 27695-8109

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