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TAX TREATMENT OF PIK AND ROLL PROCEDURE CHANGED

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INTRODUCTION

On October 26,1987, the IRS issued Rev. Rul. 87-103 regarding the taxability of generic commodity certificates to farmers. This ruling revoked Rev. Rul. 87-17 and explained the federal income tax consequences of receiving generic commodity certificates, pledging grain to secure loans from the Commodity Credit Corporation (CCC) and using generic commodity certificates held by farmers to pay off loans. Farmers receive these certificates, which come in dollar denominations and are called PIK or payment-in-kind, as part of the government's price and income support program.

This ruling appears to provide a reasonable set of rules for tax reporting that is consistent with long-time treatment of reporting of CCC loans. Farm taxpayers and their tax preparers need to review their 1986 returns to see if they are consistent with Rev. Rul. 87-103. However, not all questions on cert's were answered in Rev. Rul. 87-103. For example, they still did not address the question of purchased certificates. And the farmer who reports CCC loans as taxable income generally reported the PIK and Roll profit in 1986. Rev. Rul. 87-103 indicates the profit should reduce the basis of the grain and therefore be recognized in the year the grain is sold, not the year of the PIK and Roll procedure. Technically he needs to file an amended 1986 return.

CHANGES TO 1987 FARM TAX WORKBOOK

The 1987 Farm Income Tax Workbook was written prior to issuance of Rev. Rul. 87-103, and thus the discussion and examples on treatment of CCC certificates is largely incorrect. The discussion on pages 544-550 may help you to understand the problems created by Rev. Rul. 87-17. In this discussion I will first present a summary of Rev. Rul. 87-103, followed by my answers to the problems in Case Illustration # 6, in line with the new Rev. Rul. 87-103.

Highlights of Rev. Rul. 87-103, Issued October 26,1987

Farmers receive generic commodity certificates (cert's) as partial payment for participation in the government's price and income support program. A farmer who receives a commodity certificate must include the face value of the certificate in income in the same year.

Revoked Rev. Rul. 87-17., 1987-9 IRB 4, on the same subject, sometimes called "PIK-and-roll".

Tax treatment for farmers who treat CCC loans as loans:

1. Taking out a loan is not a taxable event.

2. Redeeming a loan with certificates creates a taxable profit as of the date of redemption.

3. Farmer regains title to the grain and (if on cash basis accounting) continues to have a zero basis in the grain.

4. The full value received when the grain is sold is taxable at that time. (Or when the livestock to which it is fed is sold).

Tax treatment for farmers who treat loans as income:

1. Taking out a loan IS a taxable event in the amount of the loan as of the date of the loan.

2. Redeeming a loan with certificates creates a new basis in the grain equal to the basis of the certificates. If the certificates were issued , basis is face value. While Rev. Rul. 87-103 doesn't address this, it assumed that the basis of purchased certificates is equal to the amount paid for the certificates. This basis is not a tax benefit until the grain is fed or sold.

3. However, no profit need be recognized at the time of redemption on loans treated as income..

4. The difference between basis and sale value of the grain is added profit or loss and is reported in the year of sale. (Or the basis is a deductible expense if the grain is fed.)

Page 548 Revised to Rev. Rul. 87-103 TAX TREATMENT - CERT'S

ASSUME THESE FACTS:

Loan price of one bushel of corn	= $1.82
Posted county price of one bushel of corn	= $1.50
Cost of commodity certificate with $1.50 face value	= $1.55
Fair market value of one bushel of grain	= $1.50

	TAX CONSEQUENCES	
STEP NO.	As Loan	As Income
1) Receive loan of $1.82	NONE	$1.82
2) Pay off loan with certificate with $1.50 face value. (This will equal the posted county price.)	$0.27 profit	NONE
3) 1 bu. of corn is released from loan with $1.50 fair market value.	$0 BASIS	$1.55 BASIS
4) Sell 1 bushel of corn for $1.50	$1.50	-$0.05
TOTAL INCOME	$1.77	$1.77

WHAT IF CORN HELD OVER TO FOLLOWING YEAR & SOLD?

Year 1 Income	$0.27	$1.82
Year 2 Income	$1.50	-$0.05
TOTAL INCOME	$1.77	$1.77

NEITHER REV. RULING 87-103, NOR ANY OTHER IRS PUBLICATION, ADDRESSES THE ISSUE OF PURCHASED CERT'S, BUT THIS TREATMENT IS CONSISTENT WITH SIMILAR TAX TRANSACTIONS.

In Reporting CCC Loans Entries May Need To Be Made On The Following Lines of Schedule F.

E. Did you make an election in a prior year to include commodity credit loan proceeds as income in that year? Yes__ No __

Line 4. Sales of livestock, grain,etc.
Sales of grain (Loans treated as loans).
Profit or loss on sale where loans are treated as income.

Line 7a. Agricultural program payments, Cash
Face value of commodity certificates issued.

Line 8. Commodity credit loans under election (or forfeited).
Loan value of loans treated as income.
Loan value of loans as loans that are forfeited.

Line 11. Other Income.

(Profit on sale of certificates to others.
(Profit on redemption of loan as loan.

CASE ILLUSTRATION # 6: COMMODITY CERTIFICATES (pp. 551-3 revised)

Timothy Grove received a commodity certificate on June 4, 1987 in partial payment of his 1987 land diversion and deficiency payments. The face value of the certificate was $10,000. Timothy sold the certificate to his neighbor, Priscilla Blum, on July 10, 1987 for $11,000. Timothy uses the cash method of accounting and is a calendar year taxpayer. The ASCS reported $10,000 on a 1987 Form 1099-G for this commodity certificate.

Question 6A:
What are the income tax consequences of these transactions?

Answer 6A:
Timothy will have to report a total of $11,000 on his Schedule F. He should report $10,000 (the amount shown on the Form 1099-G filed by ASCS) on the Government Program payments line of Schedule F. The difference between the amount reported on Form 1099-G and the amount received for the certificate ($11,000 -$10,000 = $1,000) should be reported on the "other income" line of Schedule F.

Question 6B:
Assume Timothy instead redeems the certificate on October 1, 1987 for $10,000 (the face value amount). What are the tax consequences for Timothy?

Answer+r 6B:
If Timothy redeems the certificate for cash, he should simply report $10,000 (the amount shown on Form 1099-G) on the Agricultural Program payments line of Schedule F.

Question 6C:
Assume that instead of selling the certificates or redeeming them for cash, Timothy uses them to pay off price support (CCC) loans. At the time he pays off the loan, the posted county price is $1.75 so Timothy pays off the loan on 5,714 bushels ($10,000 / $1.75 = 5,714). This payment reduces Timothy's loan by $14,571 since the loan rate on those bushels was $2.55 (5,714 bushels x $2.55 = $14,571). Timothy then sold the 5,714 bushels for $8,571. Timothy has not elected to treat CCC loans as income in the year they are received. What are the tax consequences to Timothy? (Note: Problem simply assumes a $2.55 loan rate.)

Answer 6C:
As in the above answers, Timothy must report the Form 1099-G amount ($10,000) as income on the Government Payments line of Schedule F.

Using the form which follows, the tax consequences are:
a) $4,571 profit on date of redemption ($14,571 - $10,000).

This profit is reported on Schedule F, Line 11, Other Income.
b) $8,571 received for the sale of the grain goes on Schedule F, Line 4, Sales of Livestock, Produce, Grains ...

LOANS REDEEMED WITH CERTIFICATES: TAX TREATMENT UNDER REV.RUL. 87-103

FACTS FOR LOAN NO. Z123456 :

1. LOAN AMOUNT $14,571

BASIS OF CERTIFICATE'S USED TO REDEEM LOAN:
FACE VALUE IF ISSUED $10,000
+ COST IF PURCHASED $ –
– FACE VALUE OF REISSUED $ –

2. = CERT BASIS THAT REDEEMED LOAN $10,000

3. BASIS OF CORN REDEEMED IF TREAT:
a) Loans as loan $0
b) Loans as income (L. 2) $______

4. VALUE OF GRAIN SOLD IN YR. 1987 $8,571

SOURCE OF INCOME:	TAXABLE INCOME IF TREAT: As Loan	As Income	SCHEDULE F, Line
5) INCOME FROM LOAN(L.1)	NONE	$______	Line 8
6) PROFIT ON REDEMPTION (L.1 – L.2)	$4,571	NONE	Line 11
7) SOLD IN SAME YEAR(L.4) A) Loans as loans (L. 4)	$8,571	xxx	Line 4
b) Loans as income L.4-L.3b)	xxx	$______	Line 4
8) YEAR 1 INCOME (L.5+6+7)	$13,142	$______	
CORN HELD OVER & SOLD IN FOLLOWING YEAR:			
9) a) LOAN AS A LOAN(L.4)	$______	xxx	Line 4
b) AS INCOME (L.4-L.3b)	xxx	$______	Line 4
10) YEAR 2 Income (L.9a or b)	$______	$______	
11) TOTAL INCOME (L.8+10)	$______	$______	

NOTE: Basis in (3) is also basis if fed.

Question 6D: Skip.

Question 6E:

Assume that Timothy elected to report the CCC loan as income in the year it was received. What are the tax consequences to Timothy?

Answer 6E:

Again, Timothy must report the Form 1099-G amount ($10,000) as income on the Government Payments line of Schedule F.

Since he reports loans as income, the $14,571 loan amount is reported on Schedule F, line 8 - CCC Loans Under Election, in the year taken. When the loan is redeemed with PIK certificates, the grain receives a tax basis of $10,000, the face value of owned certificates used to pay off the loan. When the grain is sold for $8,751, he reports a loss of ($8,751-$10.000 = -$1,429) on Schedule F, line 4.

Question 6F:

Assume that Priscilla Blum purchased Timothy's certificate for $11,000 and used the certificate to pay off loans to the CCC. She does not report a loan as income when it is received. At the time of the purchase, the posted county price is $1.75 so Priscilla paid off the loan on 5,714 bushels, which was $14,571 since the loan rate was $2.55. Priscilla did not elect to treat the CCC loan as income when it was received. What are the tax consequences to Priscilla?

Answer 6F:

Upon pùrchase of Timothy's certificates, Priscilla has a basis in the certificates of $11,000 (the amount paid for the certificates). When Priscilla used the certificates to pay off $14,571 of her loan, she has additional income of $14,571-$11,000 or $3,571 to report on Schedule F, line 11, Other Income.

Since Priscilla is cash basis taxpayer, the grain now has a zero tax basis.

LOANS REDEEMED WITH CERTIFICATES: TAX TREATMENT UNDER REV.RUL. 87-103

FACTS FOR LOAN NO. ______________:

1. LOAN AMOUNT $________

BASIS OF CERTIFICATE'S USED TO REDEEM LOAN:
FACE VALUE IF ISSUED $__________
+ COST IF PURCHASED $__________
- FACE VALUE OF REISSUED $__________

2. = CERT BASIS THAT REDEEMED LOAN $________

3. BASIS OF CORN REDEEMED IF TREAT:
a) Loans as loan $0
b) Loans as income (L. 2) $________

4. VALUE OF GRAIN SOLD IN YR._____ $________

SOURCE OF INCOME:	TAXABLE INCOME IF TREAT: As Loan	As Income	SCHEDULE F, Line
5) INCOME FROM LOAN(L.1)	NONE	$________	Line 8
6) PROFIT ON REDEMPTION (L.1 - L.2)	$________	NONE	Line 11
7) SOLD IN SAME YEAR(L.4)			
A) Loans as loans (L. 4)	$________	xxx	Line 4
b) Loans as income_L.4-L.3b)	xxx	$________	Line 4
8) YEAR 1 INCOME (L.5+6+7)	$________	$________	
CORN HELD OVER & SOLD IN FOLLOWING YEAR:			
9) a) LOAN AS A LOAN(L.4)	$________	xxx	Line 4
b) AS INCOME (L.4-L.3b)	xxx	$________	Line 4
10) YEAR 2 Income (L.9a or b)	$________	$________	
11) TOTAL INCOME (L.8+10)	$________	$________	

NOTE: Basis in (3) is also basis if fed.