ESO 1364

IRS RULING ON TAX TREATMENT OF DAIRY TERMINATION PAYMENTS

By

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IRS has provided guidance concerning the tax treatment of payments received by milk producers participating in the Dairy Termination Program. This guidance is contained in IRS Notice 87-26, made public early in March. Since this guidance was released late in the tax filing season, many persons who received such payments in 1986 may need to file an amended return.

The issue concerns whether the entire payment under the Dairy Termination Program (DTP), must be treated as ordinary income. Notice 87-26 states that the payments under the DTP are to compensate producers for lost receipts from two sources. First, the payments compensate the producer for the difference between the amount received when the dairy cattle are sold under the DTP and the higher price that could have been received if the cattle were sold for dairy purposes. Second, the payments are also intended to replace receipts from the milk production operation.

Allowing a portion of the DTP payment to represent lost income from a lower sale price for the dairy cattle may benefit the producer in two ways; 1) it may reduce income tax by converting some income from ordinary to capital gain, and 2) it may reduce self-employment tax by reducing the income on Schedule F.

How might it be handled on a tax return? First, the entire DTP payment should be reported as Agricultural Program Payments on line 7 of Schedule F. Then deduct the amount due to lower sale price on line 11, Other Income, and note that it is additional income realized on the sale of animals per IRS Notice 87-26. Next, enter the appropriate amounts as short-term or long-term capital gain on Form 4797, depending on whether or not the animals met the 2 year holding period, etc., again referencing Notice 87-26.

How can I determine the loss in receipts by sale of dairy cattle for beef purposes? IRS Notice 87-26 states: "The milk producer must show specific evidence that the milk producer's cattle were actually sold for less than the producer could have obtained for them had they been sold for dairy purposes, at the same general

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time and at the same general geographical location as the producer actually sold them. The DTP payment will be considered as an additional amount realized on the sale of dairy cattle to the extent of such a difference. The Internal Revenue Service will accept as specific evidence of the price at which a milk producer could have sold the cattle for dairy purposes the price published in "Agricultural Prices", by the United States Department of Agriculture, National Agricultural Statistics Service, Agricultural Statistics Board, for milk cow sales in the state in which the milk producer sold the cattle during the year and month in which the milk producer actually sold the cattle." Prices reported are shown in Table 1.

Table 1- Milk Cow Sale Prices, Ohio and Nearby States, 1986-7.

Month and Year	Ohio	Indiana	Kentucky	Michigan	Pennsylvania
January, 1986	$800	$830	$750	$800	$840
April, 1986	$810	840	740	800	865
July, 1986	$840	860	750	820	840
October, 1986	$840	890	760	820	850
January, 1987	$850	850	770	850	880
April, 1987	940	900	830	920	940
July, 1987	950	890	880	950	930

Source: Agricultural Prices, ASB, NASS, USDA, Washington, D.C. 20250, various issues.

($950)

Sale of dairy cows over 2 years old at the time of sale can be reported on Form 4797, Part I (or Part III if purchased and depreciated) using the above prices. Prices are reported quarterly, and prices for the intervening months can be estimated. Young stock under 2 years of age are not changed from prior reporting, and should already have been reported on Part II of Form 4797.

Related Issues

As always, the IRS guidance doesn't answer all questions. For example, can you take the entire amount for additional sale of cattle from the first payment? Paragraph (3) of the Notice says the first portion of the DTP payment is to reimburse for the lost revenue from cow sales under the DTP program. Hence, the first payment would be largely compensation for the lost revenue from sale of cows, with any balance considered as replacement for lost milk receipts. In succeeding years, the payment is only compensation for lost milk sales.

A more conservative position would be that each payment is an "installment sale" payment. Installment payments must be reported as the portion representing profit (and eligible for capital gain treatment) and the portion representing interest (and taxable as ordinary income). If a similar argument for prorating applied here, each payment would need to be divided into the portion representing added sale of cattle and the portion representing lost milk sales.

This could be a significant decision, especially for producers who sold large herds. The 60 percent capital gains exclusion is only available on the sale of dairy herds under the DTP program on or before August 31, 1987. Therefore, the installment sale interpretation would seem to limit the 60 percent capital gain deduction to the portion of the payments received in the first year. Thus, a producer who elected to receive 80% of his DTP payment in year 1 would get the 60% deduction on 80% of the adjustment to capital gains. However, a producer who elected DTP payments in five equal installments would get the deduction only on the 20% capital gain adjustment included in the first year payment.

Of course, the re-allocation of income from ordinary to capital gain income will change Ohio taxes as well as federal and self-employment taxes. Another consideration, especially for those who elected to receive 80% in their first payment, is that the reallocation may trigger the AMT. In addition, it may free up additional ITC credits, and the amount of sales tax and medical expense allowed may be reduced due to a lower AGI for those who itemized deductions.

Also not addressed is the question of various ages and qualities of cattle sold. Is a 8 year old cow, soon to be culled, treated the same as a first calf heifer? The first rule should be to make a good faith attempt to be reasonable. If all the cows would normally be kept for milk purposes, it's probably not out of line to take the difference on all milking animals. Keep records that show how the decision was reached. The amount "must be determined with reference to all of the facts and circumstances."

How about registered cattle, can a higher sale price be claimed? The burden of proof is on the taxpayer to show specific evidence for the price claimed. USDA data will be accepted as specific evidence, but a higher price would need to be justified with facts and figures.

Amended federal and state returns may be needed for participants who sold out in 1986. And other producers will be affected on their 1987 returns. But, all dairy producers who participated in the Dairy Termination Program will benefit from IRS Notice 87-26.

Administrative Ruling Concerning the Dairy Herd Termination Program from the Internal Revenue Bulletins 1987-10, March 9, 1987

Dairy Termination Program

Notice 87–26

In response to questions from the public, the Internal Revenue Service provides guidance in this notice concerning the federal income and self-employment tax treatment with respect to participation by milk producers in the Dairy Termination Program, which was authorized by section 101(b) of the Food Security Act of 1985, Pub. L. No. 99–198, 99 Stat. 1354, 1363 (1985), as implemented by the regulations of the Commodity Credit Corporation published in the *Federal Register* on March 7, 1986. (51 Fed. Reg. 7, 913).

Under the Dairy Termination Program (DTP), the Commodity Credit Corporation (CCC) will make payments to a milk producer who enters into a contract that provides that the milk producer will sell all the producer's dairy cattle for slaughter or export and who, for a period of five years beginning on the date specified in the contract, agrees not to acquire any interest in dairy cattle or in the production of milk or make available to any person any milk production facility. The payments under the DTP are intended to compensate the milk producer for lost receipts from two sources. First, the payments compensate the producer for the difference between the amount received when the dairy cattle are sold under the DTP and the higher price that could have been received if the cattle were sold for dairy purposes. Second, the payments are also intended to replace receipts from the milk production operation.

The following guidance is provided for filing tax returns for 1986 with respect to the federal income and self-employment tax treatment of participation in the DTP.

1) To the extent that a portion of the DTP payment compensates the milk producer for selling dairy cattle at a lower price, that portion represents an additional amount realized on the sale of the cattle. If the two-year holding period requirement of section 1231(b)(3)(A) of the Internal Revenue Code is met on the date the milk producer sold raised dairy cattle, whose costs have been previously expensed, the total amount realized on the sale of the cattle is eligible for reporting as gain under section 1231 of the Code. Such sales should be reported on Form 4797, Part I. If the two-year holding period was met on the date the milk producer sold purchased dairy cattle, the gain (other than the depreciation recapture under section 1245) or loss is also eligible for reporting under section 1231. The total amount realized from such sales should be reported on Form 4797, Part III. Any recapture of investment credit in a case of purchased dairy cattle should be reported on Form 4255. If the two-year holding period requirement is not met, all gains and losses constitute ordinary gains and losses. Part II of Form 4797 should be used to report proceeds from such sales of dairy cattle, regardless of whether raised or purchased, held less than two years.

2) The portion of the DTP payment in excess of the amount that compensates the milk producer for selling dairy cattle at a lower price is not an amount realized on the sale of cattle, but is a replacement for milk production receipts, and thus is ordinary income. Such amounts should be reported on Form 1040, Schedule F.

3) The portion of the payment that compensates the milk producer for a below market sale of the cattle must be determined with reference to all of the facts and circumstances. The remainder of the DTP payment is the portion of the payment that replaces milk production receipts. The milk producer must show specific evidence that the milk producer's cattle were actually sold for less than the producer could have obtained for them had they been sold for dairy purposes, at the same general time and at the same general geographical location as the producer actually sold them. The DTP payment will be considered as an additional amount realized on the sale of dairy cattle to the extent of such a difference. The Internal Revenue Service will accept as specific evidence of the price at which a milk producer could have sold the cattle for dairy purposes the price published in "Agricultural Prices," by the United States Department of Agriculture, National Agricultural Statistics Service, Agricultural Statistics Board, for milk cow sales in the state in which the milk producer sold the cattle during the year and month in which the milk producer actually sold the cattle. The extent to which the applicable price published in "Agricultural Prices" exceeds the price at which the milk producer actually sold the cattle may thus be treated as an amount realized on the sale of the cattle and is taxable as described in paragraph 1 above. The remaining amount of the DTP payment would be taxed as described in paragraph 2 above.

4) The portion of the DTP payment that is not treated as an amount realized on the sale of the dairy cattle is includible in determining a milk producer's net earnings from self-employment and subject to the taxes imposed on self-employment income if the milk producer operated the milk production unit personally or through agents or employees, or if the milk production unit was operated by others and the milk producer participated materially in the production of the milk or in the management of the milk production unit.