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Income Tax Status of the Farm Credit System

— by Neil E. Harl*

The proposed buyout by Rabobank, a giant Dutch lender, of the Farm Credit Services of America (FCSA),¹ a component of the Farm Credit System, announced in late July, 2004, has focused attention on the income tax status of the various units of the farm credit system.²

The income tax implications are important in the buyout because of—(1) the impact on the purchase price (the greater the negative income tax consequences the lower the purchase price) and (2) the potential effect on the amount available for distribution to stockholders.

History of exemptions from income tax

Federal Land Banks. Income earned by the Federal Land Banks and the Federal Land Bank Associations is exempt from federal, state, municipal and local taxation.³ The exempt status was provided for in the original act creating the Federal Land Banks in 1916 (the Federal Farm Loan Act) and has been continued in subsequent legislation.⁴ A 1988 amendment, which is reflected in the current statutory exemption, specifies that the income of “Farm Credit Banks” is exempt from all federal, state, municipal and local taxation.⁵ The term “Farm Credit Bank” is defined to *include Federal Intermediate Credit Banks and Federal Land Banks but not production credit associations or banks for cooperatives.*

The provision states—

“The Farm Credit Banks and the capital, reserves, and surplus thereof, and the income derived therefrom, shall be exempt from Federal, State, municipal, and local taxation, except taxes on real estate held by a Farm Credit Bank to the same extent, according to its value, as other similar property held by other persons is taxed. The mortgages held by the Farm Credit Banks and the notes, bonds, debentures, and other obligations issued by the banks shall be considered and held to be instrumentalities of the United States and, as such, they and the income therefrom shall be exempt from all Federal, State, municipal, and local taxation, other than Federal income tax liability of the holder thereof under the Public Debt Act of 1941 (31 U.S.C. 3124).⁶

The FLB and FLBA exemptions were similar to the exemptions for federal instrumentalities.⁷ As a result of the exemptions, a substantial amount of FCSA earnings has not been subject to federal or state income tax. The Federal Land Bank exemption, continued to the present, represents the vast majority of earnings, estimated to be as

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high as 70 percent of the total in FCSA. The substantial amount of exempt earnings poses a question about the income tax consequences of a take-over of FCSA funds inasmuch as the proposed buyout involves the purchase by Rabobank of the FCSA stockholders' stock.

Production Credit Associations and Banks for Cooperatives. The current provision on the exempt status of production credit associations states as follows—

“Each production credit association and its obligations are instrumentalities of the United States and as such any and all notes, debentures and other obligations issued by such associations shall be exempt, both as to principal and interest, from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States or any state, territorial, or local taxing authority, except that interest on such obligations shall be subject to Federal income taxation in the hands of the holder.”⁸

Note that the *income* of production credit associations is not exempt. An almost identical provision applies to banks for cooperatives.⁹

Effect of the Agricultural Credit Act of 1987 on FLB and FLBA

The FLB and FLBA exemptions were called into question by IRS following the enactment of authority in the Agricultural Credit Act of 1987 allowing the merger of Federal Land Banks into an Agricultural Credit Association (ACA).¹⁰ Production Credit Associations were to be merged with Federal Land Banks within the same geographic area.¹¹

The Internal Revenue Service ruled on three occasions¹² that Agricultural Credit Associations (created upon the merger of Federal Land Banks and Production Credit Associations under the Agricultural Credit Act of 1987) were not exempt from income tax from long-term lending activities previously carried on by a predecessor Federal Land Bank or Federal Land Bank Association. FCSA is listed as an Agricultural Credit Association. However, a federal district court¹³ has confirmed that the Federal Land Bank exemption for income could continue after 1987. In that case, an ACA was formed by the merger of an exempt FLBA (offering long-term land loans) and a non-exempt production credit association (PCA) offering short- and intermediate-term loans. The income from the ACA's long-term land loans was held to be exempt. The court said that to conclude that Congress intended to deny the continuance of the exemption would be “illogical and absurd.” The court said that no specific language was needed for the long-term land loan income exemption because it already existed and was incorporated by reference. Thus, FCSA has continued to enjoy an exemption of income from long-term land lending.

Treatment of the exit fee

The proposed buyout of FCSA by Rabobank also raises a question about the income tax consequences of payment by FCSA of the exit fee which is expected to exceed

\$800,000,000. Inasmuch as earnings from the Federal Land Bank (and Federal Land Bank Associations) are exempt from income taxes, payment of the exit fee out of tax-exempt funds raises a question of whether the payment would be subject to federal (and state) income tax. That would be the case under well-established tax principles.

Taxation of other exempt earnings

It is also unclear how the remaining tax-exempt earnings in FCSA will be taxed and to whom (FCSA or Rabobank) upon completion of the transaction or at a later time.

The United States Supreme Court has long held to the view that when a new corporation succeeds to the rights and powers of an old corporation, the new corporation is not entitled to the old corporation's special statutory exemptions, including exemptions from taxation, in the absence of an express provision in a statute.¹⁴ As the court said in *Phoenix Fire & Marine Insurance Co. v. Tennessee*,¹⁵ the claim for exemption must be made out “wholly beyond doubt.” The court added that “[m]ere silence is the same as a denial of exemption.”

Therefore, it would appear that Rabobank would not succeed to the tax exempt status enjoyed by FCSA for long-term land loans.

FOOTNOTES

¹ See Harl, “Rabobank Buyout of FCSAmerica,” 8 *Ag Lender* 12-13 (2004). See generally Harl, *Agricultural Law* ch. 100 (2004); Harl, *Agricultural Law Manual* § 11.01[2] (2004).

² See website at www.rabobankbuyout.org for a discussion of topics relevant to the buyout.

³ 12 U.S.C. § 2023.

⁴ See 12 U.S.C. § 2023 (2000).

⁵ *Id.*

⁶ 12 U.S.C. § 2023.

⁷ See I.R.C. § 501(e)(1).

⁸ 12 U.S.C. § 2077.

⁹ 12 U.S.C. § 2134 (2000).

¹⁰ Pub. L. No. 100-233, Sec. 410, 101 Stat. 1637 (1988).

¹¹ *Id.*, Sec. 411.

¹² Ltr. Rul. 9641006, July 18, 1996; Ltr. Rul. 9652001, July 17, 1996; Ltr. Rul. 9652002, July 17, 1996.

¹³ *United States v. Farm Credit Services of Fargo, ACA*, 89 AFTR 2d 2002-334 (D. N.D. 1998).

¹⁴ *People's Gaslight & Coke Co. of Chicago v. Chicago*, 194 U.S. 1 (1904).

¹⁵ 161 U.S. 174 (1895).