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History and Unique Features of the Farm Credit System

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The proposed buyout of Farm Credit Services of America (FCSA) by Rabobank in late July 2004, and the subsequent rejection of the offer by the FCSA board in late October 2004, focused attention on the uniqueness of the Farm Credit System as a national cooperative lender to agriculture, on congressional expectations for the system (inasmuch as the system was created by successive congressional acts), and on the very unusual tax status of the Farm Credit System, especially the Federal Land Bank segment. The proposed Rabobank buyout posed the policy question of whether a buyout of a component of the Farm Credit System was inconsistent with the statutory and regulatory framework of the system.

The matter of expectations of the stockholders of the buyout target was also highly relevant but the proposed buyout did not progress to the point of assessing stockholder positions on the matter.

History of the Farm Credit System

Early History

By 1912, politicians found it universally popular to promise that strong measures to deal with the farm credit problem would be taken by government. In that year, all three political parties (Republican, Democratic, and Progressive) adopted platform planks calling for strong rural credit legislation. As early as 1908, President Theodore Roosevelt's Country Life Commission had recommended a cooperative credit system that would provide agricultural credit to farmers and ranchers on fair terms.

Compromises or reconciliation of such polarized concepts—the one system private, the other public—proved difficult. Congress tied both plans together and adopted them into a single enactment as the Farm Loan Act of 1916.

Thus, the Land Banks and their affiliated associations came into being in 1916, because farmers had an urgent need for more and better long-term mortgage financing. Money was scarce in most rural areas, and when lenders could be found, costs usually were high. Every few years, mortgages had to be renewed or refinanced. There was the ever-present danger that renewals or a new lender would not be available.

After the wartime prosperity of 1918–1920, American agriculture fell into a deep depression, and the Federal land program and its private counterpart, the joint stock land banks, were unable to provide the needed credit.

In the early 1920s, the War Finance Corporation endeavored to establish a program for short-term agricultural credit. Congress, responding to the nation's depressed rural economy, enacted the Agricultural Credit Act of 1923, which established the Federal Intermediate Credit Banks to finance and discount the paper of agricultural credit organizations, commercial banks, savings institutions, and cooperatives, in order to channel funds to individual farmers for their operating needs.

The Great Depression

The nationwide depression that deepened in 1929 and continued into the 1930s accelerated the problems of rural America. Upon assuming office, President Roosevelt acted quickly to establish a means to revive financially the farm economy. By Executive Order, the President created the Farm Credit Administration, thereby concentrating the supervision and authority over the foundering rural assistance programs.

Thereafter, Congress enacted the Farm Credit Act of 1933, establishing a system of production credit corporations and associations, with financing from the Federal Intermediate Credit Banks, to provide operating loans to farmers on a short-term credit basis. That legislation also brought into the Farm Credit Administration the banks for cooperatives. In the same year, the Emergency Farm Mortgage Act provided for refunding and revising the operations of the Federal Land Bank associations to meet the problems of farm foreclosures and debt defaults.

In the late 1960s, it became increasingly apparent that the system, which was based on several underlying statutes, should be recodified, updated, and made ready for the years ahead.

In 1985, in the midst of a deepening farm debt crisis characterized by low commodity prices, high farm debt-to-asset ratios, and steeply falling land values, the Farm Credit System banks held some $6 billion in loans in which the face amount exceeded the value of the collateral. Increasing amounts of nonaccrual and other high-risk loans ($10 billion in September 1985), record losses, and increasing acquisition of property through foreclosure or liquidation severely strained the resources of the system, with individual banks and associations in danger of collapse. In response to the growing crisis, Congress passed the Farm Credit Act Amendments of 1985 which (a) reorganized the central administration of the system to make the Farm Credit Administration a more independent, arm's-length regulator of the System; (b) increased the FCA's enforcement powers; and (c) created the Farm Credit System Capital Corporation to assist the system as a ready source of financial assistance. Although the act did not appropriate additional funds for the FCA, it did provide the Department of the Treasury with discretionary authority to provide financial assistance after certification of need from the FCA.

The Agricultural Credit Act of 1987 provided for reorganization of the Farm Credit System in terms of powers and capitalization. Federal Land Banks and Federal Intermediate Credit Banks within each district were merged.

Under the Agricultural Credit Act of 1987, on consolidated or system-wide obligations, each bank was responsible for obligations issued on its own behalf and jointly and severally liable on other obligations as called upon by the Farm Credit Administration. After five years, the FCSIC fund was to be exhausted before a bank was asked to be liable for other banks' obligations.

The Agricultural Credit Act of 1987 created an FDIC-type fund for the Farm Credit System. The new fund was designated the Farm Credit System Insurance Corporation (FCSIC). The 1987 legislation also created the Farm Credit System Financial Assistance Corporation (FCSFAC) to provide capital to FCS institutions experiencing financial difficulty.

The Exit Fee

The payment of the exit fee in the proposed Rabobank buyout in 2004 was of importance because (a) much of the capital involved, which was held as unallocated earnings, would flow out of FCSA and, in large measure, outside the four-state area to benefit other FCS borrowers in other states; (b) payment of the fee would diminish the amount to which stockholders would be entitled; and (c) the expected income tax consequences meant that the US government and the respective states would be major beneficiaries of the payment of the exit fee.

Payment of the exit fee, estimated to total nearly $900,000,000, was to be paid by FCSAmerica out of unallocated surplus—not by Rabobank.

The exit fee is based on the average daily balances of assets and liabilities for the 12-month period preceding the termination date with adjustments. To calculate the fee, assets are multiplied by 6%, and that amount is subtracted from total capital. Thus, the exit fee is all capital above 6% of assets.

The exit fee is paid to the Farm Credit System Insurance Fund. The exit fee could have been avoided if a buyout or merger were to occur with another Farm Credit System unit with the full amount of the fee retained within the system.

Income Tax Implications

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

History of Exemptions from Income Tax

Income earned by the Federal Land Banks (FLB) and the Federal Land Bank Associations (FLBA) is exempt from federal, state, municipal, and local taxation. 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.

Bonds, debentures, and other obligations issued by Federal Land Banks are exempt from all taxes other than federal income tax. This makes Federal Land Bank bonds more attractive to the investing public. The exemption benefits security holders and also allows securities to be priced more favorably.

Effect of the Agricultural Credit Act of 1987 on FLB

The FLB and FLBA exemptions were called into question by the 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). The Internal Revenue Service ruled on three occasions 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 court in Fargo, North Dakota held that the Federal Land Bank exemption from income tax 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 nonexempt 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.

Taxation of Other Units of FCSA

The production credit lending of FCSA has continued to be subject to cooperative taxation rules.

The special tax status of cooperatives involves patronage refunds whereby a percentage of the patronage earnings (80%) is retained by the cooperative, with 20% of the earnings paid out to the member as patronage. The income tax on the entire amount is paid by the patron. For earnings not classified as patronage, the cooperative (other than those earning exempt income) pays income tax on the earnings at the corporate rate.

Treatment of the Exit Fee

The proposed buyout of FCSA by Rabobank also raised a question about the income tax consequences of payment by FCSA of the exit fee that was expected to total nearly $900,000,000. 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 subject tax-exempt earnings used to pay the fee to federal (and state) income tax. That is the case under well-established tax principles.

Because of a 1992 US Supreme Court case, which held that fees and costs associated with a merger or acquisition were not deductible but had to be amortized over a lengthy time period, there would have been no offsetting deduction.

Taxation of Other Exempt Earnings

It was also unclear how the remaining tax-exempt earnings in FCSA would 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 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.

Therefore, it appeared that Rabobank would not have succeeded to the tax-exempt status enjoyed by FCSA for long-term land loans. Thus, the remaining tax-exempt earnings would have been subjected to tax, probably upon takeover.

No Guidance Requested from IRS

Apparently, a private letter ruling had not been requested from the Internal Revenue Service on the exit fee issue, the issue of tax reporting by stockholders of the purchase price (which was payment for the interest of the stockholders in FCSAmerica), and the issue of taxation of the remaining tax-exempt earnings inside FCSA.

Policy Implications

The question still remains (and will persist until the Congress revisits the issue) of whether it was the intent of Congress from 1916 to the present to allow a buyout of part or all of the Farm Credit System by a private-sector lender. This is an important policy issue that deserves a full-dress debate in Congress with an opportunity for all points of view to be heard. If that is not done, the stage will be set for another buyout proposal at some future time, which will likely proceed under the assumption that inaction by Congress indicates acquiescence in the idea of a private-sector buyout. The public interest in this issue goes well beyond the public resources that have been invested in the system over nearly 90 years.

At a minimum, if Congress decides to allow private sector buyouts, a clear legislative roadmap should be enacted showing the income tax consequences, when those consequences are triggered, and who bears liability for the tax.

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