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We begin 2007 with our annual look at the most significant agricultural law developments of the previous year. Legal issues continue to be at the forefront of developments that are shaping the present and future of American agriculture, and it is very likely that the involvement of the legal system in agriculture will continue to grow. The following is my list of what I view as the top ten agricultural law developments of 2006 based on their impact (or potential impact) on U.S. agricultural producers and the sector as a whole.

1. **IRS issues Notice concerning self-employment tax treatment of Conservation Reserve Program (CRP) payments.** In early December, the IRS issued proposed guidance on the self-employment tax treatment of Conservation Reserve Program (CRP) payments. The key point of the Notice is that participating in the CRP is deemed to be a trade or business - regardless of whether the participant performs the required activities or uses a third party. Thus, CRP rental payments are subject to self-employment tax, regardless of whether the recipient is actively conducting a farming business on non-CRP land, is retired or is simply a passive investor in farmland that happens to be enrolled in the CRP. The IRS has concluded that CRP rental payments are made in exchange for conducting activities that meet the commitments of a CRP contract and are not simply payments for the right to use or occupy real property. The Notice takes the same position that the IRS Chief Counsel's Office took on the matter in 2003. Interested persons may submit comments on the proposed ruling to the IRS by March 19, 2007. *IRS Notice 2006-108, I.R.B. 2006-51.*
2. **Bankruptcy court construes language of 2005 Bankruptcy Act of importance to farm debtors.** The Bankruptcy Court for the Northern District of Iowa has become the first court in the nation to rule on the meaning and scope of language contained in the 2005 Bankruptcy Act designed to provide tax relief to farmers that file Chapter 12 (reorganization) bankruptcy. Historically, taxes triggered upon sale of farm assets were a priority claim in the bankruptcy estate and had to be paid in full ahead of the claims of general unsecured creditors. The 2005 Act changed that by stating:

"[claims]...owed to a governmental unit that arises as a result of sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation...shall be treated as an unsecured claim that is not entitled to priority... if the debtor receives a discharge."

The questions in the case involved the scope and breadth of that language. The court ruled for the IRS on some of the issues involved in the case, and for the debtors on other issues. Here's a summary of how the court ruled:

- a. The provision does *not* necessarily apply to the sale of all of the debtors' farm assets that are sold in connection with the reorganization of the debtor's farming business. Instead, the provision is limited to the sale of the debtor's capital assets that are used in the farming operation.
- b. The allocation of income taxes between priority tax debt and "unsecured" tax debt (under the new provision) is to be calculated by prorating the actual tax for the period according to the proportions of income arising from the sale of farm (capital) assets used in the operation and income arising from all other sources;

- c. In applying the "best interest" test to the portion of the IRS tax claim treated as unsecured, a debtor satisfies the best interest test by showing that the distribution to the IRS under the plan is the same as it would be under a Chapter 7 liquidation for the same treatment status - that of an unsecured claim;
- d. The provision permits the discharge of all debts permissibly provided for by the debtors' reorganization plan;
- e. The tax generated by post-petition sale of farm assets which were used in the farming operation (i.e., land, machinery and equipment) is eligible for the favorable tax treatment under the new provision as an administrative expense that can be discharge without being paid in full.

By limiting relief to the debtor's sale of capital assets, the court has severely limited the relief afforded to debtor's by the provision. The case has been appealed to the Federal District Court for the Northern District of Iowa. *In re Knudsen, No. 05-03136M, 2006 Bankr. LEXIS 3179 (Bankr. N.D. Iowa Nov. 20, 2006).*

3. **Supreme Court muddies waters on isolated wetlands.** The extent of federal jurisdiction over isolated wet areas on private property has been an issue since the mid-1970s. The regulatory agencies (U.S. Army Corps of Engineers and the Environmental Protection Agency) and the federal courts have generally taken an expansive view of the scope of the federal government's ability to regulate activities that impact these wetlands. That means that a farmer, rancher or other landowner generally cannot conduct activities such as land clearing, drainage or customary farming practices without first obtaining a federal permit. The key to whether the feds could require a permit is whether the wet area is "sufficiently connected" to interstate commerce. In 2001, the U.S. Supreme Court said that the presence of migratory waterfowl on an isolated wetland is not enough, by itself, to give the feds jurisdiction. But, what if there is some other connection to interstate waters through hydrology or by some other means? Where is the line to be drawn?

We thought we were going to get an answer to that question when the U.S. Supreme Court, in the fall of 2005, decided to hear two cases involving Michigan land developers that developed isolated wet areas without a federal permit. On June 19, 2006, the Court rendered an opinion covering both of the cases. Unfortunately, no majority opinion was issued, so the matter is still very much up in the air. Clearly, some type of connection to interstate waters is required, but the extent of that connection remains uncertain. Indeed, two other federal courts issued opinions involving isolated wetlands in 2006 and tried to apply the 2006 Supreme Court opinion. One of the courts said that the Supreme Court's rationale was not workable in its application, and the other court found a connection with interstate commerce based on the Supreme Court's opinion. *Rapanos, et ux., et al. v. United States Army Corps of Engineers, 126 S. Ct. 2208 (U.S. 2006).*

4. **Jury hits major packers with judgment for violating Packers and Stockyards Act.** There has been a lot of legal activity in recent months surrounding the conduct of the big meatpackers. In early 2004, a federal jury returned a \$1.28 billion verdict against Tyson Fresh Meats in a nationwide class action case for violating the price manipulation provision in the PSA. That case involved Tyson's use of private contracts (captive supplies) to acquire feeder cattle which allowed them to need not rely on auction-price purchases in the open market for most of their supply. Tyson was then able to use the leverage gained by such a practice to depress the market prices for independent producers on the cash and forward markets. The trial court judge later tossed the jury verdict because he said the PSA contained a "legitimate business reason" defense. The judge's decision was upheld on appeal and the U.S. Supreme Court declined to hear the case. *Pickett, et al. v. Tyson, 420 F.3d 1272 (11th Cir. 2005), cert. den., 126 S. Ct. 1619 (2006).*

In 2006, another federal jury in a different class action case found three major meatpackers to be in violation of the PSA. The case stems from the advent of mandatory price reporting in early 2001. Under that law, the packers were required to report twice daily to USDA information on cattle prices, including prices they received for boxed-beef cuts. The USDA would then release the price information to the public so that cattle producers and others in the market would have accurate information on cattle prices. Unfortunately, USDA issued reports containing faulty boxed beef cutout prices due to a flawed computer program which understated the actual amounts the packers had reported. During the same timeframe, fed cattle prices declined sharply. The plaintiffs claimed that there is a strong relationship between the prices the packers

receive for boxed beef and the prices the packers pay for fed cattle, and that the reason for the low fed cattle prices was because the packers were knowingly using the faulty USDA data to their advantage in violation of the PSA's provisions against unfair and deceptive practices and against controlling and manipulating prices. The jury agreed, hitting Tyson with \$4 million in damages, Cargill with \$3 million and Swift with \$2.25 million. Importantly, the court ruled that the PSA did not prohibit only those unfair and deceptive practices which adversely affect competition, thus the plaintiffs were not required to establish the existence of the element of adverse effect on competition. The court later denied the defendants' renewed motion for judgment as a matter of law.

Tyson and Swift have announced that they will appeal the verdict. Watch this case as it winds through the appellate stage. It may have the effect of breathing some life back into the PSA. *Schumacher, et al. v. Tyson Foods*, 434 F. Supp. 2d 748 (D. S.D. 2006), *motion for JML den.*, 447 F. Supp. 2d 1078 (D. S.D. 2006).

5. **No federal preemption in case against pesticide manufacturer.** The Federal Insecticide, Fungicide and Rodenticide Act (FIFRA) authorizes the EPA to regulate pesticide sale and use. Under FIFRA, it is unlawful to use any registered pesticide in a manner inconsistent with its labeling. While this "label use" provision gives the EPA authority to assess civil penalties against producers that use pesticides improperly or damage the environment, it also limits the ability of injured parties to sue pesticide manufacturers in state court on either an inadequate labeling or wrongful death theory. This is known as "FIFRA preemption," but in 2005 the U.S. Supreme Court ruled in a case involving Texas peanut farmers that their state law claims for defective design, defective manufacture, negligent testing and breach of express warranty with respect to a pesticide that damaged their peanut crops on highly acidic soils (the pesticide label said it was fit for all areas where peanuts were grown) were not preempted. That reversed an opinion of the U.S. Court of Appeals for the Fifth Circuit where the claims were held to be preempted on the basis that if the claims were successful, the pesticide manufacturer would be induced to change its label. The U.S. Supreme Court said that test was too broad. The test for preemption, the Court said, was whether successful claims would actually require a pesticide label to be changed. The key is whether state law imposes broader obligations on pesticide manufacturers than does FIFRA. It was believed that the Court's opinion would lead to a greater percentage of farmers' claims not being preempted.

In a significant recent case, the Minnesota Supreme Court has held that a claim was not preempted by FIFRA. In this class-action case, farmers sued BASF for what they alleged were deceptive marketing practices involving Poast and Poast Plus herbicides. BASF registered both products with the EPA under FIFRA for use on the same crops and they each contained the identical amounts of the same active ingredient, but the company's marketing strategy involved utilizing a label for Poast Plus that did not indicate it was suitable for use on minor crops (sugarbeets, vegetables and fruits, for example). In addition, BASF used ads and brochures designed to prevent farmers from learning that the lower-priced Poast Plus was EPA-registered for minor crops and was the equivalent of Poast. A jury found that BASF had violated the New Jersey Consumer Fraud Act, and the trial court entered judgment for the farmers in an amount in excess of \$52 million. The Minnesota Court of Appeals affirmed, as did the Minnesota Supreme Court. BASF had argued that the farmers' claim was preempted by FIFRA, but that was rejected because the courts determined that the farmers' claim was based on marketing and advertising actions and not on the content of the herbicide labels.

After losing in the state courts, BASF asked the U.S. Supreme Court to review the case. The Court granted BASF's petition, vacated the state court judgment, and sent the case back to the Minnesota Supreme Court for reconsideration in light of the U.S. Supreme Court's opinion in 2005. The Minnesota Supreme Court, on further review, again held that the farmers' claim was not preempted by FIFRA. The court was convinced that the farmers' claim challenged not the label, but BASF's misrepresentations concerning the two herbicides. The issue was not whether the manufacturer, in seeking to avoid liability, would choose to alter the product or label, but whether the claim was a label-based claim that, if successful, would cause the federally-required label to be changed. That wasn't the case and the claim was not preempted by

FIFRA. *Peterson, et al. v. BASF Corp.*, 711 N.W.2d 470 (Minn. Sup. Ct. 2006), cert. den., sub nom., *BASF Corp. v. Peterson, et al.*, 127 S. Ct. 579 (2006).

6. **Nebraska anti-corporate farming law ruled unconstitutional.** On December 13, 2006, the United States Court of Appeals for the Eighth Circuit upheld the Federal District Court for the District of Nebraska and ruled that Initiative 300, the Nebraska constitutional ban on corporate involvement in agriculture, was unconstitutional as a violation of the Commerce Clause. The court ruled that the provision, which places restrictions on corporate ownership of Nebraska farm and ranch land, violates the dormant commerce clause of the U.S. Constitution. The court ruled that Initiative 300 is discriminatory on its face because it affords differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter. In addition to possessing discriminatory effects, the court held the Initiative to be unconstitutional because it was adopted with a discriminatory intent and purpose, and that the state of Nebraska failed to meet its burden of showing that the state could not advance a legitimate local interest without discriminating against non-resident farm corporations and limited partnerships. The court also ruled that severing constitutional portions of the initiative amendment would not be consistent with Nebraska law as announced by the Nebraska Supreme Court and, as a result, the entire amendment must be declared unconstitutional.

The case represents the most recent judicial pronouncement concerning the ability of a particular state's citizenry to shape the future structure of agriculture within that state, and the ultimate outcome of the case will have implications for other states that restrict corporate involvement in agriculture. *Jones v. Gale*, No. 06-1318, 2006 U.S. App. LEXIS 30588 (8th Cir. Dec. 13, 2006).

7. **New Medicaid rules and their impact on estate planning for long-term health care.** On February 8, 2006, the President signed into law the Deficit Reduction Act of 2005. Among other provisions, the Act contains fundamental changes to the Medicaid eligibility rules and long-term care coverage. The new rules will impact significantly estate plans where preservation of family business assets is a major objective. That is a common estate planning objective for farm and ranch families.

Perhaps the most important provisions in the Act are that it extends Medicaid's "look-back" period for all asset transfers from three to five years *and* changes the start of the penalty period for transferred assets from the date of the transfer to the date when the individual transferring the assets enters the nursing home and would otherwise be eligible for Medicaid coverage. In other words, the penalty period does not begin until the nursing home resident is out of funds – i.e., cannot afford to pay the nursing home. The Act also makes any individual with home equity above \$500,000 ineligible for Medicaid (unless the applicant's spouse resides in the home or the home is occupied by a child under age 21, blind or disabled), although states may raise the threshold to up to \$750,000.

In addition, the Act requires all states to apply the so-called "income-first" rule to community spouses who appeal for an increased resource allowance based on their need for more funds invested to meet their minimum income requirements. The Act also closes certain asset transfer "loopholes" such as - (1) the purchase of a life estate would be included in the definition of "assets" unless the purchaser resides in the home for at least one year after the date of purchase; (2) funds to purchase a promissory note, loan or mortgage would be included among assets unless the repayment terms are actuarially sound, provide for equal payments and prohibit the cancellation of the balance upon the lender's death; (3) states are barred from "rounding down" fractional periods of ineligibility when determining ineligibility periods resulting from asset transfers; and (4) states are permitted to treat multiple transfers of assets as a single transfer and begin any penalty period on the earliest date that would apply to such transfers.

The big change (besides the five-year look-back period on all transfers), is that, under the new law, individuals in need of long-term care will be penalized for any gifts they have made during the extended look-back period, regardless of the purpose of the gift. It is immaterial that a moderate gift was made exclusively for a purpose other than to qualify for Medicaid, and it essentially prohibits any gift giving by individuals who have even a remote chance of needing long-term care coverage within the next five

years. *Deficit Reduction Act of 2005, S. 1932, Pub. L. No. 109-171, effective for transfers made after February 8, 2006.*

8. **Government speech doctrine expanded.** In June 2005, the U.S. Supreme Court ruled that the Beef Promotion and Research Act which created the beef check-off was government speech and, as a result, the program could not be challenged constitutionally on First Amendment grounds by those opposed to mandatory program. While the Court's opinion is highly questionable (even supporters of the check-off always referred to it as a private, self-help program), what is of greatest concern is how far the government speech doctrine could be expanded based on the Court's opinion. We now may have at least a partial answer to that question.

In 2003, the Tennessee legislature passed a law authorizing issuance of a specialty license plate with a "Choose Life" logotype. The plate was designed in consultation with a representative of New Life Resources, with half of the profits from sale of the plates going to New Life Resources, Inc. The law required New Life's portion of the profits to be used exclusively for counseling and financial assistance, including food, clothing and medical assistance for pregnant women in Tennessee. During legislative consideration of the Act, Planned Parenthood of Tennessee lobbied for an amendment authorizing a pro-choice specialty license plate, but the measure was defeated. Consequently, the ACLU of Tennessee sued challenging the Act as unconstitutional. The trial court agreed and enjoined enforcement of the Act on the basis that the Act involved a mixture of government and private speech and had a discriminatory viewpoint.

Based on the beef check-off case, the appellate court reversed. Following the rationale of the U.S. Supreme Court in the beef check-off case, the court noted that the "Choose Life" license plate was a government-crafted message where the legislature had retained the right to approve the wording and design of the plate even though the design and message itself was developed by a private organization. The court reasoned that was just like the structure of the beef check-off where a private organization (the Beef Board) developed the advertisements, but the Secretary of Agriculture retained ultimate veto power over the ads. Also in accordance with the beef case, the court held that dissemination of a government-crafted message by a private organization did not require the views expressed to be neutral.

It will be interesting to see how far the government speech doctrine goes. The beef check-off case may have set in motion a process that not many had thought out clearly while that litigation was winding through the courts. *American Civil Liberties Union of Tennessee, et al. v. Bredesen, 441 F.3d 370 (6th Cir. 2006).*

9. **D.C. Circuit Court of Appeals holds portion of Internal Revenue Code unconstitutional.** Monetary damages received either by means of court judgment or settlement that are on account of personal physical injury or physical sickness are excluded from income. Thus, amounts received on account of physical sickness or mental distress may be received tax-free if the sickness or distress is directly related to personal injury. As the regulations point out, nontaxable damages include "an amount received (other than workmen's compensation) through prosecution of a legal suit or action based on tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution. However, 1996 legislation specified that recoveries representing punitive damages are taxable as ordinary income regardless of whether they are received on account of personal injury or sickness. The enactment also made it clear that damages not attributable to physical injury or physical sickness are includible in gross income.

In 2006, the U.S. Circuit Court of Appeals for the District of Columbia ruled that the distinction drawn in the 1996 amendment was unconstitutional. In the case, Marrita Murphy received compensatory damages of \$45,000 for "emotional distress or mental anguish" and \$ 25,000 for "injury to professional reputation" after bringing a complaint with the Department of Labor under various whistle-blower statutes. She alleged that the New York Air National Guard retaliated against her by "blacklisting" her and providing unfavorable employment references after she complained to state authorities about environmental hazards at a Guard air base.

In Murphy's subsequent tax litigation, a three-judge panel of the D.C Circuit Court of Appeals unanimously

held that Murphy's damages were not due to "physical" injury and thus could not be excluded under the authority of the Internal Revenue Code, but that the government nevertheless could not, under the Constitution, tax those damages as "income." The panel based its stated conclusion on two grounds: (1) as compensation for the loss of a personal attribute, such as well-being or a good reputation, the damages are not received in lieu of income; (2) the framers of the Sixteenth Amendment would not have understood compensation for a personal injury -- including a nonphysical injury -- to be income. The Court reasoned that the compensation was awarded to make the Murphy emotionally and reputationally "whole" and not to compensate her for lost wages or taxable earnings. "Income" as contemplated by the 16th Amendment, the Court reasoned, clearly did not include damages received in compensation for a physical personal injury, and it could be inferred that it likewise did not include damages received for a nonphysical injury that was unrelated to lost wages or earning capacity. *Murphy v. United States*, 460 F.3d 79 (D.C. Cir. 2006).

**Note:** The government asked the full D.C. Circuit to hear the case en banc and reverse. In late December, the Court vacated its opinion and agreed to rehear the case.

10. **2006 Tax Legislation.** Significant tax legislation was enacted in 2006, that has relevance to agricultural producers and rural landowners. In May, the President signed into law the Tax Increase Prevention and Reconciliation Act (TIPRA). In August, the Pension Protection Act (PPA) became law and in December the President signed the Tax Relief and Health Care Act (TRHCA) into law. TIPRA extends certain tax provisions

**The major provisions of the TIPRA include:**

- The enhanced expense method depreciation amount under I.R.C. §179 (presently \$108,000) remains in place through 2009 (instead of ending after 2007).
- The favorable tax rates under present law for capital gains and qualified dividend income remains in place through 2010 (instead of ending after 2008).
- For 2006, the alternative minimum tax exemption amount for married taxpayers increased to \$62,550 and for unmarried individuals to \$42,500 (instead of dropping to \$45,000 and \$33,750, respectively).
- For 2006, nonrefundable personal tax credits (such as the dependent care credit, elderly and disabled credit, Hope Credit, and Lifetime Learning Credit) may be claimed to the full extent of an individual's regular tax and alternative minimum tax instead of being allowed only to the extent that regular tax liability exceeds tentative minimum tax - i.e., they had been disallowed when determining the AMT.
- Effective for tax years beginning *after 2005*, the bill increases the age of minors from 14 to 18 for purposes of subjecting the minor's unearned income to tax at the parents' tax rate (the so-called "kiddie tax). An exception applies for a child who is married and files a joint return for the tax year, and for distributions from certain qualified disability trusts.
- Currently, in order to be able to convert from a traditional IRA to a Roth IRA, the taxpayer's adjusted gross income (AGI) for the year must not exceed \$100,000 (for married persons filing jointly). TIPRA eliminates the \$100,000 AGI limit on conversions, effective for tax years beginning after December 31, 2009. For conversions in 2010, unless a taxpayer elects otherwise, the amount includible in gross income as a result of the conversion is included ratably (in equal amounts) in 2011 and 2012. However, if the converted amounts are distributed before 2012, the amount included in the year of the distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 and 2012 in the case of a distribution in 2010) is the lesser of: (1) half of the amount includible in income as a result of the conversion; and (2) the remaining portion of such amount not already included in income.
- Effective for amounts paid or incurred after May 17, 2006, the 2-year amortization period for geological and geophysical (G&G) costs is extended to 5 years for certain major integrated oil companies. The 5-year amortization rule for G&G costs applies only to integrated oil companies that have an average daily worldwide production of crude oil of at least 500,000 barrels for the tax year, gross receipts in excess of \$1 billion in the last year ending during calendar year 2005, and an ownership interest in a crude oil refiner of 15 percent or more. *Tax Increase Prevention and Reconciliation Act of 2005, H.R. 4297, enacted May 17, 2006.*

**The major provisions of the PPA include:**

- Direct deposit of tax refunds into an IRA.
- Direct rollovers (rather than two-step rollovers) can be made from a qualified retirement plan, tax-sheltered annuity or governmental plan directly into a Roth IRA and the amount will be treated as a Roth conversion if all other conversion qualifications are met.

*Certain previously-enacted tax provisions were made permanent:*

- Ceiling on IRA contributions (\$4,000 in 2006; \$5,000 in 2008; inflation adjusted thereafter);
- Higher dollar limits on defined contribution plans (\$44,000 in 2006); elective deferrals (including \$15,000 in 2006 for 401(k) plan deferrals); 457 plan deferrals (\$15,000 in 2006); SIMPLE plan contributions (\$10,000 in 2006);
- Roth 401(k)s and 403(b)s;
- Saver's credit (with gross income amounts used to compute the amount of the credit indexed for inflation beginning in 2007; however the credit itself is not adjusted for inflation);
- I.R.C. §529 plans

*Charitable donation provisions:*

- For taxpayers on the calendar year, beginning in 2007, cash donations *of any amount* must be substantiated either by a cancelled check, bank record or written substantiation from the charity indicating the amount of the contribution, the date the contribution was made and the name of the charity;
- The Act allows tax-free distributions from IRAs (both traditional and Roth) for charitable purposes through 2007, with a maximum annual cap of \$100,000;
- For 2006 and 2007 only, the Act raises the deduction limits for qualified conservation easements from 30 percent to 50 percent of adjusted gross income. For a donor that is a "qualified farmer or rancher" the deduction limit is 100 percent provided the donated property remains available for agricultural production. *Pension Protection Act of 2006, H.R. 4, enacted August 17, 2006.*

**The TRHCA extends through 2007:**

- The deduction for qualified tuition and related expenses for higher education;
- The deduction for state and local sales taxes;
- The above-the-line deduction of up to \$250 for out-of-pocket classroom expenses of school teachers;
- The authority for Archer medical savings accounts;
- The suspension of the percentage depletion method's income limitation for oil and natural gas produced from marginal properties;

**The TRHCA extends several temporary energy tax provisions through 2008, including:**

- The renewable energy credit;
- The clean renewable energy bonds credit.
- The deduction for energy-efficient commercial buildings;
- The credit for energy-efficient homes;
- The credit for residential energy-efficient property;
- The energy credit; and
- The rule contained in I.R.C. §4041 that lowers the fuel excise tax rate on qualified methanol and ethanol fuel.

The Act also allows a one-time, tax-free distribution (roll-over) from an individual retirement account to an HSA, subject to several limitations. The Act also retools the limits on deductible annual contributions to an HSA. HSA contributions are no longer limited to the annual deductible of the individual's high deductible health policy. Instead, for 2007, the maximum contribution limit is \$2,850 for single coverage or \$5,650 for family coverage. Individuals age 55 or over may make an additional catch-up contribution of \$800 for 2007.

To assist home buyers that pay either no down payment or very little, the Act provides for an itemized deduction for qualified mortgage insurance premiums paid or accrued in 2007 on contracts issued in 2007 for qualified residences purchased or refinanced in 2007. *Tax Relief and Health Care Act of 2006, H.R. 6111, enacted December 20, 2006.*