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Top Ten Agricultural Law Developments of 2010

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We begin 2011 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 2010 based on their impact (or potential impact) on U.S. agricultural producers and the sector as a whole.

1. **Transfer tax provisions of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("Act").** In addition to containing income tax provisions (among other things), the Act significantly changes the federal estate tax, which will impact estate planning for many persons, and presents significant estate planning opportunities for everyone (at least for two years). Before the Act was enacted, legislation enacted in 2001 gradually reduced the federal estate tax over several years, and then eliminated it for decedents dying in 2010. Had the Congress not done anything, the estate tax would have reappeared for deaths in 2011with a per-decedent exclusion of $1 million and a tax rate of 55 percent. The Act, at the executor's election, reinstates the estate tax for decedents dying during 2010, but with an exclusion of $5 million, and maximum tax rate of 35 percent, and continues the $5 million exclusion and 35 percent top rate for deaths in 2011-2012. After, 2012, if the Congress does not enact additional legislation, the estate tax rate will be 55 percent with an exclusion of only $1 million per-decedent for deaths after 2012.

The Act also replaces the modified carryover basis rule for 2010 with the fair market value date-of-death basis rule that had been utilized for deaths through 2009. Under the modified carryover basis rules that applied during 2010, executors could increase the basis of estate property only by a total of $1.3 million (plus an additional $3 million for assets passing to a surviving spouse, for a total increase of $4.3 million), with other estate property taking a carryover basis equal to the lesser of the decedent's basis or the property's fair market value as of the decedent's death. But, the Act specifies that executors of decedent's estates for 2010 dying during 2010 have the option to apply the 2011-2012 rules (as to the basis rule, exclusion and tax rate) or the 2010 rules. The Act also provides for "portability" between spouses of the exclusion amount for estates of decedents dying in 2011 and 2012 *if both spouses die before 2013*. That means that a surviving spouse can elect to use any unused amount of the exclusion of the predeceased spouse. But, in order to get portability, the executor must file an estate tax return for the estate of the first spouse to die (even though no estate tax is due and a return would not otherwise be required) and make an election.

For gifts made in 2010, the maximum gift tax rate was 35 percent and the applicable exclusion amount was $1 million. But, the Act specifies that, for gifts made in 2011 and 2012, the maximum gift tax rate is 35 percent and the applicable exclusion amount is $5 million. This is exactly the same exclusion and rate as the estate tax for 2011-2012.

Also, the Act provides a $5 million generation-skipping transfer tax (GSTT) exemption amount for 2010 (equal to the applicable exclusion amount for estate tax purposes) with a GSTT tax rate of zero percent for 2010. For transfers made in 2011-2012, the GSTT tax rate is 35 percent with a $5 million exclusion. *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, H.R. 4853, signed into law on December 17, 2010 as Pub. L. No. 111-312.*

2. **U.S. Supreme Court denies review in case expanding reach of Clean Water Act to agricultural activities.** In early 2009, the United States Court of Appeals for the Federal Circuit ruled that even though a pesticide complies with the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA), the pesticide is *not exempt* from the Clean Water Act's permitting requirements. As a result, the court invalidated an EPA regulation made final in late 2007, with the impact of the court's ruling broadening the potential application of the CWA to agricultural activities. The EPA's final rule excluded pesticides from the CWA's permitting requirements so long as the pesticides complied with the labeling requirements of FIFRA. FIFRA is the law that requires registration of all pesticides intended to prevent, destroy, repel or mitigate certain pests. FIFRA also regulates pesticide use and requires certification of all pesticide applicators. Importantly, the EPA cannot register a pesticide for use (or approve its label) unless it determines that that pesticide will not have "unreasonable adverse effects on the environment." So, by definition, a pesticide that meets FIFRA requirements does not have any unreasonable adverse effects on the environment – if a pesticide won't have any unreasonable adverse effect on the environment (i.e., it satisfies FIFRA), then it should also be exempt from the CWA permitting requirements. But, environmental groups challenged the rule, arguing that the EPA overstepped its authority by excluding "pesticide residuals" from the definition of pollutants, deeming pesticides a "nonpoint source pollutant," and exempting FIFRA-compliant pesticides from CWA requirements.

The Sixth Circuit concluded that the CWA clearly establishes a list of pollutants that don't require permits, and noted that pesticides are not on that list. The court also rejected the EPA's attempt to introduce a temporal restraint to the meaning of the phrase "discharge of a pollutant." EPA claimed (based on the plain language of the CWA) that pesticide residue is not subject to the permitting program, because "at the time of discharge ... the material in the discharge must be both a pollutant, and from a point source." But the court said that if it adopted the plain statutory meaning, "discharges that are innocuous at the time they are made but extremely harmful at a later point would not be subject to the permitting program." Thus, the court vacated the EPA's final rule. But, that conclusion doesn't seem correct. As noted above, to meet the FIFRA requirements, a pesticide must not have any unreasonable adverse effects on the environment. So, a FIFRA-approved pesticide is not a "pollutant" for CWA purposes. But, it was the later effect of the discharge that was problematic to the court.

While the CWA clearly applies to the discharge of a pollutant from a point-source, pesticide residue is something that occurs *after* a discharge occurs. Other federal courts have ruled that pesticides applied consistent with FIFRA are not "chemical wastes" (i.e., not "pollutants") and no CWA permit is required. But, some of these courts have reached this conclusion only when the pesticide leaves no residue. Thus, many in agriculture had hoped that a rehearing would be granted in the case and, if necessary that the U.S. Supreme Court would agree to hear the case and clarify the differing outcomes among the lower courts. However, the full Sixth Circuit declined to rehear the case last August and on Feb. 22, 2010, the U.S. Supreme Court refused to take the case. *The Cotton Council of America, et al. v. United States Environmental Protection Agency, 553 F.3d 927 (6th Cir. 2009), cert. den. sub. Nom., American Farm Bureau Federation v. Baykeeper, 130 S. Ct. 1505 (2010).*

3. **Court blocks U.S. Army Corps of Engineers attempt to extend jurisdiction over "prior converted" wetland.** In 2010, a Florida federal district court issued an order blocking an attempt by the U.S. Army Corps of Engineers (COE) to expand its powers over "prior converted cropland" under the Clean Water Act (CWA) without first subjecting its rulemaking to the applicable administrative requirements. The court invalidated new rules that would have given the COE jurisdiction over prior converted croplands – croplands that were lawfully converted before the enactment of the CWA.

   Section 404 of the CWA makes illegal the discharging of "dredge or fill material" into the "navigable waters of the United States" (including wetlands) without first obtaining a permit from the Secretary of the Army acting through the COE. But, former wetlands that were altered *before* 1985 were exempted. Thus, such prior converted cropland is not subject to the permit requirements of Section 404 of the CWA. At least that was the case before a 2009 change in COE policy. That change in policy was at issue in the case.

   The plaintiff operated a "renewable energy" facility on portions of land that was previously used to grow sugarcane. In 1993, the COE designated the property as a "prior converted wetland" and informed the plaintiff that it did not need a CWA permit to build its plant. Years later, however, the plaintiff wanted to build an "ash monofill" (a landfill for waste produced at the facilities) on other parts of the former sugarcane farmland adjacent to the plant. The project involved transforming some of the land to limestone quarries which would eliminate the need for the long-distance hauling of ash. The plaintiff planned to use "continuous pumping" to keep the ash monofill area dry. In January 2009, however, the COE announced that it was asserting jurisdiction over prior converted cropland. No notice or comment period accompanied the release of an "Issue Paper" that was prepared by the COE's Jacksonville, Florida, Field Office. The Issue Paper was issued in response to several applications for jurisdictional determinations involving the proposed ash monofill project. While state and local agencies had reviewed the proposed project and issued the appropriate permits, when the COE learned of the proposed project the COE applied its new rule to the project with the result that the project became subject to COE permit requirements and became much more costly to implement. The COE's field office concluded that the plaintiff's proposed project would be an "atypical" transformation of the property subject to COE jurisdiction. The COE determined that "continuous pumping" to keep out wetland conditions was not the "normal circumstances" under the statute. The COE's position which was adopted by the COE Director in April of 2009 and affirmed by the local field office became known as the "Stockton Rules." Under the COE's new position as applied to the proposed project, a wetland determination was to be made based on what the property's characteristics would be if continuous pumping ceased. Consequently, as applied to the plaintiff's proposed project, the rules had the effect of changing the regulatory definition of "normal circumstances." Importantly, the new regulatory definition was applied without being subjected to the notice and comment requirements of the Administrative Procedures Act (APA).

The plaintiff filed a formal complaint in federal court, seeking to set aside the so-called "Stockton Rules." The company claimed that the Stockton Rules improperly expanded the COE's jurisdiction by creating a new rule that wetland exemptions for prior converted croplands are lost upon conversion to a non-ag use. The plaintiffs further alleged that the rules also created a new interpretation for "normal circumstances" where dry lands are "maintained" using continuous pumping. They claimed that the rules were unconstitutionally vague and exceeded the COE's statutory authority.

The plaintiff argued that the COE improperly developed the new rules without issuing general notice of proposed rule-making in accordance with the APA. The court held that the new rules were not mere formalities or policy statements, but were legislative rules that substantially changed the COE's treatment of prior-converted cropland and "broadly extended the Corps' jurisdiction and sharply narrowed the number of exempt prior converted croplands." Accordingly, the rules were subject to the APA's notice and comment requirements which accompany changes to administrative regulations that are required to be published in the Federal Register. The court also noted that the Stockton Rules also varied from the plain language of the Wetlands Manual which requires the COE to find present evidence of wetland indicators before an area can be designated as a wetland. While there are exceptions for atypical situations, such as emergencies, unauthorized activities or natural events, none of those existed in this case. The COE also argued that the Director lacked the power to implement the Stockton Rules and, as a result, the rules were not binding even though they constituted the COE's current policy. Again, however, the court disagreed, noting that the Stockton Rules constituted new legislative rules that were subject to the APA's notice and comment requirements. Accordingly, the court set aside the Stockton Rules in their entirety. *New Hope Power Company, et al. v. United States Army Corps of Engineers, No. 10-22777-CIV-Moore/Simonton, 2010 U.S. Dist. LEXIS 101828 (S.D. Fla. Sept. 28, 2010).*

4. **Congressional passage of the FDA Food Safety Modernization Act (Act).** In late 2010, the Congress passed major legislation which gives the Food and Drug Association (FDA) authority to oversee the food marketplace. The Act represents the biggest change in U.S. food safety laws since the 1938 enactment of the Federal Food, Drug, and Cosmetic Act. The law authorizes the Food and Drug Administration (FDA) and the Secretary of Health and Human Services (HHS) to engage in heightened inspections (to increase by a factor of seven over the next five years) of "food facilities" to be paid for by a tax on such facilities, and the enforcement of strict record-keeping requirements. However, importers that are in compliance with "existing seafood, juice and low-acid canned food regulations" are exempted. The Act requires all "food facilities" to produce "risk-based" preventative controls and undertake periodic hazard analyses, but the Act does not apply to meat, poultry and dairy products. The Act also gives the FDA mandatory recall authority over covered food products, except alcoholic beverages. Under the Act, most food companies will be required to write and implement food safety protocols designed to minimize potential food hazards (a written plan spelling out the possible problems that can affect the safety of their products and outlining steps to be taken to keep those problems from occurring) – with the costs of the additional administrative burden ultimately passed-on to consumers.

   The Act requires registration and payment of a fee by any "person" who "manufactures, processes, packs, distributes, receives, holds, or imports an article of food." Restaurants are exempted from the requirement, as are those that are classified as a "very small business" (to be determined by FDA regulation or where the average annual monetary value of all food sold by the facility during the previous three-year period was less than $500,000 (but only where the majority of the food sold by the facility was sold directly to consumers, restaurants, roadside stands or farmers' markets, or grocery stores (as opposed to third party brokers) and were in the same state where the facility sold the food or was within 275 miles of the facility)). Even though a facility qualifies for the exemption, they would still have to demonstrate that the facility has identified potential hazards and are implementing preventative controls to address the hazards, or they demonstrate to the FDA that they are in compliance with state or local food safety laws. In other words, the exemption only applies to the requirement of submitting food safety plans. It does not create an exemption from inspection and licensing requirements. The Act also contains an exemption from the registration/certification requirement for food sold at farmers' markets. In general, enforcement lies with the Department of Homeland Security

The Act also applies "whistleblower" protections to all employees of employers that are "engaged in the manufacture, processing, packing, transportation, distribution, reception, holding or importation of food." Such employees can have their case heard before a federal jury, and be reinstated, receive back-pay and recover compensatory damages.

The Act also gives the FDA the power to "harmonize" the U.S. food and dietary supplement industries with internationally recognized standards (Codex Alimentarius). Generally, that will ensure that basic food staples are genetically modified (Monsanto was a major supporter of the Act). Similarly, the Act says that its provisions are to be construed in a manner that is consistent with the agreement establishing the World Trade Organization "or any other treaty or international agreement to which the United States is a party."

The Congressional Budget Office estimates that the Act requires additional spending of $1.4 billion over the next four years. The additional costs to private sector have not yet estimated. Interestingly, the Act passed despite data showing that the incidence of food-borne illnesses has dropped by one-third over the past 14 years. *H.R. 2751, signed into law on January 4, 2011 as Pub. L. No. 111-353*.

5. **Court provides first interpretation of bona fide purchaser defense under Superfund law**. In November of 2006, the EPA regulations regarding the bona fide purchaser (BFP) defense became final. At least theoretically, the BFP defense allows the purchase of contaminated real estate without the purchaser acquiring Superfund liability. The first judicial interpretation of the regulatory requirements of the BFP defense occurred in late 2010. In a South Carolina Federal District Court opinion in 2010, the court was faced with a case involving an $8 million clean-up on a 43-acre property that had previously been used as a fertilizer manufacturing plant. Remediation of the site required the removal of arsenic, lead, polycyclic aromatic hydrocarbons (PAH) contamination and the raising of pH levels at the site. Multiple parties were brought into the action and the court allocated clean-up responsibility to each party involved. The plaintiff obtained a Phase I Environmental Site Assessment (ESA) before buying the property, which identified some sumps and stained concrete pads as Recognized Environmental Conditions ("RECs"). However, the plaintiff did not do any testing around the sumps or the concrete pads to determine if the RECs had, in fact, caused a release. Some time thereafter, the plaintiff tore down some buildings on a parcel of the property which had covered sumps that previously contained hazardous substances. No testing was done around the sumps before removal of the buildings. The government brought a CERCLA cost recovery action and the plaintiff was assessed $194,232 in remediation costs as the current owner of the

property. The plaintiff sought reimbursement (contribution) of that amount from various parties who had either owned or operated the site in the past. The plaintiff asserted the BFP defense as the basis for contribution from the prior owner and operators.

In analyzing the defense, the court required the plaintiff to prove eight elements of the defense by a preponderance of the evidence: (1) no disposal after acquisition; (2) conduct all appropriate inquiry: (3) report all subsequent releases; (4) exercise appropriate care; (5) fully cooperate and assist in providing access to the property; (6) have all appropriate institutional controls; (7) comply with all requests and subpoenas; and (8) have no affiliation with parties that are potentially responsible parties

Ultimately, the court found that the plaintiff was PRP because it was the current owner of contaminated property and it did not satisfy the requirements of the BFP defense. The court then allocated the clean-up costs to the various parties. The plaintiff was allocated 5 percent of the entire costs of clean-up – approximately $400,000. The original owner was allocated 45 percent of the responsibility, and the plaintiff was entitled to 76 percent contribution from other prior owners and operators (which would also apply to any future remediations). *Ashley II of Charleston, LLC v. PCS Nitrogen, Inc. v. Ross Development Corp. et al*., No. 2:05-cv-2782-MBS, 2010 U.S. Dist. LEXIS 104772 (D. S.C. Sept. 30, 2010).

6. **U.S. Supreme Court reversal - injunction against Monsanto's Roundup Ready alfalfa should not have been entered.** The use of biotech crops has spawned numerous legal issues, but none of them have ever made it to the U.S. Supreme Court – until 2010. The case involved review of a decision by the U.S. Court of Appeals for the Ninth Circuit that resulted in a temporary ban on genetically modified alfalfa – Monsanto's Roundup-Ready Alfalfa. The key issues were whether the plaintiffs, producers of organic alfalfa seeds, are exempt from being required to show a likelihood of irreparable harm to get an injunction under the National Environmental Policy Act (NEPA), whether the trial court can enter an injunction to remedy a NEPA violation without holding an evidentiary hearing to resolve factual issues that are relevant to the scope of the injunction being sought, and whether the appellate court was correct to affirm the nationwide injunction based solely on a remote possibility of irreparable harm.

USDA's Animal and Plant Health Inspection Service (APHIS) regulates the introduction of genetically modified organisms and products, and initially classified Monsanto's alfalfa as a regulated article. Monsanto requested the agency grant it non-regulated status. APHIS made a finding of "no significant impact" in June of 2005. Importantly, APHIS also unilaterally concluded that it need not prepare an EIS and unconditionally deregulated Roundup Ready Alfalfa. That's when the legal battle began.

The trial court criticized the USDA as being "cavalier" and held that USDA violated federal law by failing to assess the possible environmental impacts before approving Monsanto's genetically engineered alfalfa. The plaintiffs claimed that the biotech alfalfa could create super weeds resistant to herbicide, hurt production of organic dairy and beef products, and could cause farmers to lose export business due to risks of contamination to natural and organic alfalfa. The suit also alleged that contamination of conventionally grown alfalfa could force farmers to pay for Monsanto's patented gene technology whether they wanted it or not. The plaintiffs sought an injunction against future seed sales or plantings of biotech alfalfa. On March 12, 2007, the court vacated APHIS' decision to deregulate Roundup Ready Alfalfa and issued a preliminary injunction that temporarily halted the planting of GMO alfalfa in the U.S. The injunction allowed continued harvest, use and sale of Roundup Ready Alfalfa, but placed limits on the purchase and planting of seed until further hearings were held. Farmers who already have purchased Monsanto's Roundup Ready alfalfa were required to plant it by March 30, 2007. No new sales of the seed were allowed after March 12. The order also specified that farmers intending to plant alfalfa after March 30, 2007, must plant non-genetically engineered alfalfa. Approximately 200,000 acres of genetically modified alfalfa already had been planted in across the U.S., and the court's order did not require those crops to be removed. The court later heard oral arguments in the case concerning the nature of any permanent injunctive relief, and on May 3, 2007, the court the temporary injunction permanent.

In 2008, the U.S. Court of Appeals for the Ninth Circuit upheld the injunction barring the future planting of Monsanto alfalfa until the government prepares an Environmental Impact Statement (EIS).

On June 21, the U.S. Supreme Court reversed. The Court held that existence of a NEPA violation does *not* create a presumption that injunctive relief is available and should be granted absent unusual circumstances. Here, the Court determined that the farm groups had not satisfied any of the four factors, and could not show that they would suffer irreparable injury if APHIS were allowed to proceed with any partial deregulation. Indeed, the Court noted that a partial deregulation could be constructed to result in practically no injury to the farmers by limiting its scope such that the risk of gene flow is practically nonexistent. The Court even went so far to note that the trial court's injunction basically pre-empted the APHIS process that could determine whether a partial deregulation would pose any appreciable risk of environmental harm. The Court also held that the trial court erred in entering a nationwide injunction against the planting of Roundup Ready Alfalfa. The Court held that the trial court acted improperly in preventing the possibility of a partial and temporary deregulation and, therefore, acted improperly in enjoining planting. In addition, the Court noted, an injunction is not to be granted "as a matter of course." The Court noted that the farmers conceded that a less drastic remedy was available (a partial or complete annulment of APHIS's deregulation decision) to redress their injury. *Monsanto Co. v. Geertson Seed Farms, 130 S. Ct. 1133 (U.S. 2010).*

7. **GIPSA proposed rules.** On June 22, 2010, the Grain Inspection, Packers and Stockyards Administration (GIPSA) published proposed rules as required by the 2008 Farm Bill. The proposed rules would add "several new sections" to the regulations under the PSA. According to the summary of the proposed rules, the new regulations would "describe and clarify conduct that violates the P&S Act and allow for more effective and efficient enforcement by GIPSA. The proposed regulations would clarify conditions for industry compliance with the P&S Act and provide for a fairer market place." Among other things, the regulations provide new rules in several areas, including the following:

- The applicable rules when a contract grower is required to make an additional capital investment to get a contract;
- The criteria the Secretary may consider in determining whether a packer, swine contractor or live poultry dealer has provided a grower a reasonable time to remedy a breach of contract that could lead to contract termination;
- Arbitration-related provisions – the Secretary can consider various criteria when determining whether arbitration has given the grower a "meaningful opportunity" to participate in the process;
- Regulations governing "unfair, unjustly discriminatory and deceptive" practices or devices; and
- Regulations governing the "tournament system" of buying livestock.

8. **U.S. Tax Court opinion on medical reimbursement plans**. It is possible to generate income tax advantages through various fringe benefits that can be provided to a spouse as an employee of the family business. One of those fringes for an employee/spouse that is a bona fide employee is employer-provided health insurance coverage that can also include other family members. The technique, if done properly, can also convert family health insurance premiums into deductible business expenses. Pursuant to I.R.C. §105, an employer can establish a medical reimbursement plan covering the employer's spouse. But, to get the desired tax benefits, the arrangement must be properly structured. Here's what IRS requires: (1) the employee-spouse must be a bona fide employee of the business and provide services to the business for which the compensation *and* fringe benefit package represents reasonable compensation; (2) the employer-spouse deducts 100 percent of the fringe benefits as a business expense, and the employee-spouse receives a tax-free fringe benefit; (3) the employer-spouse may be covered by the medical benefits as a member of the employee's family; (4) payments for reimbursement of medical expenses incurred before the adoption of the fringe benefit arrangement are *not* permitted; (5) the performance of nominal or insignificant services that have no economic substance will be challenged; and (6) the medical insurance policy should not be held in the name of the employer-spouse, but should be owned by the employee-spouse.

   In 2010, the Tax Court decided a case involving a Kansas farm couple. The couple jointly owned three pickup trucks that were used on the farm and the husband individually owned other farm equipment, including a tractor and a combine. The couple had a joint checking account, on which they both wrote checks to pay expenses. They also took out various farm loans with both of them signing most of the notes for the loans. The wife had assisted with farming chores for over twenty years before the medical reimbursement plan was established. In 2001, the couple executed an employment agreement and filled-out a pre-printed application for an Agriplan/BIZPLAN medical reimbursement plan. Under the plan, the wife was to be reimbursed for health insurance premiums for her and the family, up to $15,000 for out-of-pocket medical expenses for her and the family and $50,000 of term life insurance for herself. The wife also opened up a checking account in her name in which she deposited her monthly "paycheck" of $100. For 2001, the wife paid almost $8,000 in medical expenses and health insurance premiums for herself and the family for which she was reimbursed pursuant to the reimbursement plan. The wife did receive an IRS Form W-2 for 2001 on which wages of $754 was reported. On the couple's 2001 tax return, they claimed a Schedule F deduction of over $15,000 for "Employee benefit programs" and a $700 deduction for "Labor hired." The wife was listed on the return as "HOUSE WIFE." The same events occurred in 2002 except that reimbursement for medical expenses was greater as was the amount paid as "wages." That resulted in a $20,897 deduction being claimed on the 2002 return for "Employee benefit programs" and a $1,200 deduction for "Labor hired." Again, on the 2002 return, the wife was listed as "HOUSE WIFE." For both 2001 and 2002, IRS disallowed the vast majority of the amount claimed for "Employee benefit programs."

   The Tax Court upheld the IRS determination on the basis that the wife was not a bona fide employee of her husband. The court rejected the couple's argument that the 2001 employment agreement simply formalized a pre-existing employer-employee relationship, pointing out that the wife had never been remunerated for her services and, without remuneration, there could be no employment relationship. The court was convinced that nothing happened in 2001 that changed the nature of the economic relationship between the couple and that the low-level of compensation that was paid beginning in 2001 was "illusory." Instead, the court determined that the whole arrangement was for the purpose of simply reimbursing family medical expenses and insurance premiums in a tax deductible fashion. The court noted that the funds in the joint account were owned equally by the spouses. As such, the husband (the employer) owned the funds equally with the wife and amounts paid from the account (although, there was evidence that the spouse was not paid from the joint account) were deemed to have been paid equally by each of them. So, the wife was "reimbursed" with her husband's funds with any resulting economic benefit was directly offset and negated by the wife assuming and paying her husband's liability for the family medical expenses. The end result was that the medical expenses continued to be paid from the joint checking account, just like they had been for many years prior. That further confirmed to the court that there was no bona fide employment relationship between the parties. Indeed, the wife's occupation was denoted on the couple's tax return as "HOUSE WIFE." The end result was that the court disallowed any deduction for employee program benefits. The case is on appeal to the U.S. Circuit Court of Appeals for the Tenth Circuit. *Shellito v. Comr., T.C. Memo. 2010-41.*

9. **Expense method depreciation and leased property.** Farmers and other business owners who buy equipment to use in their operation often prefer to deduct the cost of the purchase in the year of purchase to the greatest extent possible. The aggregate basis amount eligible for the deduction (federal) is $500,000 for 2010 through 2012. That dollar limit is for all eligible property placed in service during the year, not for each item. Property that is eligible for expense method depreciation is tangible, depreciable personal property. For 2010-2012, expense method depreciation is phased out for taxpayers with cost of qualifying property exceeding $2,000,000 per year. Several technical rules must be satisfied for property to be eligible for expense method depreciation, including one that involves leased assets. That special rule was at issue in this case.

The taxpayers were a farm couple in southeast Iowa that owned and operated a 504-acre farm. Sometime around 2000, the couple orally agreed to lease 124 acres of their farmland along with buildings, grain storage bins and equipment to Circle T Farms, Inc., a hog farrow-to-finish business that the couple owned. Under the oral agreement, the taxpayers would annually receive $70,000 cash rent. They leased the balance of their farmland to C&A, Inc., an unrelated party, again via an oral lease. The husband also entered into an oral farming agreement with C&A that was put in writing in 2006 to state that the agreement "covered any future year[']s crops, so long as neither party requested a change on or before Sept[ember] 1 of the calendar year." In 2004, 2005 and 2006, they purchased property that qualified for expense method depreciation. On their tax return for 2004, they expensed $52,000 for drainage tile and a fence that was installed on the land that they leased to C&A, and $10,000 for material they purchased to remodel their farm office, including furniture and fixtures. For 2005, they expensed $63,488 for a grain bin. For 2006, the expensed $8,467 for a pickup truck and $31,000 for a grain bin and grain dryer. The bin and dryer (and, presumably, the pickup truck) were orally leased to Circle T Farms – for the $70,000 annual "cash rent." The IRS disallowed all of the expense method depreciation deductions for the farm-related property - citing the non-corporate lessor rule.

As for the office equipment, the court agreed with the IRS that the couple didn't substantiate the deduction on their return and, as such, the court couldn't determine whether the office material were "other property" under I.R.C. Sec. 1245. Importantly, the court *did not hold* that the office materials were *not* I.R.C. §1245 property, but did hold that the taxpayers failed to present sufficient evidence to allow the court to determine whether the office materials were not "structural components" and would, therefore, be eligible for expense method depreciation. So, an expense method deduction was denied for those items. The court did not address the non-corporate lessor rule with respect to the office equipment.

As for the grain bins, grain dryer, drainage tile, pickup truck and fence, the non-corporate lessor rule was applicable. That rule can bar an I.R.C. §179 deduction for non-corporate taxpayers that acquire property for leasing purposes. To get around the rule, a non-corporate lessor must be able to show that the lease (accounting for renewal options) must be less than 50 percent of the class life of the leased property. Once that rule is satisfied, the claimed business expenses for the first 12 months after the transfer of the property to the lessee must exceed 15 percent of the rental income that the property produces. The couple claimed that they met the first test because they renewed their leases involving the farm property every year. So, they claimed, the lease term was a series of one-year leases and was, therefore, less than 50 percent of the class life of the farm-related property. But, the IRS and the court disagreed. None of the leases were in writing and the couple didn't provide any evidence of the actual lease terms. As a result, the court concluded that the leases were for an indefinite period of time and couldn't be claimed to have a term of less than 50 percent of the class life of the property. Since the first part of the test was not satisfied, the second part was immaterial. The court also imposed an accuracy-related penalty. *Thomann v. Comr., T.C. Memo. 2010-241.*

10. **Crop insurance fraud case stays alive.** In 1938, Congress enacted the Federal Crop Insurance Act (FCIA), establishing the Federal Crop Insurance Corporation (FCIC) (a wholly owned government corporation within the U.S. Department of Agriculture). In 1996, the system was updated with the creation of the Risk Management Agency (RMA) which was tasked with the administration of the FCIC. What developed was a system of private crop insurance companies that would be reinsured by the FCIC. Thus, farmers could purchase a policy from a private insurance company which would pay farmers for covered losses, and the insurance company could then seek reimbursement by the federal FCIC. At issue in this case was whether the defendant, the owner of a private crop insurance company in Iowa committed crop insurance fraud when, as the government claimed, he submitted false insurance claims to the FCIC for reimbursement.

The defendant sold Multi-Peril Crop Insurance (MPCI) policies to farmers across the Midwest and received commissions on those policies. To obtain MPCI, a farmer must have an "insurable interest" in the crop "at the time the coverage begins." Each farmer must turn in annual acreage reports to certify their insurable interest. Throughout the years of 2000 and 2001, the agent turned in crop insurance applications in the names of several farmers who had no insurable interest in the crops that they claimed losses on. Thus, these farmers were not eligible to receive FCIC reinsured coverage. Even though the agent knew these farmers had no insurable interest, he submitted claims for crop losses in excess of $300,000 and the FCIC reimbursed his company. In addition, some of the farmers submitted false acreage reports on non-eligible property and others never even signed the crop insurance application and were generally confused as to what ground they had covered. Even so, the defendant knew the reports were false and that some of the claims had not been properly made.

When the federal government learned of the agent's actions in 2006, they sued him for violation of the False Claims Act (31 U.S.C. §3729(a) (1)-(3) and Iowa law. The defendant moved for summary judgment and the trial court agreed. The court determined that the government failed to prove that the agent actually "presented" a false claim to representatives FCIC because the claims were actually presented to the North Central Crop Insurance (NCCI), a private company, who then presented the claims to the FCIC. The trial court believed that the government was unable to prove that the agent intended for the *government* to rely on false documents to reimburse the private insurance company's pay out for claims. The court also tossed the Iowa fraud claim.

On appeal, the court reversed. On the issue of "presentment of false claims," the appellate court found that there was a "genuine issue" as to whether the insurance agent actually presented, or caused to be presented, a false claim to the U.S. government. The court focused on the depositions of witnesses who would testify at trial that the agent did, indeed, submit false information on loss data electronically. An official of the USDA testified in his deposition that the insurance agent would have to initially submit the loss amount through FCIC's electronic "Data Acceptance System" to begin the reimbursement process. The court found that submitting false claims electronically to FCIC, even though it is initially presented to a private company, still amounts to the presentation of a false claim to the federal government.

On the issue of whether there was enough evidence to present a triable question concerning whether the agent made a false claim "knowingly using" false documentation, the primary issue was whether the false records were material to the Government's decision to pay the claims. Central to the court's analysis was evidence of the agent's intent that the government rely on the electronic claim submissions. The court noted that there must be a direct link between the false statement and the Government's decision to pay the claim, and the court determined that there was sufficient evidence to show that there was a direct link – there existed a question of whether the farmers and the defendant knowingly agreed to participate in a "scheme" to allow ineligible farmers to obtain crop insurance. On that point the court noted that the defendant had extensive experience selling federally reinsured crop insurance.

The appellate court also reversed the trial court on the Iowa common law fraud charge, and remanded the case to the trial court where the case will proceed. *United States v. Hawley, 619 F.3d 886 (8th Cir. 2010).*

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