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Top Ten Agricultural Law Developments of 2012

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We begin 2013 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 2012 based on their impact (or potential impact) on U.S. agricultural producers and the sector as a whole.

1. **The uncertainty caused by expiring tax legislation.** Much of 2012 was consumed with uncertainty over many tax provisions set to expire at the end of 2012. The uncertainty involved income tax, transfer taxes, alternative minimum tax, and payroll tax. The expiring provisions were largely part of tax provisions enacted in 2001 that were initially set to expire at the end of 2010, but were extended in late 2010 for an additional two years. The uncertainty made tax, financial, estate, and business planning incredibly difficult through 2012. The Congress failed to enact legislation to deal with the uncertainty by the end of 2012, but as the year expired, the Congress was working to pass legislation to deal with the expiring provisions. For farmers, if tax rates increase in 2013 and beyond (outside of the tax increases included in the 2010 health care law that take effect in 2013), farm income averaging can be utilized to delay any tax increases on a large chunk of farm income for another three years. Also, the ability to make or revoke an I.R.C. §179 election on an amended return for an open tax year beginning before 2013 is an important tool farmers and ranchers can utilize to minimize the impact of higher taxes in 2013. In addition, the ability to elect out of installment sale treatment on deferred payment contracts and other installment sales can be a good tax planning tool in light of the uncertainty.

   Note: On January 1, 2013, the Congress passed tax legislation (H.R. 8 — The American Taxpayer Relief Act of 2012) designed to deal with the expiring provisions. The legislation retains the existing individual income tax rates for incomes under $400,000 (single) and $450,000 (MFJ). For incomes over the threshold, the 2001 rate structure is maintained. The top capital gain rate stays at 15 percent for those under the $400,000 or $450,000 threshold, as does the top dividend rate. The legislation also enacts a permanent AMT "patch," and retroactively reinstates expense method depreciation to the $500,000 level for 2012 and extends that level through 2013 (with a drop to $25,000 for 2014). The legislation also extends first-year bonus depreciation at the 50 percent level for 2013, and sets the unified credit exemption equivalent for estate and gift tax purposes at $5 million (inflation-indexed starting in 2012), but sets the rate at 40 percent for amounts over the exemption threshold. The Act also generally extends existing Farm Bill programs through September 30, 2013. The President signed the Act into law on January 2, 2013.

2. **The U.S. Supreme Court upholds the individual mandate provision of the 2010 health care law.** On June 28, 2012, the U.S. Supreme Court upheld as constitutional the Patient Protection and Affordable Care Act (more commonly known as "Obamacare"). In its ruling, the Court upheld the provision in the Act that mandates that each person obtain health coverage or pay a tax. Likewise, the Court found constitutional the "employer responsibility mandate" which imposes cost-sharing, reporting, and other obligations on employers.[1] There were two separate majority opinions in the case. Under the first opinion, the majority determined that the Commerce Clause did *not* support the individual mandate, nor did the Necessary and

Proper Clause. In the second majority opinion, however, the Court chose "to read the mandate not as ordering individuals to buy insurance, but rather as imposing a tax on those who do not buy that product." The majority went on to state: "If a tax is properly paid, the Government has no power to compel or punish individuals subject to it" and "[i]f it were read as a command, it would be unconstitutional because the Federal Government does not have the power to order people to buy health insurance." So, the Court determined that there is no legal obligation to purchase health insurance, and upheld only the mandate provision under the Constitution's taxing power. *National Federation of Independent Businesses v. Sebelius*, 132 S. Ct. 2566 (2012).

Why is the Act of importance to agriculture? It is important because it is primarily tax legislation with numerous provisions that will apply to everyone, ag and non-ag, and some provisions will cause agricultural producers to re-evaluate leases and business organizational structures. Here's a rundown of the tax provisions that have already taken effect: small business health insurance tax credit; economic substance doctrine (codified); group health insurance plans and insurers required to offer coverage for unmarried adult children until age 26; 10 percent surtax on indoor tanning services; employer W-2 reporting of the value of health benefits (for employers filing 250 or more W-2s); doubling of the penalty on non-qualified HSA withdrawals; increased limits on qualifying expenses for HSAs, HRAs and Flex Accounts; an additional 0.9 percent increase in the Medicare tax on wages and self-employment income over $250,000 (MFJ); an additional 3.8 percent Medicare tax on "investment" income; a lower ceiling ($2,500) on flex accounts; an increase in the itemized deduction floor for medical expenses; an additional 2.3 percent non-deductible excise tax on the gross sales of companies that manufacture or import medical devices.

For agricultural producers, perhaps the most significant tax provision is the additional 3.8 percent Medicare tax (effective Jan. 1, 2013) on passive sources of income. It applies to taxpayers with modified adjusted gross income over $250,000 on a joint return, and includes capital gains, dividends, rents, royalties, and passive K-1 income. For farmers and ranchers, several things need to be kept in mind. Sales of farm business assets (land and equipment, etc.) will not be subject to the tax if the taxpayer had materially participated in the business for five years in the eight-year period before receipt of Social Security benefits. Cash lease income is passive and is potentially subject to the tax, as is non-material participation crop share or livestock share lease income. Simply running investment income through a pass-through entity that otherwise has trade or business income does not avoid the tax. Also, self-rental income is subject to the tax, as is royalty income.

Additional constitutional challenges to Obamacare are presently in process. On Nov. 26, 2012, the U.S. Supreme Court ordered the U.S. Circuit Court of Appeals for the Fourth Circuit to again take up a case that the Fourth Circuit had earlier dismissed.[2] The case involves a constitutional challenge to the employer mandate provision of the Act. A second case is also challenging the constitutionality of the Act on the basis that the Supreme Court's construction of the individual mandate as a tax created an additional constitutional problem with the Act. Specifically, the argument is that when the Senate enacted the Act that included a "tax" for not purchasing health insurance, the Congress violated the Origination Clause which requires all revenue bills to originate in the U.S. House. In September of 2012, the Federal District Court for the District of Columbia refused to grant the government's motion to dismiss the case.[3]

3. **Constitutional "takings" developments.** There were two significant court opinions in 2012 that involved constitutional takings of importance to agriculture. One is a Texas Supreme Court opinion that is important for the utilization of underground water for crop irrigation purposes. The second case involved the U.S. Supreme Court's decision in a case involving temporary flooding of farmland.

   The power to "take" private property for public use (or for a public purpose) without the owner's consent is an inherent power of the federal and state government. However, the United States Constitution limits the government's eminent domain power by requiring federal and state governments to pay for what is "taken." [4] The Fifth Amendment states in part ". . . nor shall private property be taken for public use without just compensation." [5] The clause has two prohibitions: (1) all takings must be for public use, and (2) even takings that are for public use must be accompanied by compensation.

   In 2012, the Texas Supreme Court issued an important decision in a case with significant implications for agriculture involving the appropriation of water for agricultural purposes. In the mid-1990s, the farmers involved in the case were denied a permit to pump water from the Edwards Aquifer for use on their ranch near San Antonio. Their permit was denied because

they couldn't prove historical use of the aquifer. As a result, they were granted 14 acre-feet of water rather than the 700 acre-feet that they requested. Under Texas law, landowners have an absolute right to water beneath their land. Article I of the Texas Constitution provides: "No person's property shall be taken, damaged, or destroyed for or applied to public use without adequate compensation being made." Texas law specifies that both groundwater and oil and gas deposits are subject to the common-law rule of capture. Thus, landowners can (as long as malice or willful waste is not involved) use as much groundwater as can be captured without any liability to others. The plaintiff was created by the Texas Legislature in 1993 to manages groundwater usage in certain counties in southern Texas. The plaintiff grants water usage permits on the basis of "historic use" — the extent to which groundwater beneath a particular tract has been put to beneficial use in the past. But if groundwater hadn't been used in the past, how could historic use be established? Under the facts of the case, the ranchers' tract had an abandoned well on it without a pump. The defendants wanted to drill a replacement well so that they could irrigate their oats and peanuts and provide water to cattle. The plaintiff determined that the prior owner had used the old well to irrigate approximately seven acres in 1983 and 1984, so a permit was granted consistent with that historic use. The court determined that the denial of a permit allowing water withdrawals under the entire property was a taking. The court said that, for constitutional takings purposes, "property" may include more than just the surface estate. For example, the Texas Supreme Court unanimously held, on the basis of oil and gas law, that land ownership in Texas includes interests in in-place groundwater. As such, water cannot be taken for public use without adequate compensation guaranteed by Article I, Section 17(a) of the Texas Constitution. The court determined that the plaintiff's practice of issuing permits based on historical use was an unjustified departure from the Texas Water Code permitting factors. The court's decision is anticipated to enhance water conservation efforts in Texas and be influential in other states where irrigation is essential to crop and/or livestock production. *The Edwards Aquifer Authority, et al. v. Day, et al*., 369 S.W.3d 814 (Tex. 2012).

In late 2012, the U.S. Supreme Court further defined the scope of taking jurisprudence with respect to temporary takings. Under the facts of the case, the United States Army Corps of Engineers deviated from its operating plan for a dam that resulted in increased downstream flooding of a wildlife management area that the plaintiff owned. The flooding was only temporary and was not "inevitably recurring." The trial court determined that the Corps' action constituted the taking of a temporary flowage easement over the plaintiff's property and awarded damages of $5,778,758. On appeal, the Federal Circuit reversed. But on further review by the U.S. Supreme Court, the Court agreed with the trial court and held that "recurrent floodings, even if of finite duration, are not categorically exempt from Takings Clause liability." The Court's opinion sends an important message to government agencies whose actions may have a temporary impact on private property rights — such impacts may be compensable. *Arkansas Game & Fish Commission v. United States*, No. 11-597 (U.S. Sup. Ct. Dec. 4, 2012), *rev'g., and rem'g*., 637 F.3d 1366 (Fed. Cir. 2011).

4. **Chapter 12 bankruptcy taxation.** In 2012, the U.S. Supreme Court decided a Chapter 12 (farm) bankruptcy case involving one aspect of the changes made to bankruptcy law in 2005. The 2005 Bankruptcy Act allows a Chapter 12 debtor to treat claims arising out of "claims owed to a governmental unit" as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" to be treated as an unsecured claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, *provided the debtor receives a discharge*. Under prior law, taxes were a priority claim and had to be paid in full.

   The United States Court of Appeals for the Eighth Circuit had ruled that a debtor's pre-petition sale of slaughter hogs came within the scope of the provision, and that the provision changed the character of the taxes from priority status to unsecured such that, upon discharge, the unpaid portion of the tax is discharged along with interest or penalties.[6] The court also held the statute applies to post-petition taxes and that those taxes can be treated as an administrative expense. Such taxes can be discharged in full if provided for in the Chapter 12 plan and the debtor receives a discharge.[7] Upon the filing of a Chapter 12, a separate taxpaying entity apart from the debtor is not created. That is an important point in the context of the 2005 amendment. The debtor remains responsible for taxes triggered in the context of Chapter 12. That's a key point because the amendment allows non-priority treatment for claims entitled to priority under 11 U.S.C. §507(a)(2). That provision covers administrative expenses that are allowed by 11 U.S.C. §503(b)(B) which includes any tax that the *bankruptcy estate* incurs. Pre-petition taxes are covered by 11 U.S.C. §507(a)(8). But post-petition

taxes, to be covered by the amendment, must be incurred by the bankruptcy estate, as is the case with administrative expenses. Indeed, the IRS position is that post-petition taxes are not "incurred by the estate" as is required for a tax to be characterized as an administrative expense in accordance with 11 U.S.C. §503 (b)(1)(B)(i), and that post-petition taxes constitute a liability of the debtor rather than the estate.[8] The U.S. Circuit Courts of Appeal for the Ninth and Tenth Circuits agreed with the IRS position.[9] On review of the Ninth Circuit's opinion, the U.S. Supreme Court also agreed. So, unless additional legislation is enacted to change the statutory language, timing of asset sales to ensure that taxes are triggered *before* a Chapter 12 petition is filed will be necessary. *Hall v. United States*, 132 S. Ct. 1882 (U.S. 2012).

5. **Wetlands and Swampbuster developments.** Section 404 of the Clean Water Act makes illegal the discharging of dredge or fill material into the "navigable waters of the United States" without obtaining a permit from the Secretary of the Army acting through the Corps of Engineers (COE). Over the years, EPA has issued "compliance orders" to landowners and other parties when EPA believed that the land in issue contained wetlands subject to EPA's jurisdictional control. The issuance of a compliance order has the effect of freezing the affected party in place until a Section 404 permit is obtained. EPA has also taken the position that such orders do not give the affected party the right to a hearing or the ability to obtain judicial review because (in EPA's view) such orders are not "final agency action" that carries appeal rights with it. However, in 2012 a unanimous U.S. Supreme Court held that the CWA does not preclude pre-enforcement judicial review of EPA administrative compliance orders. Preclusion, the Court held, would violate constitutional due process requirements. Under the facts of the case, the plaintiffs had filled in approximately one-half acre of their property with dirt and rock in preparation to build a house. The EPA issued a compliance order alleging that the parcel contained a wetland subject to the CWA permit requirements. The plaintiffs sought a hearing with the EPA to challenge the finding, but EPA did not grant a hearing. The EPA continued to assert jurisdiction and the plaintiffs sued in federal district court, seeking injunctive and declaratory relief. The trial court granted the EPA's motion to dismiss for lack of subject matter jurisdiction because, according to the court, the CWA precludes judicial review of compliance orders before EPA starts enforcement action. The case was affirmed on appeal, but the U.S. Supreme Court reversed, noting that a compliance order constitutes "final agency action" under the Administrative Procedures Act, and the landowners did not have an adequate remedy at law. *Sackett v. United States Environmental Protection Agency*, 132 S. Ct. 1367 (2012), *rev'g.*, 622 F.3d 1139 (9th Cir. 2010).

In another case, the Swampbuster rules included in the 1985 Farm Bill were at issue. Those rules completely protect three types of wetlands — natural wetlands, abandoned wetlands, and wetlands converted to crop production after December 23, 1985. Agricultural production on these types of wetlands triggers ineligibility for farm program benefits. Likewise, the cultivation of farmed wetlands triggers ineligibility for federal farm programs, but prior converted cropland is not protected and can be farmed. In 1990, the Congress tightened the Swampbuster rules by adding a new provision which provided that "any person who in any crop year subsequent to November 28, 1990, converts a wetland by draining, dredging, filling, leveling, or any other means for the purpose, or to have the effect, of making the production of an agricultural commodity possible on such converted wetland shall be ineligible for" USDA farm benefits.[10] Thus, after the 1990 Swampbuster amendments, a person could become ineligible for USDA farm benefits either by (1) converting wetland and growing crops on the land if the conversion was accomplished after December 23, 1985, or (2) merely converting wetland after November 28,1990, so that crops could be grown on the land.[11] The rules were changed to also add a stronger penalty for wetland conversions. While converting a wetland before November 28, 1990, resulted in only a proportional loss of benefits, conversion after that date results in the loss of *all* USDA benefits on *all* land the farmer controls until the wetland is restored or the loss is mitigated.[12] After the 1990 Swampbuster rule change, the USDA took the position that activities that made ag production "possible" on converted wetland meant that any activity that made such land more farmable was prohibited.[13] The USDA's regulatory position was upheld by the U.S. Circuit Court of Appeals for the Eighth Circuit in 2008,[14] but in 2012, it was rejected by the Federal District Court for the Eastern District of California. *Koshman v. Vilsack*, 865 F. Supp. 2d 1083 (E.D. Cal. 2012).

Later, the 1996 Farm Bill rules specified that a farmed wetland located in a cropped field could be drained without sacrificing farm program benefit eligibility if another wetland is created elsewhere. Thus, through "mitigation," a farmed wetland can be moved to an out-of-the-way location. In addition, the 1996 legislation provides a good faith exemption to

producers who inadvertently drain a wetland. If the wetland is restored within one year of drainage, no penalty applies. The legislation also revises the concept of "abandonment." Cropland with a certified wetland delineation, such as "prior converted" or "farmed wetland" is to maintain that status as long as the land is used for agricultural production. In accordance with an approved plan, a landowner may allow an area to revert to wetland status and then convert it back to its previous status without violating Swampbuster provisions. Also, while there is an exception from the Swampbuster restrictions for prior converted wetland that returns to wetland status after December 23, 1985, as a result of specified events,[15] the exception does not apply if the land had returned to wetland status before or as of December 23, 1985.[16] That point was reaffirmed by a federal district court in Michigan in 2012. The case involved a 2.24-acre tract on the plaintiff's farm that the defendant claimed was a wetland. The tract at issue was initially drained and tiled in 1964, and crops were grown on the tract through at least 1982. In the early 1980s, drainage on the tract deteriorated. After enactment of the Swampbuster provisions in the 1985 Farm Bill, the NRCS made wetland determinations on the tract in 1988 and 1993 from which the plaintiff did not appeal. The plaintiff later executed Form AD-1026 in 2008, indicating he was intending to plant crops on the land for which a highly erodible determination had not been made and conduct land drainage or associated activities that had not been evaluated by NRCS. The form that the plaintiff executed also authorized the NRCS to conduct a wetland determination on the plaintiff's property. In 2008, a wetland determination was made, and the plaintiff appealed by requesting reconsideration and mediation. A mediation agreement was entered into in early 2009 under which NRCS agreed to make a wetland delineation and allow the planting of crops in the spring of 2009. The NRCS conducted its delineation *after* spring crops had been planted, resulting in a Final Technical Determination that the tract was converted wetland and that the plaintiff was ineligible for farm program benefits. The plaintiff appealed to the NAD which suspended further appeal while mediation continued. The mediation ultimately failed and the appeal proceeded. The NAD Hearing Officer upheld the NRCS determination and noted that the tract could not be determined to be prior converted wetland because it had wetland conditions as of December 23, 1985. The Hearing Officer also noted that the plaintiff did not request a minimal effect determination before converting the wetland. The Deputy Director upheld the NAD Hearing Officer decision on appeal. Ultimately, the court upheld the NRCS interpretation of 16 U.S.C. §3822(b)(2)(D) that the status of the land as of December 23, 1985, was determinative of the issue irrespective of whether land had been drained and cropped before that date and merely reverted to wetland status as a result of deterioration to drainage work. *Maple Drive Farms Family Limited Partnership v. Vilsack*, No. 1:11-CV-692, 2012 U.S. Dist. LEXIS 176539 (W.D. Mich. Dec. 13, 2012).

6. **Developments on whether pesticide drift can be a viable trespass claim.** A trespass typically involves some sort of physical invasion of another person's property. But is a physical invasion present if the only invasion involves pollen drift or particulate matter? Presently, there has not been a case of pollen drift involving GMO crops litigated to an appellate-level court on a trespass claim. However, cases involving comparable situations have been litigated. For example, in *Martin v. Reynolds Metal*,[17] the defendant was held liable for trespass onto the plaintiff's property for the emission of microscopic fluoride particles from the defendant's plant that rendered the plaintiff's land and drinking water unfit for livestock grazing. Also, another court has found a trespass for the invasion onto the plaintiff's land of a cloud of silicon dust that had the potential to cause injury.[18] More recently, Texas law has been construed to allow property owners to recover on a trespass claim for contamination caused by the emission of airborne particulates.[19] Likewise, the Minnesota Court of Appeals has held that a trespass action can arise from a chemical pesticide that is deposited in discernible and consequential amounts onto property as a result of errant overspray. While the court noted that odors emanating from the application of chemical pesticides cannot alone constitute a trespass, the court held that a trespass may occur if the odors are joined with the dispersion of substances that drift onto another person's property and leave deposits which damage crops.[20]

   On further review by the Minnesota Supreme Court in 2012, the lower court's decision was reversed. The case was brought by organic farmers against conventional crop farmers that were having their fields sprayed by a third party. Some of the chemical spray drifted onto the organic crops and an organic certifying agent told the plaintiffs that they must destroy 10 acres of soybeans and start over on the three-year process for transferring land into the organic program. However, there was no evidence presented regarding whether the drift reached the EPA threshold of 5 percent before any of these actions were taken. The Minnesota Supreme Court held that a trespass under state law required an intentional and direct physical and tangible entry upon

land that someone else possesses. Spray drift, the court reasoned, is particulate matter that does not create a direct physical or tangible entry on the land so it could not constitute a trespass. Nuisance and negligence were appropriate remedies. The court also held that the plaintiffs caused their own damages rather than the defendants' causing the plaintiffs to violate pesticide regulations governing organic growers. Thus, the pesticide drift was not the cause of the plaintiffs' damages. *Johnson, et al. v. Paynesville Farmers Union Cooperative Oil Co*., 817 N.W.2d 693 (Minn. 2012).

7. **Federal court again invalidates special use valuation treasury regulation.** Most assets are valued at fair market value as of the date of a decedent's death. The IRS defines fair market value as the price at which a willing buyer and a willing seller would exchange the property, neither being under any compulsion to buy or sell and each having full knowledge of all relevant facts.[21] The only major exception to the willing buyer/willing seller test is special use valuation of land used in a farming or ranching business.[22] Since 1976, there has been a special way to value farmland at death which has been criticized and is controversial. The executor of an estate may elect to value real property devoted to farming or ranching (or other closely-held businesses) at its special use or "use" value rather than its fair market value. This valuation provision, however, could not reduce the gross estate by more than $1,040,000 for deaths in 2012.
In order for an estate to utilize special use valuation, many pre-death requirements must be satisfied. The pre-death eligibility requirements are very complex and technical, and one of them requires that the farmland itself must make up at least 25 percent of the gross estate less secured indebtedness.[23] Thus, at least 25 percent of the adjusted value of the decedent's gross estate must be qualified farm real property that was acquired from or passed from the decedent to a qualified heir. As such, the land itself must be a significant part of the total value of the estate.[24] The Treasury Department, however, adopted a regulation stating that "[a]n election under I.R.C. §2032A need not include all real property in an estate which is eligible for special use valuation, but sufficient property [that is, 25 percent] to satisfy the threshold requirements of §2032A(b)(1)(B) must be specially valued under the election." But, in 1988, a federal court in Illinois invalidated the regulation as creating a qualification requirement that was substantive in nature rather than simply interpreting the statute.[25] The court noted that the special use valuation statute allowed the Treasury to write regulations detailing only the procedure for making the special use valuation election. The statute, I.R.C. §2032A(d)(1), gave the Treasury the power to promulgate regulations detailing the manner for making the special use value election, but no power to add a substantive requirement for an estate to be *eligible* to make a use value election.
In 2012, the IRS brought the same issue on the same set of facts back to the same court. This time, IRS argued that the regulation should be upheld under a more deferential standard, known as the "*Chevron*" deference.[26] That higher deferential standard applied, IRS argued, because of a federal court opinion in 2008 that held that the *Chevron* standard applied to Treasury Regulations where the statute at issue did not address the specific issue involved.[27] However, the Illinois federal court again ruled against the IRS, determining that the statute clearly established that the 25 percent requirement applied to the adjusted value of the gross estate and did not include any requirement that the estate had to make the use value election on sufficient real estate representing at least 25 percent of the adjusted value of the gross estate. Because the statute was clear, and the regulation added a substantive requirement to the statute which was impermissible even under the more deferential standard, the court did not have to decide whether the regulation was a permissible construction of the statute. *Finfrock v. United States*, 860 F. Supp. 2d 651 (C.D. Ill. 2012).

8. **More guidance provided on how to determine "reasonable" compensation for an S corporation shareholder/employee.** Owners of S corporations can get income out of the corporation in the form of wages and also in distributions (dividends). Wages are reported on Form W-2 and are subject to self-employment tax, but distributions are reported on Form K-1 where they are not subject to self-employment or payroll tax (note: the FICA tax wage base for 2013 is $113,700). This creates a built-in incentive for S corporation owners to minimize their salaries and take earnings out of the corporation as distributions. However, IRS requires that an S corporation owner be paid a "reasonable" salary. If the salary is too low, IRS will recharacterize a portion of the dividend distribution as salary with additional tax imposed. IRS uses various factors to determine what constitutes a reasonable salary, including the owner's training and experience, duties and responsibilities, time and effort devoted to the business, and the dividend history of the business, among other things. In essence, reasonable compensation would be the amount necessary to hire someone to do what the owner is currently doing. For farming and ranching operations, the primary focus is on the labor costs involved, but value would also need to be placed on management services the owner

provides.

In 2012, the U.S. Court of Appeals for the Eighth Circuit affirmed a Tax Court decision upholding the IRS position that a full-time CPA with 20 years of experience who worked full-time for his firm that generated between $2 and $3 million annually had too low of a salary when he took $24,000 in salary in one year with $203,651 in distributions and $24,000 in salary in the following year with distributions of $175,470. The court agreed with the IRS that a reasonable salary should be $91,044 each year, which was slightly above the FICA wage base for each year. Later in 2012, the U.S. Supreme Court declined to hear the case. So, there are limits to how low courts will allow S corporation shareholders to set their salaries. But not all income an owner receives has to be in the form of wages — just the amount that is deemed reasonable. Reasonable compensation for S corporation owners is a big audit issue with the IRS. Farm and ranch S corporations need to pay close attention to salary amounts paid to owners so as to avoid problems with the IRS. It is critical to maintain good records, keep personal and corporate spending separate, and account for all expenses. Another case in the Tax Court in late 2012 demonstrates that the IRS doesn't even care if the S corporation is profitable — a reasonable wage must still be paid. *David E. Watson, P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012), *aff'g*., 757 F. Supp. 2d 877 (S.D. Iowa 2010), *cert. den*., 133 S. Ct. 364 (2012).

9. **Court upholds defined value clause without any "pourover" to charity.** In recent years, several courts have validated an estate planning technique that effectively caps an estate's tax liability.[28] The technique also is effective for gift tax purposes.[29] The estate planning version of the technique involves an estate plan whereby the decedent leaves a set dollar amount of the estate to the decedent's children (or other specific beneficiaries) with the residuary estate passing to a charitable organization. The portion passing to the charity qualifies for the estate tax charitable deduction and, thus, puts a "lid" on the amount of the estate tax owed. Until a court opinion in 2012, the technique involved a transfer of a residual interest to charity each time.

   In the 2012 case, a married couple gifted units in their LLC in 2004 to their children and grandchildren by means of a formula that fixed the number of LLC units to be gifted as of the date of the gift, with the value to be determined based on the fair market value of the gifted units which would be determined sometime later based on an appraisal, the IRS, or a court. In other words, the dollar value of each gift was established based on gift tax exclusions at the time of the gifts, with the number of LLC units gifted to be based on the fair market value of the LLC as determined later. The IRS challenged the gifts on the basis that they represented the transfer of a fixed percentage interest of the LLC instead of a specified dollar value. The court upheld the formula clause because it simply involved the allocation of LLC units among the parents and the donees. The parents could not re-claim the gifted units once the gifts had been made if a higher unit value was established post-gift — they simply had defined the units gifted as of the date of the gift. The IRS appealed to the U.S. Circuit Court of Appeals for the Tenth Circuit, but the IRS voluntarily withdrew its appeal before the court could rule. Later, the IRS issued a non-acquiescence to the Tax Court's opinion. So, while the IRS will continue to challenge the technique, it can be a good approach to gifting business interests of large value as well as those interests that are difficult to value — both types of interests which are common in agricultural operations. *Wandry v. Comr*., T.C. Memo. 2012-88, *non-acq*., A.O.D. 2012-04, I.R.B. 2012-46.

10. **Court shuts down EPA's emission cap program.** In 2009, the EPA began promulgating new pollution rules designed to diminish U.S. coal production. The rules were known as the Cross-State Air Pollution Rule, the Mercury and Air Toxics Standards for Utilities, the Cooling Water Intake Structures regulations, and the Disposal of Coal Combustion Residuals rule. In 2012, however, a federal court invalidated the EPA's authority to implement the Cross-State Air Pollution rule. The EPA rule imposed a cap and trade style program that expanded existing limitations on sulfur dioxide and nitrogen oxide emissions from coal-fired power plants in 28 "upwind" states. EPA claimed to have the authority to cap emissions that supposedly traveled across state lines. While the Clean Air Act grants the EPA authority to require upwind states to reduce their own significant contributions to a downwind state's non-attainment, the court noted that the rule could impermissibly require upwind states to reduce emissions by more than their own significant contributions to a downwind state's non-attainment. The court also held that the EPA failed to allow states the initial chance (as required by statute) to implement any required reductions with respect to in-state sources by quantifying a state's obligations and establishing federal implementation plans. The EPA admitted that the rule would cost the private sector $2.7 billion and force numerous coal-fired power plants to shut down.

EME Homer City Generation, L.P. v. Environmental Protection Agency, et al., No. 11-1302, 2012 U.S. App. LEXIS 17535 (D.C. Cir. Aug. 21, 2012).

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[1] The employer insurance mandate specifies that, for months beginning after 2013, a "large" employer (with at least 50 full-time employees) must make an "assessable payment to the IRS if any full-time employee is certified to the employer as having purchased health insurance through a state Exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee, if the employer either (1) does not offer health care coverage for its full-time employees, or (2) offers minimum essential coverage that either is unaffordable or fails the "60 percent test" (*i.e.*, the plan's share of the total allowed cost of benefits is less than 60 percent).

[2] *Liberty University, et al. v. Geithner*, No. 11-438, 2012 U.S. LEXIS 8942 (U.S. Sup. Ct. Nov. 26, 2012), *pet. for rehearing granted*, initial Fourth Cir. opinion vacated, and case remanded to the Fourth Circuit.

[3] *Sissel v. United States Department of Health and Human Services, et al*., No. 1:10-cv-01263 (BAH) (D. D.C. Sept. 11, 2012).

[4] The "takings" clause of the Fifth Amendment has been held to apply to the states since 1897. (*See Chicago, Burlington and Quincy Railroad Co., v. Chicago*, 166 U.S. 226 (1897). In addition, the state constitutions of 47 states expressly prohibit the taking of private property for public use without just compensation (the exceptions are Kansas, North Carolina, and Virginia).

[5] "Just compensation" equals fair market value, generally in cash. For partial takings, "severance damages" may be awarded in addition to compensation for the part taken. *See, e.g., Sharp v. United States*, 191 U.S. 341 (1903).

[6] *In re Knudsen, et al. v. Internal Revenue Service*, 581 F.3d 696 (8th Cir. 2009).

[7] *See also In re Schilke*, No. 4:07CV3283, 2008 U.S. Dist. LEXIS 68176 (D. Neb. Sept. 9, 2008), *aff'g*, 379 B.R. 899 (Bankr. D. Neb. 2007) (11 U.S.C. §1222(a)(2)(A) applicable to post-petition taxes; to construe statute otherwise would render statute meaningless); *In re Dawes*, 382 B.R. 509 (Bankr. D. Kan. 2008) (post-petition taxes may be treated as an administrative claim; fact that Chapter 12 did not create a separate taxable entity from the debtor not relevant); *see also In re Hall*, 393 B.R. 857 (D. Ariz. 2008), *rev'g*, 376 B.R. 741 (Bankr. D. Ariz. 2007) (11 U.S.C. §1222(a)(2)(A) applicable to post-petition taxes on basis that legislative history showed that it was intended to apply to taxes generated during the bankruptcy reorganization from the sale of assets used in a farming business); *In re Gartner*, No. BK06-40422, 2008 Bankr. LEXIS 3525 (Bankr. D. Neb. Dec. 29, 2008) (statute applicable to post-petition taxes); *In re Rickert*, No. BK06-40253-TLS, 2009 Bankr. LEXIS 17 (Bankr. D. Neb. Jan. 9, 2009) (statute applicable to post-petition taxes, but IRS proportional method used to compute allocation of taxes entitled to priority and non-priority treatment); *In re Uhrenholdt*, No. BK-06-40787-TLS, 2009 Bankr. LEXIS 144 (Bankr. D. Neb. Jan. 26, 2009) (statute applicable to post-petition taxes; taxes generated by sale of corn entitled to non-priority treatment as a farm asset used in farming because of its sale to debtors' cattle farming operation); *but see In re Ficken*, No. 05-52940-HRT, 2009 Bankr. LEXIS 3008 (Bankr. D. Colo. Jul. 30, 2009), *aff'd*, No. CO-09-042 (B.A.P. 10th Cir. May 7, 2010) (statute applicable to post-petition taxes; taxes triggered by sales of both calf inventory and breeding livestock qualified for non-priority treatment — provision not limited to taxes triggered by sale of capital assets, and calf inventory and breeding livestock were used in the debtors' farming business; marginal approach to be utilized in determining amount of tax entitled to non-priority treatment); *Smith, et ux. v. United States, et al*., 447 B.R. 435 (Bankr. W.D. Pa. 2011) (statute inapplicable to post-confirmation sale of farm assets; court noted that case involved post-confirmation sale rather than post-petition sale; while court not entirely persuaded by *Hall* or *Knudsen* approach, court noted it would side with *Hall*).

[8] ILM 200113027 (Mar. 30, 2001) (Chapter 13 case).

[9] *Hall v. United States*, 617 F.3d 1161 (9th Cir. 2010), *cert. granted*, 131 S. Ct. 2989 (2011); *United States v. Dawes*, 652 F.3d 1236 (10th Cir. 2011).

[10] 16 U.S.C. §3821(b)-(c) (2008).

[11] *See, e.g., United States v. Dierckman*, 201 F.3d 915 (7th Cir. 2000), *aff'g*, 41 F. Supp. 2d 870 (S.D. Ind. 1998).

[12] 16 U.S.C. §3821(c) (2008).

[13] In its 1996 edition of the National Food Security Act Manual, the USDA's regulatory definition of a converted wetland (which the statute defines in 16 U.S.C. §3821(c)) to mean any "manipulation which allows or would allow production of an agricultural commodity where such production was not previously possible, or making an area farmable more years than previously possible . . . ."

[14] *Clark v. United States Department of Agriculture*, 537 F.3d 934 (8th Cir. 2008).

[15] 16 U.S.C. §3822(b)(2)(D) (2008).

[16] *See Horn Farms, Inc. v. Johanns*, 397 F.3d 472 (7th Cir. 2005), *rev'g*, 319 F. Supp. 2d 902 (N.D. Ind. 2004), *cert. den*., 126 S. Ct. 1565 (2006); *Maple Drive Farms Family Limited Partnership v. Vilsack*, No. 1:11-CV-692, 2012 U.S. Dist. LEXIS 176539 (W.D. Mich. Dec. 13, 2012).

[17] 342 P.2d 790 (Or. 1959).

[18] *Hall v. DeWeld Mica Corp*., 93 S.E.2d 56 (N.C. 1956).

[19] *Stevenson, et al. v. E.I. DuPont de Nemours & Co*., 327 F.3d 400 (5th Cir. 2003) (only showing necessary for trespass claim is entry over land by some "thing"; however, evidence insufficient to support award of damages). The rule is the same in Tennessee. *See In re Tennessee Valley Authority Ash Spill Litigation*, 2012 U.S. Dist. LEXIS 122231 (E.D. Tenn. Aug. 23, 2012).

[20] *Johnson, et al. v. Paynesville Farmers Union Cooperative Oil Company*, 802 N.W.2d 383 (Minn. Ct. App. 2011).

[21] Treas. Reg. §1.170A-1(c)(2) (1990).

[22] I.R.C. §2032A.

[23] I.R.C. §2032A(b)(1)(B).

[24] But the land subject to the election need not exceed 25 percent of the adjusted value of the gross estate. *Finfrock v. United States*, 860 F. Supp. 2d 651 (C.D. Ill. 2012) (Treas. Reg. Sec. 20.2032A-8(a)(2) invalid insofar as it attempts to impose a non-statutory requirement that 25 percent of the adjusted value of the gross estate must consist of farmland subject to the special use valuation election).

[25] *Miller v. United States*, 680 F. Supp. 1269 (C.D. Ill. 1988).

[26] The higher deferential standard is a result of *Chevron v. Natural Resources Defense Council*, 467 U.S. 837 (1984).

[27] *Swallows Holding, Ltd. v. Comr*., 515 F.3d 162 (3d Cir. 2008).

[28] *McCord v. Comr*., 461 F.3d 614 (5th Cir. 2006); *Estate of Christiansen v. Comr*., 586 F.3d 1061 (8th Cir. 2009).

[29] *Estate of Petter v. Comr*., T.C. Memo. 2009-280; *Hendrix v. Comr*., T.C. Memo. 2011-133.