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One man's word is no man's word; we should quietly hear both sides.

— Goethe

USDA's animal productivity and DNA research not violative of NEPA

A federal district court has granted summary judgment against plaintiffs concerning allegations that the U.S. Department of Agriculture's (USDA) animal productivity research violates the National Environmental Policy Act (NEPA), 42 U.S.C. §§ 4321-4347, and the Administrative Procedure Act, 5 U.S.C. §§ 551-558. *Foundation on Economic Trends v. Block*, Case No. 84-3045 (D. D.C. April 29, 1986).

A major allegation concerned the adverse environmental impact of defendants' experiments in the field of genetic engineering. The USDA, through the Agricultural Research Service and the Cooperative State Research Service, funded two major research projects on whole animals involving recombinant DNA as well as over 200 other research projects involving recombinant DNA.

The two projects concerning whole animals were conducted pursuant to guidelines established by the National Institutes of Health to the extent and in a manner provided by a memorandum of the Secretary of Agriculture on "Guidelines for Research Involving Recombinant DNA Molecules."

The plaintiffs alleged that the defendants' selective breeding programs, which included genetic engineering, have or would have significant environmental, economic and social impact by forcing dislocations in the farm economy, affecting the gene pool of farm animals and polluting the air and water. Plaintiffs requested declaratory relief based upon defendants' alleged violation of NEPA for failure to prepare neither an Environmental Impact Statement (EIS) nor an Environmental Assessment (EA).

Finally, plaintiffs alleged that defendants' failure to consider alternative programs for improving animal productivity was arbitrary and capricious, in addition to being in violation of the Administrative Procedure Act.

(continued on next page)

Forbearance policy of Farm Credit System questioned

On June 11, 1986, the Ohio Supreme Court (in a 4-3 decision) held that the specific language of the Farm Credit Act of 1971 does not provide a valid defense to a foreclosure action. *Farmers Production Credit Association of Ashland, Appellee v. Johnson, et al., Appellants* and *Federal Land Bank of Louisville, Appellee v. Johnson, et al., Appellants*, Nos. 84-1915 and 85-860. Five justices have approved a stay on the foreclosure pending a request for hearing before the U.S. Supreme Court.

Appellants own a 1,400-acre farm. Between Jan. 15, 1981 and May 6, 1981, the appellants signed promissory notes to the Production Credit Association (PCA) for a total of $367,110, which were secured by a security agreement and an open-ended mortgage on portions of their farm.

In 1983, the appellants experienced financial difficulty, and defaulted in accrued interest payments. In June 1983, the appellants signed another promissory note to the PCA for $41,623, secured by a mortgage on additional land and a Memorandum of Understanding, which defined the terms and conditions for extension of their loan.

The appellants were unable to meet the terms of the memorandum, and the PCA began foreclosure proceedings on Oct. 4, 1983, in the Court of Common Pleas of Knox County, Ohio.

In addition to the PCA loans, the appellants borrowed $660,000 from the Federal Land Bank of Louisville in August 1979, at a variable rate of interest secured by a mortgage on 885 acres of their farm. A payment due on Jan. 2, 1982 was not paid until August 1982, at which time the Federal Land Bank informed the appellants there would be no extension on their payment due in January 1983.

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RESEARCH NOT VIOLATIVE OF NEPA
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The court analyzed defendants' animal research programs to determine whether there existed a proposal for legislative or major federal action, as required to activate NEPA. The court found that the research did not constitute proposed federal action so that the USDA did not need to prepare an EIS or an EA.

In addition, since all of the USDA's genetic research is currently being conducted in laboratories and controlled environments so that organisms or animals are not being released into the general environment, the court concluded that the genetic research had not progressed to a point where it might be expected to have a significant impact on the environment. Thus, it was premature to require an EIS or an EA evaluating the consequences of the research.

The court declined to find a violation of the Administrative Procedure Act based upon arbitrary agency action because it concluded that the challenged research activities had been committed to agency discretion by law. The relevant statute, 7 U.S.C. § 427 (1982), authorizes the USDA to research agriculture's basic problems in their broadest sense.

Since the statute fails to provide any meaningful standard against which to measure agency action for a possible abuse of discretion, the USDA has discretion to conduct its current research.

Although the court denied plaintiffs' relief, it chose to note that there exists a possibility that genetic engineering will eventually progress to a stage where an EIS may be required. Thus, the court's decision leaves the door open for further challenges if genetic research results in the introduction of new organisms into the environment. *See* Stern, *Agriculture and Biotechnology: The Legal Climate*, 60 *Florida B.J.* 43 (May 1986).

— Terence J. Centner

FARM CREDIT SYSTEM FORBEARANCE
CONTINUED FROM PAGE 1

The bank advised the appellants to make provision for that payment, or seek long-term credit. A partial payment was made late in January. The bank gave the appellants various extensions to allow time for sale of some of their land, and also asked them to provide the bank with a plan for practical means of repayment.

The appellants were unable to sell any land, and did not respond to the bank's final request for a repayment plan. On Sept. 26, 1983, the Federal Land Bank began foreclosure proceedings.

The appellants lost in both the trial and appellate courts. Both cases were appealed to the Ohio Supreme Court. The appellants claimed that the trial court in the PCA case had abused its discretion by not allowing amendment of answer. In the Federal Land Bank case, they claimed the trial court had improperly denied motion for relief from judgment provided under Civ. R. 60(B).

Appellants sought to amend their answer in the PCA case to raise as a defense the Farm Credit Act of 1971 regulation, 12 C.F.R., Section 614.4510, which, in part, provides that bank and association loan servicing policies and procedures "shall provide a means of forbearance for cases when the borrower is cooperative, making an honest effort to meet the conditions of the loan contract, and is capable of working out of the debt burden."

The Ohio Supreme Court held that the "shall" term in the regulation indicates the mandatory nature of the policy, but that the regulation is directed at agency policy and is not a substantive rule with the force and effect of law. The court further determined that the PCA did have a written policy of forbearance, which it extended to the appellants.

The court found the appellants' motion for leave to amend their answer did not state a valid defense — therefore, the trial court did not abuse its discretion in denying the motion.

In the Federal Land Bank case, appellants sought relief from a summary judgment under Civ. R. 60(B), which allows a court to provide relief where there has been "mistake, inadvertence, surprise or excusable neglect." Ohio courts have held a movant must satisfy three conditions in order to prevail: 1) existence of a meritorious defense of claim; 2) entitlement to relief under one of the grounds set forth in the rule; and 3) that the motion is made within a reasonable time.

Appellants claimed their "meritorious defense" to be the "forbearance defense" of 12 C.F.R., Section 614.4510(d)(1). The Ohio Supreme Court held that due to their finding in the PCA case, appellants failed to satisfy the first required prong while the second prong was also not satisfied. Therefore, the trial court properly denied appellants' motion for relief from judgment.

Although the majority ruled against the appellants, the court noted in its opinion: "This court takes notice that the strength of our state lies in its agricultural industry. We also recognize that many of this nation's family farms, which are products of generations of hard work and sacrifice, have succumbed to the perils of foreclosure. High interest rates and declining exports have created the worst farm depression since the 1930s. The men and women who toil to feed not only this nation, but the entire world, deserve a much better fate. With this in mind, we urge our federal government to take the measures necessary to provide these proud men and women with the relief they so justly deserve."

Two justices wrote dissenting opinions that took issue with the majority interpretation of the specific language in regulation 12 C.F.R., Section 614.4510. Both dissenters interpret the "shall" in the regulation to be mandatory and to have the force and effect of law since the regulation was issued pursuant to statutory authority granted to the Federal Farm Credit Bureau. This interpretation would permit a forbearance defense to the lenders' foreclosure action.

— Paul L. Wright

Proposed rules on clear title to farm products

New proposed rules were issued July 23, 1986 concerning the certified "central filing system" affecting lenders and buyers of farm products. 51 Fed. Reg. 22814 (1986). Comments should be received by July 23, 1986.

The proposed regulations would amend interim final regulations published in the Federal Register on March 31, 1986 (See previous story appearing in the May 1986 issue of *Agricultural Law Update*.

— Donald L. Uchtmann

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AALA Editorial Liaison . . Donald B. Pedersen
University of Arkansas

Editor . Nancy Harris
Century Communications Inc.

Contributing Editors: Terence J Centner, University of Georgia; John H. Davidson, University of South Dakota; Mary Elizabeth Matthews, University of Arkansas; Donald B. Pedersen, University of Arkansas; Donald L. Uchtmann, University of Illinois; Paul L. Wright, Ohio State University.

State Reporters: John H. Davidson, South Dakota; Linda Grim McCormick, Washington; William H. Rice, Vermont; Kim Williamson Tucker, Arkansas.

For AALA membership information, contact Terence J Centner, University of Georgia, 315 Conner Hall, Athens, GA 30602.

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Eighth Circuit issues U.C.C. 9-307(1) opinion

In *U.S. v. Progressive Farmers Marketing Agency*, No. 85-1719, slip op. (8th Cir. April 15, 1986), the Eighth Circuit Court of Appeals construed the Iowa Farm Products Rule as it existed prior to July 1, 1985:

> A buyer in ordinary course of business other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by the seller even though the security interest is perfected and even though the buyer knows of its existence. Iowa Code § 554.9307(1).

In *Progressive*, farmers by the name of Newman placed hogs on consignment with Progressive, a marketing agent. The hogs and proceeds were subject to a perfected Farmers Home Administration (FmHA) security interest, but neither Progressive nor the ultimate buyer had actual knowledge.

Progressive paid the farmer the full proceeds, less the sales commission. When the FmHA did not get its money, it sued Progressive on a conversion theory.

The Eighth Circuit reversed a district court holding favoring the FmHA. In determining that Progressive was not a converter, the court reasoned as follows:

1. The Official Comment to 9-109 states that when farm products come into the hands of a marketing agent for sale, they become inventory. Accordingly, the marketing agent cannot be held to have committed an act of conversion as to farm products, as it was not receiving or selling farm products. In other words, the marketing agent takes free of the FmHA security interest under the general rule of 9-307(1).
2. Public policy requires a narrow reading of the farm products exception in light of the Iowa amendment to 9-307(1) (effective July 1, 1985), which appears to protect commission merchants who receive livestock, unless they have actual notice of an existing perfected security interest or deal outside of the farmer's trade area. Thus, the collateral is to be viewed as inventory (rather than as farm products) when it comes from farmer to commission merchant.
3. A narrow reading is also suggested by the action of Congress in the 1985 Farm Bill, Public Law 99-198, § 1324(g), protecting commission merchants from secured parties who claim farm products as collateral, except where the commission merchant has received direct notice, or the commission merchant has received or is charged with notice pursuant to a statewide central filing system. Of course, this legislation does not become effective until Dec. 23, 1986. See article by Uchtmann in this issue and in the January and May 1986 issues of *Agricultural Law Update*.

While the decision of the Eighth Circuit might delight those who have jumped on the anti-9-307(1) farm products exception bandwagon, it is a decision that arguably uses suspect reasoning.

First, is it really true that the drafters of the Official Comment to 9-109 meant to suggest that farm products are transformed into inventory at the time of the transfer by the farmer to the commission merchant? It seems more likely that collateral retains its character as farm products, and that the commission merchant could be subject to a conversion action if they fail to honor the interest of the secured party.

The Official Comment to 9-109 may mean that the ultimate buyer from Progressive was purchasing from inventory. That issue is not raised in *Progressive*, however.

Second, the Iowa amendments to 9-307(1) (effective July 1, 1985) appear to contemplate that under the preamendment law applicable to the *Progressive* facts, commission merchants might have to remit the proceed twice.

Indeed, the changes add protection for commission merchants and selling agents by treating them as buyers in the ordinary course of business and freeing them from claims under the security interest created by the farmer/seller — unless the commission merchant or selling agent has received prior written notice, or deals outside of the farmer's trade area.

What the Eighth Circuit appears to have done, for all practical purposes, is to give the Iowa amendments to 9-307(1) retroactive effect, which wasn't intended.

Finally, whatever policy lesson the Eighth Circuit wants to draw from the cited 1985 Farm Bill provision, it is apparent that the court had, at best, a superficial understanding of what the "clear title" provision does. The court says that Congress has engaged in a "repeal of the farm products exception." This is simply not accurate.

Congress may have preempted in this area, but it has certainly not dictated a repeal of the farm products rule. Rather, it has significantly changed its operation effective Dec. 23, 1986.

Indeed, the provisions at § 1324(g), suggest that Congress saw a need to add some measure of protection for commission merchants and selling agents. Such commission merchants and selling agents become full participants in the actual notice or central filing system, whichever approach is selected by a particular jurisdiction.

Section 1324(g) seems to contemplate the view taken by the district court in *Progressive*, then provides alternative notice systems so that commission merchants can protect themselves from being forced to remit proceeds twice.

Commission merchants and selling agents, regardless of their location, should not be lulled into complacency by the decision in *Progressive*. Other courts may not find it to be permissive.

— Donald B. Pedersen

Landowner's lien claim rejected

In times of severe financial stress, novel theories emerge as debtors attempt to salvage their situation.

In *Federal Land Bank of Omaha v. Boese*, 373 N.W.2d 118 (Iowa 1985), owners of farmland faced foreclosure of a Federal Land Bank mortgage after the automatic stay was lifted in their bankruptcy action.

In a last ditch effort to slow down the foreclosure and to salvage something, the debtors raised as a defense (and sought to litigate in the foreclosure action) a claim that they had a common law lien for labor, services and materials that they had supplied to improve their mortgaged farm. No statutory lien was asserted "because such a lien is not recognized under Iowa statute." *Id.* at 120.

When the debtors were forced to concede that a common law lien of this variety could attach only to personal property, they continued to press for an equitable lien, arguing that in some cases, such liens attach to real property.

The Iowa Supreme Court, however, citing cases from a good many jurisdictions, held for the Federal Land Bank:

> The suggestion by the Boeses that they not only own the property, but also hold a lien upon it, is a novel one. However, an essential element in establishing a lien is showing a debt or an obligation of the landowner. This element cannot be satisfied when a property owner claims a lien on his own real estate, because an owner cannot owe himself a debt.
>
> We hold the landowners failed to establish a defense to the foreclosure action because generally, a landowner cannot have a lien on his own property. There was no issue as to any material fact in the foreclosure action. The trial court correctly sustained the Land Bank's motion for summary judgment foreclosing the mortgage. *Id.* at 121.

— Donald B. Pedersen

Cooperatives — Netting and tracing issues after the Budget Reconciliation Act of 1985

by Mary Elizabeth Matthews

Introduction

The Consolidated Omnibus Budget Reconciliation Act of 1985, Public Law 99-272, 100 Stat. 323 (1986), was signed into law on April 7, 1986. Section 13210 of that act amends Subchapter T of the Internal Revenue Code (IRC), which governs the income tax treatment of cooperatives. The amendment is designed to clarify the right of cooperatives to net (for federal income tax purposes) losses in one area of operation against earnings in another.

The amendment represents at least a partial victory for cooperatives in their long-standing dispute with the Internal Revenue Service (IRS) regarding the right to net. Important issues remain to be resolved, however.

The Netting Issue

"Netting" refers to an accounting procedure that reconciles the activities of different areas of cooperative operation. The typical cooperative is separated into divisions which specialize in particular activities. The marketing of members' products is generally handled separately from the purchase of supplies for members, while the two functions are frequently further subdivided.

The marketing function, for example, may be divided into departments based on the different commodities handled. Since not all units will be equally profitable, and some may, in fact, suffer losses, a cooperative's board often will believe it to be in the best interest of all members to aggregate the earnings and losses across functions or departments.

This process of offsetting losses against earnings from various activities to produce an aggregate income or loss amount is known as "netting."

The key to the netting controversy is found in the language of Subchapter T of the IRC (I.R.C. §§ 1381-1388). That subchapter was enacted to accord special income tax treatment to cooperatives by providing a method of obtaining relief from taxation at the cooperative level for amounts distributed to members as patronage refunds.

Mary Elizabeth Matthews is an assistant professor at the University of Arkansas School of Law, Fayetteville, where she teaches courses in business organizations, including an advanced course in agricultural cooperatives.

This treatment is available to both non-exempt cooperatives and to the so-called "exempt" cooperatives qualifying under I.R.C. § 521, which are entitled to additional deductions. See I.R.C. § 1382(c). The tax relief provided by Subchapter T is available to a cooperative only if it is "operating on a cooperative basis." I.R.C. § 1381(a)(2).

The phrase "operating on a cooperative basis" is not defined by the statute, and has generated differences in interpretation. The cooperative position has been that netting is consistent with operating on a cooperative basis because it reflects one of the underlying premises of cooperative operation — the sharing of risks so as to result in an overall benefit to the membership.

Cooperatives also argue that netting is a device available to other corporate entities, and that it is consistent with cooperative operation that the board of directors be entitled to make reasonable business decisions regarding its use.

The IRS' position has been, however, that the unrestricted use of netting violates the concept of operation on a cooperative basis. As the IRS' Chief Counsel Ken Gideon pointed out in a speech to the National Council of Farmer Cooperatives in January 1982, *see* 35 *Coop. Acc't* 7 (Spring 1982), it must be remembered that Subchapter T is a general statute — not limited to farmer cooperatives.

The IRS has always been concerned that the statute would be used as a device to misallocate earnings and losses between unrelated groups, and has, therefore, advocated a "conduit" theory which, ideally, would trace the profit or loss on each transaction to the patron who generated it. Unrestricted netting, the IRS felt, would allocate income attributable to patrons of profitable departments to patrons of losing departments, thus violating the cooperative principle of operation at cost.

Prior to the enactment of the Budget Reconciliation Act, the courts had shown little sympathy for the IRS position on netting, at least between functions. In *Ford-Iroquois FS Inc. v. Commissioner*, 74 T.C. 1213 (1980), for example, the court permitted the netting of marketing losses against supply income over the objections of the IRS. The court relied on the high degree of overlap between the patrons of the two functions, as well as the acquiescence of the members in the method of allocation. The court also emphasized the desirability of allowing the cooperative's board to make such allocation decisions.

The IRS' view was that *Ford-Iroquois* might have been decided differently if there had been less patron overlap between functions. Although occasionally acquiescing in cases of near-complete integration between functions where there was little danger of misallocation (*see* Rev. Rul. 72-547, 1972-2 C.B. 511; LR of August 1973, reproduced at T.M. Portfolio 229-2nd, p. B-801), the IRS continued to argue that cross-functional netting was improper.

In a Technical Advice Memorandum issued early in 1985, for example, the IRS advised that the tax-exempt status of a Section 521 cooperative should be revoked for netting its supply and marketing functions. LR 8521003, Jan. 25, 1985.

Netting between departments within the same function (e.g. marketing of wheat and soybeans) has been considered less objectionable, even by the IRS. The disparity of interest and involvement between patrons marketing different commodities has not been thought to be as great as that between patrons only marketing or only purchasing supplies through the cooperative.

Chief Counsel Gideon indicated that the IRS was prepared to consider a rule permitting intrafunctional netting — provided that certain tests were met. One of the first hurdles, from the IRS' point of view, was the definition of a patronage dividend contained in Section 1388(a).

In order to be deductible from income at the cooperative level, a patronage dividend must be paid "under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid." I.R.C. § 1388(a)(2).

Gideon stated that this requirement would be satisfied by specific bylaw provisions designating in advance what departments would be netted, the circumstances, as well as any limitations on amounts. Thus, the obligation would be clearly delineated, rather than left to board discretion.

Furthermore, the chief counsel advocated an "artifice and device" rule to prevent abuses, even for intrafunctional netting. Such a rule would allow the IRS to review allocations made by a cooperative in order to prevent the perpetual subsidy of one department by another.

On a third netting issue — that of aggregation of gains and losses between patronage and non-patronage sources — the courts have found the IRS' position more persuasive. The Eighth Circuit in *Farm Service Cooperative v. Commissioner*, 619

F.2d 718 (8th Cir. 1980), refused to allow a cooperative to use losses generated on broiler sales to offset income earned from non-patronage sources (such as gains on sales of property and dividends on stock owned by the cooperative).

Since the income from a non-patronage source of a non-exempt cooperative is taxable at the cooperative level, the effect of netting in such an instance would be to reduce otherwise taxable income — thus shifting part of the broiler pool losses from broiler patrons to the U.S. Treasury. The court refused to allow this distortion.

As to the reverse issue — the right to net non-patronage losses against patronage income — the court indicated less concern. Recognizing that no tax avoidance would result in such a case because the cooperative is entitled to deduct the patronage-sourced income as patronage dividends, the court (in a footnote) implied that the two could be netted. 619 F.2d 718, 725 n.16.

Of course, such netting could affect the cooperative's overall tax situation if, for some reason, the patronage income did not qualify for deductibility under Subchapter T's requirements. The IRS has indicated that the two sources should not be netted. Rev. Rul. 74-377, 1974-2 C.B. 274.

Net Operating Losses

Normally, the netting of gains against losses from different departments or functions will result in a net positive figure, which is then distributed to patrons as patronage refunds. The netting procedure, however, may generate a loss to the cooperative. Over the years, the IRS has maintained that a cooperative cannot have an actual operating loss. In the case of loss, the IRS requires that a cooperative must recoup that amount from the members so as to operate at cost.

If the cooperative is allowed to carry losses backward and forward as do other corporations pursuant to I.R.C. § 172, it is argued, losses sustained by patrons during the loss year will distort gain to patrons during other tax years. The position of the IRS was rejected by the Tax Court in *Associated Milk Producers Inc. v. Commissioner*, 68 T.C. 729 (1977), which held that a cooperative was entitled to use Section 172 like any other corporation. The court characterized the IRS' argument as "conceptually strained and lacking any fundamental policy support." 68 T.C. 729, 736.

The IRS has since indicated that the utilization of Section 172 may be proper if it does not result in a major diversion of income from one group of patrons to another, although it continued its refusal to acquiesce in *Associated Milk Producers*. LR 8030004, March 25, 1980.

The Tracing Issue

A further aspect of the entire netting problem is the issue of tracing. Not only did the IRS advocate that income be allocated horizontally to the patrons of the department that earned it, but also vertically to the patrons that utilized the department in the appropriate year.

If patronage income was not received by the cooperative until one or more years after the patronage took place (as is frequently the case where products are marketed through a federated cooperative returning patronage refunds in future years), the IRS maintained that only those amounts distributed to patrons actually generating the income were deductible. *See* Rev. Rul. 70-249, 1970-1 C.B. 181.

Cooperatives argued that the maintenance of records sufficient to trace such income to the precise transactions that generated it would impose a severe hardship on cooperatives. Agricultural commodities were usually commingled over periods of time, with no means of identifying the product of an individual member.

The courts were inclined to favor the cooperative position. In *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894 (1982), the court upheld the cooperative's allocation of gains realized from the sale of equipment (which had been used over a 10-year period) to the current patrons of the cooperative. The court found the allocation equitable in light of the practical difficulties of allocating to patrons over the 10 years, the stability of membership, and the democratic nature of the decision process.

What may have been a crippling blow to the IRS tracing argument came in *Kingfisher Cooperative Elevator Association v. Commissioner*, 84 T.C. 600 (1985). In that case, the court held that patronage dividends received from federated cooperatives (and distributed to current patrons) were deductible even if earned on business done in prior years.

The court stressed, however, that the Kingfisher membership was very stable (there was less than 5% turnover per year), that the membership had approved the allocation formula, and that there was no evidence of discrimination against past patrons. Therefore, potential litigation areas still remain.

In response to *Kingfisher*, deficiencies assessed on the basis of the tracing issue by the IRS against certain cooperatives have been dropped, but the IRS has reserved the right to raise the issue in the future. *See* 38 *Coop. Acc't* 56 (Winter 1985).

Amendment to Subchapter T

Section 13210 of the Consolidated Budget Reconciliation Act of 1985 amends I.R.C. § 1388, which sets out definitions and special rules governing the federal income tax treatment of cooperatives. A new subsection has been created, the heart of which allows organizations qualifying for Subchapter T the option of netting. It reads as follows:

> The net earnings of such organization may, at its option, be determined by offsetting patronage losses (including any patronage loss carried to such year) which are attributable to one or more allocation units (whether such units are functional, divisional, departmental, geographic or otherwise) against patronage earnings of one or more other such allocation units.

The cooperative position that netting should be allowed has thus prevailed. Not only does the amendment provide for netting between departments within the same function, but the language also appears broad enough to allow the cross-functional netting that the IRS so strongly opposed. The decision to net is clearly optional, leaving control over this policy decision to a cooperative's board. Furthermore, no specific "artifice and device" rule was included in the statute, despite the urgings of the IRS.

It is also interesting to note that the amendment specifically includes a reference to losses carried from other tax years. Patronage losses carried forward or back from other tax years can be used to offset net earnings of the current tax year.

The clear indication of this reference, if the language is not to be mere surplusage, is that a cooperative is *entitled* to carry its losses to other tax years — the position previously adopted by the Tax Court.

The cooperative is not given a completely unfettered right to net, however. The amendment retains the distinction between patronage and non-patronage income sources as emphasized in *Farm Service Cooperative*. The definition of the items that the cooperative is entitled to net, contained in new subdivision (j)(4), provides: "For purposes of this subsection, the terms 'patronage earnings' and 'patronage losses' means earnings and losses, respectively, which are derived from business done with or for pa-

(continued on next page)

trons of the organization." The holding in *Farm Service Cooperative* that patronage losses cannot be utilized to offset non-patronage income remains undisturbed.

As to the issue of netting patronage earnings against non-patronage losses, the amendment specifically states that no change in law is intended and that any determination of such issue should be made as if the amendment had not been enacted. Section 13210(c)(3). Therefore, the question remains open, with the IRS maintaining the two should not be netted. The only judicial guidance indicates that such an offset is not objectionable. *See Farm Service Cooperative*, 619 F.2d 718, 725 n.16.

The right to net as clarified by Section 13210 is further restricted by the new notice provisions created by the amendment. The Treasury Department had urged that provisions for detailed disclosure of netting practices be included in the act. Congress did adopt such disclosure requirements, although of a less stringent character than those requested by the Treasury Department.

The amendment creates a new Section 1388(j)(3), which requires the cooperative to inform its patrons (in writing) within 8½ months of the close of the relevant taxable year that netting has occurred which may have affected the amount distributed. The offsetting allocation units must be identified, and the patrons must be notified of any right to acquire additional financial information.

Protection is afforded for any commercially sensitive information which could prejudice the cooperative's competitive advantage. *See* I.R.C. § 1388(j)(3)(B), as amended. Failure to provide sufficient notice is intended to be remedied by adequate revised notices, not by loss of Subchapter T or Section 521 treatment. *See* I.R.C. § 1388(j)(3)(C), as amended.

Remaining Problems

Tracing

The new amendment is designed to allow netting between functions or departments within the same tax year, but does not address the vertical problem of tracing gains to the patrons transacting business in the appropriate year. The *Lamesa* and *Kingfisher* cases remain the best indication of the current approach to the tracing issue.

Allocation Units

The new amendment does not specify the means by which the allocation units utilized in netting shall be set. In the past, the IRS has indicated that allocation units may be established by the members in the articles of incorporation or bylaws, or by the consistent treatment of certain divisions as parts of the same allocation unit. *See* LR Oct. 24, 1974, reproduced at T.M. Portfolio 229-2nd, p. B-1001.

Once set, it is important to be aware of the IRS' position that modification of the units constitutes a change in accounting method under I.R.C. § 446, requiring prior consent of the IRS.

Pre-Existing Legal Obligation

The new amendment does not resolve the IRS' contention that leaving netting decisions to the sole discretion of the cooperative's board violates the pre-existing obligation requirement for deductibility of patronage dividends under Section 1388. A Technical Advice Memorandum issued by the IRS in January 1985 states that in order to be deductible, the amount of as well as the recipients of patronage refunds must be determinable "without action by the board of directors of the cooperative at the close of the taxable year."

To the extent that earnings could be offset against losses from other departments, the Technical Advice Memorandum continues, "the patronage dividend will not be considered distributed pursuant to a pre-existing legal obligation." LR 8521003, Jan. 25, 1985.

The objections could be met by providing mandatory guidelines for netting in the cooperative documents, as suggested by Chief Counsel Gideon. Much of the advantage of using netting as a flexible tool for equitably allocating earnings would be lost, however.

Netting of Margins

The literal language of the amendment applies only to the netting of earnings and losses. As has been pointed out by the Agricultural Cooperative Service of the U.S. Department of Agriculture (*See* Baarda and Frederick, "Cooperative Netting Amendments to Internal Revenue Code," *Farmer Cooperatives*, June 1986), attempts to net between allocation units with differing margins (but no losses) may, therefore, be subject to challenge.

Conclusion

Section 13210 has been characterized as "clarifying" the rights of cooperatives to net, rather than as "creating" such rights. A comparison of the new amendments with the judicial development generally confirms this point of view.

Cooperative supporters should be pleased that this statutory clarification has resolved much of the controversy in favor of cooperatives. There still remains, however, the task of tying up loose ends.

Biotech developments

Policy for Regulation of Biotechnology. The June 26, 1986 Federal Register carries a lengthy notice issuing from the Executive Office of the President and the Office of Science and Technology Policy announcing the policy of federal agencies involved with the review of biotechnology research and products. 51 Fed. Reg. 23302-23350 (1986).

While the announced policies are to be effective immediately, comments received on or before Aug. 25, 1986 may lead to modifications or have an impact on proposed rulemaking by the involved agencies. The notice includes separate descriptions of the regulatory policies of the Food and Drug Administration, ETA, Occupational Safety and Health Administration and U.S. Department of Agriculture (USDA), and the research policies of the National Institutes of Health (NIH), NSF, Environmental Protection Agency and the USDA.

Regulation of Genetic Engineering. The USDA, through the Animal and Plant Health Inspection Service, has proposed regulations for the introduction (importation, interstate movement, or release into the environment) of genetically engineered organisms or products which are plant pests, or which there is reason to believe are plant pests (regulated articles). 51 Fed. Reg. 23352 - 23366 (1986).

Written comments on the proposed rule must be received on or before Aug. 25, 1986. Public hearings have been scheduled for July 28, 1986 in Sacramento, Calif., and for Aug. 5, 1986 in Washington, D.C.

Proposed USDA Guidelines for Biotechnology Research. The June 26, 1986 Federal Register contains an advanced notice seeking input and comments in the development of the USDA Guidelines for Biotechnology Research. 51 Fed. Reg. 23367-23393 (1986).

All federally funded agriculture biotechnology research will be subject to the USDA Guidelines for Biotechnology Research unless a specific project is supported by and subject to the guidelines or regulations of another federal agency. The proposed guidelines encompass all phases of agricultural biotechnology research. Written comments must be received on or before Aug. 25, 1986.

More detailed coverage of all of these developments will appear in upcoming issues of *Agricultural Law Update*.

— Donald B. Pedersen

STATE ROUNDUP

ARKANSAS. *Central Filing System?* Senate Bill 17 (enacted during the 1986 Special Session) establishes a statewide central filing system for farm credit liens to comply with the requirements of the Food Security Act of 1985, by amending Arkansas' U.C.C. §§ 9-307 and 9-407.

While this change is to be effective Dec. 1, 1986, it is to be noted that the appropriation bill (Senate Bill 16) to provide the funding for this new system failed to pass.

— *Kim Williamson Tucker*

SOUTH DAKOTA. *True Lease or Security Interest?* An agreement titled a "lease," and requiring regular payments for use of animal-raising buildings placed on debtor's farm was held to be a security agreement rather than a true lease.

The agreement allowed the debtors to use the buildings for seven years, but there was no purchase option or title transfer provision. *In re Sprecher Brothers Livestock & Grain Ltd.*, Memo Dec., No. 484-00181 (U.S. Bankr. Ct., D.S.D., March 5, 1986).

— *John H. Davidson*

VERMONT. *1986 Vermont Agricultural Legislation.* During 1986, the Vermont General Assembly reviewed and passed a number of bills relating to agriculture. Those measures include:

Property Tax Relief. Farmers in Vermont have been concerned for some time that their land was being taxed at its development value, rather than its farming value. H.615 creates a new current use program for farmers who wish to enroll their land. It also provides for a penalty in the event that a farmer withdraws from the program. Towns will be reimbursed for lost property tax revenue by the state.

Meat and Poultry Inspection. Vermont continues to be one of the states that conducts its own intrastate inspection of meat and poultry products. The Vermont Legislature adopted the federal model proposal for meat inspection programs during the recent session. H.759 also includes a provision for licensing processing and slaughtering plants and for inspection of retail markets.

Water Quality. Vermont has enacted what has been billed as one of the "toughest" clean water laws in the nation, S.42. Most provisions of the new law, however, will not regulate "accepted agricultural or silvicultural practices, as such are defined by the Commissioners of Agriculture and Forests, Parks and Recreation."

Livestock Imports. The period within which the Commissioner may retest imported livestock after import was expanded from 30 days to 120 days. Further, H.308 mandates that livestock brought into the state without having been first tested and inspected shall be either returned to the state of origin, or destroyed.

Maple Products Law Amendment. H.309 makes several technical changes in the maple law. Included among those is a redefinition of adulteration and a technical amendment to the violation section. Producers of maple-flavored products will be allowed to use the word "sweetened" in conjunction with the word "maple" on their labels.

Feed, Fertilizer and Lime. Vermont has adopted the model legislation for feed, fertilizer and lime. H.310 will help the State of Vermont to conform more closely to practices in other states. In addition, the legislation will raise certain fees and create new administrative penalties.

Coyote Control. The 1986 Legislature has created a coyote control program which will be administered by the Fish and Wildlife Department. S.262 is aimed at controlling only those coyotes which pose a threat to domestic animals.

Food Irradiation. The Legislature has also mandated the labelling of certain irradiated foods sold in Vermont. S.263 requires that food, which is labeled (pursuant to federal law) as having been subjected to an irradiation process, will also have to be labeled with the words "treated with radiation" or "treated by irradiation."

Equine Infectious Anemia. H.522 requires that all equines imported into Vermont, or sold in the state, must be first tested for equine infectious anemia. Horses found to have the disease must be either destroyed or branded and permanently quarantined.

— *William H. Rice*

WASHINGTON. *State Land Bank.* Chapter 284 of the 1986 Session of the Washington Legislature gave authority for the establishment of a state land bank patterned after the federal land banks.

Features include an automatic right of a deferral of principal or interest during the first five years of the note "unless the deferral of such payment would cause the principal and accrued interest on such loan to exceed 65% of the original appraised value or the current appraised value, whichever is less." It has been directed that loans are to be made on the "basis of long-term profitability rather than short-term cash flow."

The Act will be codified in Title 31 of the Revised Code of Washington.

— *Linda Grim McCormick*

Forecast of water supply inaccurate

Farmers who brought suit under the Federal Tort Claims Act to recover economic losses suffered in reliance on faulty Bureau of Reclamation forecasts of water supply for irrigation have had their claims dismissed in *Schinmann v. United States*, 618 F.Supp. 1030 (E.D. Wash. 1985).

The court held that the Bureau's miscalculation fell within the misrepresentation and discretionary exceptions to the Federal Tort Claims Act's waiver of sovereign immunity. 28 U.S.C. §§ 2680(a), (h), 1346(b).

While the government is liable for injuries resulting from negligence in performance of operational tasks, it is not liable, under the misrepresentation exception, for injuries resulting from commercial decisions made in reliance on government representations. See *Guild v. United States*, 685 F.2d 324, 325 (9th Cir. 1982).

The *Schinmann* court also held that the decision to issue the forecast was an administrative decision grounded in social and economic policy, falling squarely within the discretionary exception.

— *John H. Davidson*

AG LAW CONFERENCE CALENDAR

Summer Institute in Agricultural Law.
Litigation and Agricultural Lending, July 21-24, 1986.

Contact Drake University Law School, Des Moines, IA; 515/271-2947.

Farmers' Legal Crisis: Hybrid Solutions for the Mid-80s.
Sessions on the legal issues of farm debt and farm restructuring.
Aug. 9, 1986, New York Hilton, New York, NY.
Sponsored by the Ag Law Committee of the ABA General Practice Section.

Contact David N. Anderson, Ill. SBA, Illinois Bar Center, Springfield, IL 62701.

1986 Annual Meeting: American Agricultural Law Association.
Oct. 23-24, 1986, Worthington Hotel, Fort Worth, TX.
Sessions on the Current State of Agriculture, Agricultural Policy, Role of the Bar, the Farmers Home Administration, the Farm Credit System, Innovative Financing, Creditor Responsibilities, Educational Directions, Farm Bankruptcies, The 1985 Farm Bill, Agricultural Labor, Tax "Reform" and U.C.C. § 9-307(1).

Watch for details.

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5520-G Touhy Avenue
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Water and Natural Resources
Norman W. Thorson
University of Nebraska
College of Law
40th and Holdrege
Lincoln, NE 68583
(402) 472-2161

Government Regulations
Neil D. Hamilton
Drake University
School of Law
Des Moines, IA 50311
(515) 271-2947

Commodity Futures Trading
Thomas M. McGivern
Attorney Advisor
Division of Trading and Markets
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Taxation
Philip E. Harris
University of Wisconsin
427 Lorch St.
Madison, WI 53706
(608) 262-9490

Finance and Credit
Philip L. Kunkel
Moratzka, Dillon, Kunkel & Storkamp
705 Vermillion St.
P.O. Box 489
Hastings, MN 55033
(612)437-7740

Seed and Plant Issues
Mary Helen Mitchell
Pioneer Hi-Bred International
700 Capital Square
400 Locust St.
Des Moines, Iowa 50309
(515) 245-3510

Cooperatives
Terence J. Centner
University of Georgia
Dept. of Agricultural Economics
301 Conner Hall
Athens, GA 30602
(404) 542-2565

Farmland Protection
Edward Thompson Jr.
Counsel
American Farmland Trust
1717 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 332-0769

Taxation
Neil Harl
Dept. of Economics
East Hall
Iowa State University
Ames, IA 50010
(515) 294-2210

Small Farm Issues
John H. Davidson Jr.
University of South Dakota
School of Law
Vermillion, SD 57069
(605) 677-5361

Environmental Issues
David Myers
Valparaiso University School of Law
Valparaiso, IN 46383
(219) 464-5477

Labor
Donald B. Pedersen
University of Arkansas
School of Law
Fayetteville, AR 72701
(501) 575-3706

Review of Law Review Literature
Sarah Redfield
Franklin Pierce Law Center
Concord, NH 03301
(603) 228-1541

Congressional Activity
R. Charles Culver
c/o Senator Dale Bumpers
Room 2527 Federal Building
700 W. Capital
Little Rock, AR 72201
(501) 378-6286