Agricultural Law Update

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The execution of the laws is more important than the making of them.

— *Thomas Jefferson*

Irrigation districts not entitled to special power rate

Reclamation projects are the dam and canal systems built to irrigate or reclaim arid land in 17 western states. The projects produce hydroelectric power used for project operations and sell surplus power.

In *Arvin-Edison v. Hodel*, 610 F.Supp. 1206 (D.C.D.C. 1985), 11 California irrigation districts brought suit against the Western Area Power Administration of the Department of Energy (WAPA).

WAPA markets the power generated from the Central Valley Project (CVP), a federal reclamation project located in California. The districts contended that reclamation law entitles them to reduced power rates. The suit was brought to contest WAPA decisions that have raised CVP power rates 750% since 1978 and on into this year.

The sale of surplus power generated by reclamation projects is authorized by Section 9(c) of the Reclamation Project Act of 1939 (43 U.S.C. § 485h (c)) and Section 2 of the Rivers and Harbors Act of 1940 (Pub. L. No. 76-868, § 2, 54 Stat. 1198). These sections provide that when power is sold, preference shall be given to municipalities and other public agencies.

California irrigation districts are public agencies. Even as to public agencies, however, the rates charged for power must be sufficient to: repay the annual power operation and maintenance costs; repay the power capital costs within 50 years (with interest); and repay (without interest) the irrigation capital cost determined to be beyond the ability of irrigators to repay.

The Bureau of Reclamation and WAPA have always set one rate for power sold — regardless of whether it was sold to an irrigator or to another preference customer (the Commercial Rate). The Bureau charges itself a lower rate (the Project Rate) for electricity used in the operation of the reclamation project.

This suit concerned the overall purpose and import of the reclamation laws more than the precise meaning of the electric power marketing statutes. The plaintiff irrigation districts asserted that all project activities should be structured to support irrigation because irrigation is the primary purpose of the reclamation project.

(continued on next page)

Highlights of Farm Credit Act amendments of 1985

Congress recently enacted the "Farm Credit Act Amendments of 1985," P.L. 99-205, which not only provide a financial "bailout" for the stressed Farm Credit System (FCS), but also substantially revise the System's basic authority. The Farm Credit Act is lengthy, and this piece will attempt only to draw attention to key changes.

System Structure. As previously constituted, the FCS was supervised by a Farm Credit Administration (FCA). Within the FCA, the Federal Farm Credit Board served as the policy-making body of the system. It consisted of 13 part-time members (12 appointed by the President and one by the Secretary of Agriculture).

Under the 1985 Act, the governing power over the FCA is to be vested in a Farm Credit Administration Board, composed of three members (appointed by the President with the advice and consent of the Senate).

The new Board's members will serve full time. The role once performed by the Governor of the FCA will now be that of Chairman of the new Board, although the position's regulatory and enforcement powers — and those of the Board — are broadened considerably by the Act, and in numerous aspects, are made more specific.

The Capital Corporation. At the heart of this Act is § 103, directing the FCA to charter the "Farm Credit System Capital Corp." (FCS-CC). The FCS-CC is to be a FCS institution existing for the stated purpose of "... carrying out a program of financial and technical assistance to institutions within the [FCS] (and their borrowers) which are experiencing financial difficulties. ..."

(continued on next page)

IRRIGATION DISTRICTS

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Both the government and the Court disagreed: "The CVP is a multipurpose project; it was not intended to serve only one of its authorized functions." 610 F.Supp. at 1217.

The logical inconsistency of requiring irrigators to partially repay their water subsidy through their power bills did not sway the Court. The Court also accepted the argument that the irrigators' power use should be limited so that power will be available to benefit municipalities and other public entities.

The government's position (accepted by the Court) was that irrigation water is specifically subsidized according to a detailed statutory scheme. No further subsidies or preferences were specifically required by the statute, and none need be conferred.

The government may, therefore, use the non-irrigation project functions to benefit a wide group of non-farming interests, as well as to generate revenue to reduce the total cost of the irrigation subsidy to the extent possible.

The irrigation districts essentially made three specific arguments. First, they began with the premise that the primary purpose of reclamation projects is to irrigate arid land. The irrigation districts are the final link necessary to fulfill that purpose. Thus, the plaintiffs argued, their own facilities should be deemed part of the reclamation project, and they should be entitled to the Project Rate for their power purchases.

The Court rejected this approach, distinguishing district-owned and operated facilities from those owned and operated by the federal government. The latter are entitled to the Project Rate — the former are not.

The plaintiffs then argued that they are — at least — entitled to an intermediate rate between the Commercial Rate and the Project Rate. They asserted that capital costs should be excluded because irrigators are not required to pay them as part of their water costs, and that purchased power costs should be borne entirely by the cities that require the additional power.

The Court rejected this argument because such a rate structure was not specifically authorized by statute.

Finally, the plaintiffs argued that the increased power rates impaired the efficiency of the irrigation function of the project. Section 9(c) of the Reclamation Project Act states: "No contract relating to...electric power...shall be made unless it will not impair the efficiency of the project for irrigation purposes."

The irrigation districts contended that power rate increases raised the cost of water to farmers and thus diminished the irrigation subsidy. The Court rejected this argument, concluding that the statute means only physical, not economic, impairment of irrigation.

The Court's conclusion ratifies the Bureau's consistent interpretation of the reclamation laws over the last 30 years. That irrigators are now challenging this interpretation is indicative of the current farm crisis. This case is only one small example of farmers' attempts to reduce production costs in the face of consistently low prices for their goods. The irrigators are not appealing this decision.

However, the irrigators which were consulted remain convinced that irrigation districts are integral and necessary components of reclamation projects. They will undoubtedly advocate this position in other forums.

— Christopher L. Campbell

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FARM CREDIT ACT AMENDMENTS

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Basic to the statutory function envisioned for the FCS-CC is the acquisition of bad paper ("non-performing assets") from system banks; and, to "...receive and administer financial assistance for [FCS] institutions that originate outside of the [FCS]." This latter power is Congress' gentler expression of the fact that the FCS-CC will be the conduit for the federal bailout.

The Act sets out the corporate powers of the FCS-CC at length. Noteworthy is the power to require system banks to invest in FCS-CC obligations, or to make funds available to it in order to "make financial assistance available to institutions of the [FCA]." The FCS-CC will administer financial assistance under regulations issued by the FCA. The FCS-CC is not authorized to provide assistance to system banks after 1990.

The Bailout. The Secretary of the Treasury is to purchase debt obligations issued by the FCS-CC. A condition precedent to the purchase is a declaration by the FCA that certain acts have been taken, primary of which is that the FCS has committed its available capital surplus and reserves to relief of the financial stress in system banks.

Under prior law, the Governor of the FCA was empowered to invest temporarily in intermediate credit banks or production credit associations in order to help meet emergency credit needs of borrowers. Certain revolving funds were available for that purpose. This provision is repealed in favor of a section which makes these funds available (at the discretion of the FCA) for purchase of capital stock in the FCS-CC.

Capital Requirements. The Act authorizes the FCA to establish minimum levels of capital for each system bank, and gives the FCA broad discretion in determining the circumstances which warrant such intervention. Failure of a bank to maintain its capital requirements will allow the FCA to directly intervene by requiring the system bank to adhere to a required plan for achieving the capital requirement.

Temporary and permanent cease and desist powers are made available to the FCA for enforcing practices that lead to violation of capital requirements or other "unsafe and unsound" banking practices.

Receivership. The prior law allowed the FCA to appoint a conservator or receiver for a system bank if that bank defaulted on any of its obligations. That provision has been repealed in favor of one which empowers the FCA to appoint a conservator or receiver whenever one or more of several designated conditions are found to exist.

Such appointment may occur *ex parte*. Activating conditions include insolvency, improper dissipation of assets, and "an unsafe or unsound condition to transact business," and so forth.

Capital Reserve. The FCS is to create a central capital reserve by diverting a percentage of proceeds of debt obligations issued by the FCA on bank systems.

Member Protection. Several provisions of the new Act purport to protect borrowers. Consolidation of system associations, by merger or otherwise, is not to occur without member approval. Certain loan disclosures (of a modest truth-in-lending nature) are mandated.

Members who have loan applications denied or loan amounts reduced are entitled to review by a credit review committee. Interestingly, the Act directs the FCA to issue regulations which require system banks, in turn, to "develop a policy governing forbearance."

The overall effect of the new Act is to concentrate more authority over the FCS through the new Farm Credit Administration Board. This authority is described in broad terms, and will necessarily await the publication of regulations before it is practically defined.

One question which surfaces immediately is whether system banks will continue to be treated by courts as private institutions, or, instead, as federal entities, not unlike the Farmers Home Administration. Years of assertion by FCA representatives that the FCS is private may not hold up in light of the new, centralized and direct regulatory structure.

Arguably, system banks and associations are now the direct arm of the FCA, which, in turn, is defined in the statute as "an independent agency in the executive branch of the Government." Thought will also have to be given to the status of individual borrower/members from the system. The cooperative notion of member control is diminished considerably by the centralization of authority.

— *John H. Davidson*

Ag Law Conference Calendar

Agricultural Finance: How Lawyers Can Help Lenders and Borrowers.

March 20-21, 1986; Denver, Co.
May 8-9, 1986; St. Louis.

For registration information, contact American Bar Association, Division for Professional Education, 750 N. Lake Shore Drive, Chicago, IL 60611; 312/988-6200.

Loss of consortium merits high damages for bull

The Colorado Court of Appeals has upheld an award of punitive damages of $1 million against the manufacturer (Dow Chemical Co.) and the distributor (Franklin Laboratories) of Dursban 44 in *Coale v. Dow Chemical Co.*, 701 P.2d 885 (Colo. App. 1985).

Plaintiff owned Super-Rex, a bull with three-quarters Brahman blood and one-quarter Angus blood. Super-Rex is the only direct cross-breed offspring of Sugar Bull, who is, according to the court, the most renowned and highly rated Brahman bull in history.

Super-Rex's owner purchased a bottle of Dursban 44, which he used to treat Super-Rex and four other bulls with three-quarters Brahman blood. All the bulls became ill, and one died. Super-Rex developed organophosphate toxic poisoning caused by Dursban 44.

Super-Rex survived, but his breeding capability was irretrievably destroyed since he was rendered sterile and impotent.

Dursban 44 was first field tested on cattle in the United States in 1975. Other manufacturers of organophosphate products used warning labels indicating that the product should not be used on Brahman cattle because such cattle have pores that allow fast chemical absorption, which causes a toxic reaction. However, the Dursban 44 label had no such language.

In 1979, the defendants began receiving reports that Brahman cattle were experiencing adverse reactions. Thereafter, Dow Chemical Co. issued a temporary halt sales memo to its distributors, but Franklin Laboratories discouraged the return of the product.

Conversely, in Canada, Dow Chemical Co. stopped the sale of the substance and sent out a news release explaining the negative reaction on cattle.

In the United States, Dow Chemical Co. withheld the press release warnings, although it later decided that Dursban 44 should have a warning label. Unfortunately, it only printed sufficient labels for a little more than one-half of the product that was on the market at the time.

The jury awarded $150,000 in compensatory damages, $800,000 in punitive damages against Dow Chemical Co. and $200,000 against Franklin Laboratories.

The Colorado Court of Appeals held that defendants' pattern of lack of care in properly warning consumers of the danger involved with the use of Dursban 44 on Brahman cattle justified the award of both compensatory and punitive damages. The record supported the jury's finding that "defendants' behavior created a substantial risk of harm to another, and was purposely performed with an awareness of risk and disregard of the consequences." *Id.* at 889.

— *Bruce McMillen*

More on FmHA adverse action notices

In recent issues of *Agricultural Law Update*, we have been following the scheduling and rescheduling by the Farmers Home Administration (FmHA) of the mailing of notices of intent to take adverse action.

Originally, these notices were scheduled to go out to delinquent borrowers on or about Dec. 31, 1985. The delay until after the Jan. 22, 1986 hearing in *Coleman v. Block* was reported in the January 1986 issue of *Agricultural Law Update*.

Now, as we go to press, the scuttlebutt is that the notices will be mailed on Feb. 10, 1986, barring further injunctive action by Judge Bruce Van Sickle.

One new development is worth noting, however. In the Federal Register of Jan. 27, 1986, the FmHA reports that if all notices are sent at one time, some 65,000 FmHA farmer/borrowers will simultaneously find them in their mailboxes. While the 65,000 figure is somewhat less than the estimates of 80,000 and 90,000 which have been circulated, the number is still staggering. The Federal Register "Background" states:

> It has been determined that the impact of such a large number of farmers receiving the notice at one time would be detrimental to the agency and to rural communities. Therefore, the agency has determined that a better approach is to establish an order for sending the notice based on the age of delinquency. 51 Fed. Reg. 3325, 3326 (1986).

There is little doubt that if 65,000 borrowers (or a substantial percentage of that number) were to simultaneously return the form requesting consideration for various servicing options, the FmHA would be overwhelmed.

The Federal Register notice does not project the extent of the reduction from the 65,000 level that will result from adding to 7 C.F.R. § 1924.71 that "the order for sending these forms will be based on the age of the delinquency."

— *Donald B. Pedersen*

Federal income tax options for farmers in financial distress

by Philip E. Harris

Paying income taxes ought to be the least of a farmer's worries in times of financial distress. After all, it is the lack of income that causes the financial distress. It turns out, however, that income tax planning is as important at the time a farmer is giving up because of lack of income, as it is when the income is rolling in.

In times of financial distress, farmers often face two types of income tax consequences. One is the recognition of income on assets that are sold or are turned over to creditors.[1] The other is the recognition of income, or the reduction of tax attributes as a result of forgiveness of debt.[2]

These tax consequences affect not only the taxes the debtor must pay in the year of quitting business, but also in the following years. Tax planning is particularly important because the financially distressed debtor has several tax options, and choices made can have a significant effect on the debtor's after-tax income.

This article first discusses the two tax consequences of quitting business. The tax options that are available to the debtor will then be presented.

Transfer of Assets

One of the advantages of the cash method of accounting is the ability to defer income by deducting expenses as they are paid, and recognizing income only as assets are sold.

For example, the cost of planting a crop can be deducted in the year the expenses (such as seed, fertilizer and fuel) are paid. The income from the crop does not have to be reported until it is sold. Or, if the crop is fed to the taxpayer's livestock, income does not have to be recognized until the livestock is sold. If the livestock is breeding stock, income may be deferred for several years.

Although this deferral effect is not as great, accrual accounting also allows a taxpayer to defer income to the extent capital assets appreciate in value while they are in the hands of the taxpayer. Farmers tend to be well aware of the advantage of deferring income. However, they sometimes are surprised when it comes time to pay the taxes that have been deferred. The surprise is particularly bad news when it comes at a time when the farmer is having difficulty paying debts.

Example No. 1

To illustrate the problem faced by some farmers, assume Farmer Brown received his farm from his father in 1975 as a gift. Because Farmer Brown had a carryover basis in the farm, his basis was $100,000, even though the fair market value was $400,000. Using the farm as collateral, Farmer Brown borrowed money to purchase a confinement hog feeding operation. High interest rates, high corn prices and low hog prices put Farmer Brown in financial distress. The bank threatens to foreclose on the farm — now worth $600,000.

If the farm is transferred, whether by foreclosure or involuntary liquidation, Farmer Brown must recognize the resulting $500,000 capital gain on his farm. If Farmer Brown has no other income, and files a joint return with his wife, the regular tax on the capital gain would be approximately $77,500. In addition, the Browns would be required to pay about $14,500 in alternative minimum taxes.[3] Needless to say, the fact that selling assets to pay debts creates additional tax liability only adds to Farmer Brown's financial distress.

Forgiveness of Debt

Another surprise for the farmer in financial distress is that the forgiveness of his or her debts also has income tax consequences. To understand the consequences, a little background is necessary.

When a farmer receives a loan from the bank, he or she does not have to report the amount received as income, because there is an equal and offsetting obligation to repay the loan. Therefore, there is no increase in wealth.[4] If the loan is repaid, there is no deduction for the payment of principal because the obligation to repay is reduced in an amount equal to the cash paid. Again, there has been no change in wealth.

If, however, the loan is forgiven instead of paid off, the farmer does have an increase in wealth because his or her obligation to repay is reduced without an equal cash payment. That increase in wealth is included in gross income.[5] Section 108 of the Internal Revenue Code (IRC) grants five exceptions to the rule that forgiven debt is included in gross income. The exceptions in the order they are to be applied are as follows: 1) Forgiveness of debt that would have been a deductible expense if it had been paid;[6] 2) The discharge of debt in bankruptcy;[7] 3) The forgiveness of debt while the debtor is insolvent;[8] 4) Purchase money debt;[9] 5) The forgiveness of qualified indebtedness of a solvent debtor.[10]

If a taxpayer fits in one of the five categories of § 108, the taxpayer generally will have to reduce (by the amount of forgiven debt) other tax attributes such as net operating losses, investment tax credit, or the basis of assets.[11] Because these tax attributes would have reduced taxes in future years, the primary effect of § 108 is to defer the recognition of income — not to forgive the recognition of income.

Because forgiven debt must generally be reported as income, and because § 108 defers that recognition of income, tax planning decisions made by a farmer can have a significant effect on both the amount of taxes that must be paid and the timing of payment.

The farmer has some choice about whether or not § 108 will apply to debt that is forgiven. If § 108 does apply, the farmer has some choices that affect when, if ever, the income must be recognized. Those options are explored below.

Declaration of Bankruptcy

One of the choices that a farmer in financial distress has is whether or not to declare bankruptcy. Unlike individuals in other households, a farmer cannot be forced into bankruptcy by creditors.[12]

The income tax effect of declaring bankruptcy is twofold. First, it may shift some of the debtor's income tax burden to the bankruptcy estate. Secondly, slightly different rules apply to debt that is discharged in bankruptcy than to debt that is forgiven while the debtor is not in bankruptcy.

Shifting the Tax Burden

When an individual goes into a Chapter 7 or Chapter 11 bankruptcy, the bankruptcy estate is treated as a separate, taxable entity.[13] No gain or loss is recognized on the transfer of debts and assets to the bankruptcy estate.[14] The bankruptcy estate takes over the debtor's tax attributes — including the debtor's basis in the assets.[15] Any capital gain, depreciation recapture or investment credit recapture that is realized on a subsequent transfer of an asset by the estate to a third party must be reported by the estate.[16]

The resulting taxes are an administrative expense and, therefore, have first priority status in the bankruptcy estate.[17] Consequently, the debtor will not be liable for the taxes since unpaid administrative expenses do not become an obligation of the debtor.[18] These provisions allow the debtor to shift the burden of some income taxes to

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the bankruptcy estate by delaying (until the bankruptcy petition is filed) the transfer of assets that would trigger tax liability.

Example No. 2

If in Example No. 1 Farmer Brown had declared bankruptcy before the farm was transferred, and if the bankruptcy trustee transferred the farm to the bank,[19] the capital gains must be reported by the bankruptcy estate, rather than by Farmer Brown. Therefore, the estate must pay both the regular taxes and the alternative minimum tax. If the bankruptcy estate does not have enough assets to pay the taxes, Farmer Brown still is not liable for them.

Different Discharge of Indebtedness Rules

All debt that is forgiven in bankruptcy qualifies for the § 108 rule that it is not included in gross income.[20] If the debtor is not in bankruptcy when the debt is forgiven, the forgiven debt is treated the same as debt discharged in bankruptcy to the extent that the debtor is insolvent when the debt is forgiven.[21]

Example No. 3

For example, assume a taxpayer has $500,000 in debts and $400,000 in assets. If $200,000 in debts are discharged in bankruptcy, none of the discharges is included in gross income. If the same $200,000 of debt is forgiven outside of bankruptcy, only the first $100,000 of the debt forgiven will be treated like the debt discharged in bankruptcy. The other $100,000 of the debt will be subject to the "qualified business indebtedness" rules.[22]

In some cases, the qualified business indebtedness rules provide the same tax benefits as the bankruptcy rules. However, the qualified business indebtedness rules differ from the bankruptcy rules in three respects. First, all debts discharged in bankruptcy qualify for the non-recognition exception of § 108. The qualified business indebtedness rules require the debt to have been incurred for the purchase of assets used in the business.[23] This requirement should pose no problem for most farmers.

The second difference is that for debts discharged in bankruptcy, the debtor has the choice of whether to first reduce the basis of depreciable assets, or to first reduce other tax attributes.[24] The qualified business indebtedness rules require the taxpayer to reduce the basis of depreciable assets.[25]

This difference has only a little practical significance because it is often advantageous to reduce the basis of depreciable assets rather than other tax attributes. Even if reducing other tax attributes is preferable, the disadvantage of reducing the basis of depreciable assets is not great.

In some cases, the third difference can have a significant effect. In the case of bankruptcy and insolvency, discharged debt is not included in gross income even if there are no tax attributes to be reduced.

The qualified business indebtedness rules allow forgiven debt to avoid recognition as income only to the extent of the debtor's basis in depreciable assets.[26] Beyond that amount, the debtor must include forgiven debt in income.

Furthermore, in the case of bankruptcy or insolvency, the debtor's basis in all of his or her assets cannot be reduced below his or her total debts after the discharge.[27] The combination of these rules means that the qualified business indebtedness rules require some debtors to recognize more income, as well as pay a higher price for the income that is recognized.

Example No. 4

To illustrate these differences, assume a taxpayer has $400,000 in qualified business indebtedness, $300,000 in assets, $75,000 in net operating losses and $50,000 of basis in depreciable assets.

If $175,000 of debt is discharged in bankruptcy, no income will be reported, and the taxpayer's net operating loss will be reduced to zero. The difference between the debt discharged and the tax attributes ($175,000 − $75,000 = $100,000) will never be included in income.

In contrast, if the same $175,000 of debt is forgiven outside of bankruptcy, the first $100,000 will be treated under the insolvency rules. The debtor would not report that $100,000 as income, but would reduce net operating losses to zero. The basis of the depreciable assets would not be reduced as a result of the forgiveness of the first $100,000 of debt since the insolvency rules do not require a reduction of basis below the total debt after the forgiveness.

The next $75,000 of debt that is forgiven is subject to the qualified business indebtedness rules because the debtor was no longer insolvent when that debt was forgiven. Under those rules, the debtor has a choice with respect to $50,000 of the debt that is forgiven. That $50,000 can be reported as income, or the basis in the debtor's depreciable assets can be reduced to zero. The debtor has no choice with respect to the remaining $25,000 of debt that was forgiven — it must be reported as income.

Therefore, by choosing bankruptcy, the debtor can avoid the recognition of all the income, and loses only $75,000 of tax attributes. If bankruptcy is not chosen, the debtor must recognize at least $25,000 of income, then lose at least $75,000 of tax attributes. In addition, the taxpayer must recognize an additional $50,000 of income, or give up another $50,000 of basis.

Reduce the Basis of Depreciable Assets First

In the case of debts discharged in bankruptcy or debts forgiven while the debtor is insolvent, the debtor has a choice about how to pay the price for the non-recognition of income. One option is to pay the price by reducing the following tax attributes in the order listed below.[28]

1. Net operating losses.
2. Credit carryovers (Credit reduced by 50 cents for each $1 of debt discharged).
   a. Regular investment credit.
   b. WIN credit.
   c. Jobs credit.
   d. Alcohol fuel credit.
   e. Investment credit for research expenditures.
3. Capital loss carryovers.
4. Basis of assets (But not below the total debt of the debtor after the forgiveness).
5. Foreign tax credit carryovers.

The other option is to first reduce the basis of depreciable assets of the debtor.[29] If that reduction in basis does not absorb all of the discharged debt, the other attributes must be reduced beginning at the top of the items listed above.

The option that is chosen by a debtor will make the difference only if there will be some tax attributes remaining after all the discharged debt is absorbed. In that case, the option that is best for the debtor will depend upon the pattern of his or her income in the succeeding years.

The advantage of electing to reduce the basis of depreciable property first is that other tax attributes that will provide a tax benefit in the following year (such as net operating losses or investment credit) may be preserved. The basis in depreciable property provides a tax benefit that is spread over the depreciable life of the asset.

Preserving the other tax attributes will not be an advantage if the debtor's income will be higher in later years when the depreciation could be claimed. The disadvantage of electing to reduce the basis of depreciable assets first is that the limit on reduction in basis (i.e., the rule that the debtor's basis in all assets cannot be reduced below the debtor's total indebtedness after the forgiveness of debt) will not apply to the reduction of the debtor's basis in depreciable property.[30] Therefore, the election

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INCOME TAX OPTIONS

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could increase the price paid by the debtor for the non-recognition of income.

Two Short Tax Years

If the debtor elects to declare bankruptcy under either Chapter 7 or Chapter 11 of the Bankruptcy Code, and has property that is not exempt, he or she will have two options with respects to choosing a tax year.

One option is to continue with the same tax year that would have been used if there were no bankruptcy. The other option is to divide the tax year that would have been used (if there were no bankruptcy) into two short years.[31] The first of the short years ends the day before bankruptcy, and the second short year begins on the day of bankruptcy.

The option that is chosen may have an effect on whether the debtor or the bankrupt estate pays the taxes, as well as on when and how much of the debtor's tax attributes are absorbed.

Who Pays the Taxes. Since the bankrupt estate is responsible for all of the debtor's liabilities at the time of bankruptcy, income taxes that accrue before the date of bankruptcy become a debt of the estate.[32]

Consequently, the election to end a tax year before the day of bankruptcy will cause the taxes on the income earned to that point in time to become a debt of the bankruptcy estate. Since income taxes are a priority item in bankruptcy, they will be paid before other debts that may be discharged.[33]

If the election of two short years is not made, the tax on the income earned during the debtor's tax year in which bankruptcy occurs will accrue after the date of bankruptcy and will, therefore, not become a debt of the estate.

Example No. 5

As an illustration, assume a farmer who is a calendar year taxpayer is in financial difficulty and sells some assets in January to pay debts. On March 1, he decides to declare bankruptcy. If he does not elect two short tax years, the gain he realized on the sale of the assets will be included on the return he files for the full year. Those taxes will not be a debt of the bankruptcy estate.

If he elects two short tax years, the income taxes on the gain from the sale of the assets will accrue before bankruptcy was declared. Therefore, the taxes on the gain will become a debt of the bankruptcy estate.

Absorption of Attributes. The debtor's selection of a single tax year or two short tax years will also affect the amount of tax attributes that pass from the debtor to the bankrupt estate. The rule is that the bankrupt estate receives the tax attributes of the debtor as of the beginning of the tax year in which bankruptcy occurred.[34]

Therefore, if the debtor chooses a single tax year, the attributes that he or she has at the beginning of that year will pass to the bankrupt estate, and cannot be used by the debtor on the tax return for that year.

If the debtor chooses two short tax years, the attributes do not pass to the bankrupt estate until the beginning of the second short year. Therefore, the debtor can apply the tax attributes on his or her return for the first short year.

If the debtor has income before the date of bankruptcy, it is usually to the debtor's advantage to choose two short years. By doing so, the debtor not only makes the taxes on that income a debt of the estate, but will reduce the amount of taxes owed on that income.

The reduction of the taxes is an advantage to the debtor if the estate does not have enough assets to pay the tax because the taxes will not be discharged in bankruptcy,[35] and will become a debt of the debtor when the bankruptcy estate is closed. The cost to the debtor of applying the tax attributes to his or her own return by electing two short years is a potential reduction in the amount of tax attributes that pass from the bankrupt estate back to the debtor when the estate is closed.

If the bankrupt estate would absorb all the tax attributes anyway, the use of the attributes in the debtor's first short year will have no effect on the attributes that are passed back to the debtor.

Conclusion

Tax planning is as important for farmers in financial distress as it is for those who have a lot of profit. Income tax consequences are triggered by the sale of assets and by the forgiveness of debts.

The farmer's choice of whether or not to declare bankruptcy will affect his or her income taxes. If bankruptcy is chosen, the farmer can further affect his or her income tax liability by electing to reduce the basis of depreciable assets before reducing other tax attributes, and by choosing two short tax years rather than the farmer's regular tax year.

The farmer should carefully consider the effect of each of the above choices because they can have a significant effect on both the taxes due for the year of bankruptcy as well as the taxes due in the years following bankruptcy.

Footnotes

1. I.R.C. §§ 1231, 1245 and 1250.
2. I.R.C. § 108.
3. The Tax Reform Bill of 1985 (as reported out of the U.S. House of Representatives Committee on Ways and Means) includes a provision that eliminates the long-term capital gain exclusion as a minimum tax preference item for farmers who are insolvent at the time of the transfer that triggered the long-term capital gain.
To qualify, a farmer must use substantially all the proceeds of the sale to pay off debt. During the tax year, the farmer must also transfer 90% or more of the land held at the beginning of the year. A taxpayer is treated as a farmer if 50% or more of his or her average annual gross income for the three preceding taxable years is attributable to the farm business. H.R. 3838, 99th Cong., 1st Sess. (1985).
4. *Lorenzo v. Dilks*, 15 B.T.A. 1294 (1929); *William H. Stayton Jr.*, 32 B.T.A. 940 (1935).
5. *U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931).
6. I.R.C. § 108(e)(2).
7. I.R.C. § 108(a)(1)(A).
8. I.R.C. § 108(a)(1)(B).
9. I.R.C. § 108(e)(5).
10. I.R.C. § 108(a)(1)(C).
11. I.R.C. § 108(b).
12. 11 U.S.C. §§ 303(a) and 1307(a).
13. I.R.C. § 1398(a).
14. I.R.C. § 1398(f).
15. I.R.C. § 1398(g).
16. I.R.C. §§ 1398(e)(1) and 1398(e)(3)(A).
17. 11 U.S.C. § 507(a)(1).
18. *In re Lambkin*, 33 Bankr. 11 (Bankr. M.D. Tenn. 1983).
19. If the secured debt on the property is greater than the value of the property, the trustee may abandon it rather than transfer it to a third party. Abandonment puts the property back in the hands of the debtor, and a subsequent transfer from the debtor to a third party would force the debtor to recognize the tax consequences.
20. I.R.C. § 108(a)(1)(A).
21. I.R.C. § 108(a)(1)(B).
22. I.R.C. § 108(a)(1)(C).
23. I.R.C. § 108(d)(4)(A).
24. I.R.C. § 108(b)(5).
25. I.R.C. § 108(c).
26. I.R.C. § 108(c)(2).
27. I.R.C. § 1017(b)(2).
28. I.R.C. § 108(b)(1).
29. I.R.C. § 108(b)(5).
30. I.R.C. § 108(b)(5)(B).
31. I.R.C. § 1398(d).
32. 11 U.S.C. §§ 502(b) and 507(a)(7)(A).
33. 11 U.S.C. § 507(a)(7)(A).
34. I.R.C. § 1398(g).
35. 11 U.S.C. § 523(a)(1)(A).

Antitrust appeal accepted

In the September issue of *Agricultural Law Update*, a report was made on an antitrust ruling in the beef industry (See p. 6).

This decision has been appealed, and the Supreme Court has granted review. *Cargill Inc. v. Monfort of Colorado Inc.*, Case No. 85-473 (54 U.S.L.W. 3446 (1986)).

The appellant has raised issues concerning whether a competitor fearing heightened competition is entitled to an injunction, and whether a court may condemn a merger that increases concentration within the beef industry without considering competition from immediately adjacent industry segments or other factors that prevent noncompetitive behavior.

— *Terence J. Centner*

STATE ROUNDUP

CALIFORNIA. *Groundwater: Priority of Unexercised Rights.* An attempt to reward current groundwater users by giving them priority over landowners with unexercised groundwater rights was rejected in *Wright v. Goleta*, 174 Cal.App.3d 74, 219 Cal. Rptr. 740 (1985).

The trial court had granted an extraction right to a landowner, which right could not be reduced below a certain floor amount, regardless of the competing uses that might arise in the future from presently unexercised groundwater rights of other landowners.

The trial court's ruling was based on the California Supreme Court's decision in *In Re Waters of Long Valley Creek Stream System*, 25 Cal.3d 339, 158 Cal.Rptr. 350 (1979), which held that unexercised riparian rights to surface waters could be subordinated to existing appropriate rights, as part of a streamwide adjudication.

The Court of Appeals in *Wright*, however, distinguished streamwide adjudications from groundwater basin litigation on the basis that California has a comprehensive permit system for establishment of appropriate rights. The Court held that since California groundwater rights are not similarly regulated, the *Long Valley* doctrine did not apply.

Flooding: The Demise of Contract Protection for Tort Liability. The Salton Sea in California is a salt lake that has no natural outlet to the ocean. It receives most of its waters as return flow from irrigation in the vast Imperial Valley.

As the amount of irrigation water delivered has increased over the years, so has the level of the Salton Sea. Most of these irrigation waters are delivered by the Imperial Irrigation District. For decades, developers of land around the edge of the sea were required as a condition of development to grant to the district flooding easements or covenants not to sue in the event of eventual flooding.

In *Salton Bay Marina v. Imperial Irrigation District*, 172 Cal.App.3d 914, 218 Cal.Rptr. 839 (1985), the district was found liable to the owners of land flooded by the continuing rise of the Sea. The Court struck down the flooding easements and covenants not to sue as (1) ambiguous, and (2) illegal exculpatory contracts void as against public policy.

Flooding: Design Criteria Irrelevant. In a separate, unrelated case, the same district was found liable for flooding damage to a livestock yard caused by unusually heavy rains from a tropical storm.

In *Imperial Cattle Co. v. Imperial Irrigation District*, 167 Cal.App.3d 263, 213 Cal.Rptr. 262 (1985), the appellate court upheld a trial court verdict against the district, noting that the flooding had been triggered by the existence of a district-constructed drain that had been designed to handle irrigation and normal rain waters. The fact that the drain was never intended to handle major storm rains was no defense.

— *Kenneth J. Fransen*

NEW MEXICO. *Stock-Raising Homestead Act of 1916 Construed.* In *Champlin Petroleum Co. v. Lyman*, No. 15,847, slip op. (N.M. Oct. 28, 1985), the New Mexico Supreme Court held caliche to be a mineral reserved to the United States in patents issued under the Stock-Raising Homestead Act of 1916, 39 Stat. 862 (1916) (SRHA). Caliche is a surface deposit consisting of sand or clay impregnated with crystalline salts.

Defendant owned land pursuant to a SRHA patent which reserved "coal and other minerals" to the United States. Plaintiff, pursuant to an easement, commenced road building and caliche removal on the land. Defendant, contending caliche was *not* a SRHA reserved mineral, attempted to halt plaintiff's activities. Defendant's argument was rejected.

In *State ex rel. State Highway Commission v. Trujillo*, 82 N.M. 694, 487 P.2d 122 (1971), the New Mexico Supreme Court had held monzonite rock, which (like caliche) is useful for road building material, not to be a SRHA reserved mineral. The surface owners were, therefore, compensated for the rock's removal.

However, in *Western Nuclear Inc.*, 462 U.S. 36 (1983), the U.S. Supreme Court found gravel to be reserved to the United States under SRHA patents. The SRHA mineral reservation clause was interpreted to include "substances that are mineral in character. . .that can be removed from the soil, that can be used for commercial purposes, and that there is no reason to suppose were intended to be included in the surface estate." 462 U.S. at 53.

Although the New Mexico Supreme Court believed the mineral definition in *Western Nuclear Inc.* to be overly broad, it ruled that the definition would include caliche. *Trujillo* was overruled to the extent that the decisions conflicted with *Western Nuclear Inc.*

— *John Copeland*

Civil penalties under FIFRA: Gravity of harm

The Eighth Circuit Court of Appeals has upheld a $5,000 civil penalty assessed against Panhandle Cooperative Association for mislabeling a tank of Telone II pesticide in violation of the Federal Insecticide, Fungicide and Rodenticide Act (FIFRA). *Panhandle Cooperative Association v. Environmental Protection Agency*, 771 F.2d 1149 (8th Cir. 1985).

Panhandle failed to attach a proper label to a 4,000-gallon bulk tank of the pesticide. The tank was simply marked "Telone II." The pesticide was dispensed from the bulk tank into customers' containers, and each customer was given an approved specimen label by the Environmental Protection Agency (EPA).

FIFRA provides that in determining the amount of a civil penalty, the Administrator is to consider the appropriateness of the penalty to the size of the business, the effect on the person's ability to continue in business, as well as the gravity of the harm.

Panhandle argued that providing proper labels to its customers minimized the seriousness of the violation and that the $5,000 penalty assessment was arbitrary, capricious and an abuse of the EPA discretion.

The administrative law judge assigned to the case concluded that although no actual injury to the environment or human health occurred, Telone II is extremely dangerous when not used properly, and the potential for harm was extremely high.

The administrative law judge also found that while customers were given the proper labels "it is likely that by that time it was too late to take the required precautions, since during the dispensing and filling process, both the purchaser and the sales person [were] exposed to quite serious hazards presented by this pesticide."

The Eighth Circuit undertook a very narrow scope of review, saying that the assessment of a penalty was particularly delegated to the administrative agency, and that its choice of sanction was not to be overturned unless "unwarranted in law" or "without justification in fact."

The administrative law judge had used the proper criteria and had carefully reviewed the stipulated facts. Accordingly, the court held the assessment was not an abuse of discretion.

— *Annette Higby*

Address Correction Requested

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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

AALA REQUESTS NOMINATIONS. The American Agricultural Law Association (AALA) Nominating Committee requests your candidate suggestions and selection comments for the 1986-87 office of president-elect and two new members of the board of directors for the three-year term beginning in 1986. Please send your nominations and comments to Professor Keith G. Meyer, committee chairperson, University of Kansas School of Law, Lawrence, KS 66045.

AALA DISTINGUISHED SERVICE AWARD. The AALA invites nominations for the Distinguished Service Award. The award is designed to recognize distinguished contributions to agricultural law in practice, research, teaching, extension, administration or business.

Any AALA member may nominate another member for selection by submitting the name to the chair of the Awards Committee. Any member making a nomination should submit biographical information of no more than four pages (in quintuplicate) in support of the nominee. The nominee must be a current member of the AALA, and must have been a member thereof for at least the preceding three years. Nominations for this year must be made by May 1, and communicated to: Patrick K. Costello, chair, AALA Awards Committee, P.O. Box 1, Lakefield, MN 56150; 507/662-6621.

THIRD ANNUAL STUDENT WRITING COMPETITION. The AALA is also sponsoring its third annual Student Writing Competition. This year, the AALA will award two cash prizes in the amounts of $500 and $250.

The competition is open to all undergraduate, graduate or law students currently enrolled at any of the nation's colleges or law schools. The winning paper must demonstrate original thought on a question of current interest in agricultural law. Articles will be judged for perceptive analysis of the issues, thorough research, originality, timeliness, and writing clarity and style. Papers must be submitted by May 1, 1986. For complete competition rules, contact: Patrick K. Costello, chair, AALA Awards Committee, P.O Box 1, Lakefield, MN 56150; 507/662-6621.