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Agricultural Law Update

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The basis of our political systems is the right of the people to make and to alter their constitutions of government.

— *George Washington*

Federal clear title rules preempt state law on Dec. 23, 1986

On Dec. 23, 1986, *lenders* who wish to fully protect security interests in farm products and *agricultural landlords* who wish to protect rent payments with Article 9 Security Interests must comply with a new federal law.

Buyers of farm products are affected because the new law will determine whether they obtain clear title. *Sellers* of farm products are affected because the new law subjects them to a possible $5,000 fine.

The new law is Section 1324 of the 1985 Farm Bill, which becomes effective on Dec. 23, 1986 — one year after the 1985 Farm Bill was signed. Proposals to delay the effective date of Section 1324 and to amend its provisions died when the 99th Congress adjourned in October.

In most states, the federal law will protect buyers of farm products through a direct notice rule. Buyers will acquire farm products free of perfected security interests unless the buyer has received actual notice of the security interest from the secured party or seller within the preceding year. Similar protection is given commission merchants and selling agents.

This new federal law applies "not withstanding any other provision of Federal, State or local law." Thus, it preempts the farm products exception of U.C.C. 9-307(1), or other non-uniform rules adopted in many states.

In those few states that have adopted a central filing system certified by the Secretary of Agriculture, different provisions of the federal law will apply. Generally, buyers who register with the Secretary of State will obtain clear title unless they receive actual notice of the security interest from the Secretary of State, or fail to comply with requirements for release or waiver of the security interest.

Under this alternative central filing/registration system, registered buyers would automatically receive financing statement information from the Secretary of State.

The certified central filing system approach also allows non-registered buyers to request information from the Secretary of State on an ad hoc basis. Final regulations concerning certified central filing systems were effective Sept. 17, 1986. 51 Fed. Reg. 29,449 (Aug. 18, 1986).

The following paragraphs focus on the impact of direct notice rules which will apply in most states. Those states adopting certified central filing (Montana, Mississippi, Utah and Idaho, with Arkansas and Kansas pending) should consult appropriate state officials for details of their particular state's system.

1. **Direct Notice: General Requirements**

A security interest will follow farm products into the hands of purchasers only if the following conditions are met:

a) There must be a valid security agreement describing the farm products;

b) The security interest must be perfected (as occurs when a financing statement is properly prepared and properly filed); and

c) Written notice of the security interest must be received by the buyer within the year preceding purchase. The following paragraphs will focus on the details of this third requirement.

2. **Frequency of Notice**

The notices must be sent annually to protect the lender. A buyer who purchases farm products without having received the actual notice within one year of the purchase obtains clear title to the farm products.

Since it will be necessary to prove receipt of the notice by the purchaser, the secured party may want to send the notice by registered or certified mail, return receipt requested. What constitutes receipt is to be determined by the law of the state in which the buyer resides.

3. **Obtaining Names and Addresses of Prospective Purchasers**

The federal law provides that secured parties may, in their security agreements with farmers, require that the farmer furnish a list of the buyers, commission merchants and selling agents to or through whom the farmer may sell the products. If a farmer sells farm products to a person not on the list, the farmer may be subject to a fine of $5,000 or more.

(continued on next page)

4. **What Buyers Must Do to Protect Themselves**

A buyer is automatically protected unless they receive the actual notice described above. If a buyer has received the actual notice, they must comply with the conditions for release or waiver of the security interest as described in the notice. If they fail to comply, they may be liable in conversion to the secured party if the seller defaults on the secured obligation.

CAVEAT — The following form is an attempt to comply with a new federal law in need of technical amendment. For example, under Section 1324(e)(1)(a) of the Farm Bill, the direct notice is supposed to be an "original or reproduced copy" of the "security interest" (was security *agreement* or financing statement intended?).

The notice is also supposed to contain the debtor's social security number or taxpayer identification number. Since most security agreements and financing statements do not contain the debtor's social security number, the two requirements are inconsistent as a practical matter.

The solution reflected in the following direct notice form is to ignore the "original or reproduced copy" requirement. The certified central filing regulations ignore a similar "original or reproduced copy" statutory requirement expressly applicable to analogous documents. *Compare* Sec. 1324 (c)(4)(A) of the 1985 Farm Bill *with* 51 Fed. Reg. 29,453, Sec. 205.202.

Because of technical inconsistencies in the clear title statute, attorneys are urged to review the legislation and the notes accompanying the form before using it. Others should not use the form without first discussing it with legal counsel.

Footnotes

1. The central filing system envisioned by Sec. 1324 is a free-standing system unrelated to the perfection of security interests in farm products under Article 9 of the Uniform Commercial Code.

2. The 1985 Farm Bill, P.L. 99-198, at Section 1324(e)(1)(A), requires the notice to be "organized according to farm products."

3. The regulations for a certified central filing system, although not applicable to the direct notice option, can be used for guidance. *See* 51 Fed. Reg. 29,452 (Aug. 18, 1986).

4. Would it violate the Social Security Act to require borrowers to disclose their social security numbers or to make such a disclosure on the direct notice form? According to proposed regulations, any such provision in the Social Security Act would be superceded by Sec. 1324 of the 1985 Farm Bill, which expressly requires the use of such numbers with regard to farm products. 51 Fed. Reg. 22,815 (June 23, 1986). Interestingly, final regulations are silent on this issue. *See* 51 Fed. Reg. 29,449 (Aug. 18, 1986).

5. The statute expressly requires the use of "crop year" for direct notice (Sec. 1324(e)(1)(A)(ii)(IV)). The term is also used in certified central filing (Sec. 1324(c)(2)(C)(ii)(IV)). There are no regulations for direct notice, but the certified filing regulations interpret the meaning of "crop year" as follows:

The crop year...must be: 1) For a crop grown in soil, the calendar year in which it is harvested or to be harvested; 2) For animals, the calendar year in which they are born or acquired; 3) For poultry or eggs, the calendar year in which they are sold or to be sold. 51 Fed. Reg. 29,453, Sec. 205.107 (Aug. 18, 1986).

6. The regulations applicable to certified central filing (to the extent they are useful for guidance on direct notice) suggest listing "each county or parish in the same state where the farm product is produced or to be produced." 51 Fed. Reg. 29,452, Sec. 205.103(3).

7. The statute requires "a reasonable description of the property." Sec. 1324(e)(1)(A)(2). For crops, this would probably mean a description of the land where grown. For livestock, this would probably mean the location of the farm or feedlot where the livestock would be found. The reader is also referred to the somewhat analogous provision in the certified central filing regulations. 51 Fed. Reg. 29,453, Sec. 205.207.

8. Federal law is ambiguous about these signatures. They are not expressly required by Sec. 1324(e), but subparagraph (1)(A)(iii) uses the language "similarly *signed* (emphasis added)" when referring to amendments. The somewhat analogous provision for certified central filing expressly requires the signatures of both the debtor and the secured party. Sec. 1324(c)(4)(B) and (C).

Until this ambiguity is corrected by technical amendment, it is probably better to play it safe and get both signatures (if possible). But don't delay if the signature of debtor is not readily available. A notice signed only by secured party is better than no notice at all.

9. *Id.*

— Donald L. Uchtmann

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NOTICE OF SECURITY INTEREST IN (e.g., corn [2])

DATE: (insert date)

TO: (insert name and address of buyer, or other person getting notice)

You are hereby given notice pursuant to Sec. 1324(e) of the Food Security Act of 1985, P.L. 99-198, that (insert name of secured party), whose mailing address is (insert complete mailing address), is the holder of a perfected security interest securing a debt or other obligation of

Surname or Corporate Name: (insert surname or corporate name [3])

First Name and Middle Name: (insert first name and middle name)

whose mailing address is

Debtor's Street/Rural Route: (insert appropriate information)

Debtor's City, State, Zip Code: (insert appropriate information)

and whose Social Security Number or (in case of a debtor doing business other than as an individual) Internal Revenue Service Taxpayer Identification number is

SSN/Taxpayer I.D. Number: (insert appropriate number [4])

The farm products described in the perfected security interest include:

Farm Product Type: (describe farm product and amount, e.g. all corn)

Crop/Livestock Year: (insert crop/livestock year [5])

County/Counties Where Produced: (insert counties where farm product is produced [6])

Other Description: (add reasonable description [7])

The conditions under which the secured party will release or waive its security interest in the farm products are as follows:

(insert any condition, e.g., "buyer pays for the farm products with a check issued jointly to the debtor and the secured party and such check is honored when presented for payment")

(insert [8]) ____________________ Signature of Secured Party

(insert [9]) ____________________ Signature of Debtor

Farmer as employer of migrant workers

In the case of *Beliz v. W.H. McLeod & Sons Packing Co.*, 765 F.2d 1317 (5th Cir. 1985), a farmer who required additional labor during harvest time engaged a farm labor contractor to recruit, transport and oversee migrant workers.

The workers' suit alleged that the farmer was liable as an employer for minimum wages under the Fair Labor Standards Act (FLSA). The lower court found that the farmer was not the workers' employer, but the Fifth Circuit reversed.

Determination of employee status under the FLSA is not controlled by traditional common law criteria; employee status is expanded to include those persons "whose livelihood is dependent upon finding employment in the business of others." 765 F.2d at 1327.

Even if a farm labor recruiter is held to be an independent contractor, the recruiter/contractor and the farmer may still be joint employers of the farmworkers. An appropriate analysis considers the economic realities of the relationship among workers, contractor and farmer.

Critical factors are the degree of work specialization and the extent to which the labor recruiter is independent of the farmer's control. 29 C.F.R. Section 780.331(d) provides that a labor contractor and farmer can be joint employers if the farmer has the power to direct, control or supervise the work, or to determine the rate of pay or method of payment.

In this case, vegetable harvesting was not of a specialized nature and the farmer provided overall supervision of the migrant laborers, who performed the same work as regular non-seasonal employees.

Moreover, the labor recruiter invested no capital, provided only limited equipment, maintained no separate business organization and no regular work force, and, as a crew leader, made no significant decisions involving judgment, initiative, or basic control.

The recruiter's compensation was based on a price/rate arrangement, with the farmer unilaterally determining the amount paid to the recruiter per crop unit picked. To some extent, the farmer controlled the amount paid crew members.

Therefore, the court had two bases for finding the farmer an employer of the migrant workers: 1) As an employer of the labor contractor and, as a consequence, an employer of the laborers; and 2) As an employer in his own of the laborers by exercising control and supervision over the work performed, and by setting the amounts paid to the crew members.

— *Kemp P. Burpeau*

Federal Register in brief

The following is a selection of proposed rules, final rules and notices that have appeared in the *Federal Register* in the last few weeks:

1. FmHA Appeal Procedure. Final Rule. 51 Fed. Reg. 29,449. Effective date: Aug. 18, 1986. Request for review is now to be sent to the review officer rather than the hearing officer.
2. Final Regulations for Implementing National Environmental Policy Act. Final Rule. 51 Fed. Reg. 34,190. Effective date: Oct. 27, 1986.
3. Certification of Statewide Central Filing System for Idaho. 51 Fed. Reg. 34,236. Sept. 23, 1986. Amendment to Certification of Central Filing System. 51 Fed. Reg. 36,257. Oct. 6, 1986.
4. Servicing FmHA Farmer Program Borrowers Under Jurisdiction of Bankruptcy Courts. Final Rule. 51 Fed. Reg. 34,579. Effective date: Sept. 30, 1986. The FmHA amends its regulations to allow Farmer Program borrowers under the jurisdiction of a bankruptcy court to obtain a modification of the automatic stay for the limited purpose of applying for loan financing.
5. Official U.S. Standards for Grain. Proposed Rule. 51 Fed. Reg. 35,224. Comments due by Dec. 1, 1986.
6. Temporary Program to Encourage Use of Grain for Fuel Ethanol. Notice. 51 Fed. Reg. 35,672.
7. Farm Credit Administration District Director Elections. Notice of Decision. 51 Fed. Reg. 36,601. Timetable for election of and terms for at-large directors.
8. Farm Credit Administration Capital Adequacy and Minimum Capital Requirements. Notice of Proposed Rulemaking. 51 Fed. Reg. 36,824. Deadline for comments: Nov. 14, 1986.
9. Marketing Quotas and Acreage Allotments; Feed Grain, Rice, Cotton and Wheat; Food Security Act Implementation. Final Rule. 51 Fed. Reg. 36,902. Effective date: Oct. 15, 1986.
10. Certification of Statewide Central Filing System for Utah. 51 Fed. Reg. 37,769. Oct. 21, 1986.
11. Egg Marketing Order. Proposed Rule. 51 Fed. Reg. 37,822. Written exceptions due by Dec. 23, 1986.
12. Unified Agenda of Federal Regulations for Farm Credit Administration. 51 Fed. Reg. 39,172. This is a list of regulations that the FCA will have under development and review during the period of October 1986 through April 1987.
13. Farm Credit Administration Borrower Rights. Final Rule. 51 Fed. Reg. 39,486. The Farm Credit Administration Board adopts final regulations relating to the disclosure of interest rates, extensions of credit, forbearance policies, notices of equity retirement, access to stockholder lists, and disclosure of loan documents. Effective date: Nov. 28, 1986. These regulations will be discussed in an upcoming issue of *Agricultural Law Update*.

— *Linda Grim McCormick*

Delayed pricing contracts in bankruptcy

In an Indiana bankruptcy case involving a terminal grain elevator of The Early & Daniel Co., the court held that unsecured delayed pricing and basis contracts between the elevator and grain sellers are executory within the meaning of 11 U.S.C. Section 365, and can, therefore, be paid over the objections of other unsecured creditors. *In re The Early & Daniel Co. Inc.*, Bankr. S.D. Ind. March 27, 1986, Debtor No. IP86-529 RA V.

The debtor in the Chapter 11 reorganization argued that since the grain sellers had yet to set the price and the debtor had yet to pay, the contracts were executory. The debtor had $4.3 million to cover $2.5 million in contracts. Four unsecured banks with $12.5 million in claims argued that the contracts were not executory, and that payment would prejudice all other creditors.

The bankruptcy court agreed with the debtor that the contracts were executory. The banks' request for a stay of the order was denied on April 21, 1986. The banks have appealed.

If the ruling stands, it should not be interpreted as giving those waiting to be paid under delayed pricing contracts priority over secured creditors since, in this case, the banks were unsecured.

— *Gerald Harrison*

AG LAW CONFERENCE CALENDAR

Water Resources Law.
Dec. 15-16, 1986, Hyatt Regency Hotel, Chicago, IL.
Topics: Water Allocation Rights, Ground and Surface Water Regulations, and Changing Agricultural Property Rights.
Sponsored by The Society for Engineering in Agriculture, in cooperation with the American Agricultural Law Association, and other associations.
For further information, contact Lisa Zielke at 616/429-0300.

The Tax Reform Act of 1986

by Philip E. Harris

The Tax Reform Act of 1986 makes significant changes in the federal income tax rules. Some changes will reduce farmers' taxes, while others will increase taxes paid by farmers. Some farmers who have made extensive use of the investment tax credit and long-term capital gains provisions of the prior law will pay more income tax under the new rules, even though the rates have been reduced. This article summarizes some of the provisions of the new law that will affect many farmers.

Tax Rates

Both corporate and individual tax rates are reduced by the new law. Individual income is now taxed in two brackets — 15% and 28%. Income above $29,750 for a married couple filing jointly, $23,900 for a head of household, $17,850 for a single taxpayer, and $14,875 for a married person filing separately falls in the 28% bracket.

An additional 5% surtax on higher levels of income ($71,900 to $149,250 for a married couple filing jointly, $61,650 to $123,790 for heads of households, $43,150 to $89,560 for single taxpayers, and $35,950 to $113,300 for married taxpayers filing separately) effectively adds a 33% bracket for some taxpayers.

The surtax is designed to phase out the benefit of the 15% bracket and the personal and dependency exemptions, and is structured to assure that a taxpayer's average tax rate will never exceed 28%.

The new rates are not effective until 1988. In 1987, there are five brackets ranging from 11% to 38.5%.

Corporate tax rates drop to 34% on income over $75,000, 25% on income over $50,000 (but not over $75,000), and 15% on income of $50,000 or less. The benefit of the lower brackets is phased out for corporations with income between $100,000 and $335,000 (so that corporations with income over $335,000 pay a flat tax of 34%).

These new rates are effective July 1, 1987. Income in tax years that straddle that date will be a blend of the old and the new rates.

Personal Exemption Deductions

The current $1,080 personal exemption deduction is increased to $1,900 for 1987, $1,950 for 1988, and $2,000 for 1989. Beginning in 1990, the amount will be increased each year by an amount equal to the increase in the Consumer Price Index. The extra personal exemption deductions for blind taxpayers and taxpayers over the age of 65 are replaced by additions to the standard deduction for those taxpayers.

Any taxpayer who is claimed as a dependent on another taxpayer's tax return is not allowed to claim the personal exemption deduction on his or her own return. Such a taxpayer is allowed, however, to use $500 of the standard deduction against unearned income. Under prior law, the standard deduction (zero bracket amount) could be used only to offset earned income of such taxpayers.

Philip E. Harris is an associate professor of agricultural economics and law in the College of Agriculture at the University of Wisconsin-Madison. He received his law degree from the University of Chicago in 1977.

Standard Deduction

Beginning in 1988, the standard deduction is increased to $5,000 for married taxpayers filing jointly, $4,400 for heads of households, $3,000 for single taxpayers and $2,500 for married taxpayers filing separately. For 1987, the amounts are $3,760, $2,540, $2,540 and $1,880 respectively.

Unmarried taxpayers can increase the standard deduction by $750 if they are over age 65, and another $750 if they are blind. Married taxpayers can increase their standard deduction by $600 for each of those qualifications.

State Sales Taxes

Beginning in 1986, state and local sales taxes are no longer deductible as an itemized deduction. State and local sales taxes paid as part of business expenses continue to be deductible as a business expense.

Interest

The new law repeals the deduction for consumer interest — except for interest paid on a principal residence and a second home. All interest paid on debt secured by the residence is deductible, regardless of the use of the proceeds of the loan, as long as the loan amount does not exceed the greater of: 1) The original cost of the residence plus improvements made to the residence; or 2) The debt outstanding on the residence on Aug. 16, 1986.

Interest on debt in excess of the above limit (but not in excess of the current fair market value of the residence) is deductible only if the proceeds of the loan are used for medical or educational expenses.

Medical Expenses

Beginning in 1987, medical expenses are deductible only to the extent they exceed 7.5% (rather than 5%) of adjusted gross income.

Income Averaging

The income averaging rules are repealed for all taxpayers beginning in 1987.

Capital Gains and Losses

Beginning in 1987, the individual long-term capital gains exclusion is repealed. Consequently, gain on all capital assets and assets used in a trade or business will be taxed at the same rate as ordinary income.

There is an exception to the new rule for gain realized on the sale of dairy animals as a result of the dairy termination program. This exception allows the long-term capital gain exclusion for gain on sales occurring after Jan. 1, 1987 and before Sept. 1, 1987.

The limitation of deducting only 50% of net long-term capital losses from ordinary income is also repealed beginning in 1987. The limit of $3,000 of capital losses that can be deducted from ordinary income each year is retained, however. Capital losses in excess of the $3,000 per year limit can still be carried to subsequent years.

Depreciation

Property placed in service after Dec. 31, 1986 will be subject to a new set of depreciation rules. The new rules add new classes of property, shift some property from one class to another, and increase the rate of depreciation within the classes.

Classes. The new classes for depreciating property are as follows:

Three-year: Property with an asset depreciation range (ADR) midpoint life of four years or less. Examples of property in this class include breeding hogs, race horses over two years old, and other horses over 12 years old.

Five-year: Property with an ADR midpoint life of more than four years, but less than 10 years. Examples of property in this class include automobiles, light trucks (less than 13,000 pounds), computers and peripheral equipment, trailers, breeding and dairy cattle, and breeding sheep and goats.

Seven-year: Property with an ADR midpoint life of 10 years or more, but less than 16 years. Examples of property in this class are single-purpose agricultural and horticultural structures, machinery, equipment, grain bins, fences, and breeding or working horses.

Ten-year: Property with an ADR midpoint life of 16 or more years, but less than 20 years. Very few assets used in farming will fall in this class.

15-year: Property with an ADR midpoint life of 20 years or more, but less than 25 years. Examples of property in this class include waterways and drainage facilities.

20-year: Property with an ADR midpoint life of 25 years and more (other than § 1250 property with an ADR midpoint life of 27.5 years and more). Examples of property in this class include farm buildings such as

barns and machine sheds that are not single-purpose structures.

27.5-year: Property that is residential real property.

31.5-year: Property that is non-residential real property, and does not have an ADR midpoint life of less than 27.5 years.

Rates. Property in the 3-, 5-, 7- and 10-year classes can be depreciated using the 200% declining balance method over the recovery period, or by using the straight line method over the recovery period.

Property in the 15- and 20-year classes can be depreciated using the 150% declining balance method over the recovery period, or by using the straight line method over the recovery period. Property in the 27.5- and 31.5-year classes can be depreciated only under the straight line method over the recovery period.

Property depreciated under the declining balance method can be switched to the straight line method in the year that switch will maximize the depreciation deduction. The election of the method of depreciation applies to all personal property in the same class that is placed in service in the same year. The method of depreciating real property may be done on a property-by-property basis for real property.

First-year Depreciation. Real property may be depreciated for one-half of the month it is placed in service, as well as the remaining months of the year it is placed in service. Personal property may generally be depreciated for one-half of the year it is placed in service.

If more than 40% of a taxpayer's personal property is placed in service in the last three months of a tax year, however, a mid-quarter convention must be applied. The mid-quarter convention allows the property to be depreciated for one-half of the quarter it is placed in service.

First-year Expensing

The amount that can be expensed (rather than depreciated) under Internal Revenue Code § 179 is increased to $10,000 beginning in 1987. The $10,000 amount is decreased, however, by one dollar for each dollar the aggregate cost of property placed in service during the year exceeds $200,000.

Furthermore, the amount that can be expensed is limited to taxable income. Amounts that cannot be deducted because of the taxable income limit can be carried over to subsequent tax years.

Investment Tax Credit

The investment tax credit is repealed for property placed in service after Dec. 31, 1985. Property acquired or constructed pursuant to a written contract that was binding on Dec. 31, 1985 is eligible for the investment tax credit if it is placed in service by a specified date.

For property with an ADR midpoint life of less than five years, the specified date is June 30, 1986. For property with an ADR midpoint life of five years or more, but less than seven years, the specified date is Dec. 31, 1986.

For property with an ADR midpoint life of seven years or more, but less than 20 years, the specified date is Dec. 31, 1988. For property with an ADR midpoint life of 20 years or more, the specified date is Dec. 31, 1990. The basis of property within this transitional rule must be reduced by 100% of the amount of investment credit claimed.

Investment credit that is used in 1986 and subsequent years can offset only $25,000 of tax liability plus 75% (rather than 85%) of taxes in excess of $25,000. Investment credit that is carried to 1987 or claimed in 1987 (under the transition rule) must be reduced by 17.5%. Investment credit that is carried to 1988 must be reduced by another 17.5%.

Consequently, investment credit carried to 1988 and later years is reduced by a total of 35%. Investment credit claimed in 1988 or later years (under the transition rule) must be reduced by 35%.

Farmers are allowed an effective 15-year carryback of investment credit that is carried forward into 1986. To qualify for this provision, a taxpayer must earn 50% or more of their gross income from farming during the previous three years. The carryback period is the 15-year period ending with the year the farmer first had an investment credit carryforward, but it cannot begin before 1961.

The amount of credit that can be carried back is limited to the lesser of 50% of the credit carried into 1986 — or $750. The carryback reduces income taxes paid in the carry-back years, but the tax reduction is allowed as a refundable credit on the farmer's 1986 tax return.

If a farmer elects to carry back investment tax credit, the amount that can be carried forward from 1986 is reduced by twice the amount of the carryback. The carryback does not affect the alternative minimum tax calculation for the carryback years or the credit calculations for those years.

Prepaid Expenses

Beginning in 1987, farmers using the cash method of accounting will not be allowed to deduct prepaid expenses in excess of 50% of deductible farming expenses. Deductible farming expenses include depreciation and amortization deductions.

The provision will not apply if the farmer's aggregate prepaid farm supplies for the previous three years are less than 50% of the farmer's aggregate deductible farming expenses for the three previous years. The provision will also not apply if extraordinary circumstances caused the farmer to have excess prepaid expenses.

Preproduction Expenses

The new law requires a farmer to capitalize some expenses of raising or producing assets used in the trade or business. When the asset is put into production, the total cost of producing the asset can be depreciated over the appropriate recovery period.

The new rules apply to plants and animals that have a preproductive period of two years or more. According to the committee report of the House Ways and Means Committee, "the preproductive period of animals begins at the time of acquisition, breeding, or embryo implantation, and ends when the animal is ready to perform its intended function. Thus, for example, in the case of a cow used for breeding, the preproductive period ends when the first calf is dropped."

Consequently, *all* beef and dairy cows are apparently subject to the capitalization rules since their preproductive period includes two gestation periods — plus the time from birth to breeding the cow.

The new code section says the preproductive period ends on the date the animal produces the first marketable crop or yield. Therefore, it could be argued that a bull that can be used for breeding two years from the date the bull was conceived is not subject to the capitalization rules.

A farmer who is subject to the capitalization rules is allowed to use a reasonable inventory valuation method to compute the amount that must be capitalized. Therefore, a farmer should be able to use the normal cost of producing the plant or animal rather than the exact cost of raising a particular plant or animal.

A farmer can avoid the capitalization rules by electing to depreciate all farm property under the alternative depreciation rate. The alternative depreciation rate requires the taxpayer to use the straight line method over the ADR midpoint life of the asset.

For some assets, that will extend the recovery period. For example, the ADR midpoint lives of some assets are as follows: Machinery and equipment — 10 years; Breeding and dairy cattle — 7 years; Single-purpose agricultural and horticultural structures — 15 years; Fences — 10 years; General-purpose farm buildings — 25 years; and Grain bins — 10 years.

Notice that the election will result in a zero basis for the assets otherwise required to be capitalized. Consequently, the alternative

(continued on next page)

depreciation rate will apply only to the other assets used in the farm business.

Soil and Water Conservation Expenses
The new law imposes additional requirements to the provisions that allow some soil and water conservation expenses to be deducted rather than capitalized. The new requirements are that the expenditures must be consistent with a plan approved by the Soil Conservation Service of the U.S. Department of Agriculture, or a comparable state agency.

Land Clearing Expenses
The new law repeals the provisions that allowed certain land clearing expenses to be deducted rather than capitalized.

Discharged Debt
Under prior law, discharged debt was treated as ordinary income unless it fell within one of five exceptions set out in I.R.C. § 108. The last of those exceptions was for qualified business indebtedness — that is, debt used to purchase assets used in a trade or business.

Under that exception, a taxpayer could avoid recognizing the discharged debt as income if the bases of depreciable assets were reduced by the amount of the discharged debt.

The new law repeals the qualified business indebtedness exception. Therefore, if a taxpayer does not fit within one of the other four exceptions in I.R.C. § 108, the discharged debt will have to be recognized as income. As a result of this change, most solvent taxpayers who are not in bankruptcy will have to recognize discharged debt as income.

Farmers were given an additional means of avoiding the discharge of indebtedness income by the new law. All farmers (defined as taxpayers receiving 50% or more of average annual gross income from farming for the three preceding tax years) are allowed to use the insolvency exception of I.R.C. § 108 — whether or not they are insolvent at the time the debt is discharged.

The insolvency exception is particularly beneficial since it excludes discharged debt from income — even if the taxpayer runs out of tax attributes such as net operating losses, credit carryforwards, capital loss carryforwards and basis in assets.

Discharged debt that is excluded from income by this new provision will reduce other tax attributes before the basis in land. Consequently, the provision forces the taxpayer to give up tax attributes of greater value than basis in land first.

Passive Losses
The new law prevents a taxpayer from deducting passive activity losses from other income or using credits from a passive activity to reduce the taxes on other income. Passive activities include a trade or business in which the taxpayer does not materially participate, as well as any rental activity.

Material participation is defined as regular, continuous and substantial involvement in the operations of the activity. Lack of regularity of involvement and lack of knowledge of the operation of the activity are factors that tend to show a lack of material participation.

Individuals who are treated as having self-employment income from a farm under I.R.C. § 1402 will generally be treated as materially participating in the farm business. Additionally, the provisions of I.R.C. § 2032A that treat an individual as meeting the material participation requirement (even though retired or disabled) are incorporated into the passive loss rules.

Losses and credits that cannot be used because of this limitation can be carried forward and used against income and taxes from passive activities in succeeding years. When a taxpayer disposes of his or her entire interest in a passive activity, the suspended losses and credits can be used to offset income and taxes from any source.

A taxpayer who actively participates in renting real estate is allowed to deduct $25,000 of losses from that activity from any income. Active management does not require regular, continuous and substantial involvement in operations — so long as the taxpayer participates in the making of management decisions or arranging for others to provide services (such as making repairs) in a significant and bona fide sense.

The limitations of the passive activity rules are phased in for activities owned by the taxpayer before the enactment of the new law. In 1987, only 35% of losses and credits are disallowed. In 1988, 60% are disallowed. In 1989, 80% are disallowed, and in 1990, 90% are disallowed.

Alternative Minimum Tax
The new law raises the alternative minimum tax rate on individuals to 21% (from 20%). In addition, the $40,000 exclusion for married taxpayers filing jointly ($30,000 for single taxpayers and $20,000 for married taxpayers filing separately) is phased-out at a rate of 25 cents for every dollar of income in excess of $150,000 ($112,500 for single taxpayers and $75,000 for married taxpayers filing separately).

The $200 dividend exclusion and long-term capital gains exclusion are no longer preference items since they are repealed for purposes of the regular tax. For real property, depreciation claimed in excess of straight line depreciation is added to alternative minimum taxable income.

For other property, depreciation in excess of depreciation calculated under the alternative depreciation system using the 150% declining balance method is added to alternative minimum taxable income.

Unearned Income of Minor Children
Under the new law, unearned income of children under the age of 14 is taxed to the child at the marginal tax rate of the child's parents. It does not matter whether the unearned income originated from the parents, or another source.

The child is allowed to use $500 of his or her standard deduction to offset unearned income. In addition, another $500 of unearned income is taxed at the child's marginal tax rate rather than the parent's marginal rate.

Immunity of FmHA officials

In the case of *Carson v. Block*, 790 F.2d 562 (7th Cir. 1986), the farmer bought a farm and enjoyed a series of Farmers Home Administration (FmHA) loans for several years before becoming delinquent. After a combination of forbearance and further loans by the FmHA, the farmer's request in December 1981 for permission to defer payments was denied. As a result of a bankruptcy proceeding, the farm was sold and the FmHA emerged as the buyer and the farmer as a tenant.

Plaintiff claimed that the U.S. Department of Agriculture (USDA) officials were personally liable for failure to implement the payment-deferral program authorized by 7 U.S.C. Section 1981a.

The court held that the officials' motion for summary judgment was improperly denied. The farmer's argument that the officials were personally liable for failing to implement Section 1981a in time failed because of federal officials' immunity from tort liability for acts committed in the line of duty, which includes misinterpretation of a statute by an agency empowered to construe that statute.

The court also held that the FmHA's actions in response to the farmer's request for deferral relief arose out of statute — not the Constitution.

The farmer's final argument was that failure to implement Section 1981a violated due process. Among other defects in the farmer's argument, the court pointed out that no property interest was created by the discretionary deferral program.

— *John H. Davidson*

State Roundup

IOWA. *Landlord's Lien and PIK Proceeds.* In *Knosby v. First State Bank*, 390 N.W.2d 605 (Iowa Ct. App. 1986), the landlord's contractual lien, as well as the statutory lien (Iowa Code Section 570.1), referred to "crops grown on the premises."

The tenant grew no crop in the year in question, receiving instead Payment-In-Kind (PIK) proceeds, which he assigned to the defendant bank. The landlord had explicitly signed an Agricultural Stabilization and Conservation Service (ASCS) form stat ing that he claimed no share of the PIK proceeds. Neither did the landlord demand an assignment of the PIK proceeds.

The court held that PIK proceeds did not constitute a crop grown on the premises. Consequently, neither the lease provision nor the statutory lien entitled the landlord to the PIK proceeds.

Damages Awarded Despite Lease Termination Agreement. In the case of *Quade v. Heiderscheit*, 391 N.W.2d 261 (Iowa Ct. App. 1986), the plaintiff Quade had owned and farmed a 315-acre tract for over 20 years, following careful conservation and rotation practices.

In a three-year lease to the defendant, specific terms included provisions concerning seeding of alfalfa, use of atrazine, the rotation system, as well as the number of cattle to be grazed. Standard lease provisions concerning farming the land in a good and farmlike manner, keeping the premises in proper repair, and yielding the property up in good condition at the end of the term were also included.

Disagreements concerning the tenant's farming methods developed in the first year of the lease. The parties entered an agreement to terminate the lease, which contained a term releasing any claims against each other "for the remainder of the terms" spelled out in the lease.

The landlord then sued for breach of lease, and the tenant counterclaimed on theories of unjust enrichment and intentional infliction of emotional distress.

The trial court awarded the landlord damages totaling $7,070. The court also found that the tenant's claims of the landlord's unjust enrichment and a course of conduct amounting to harassment were not supported by the evidence, and were barred by the terms of the release.

The tenant appealed. On appeal, the court noted that the parties' termination agreement limited the suit to a consideration of damages from the first crop year.

The court then separately considered the various factual claims upon which the trial court granted damages, including failure to plant strip cropping, use of atrazine (which delayed a rotation and killed a nurse crop of oats), and late cutting of alfalfa (which led to frost damage). All of these factual claims were found to violate either specific lease terms or the general lease clause requiring good farming practice.

In addition, the tenant challenged the $2,000 award for erosion damages to existing waterways, claiming that to make him liable for this would be to make "all tenants guarantors of their landlord's land such that any notable erosion which occurs will make them liable."

The appeals court disagreed, holding that the trial court did not award damages for "natural erosion," but instead, indicated the evidence showed the erosion was due to the tenant's method of cropping.

The court upheld the lower court's denial of the defendant's claim of unjust enrichment and intentional infliction of emotional distress.

In conclusion, the court noted that the tenant's claim that the court had unfairly bound him to the terms of the release (but allowed the landlord to recover) was a misreading of the verdict, which had limited the damages to actions arising in the first year, although some of the consequences arose in the second year.

— *Neil D. Hamilton*

KANSAS. *Foreclosure Fails to Terminate Oral Lease.* In *Bearden v. John Hancock Mutual Life Insurance Co.*, 635 F.Supp. 1084 (D. Kan. 1986), the owner mortgaged farmland to defendant Hancock, subsequently orally leasing a portion of the same land to plaintiff Bearden.

The owner subsequently defaulted on the loan and Hancock initiated foreclosure proceedings. After expiration of the redemption period, Bearden filed suit for damages resulting from ouster prior to the expiration of the five-year lease term.

The district court, applying the Kansas statutes regarding notice of farm lease termination (Kan. Stat. Ann. Sections 58-2506 and 58-2506(a)), held that the failure of the foreclosing mortgagee to provide the lessee with statutory written notice of termination of the lease precluded cancellation of the lease.

The court also rendered ouster of the lessee legally improper as to the actual year of termination. It was noted that the farm lease statutes apply equally to leases of foreclosed land, as well as to other farm leases.

The total failure of the mortgagee to give statutory written notice of termination, however, did not permit lessee to continue to lease the land for the remaining years of the oral five-year term where the lessee clearly had actual notice within the statutory time frame of mortgagee's termination of the lease.

— *Alice Devine*

MONTANA. *Proof of Mailing by Evidence of Business Practice or Custom*. A Montana evidentiary statute states that a letter mailed in the ordinary course of business is presumed to have been received.

The Montana Supreme Court held, in the case of *General Mills Inc. v. Zerbe Brothers Inc.*, 672 P.2d 1109 (Mont. 1986), that it can be sufficient that there was an office practice or custom that was carried out.

The action involved a grain purchaser who sued a grain seller for breach of contract, alleging that the contract had been for 50,000 bushels rather than 20,000 bushels. The grain seller denied having received a confirmation form from the purchaser stating the larger amount of grain to be delivered under the contract.

The grain purchaser provided no specific evidence that the confirmation letter had been mailed or received, but rather offered testimony that its usual and customary business practice was to mail confirmation forms to a seller.

In affirming the lower district court's award of damages to the purchaser based on the smaller contract amount, the supreme court held that a usual and customary business practice presumption was not a conclusive one, and could be controverted by other evidence — such as the seller's denial of receipt of the form.

The supreme court found that the seller did overcome the presumption with other evidence.

— *Donald D. MacIntyre*

WASHINGTON. *Imperceptible Airborne Pollutants*. In the case of *Bradley v. American Smelting & Refining Co.*, 635 F.Supp. 1154 (W.D. Wash. 1986), plaintiff property owners sued a copper smelter for trespass and nuisance because of particles of cadmium and arsenic being deposited on their land.

The parties stipulated (for purposes of certification to the Washington Supreme Court) to the deposition of the particles and that the particles were imperceptible to human senses.

Under Washington state law, it is necessary, in a trespass claim based on emission of imperceptible airborne pollutants, to prove substantial damage to the *res* upon which the trespass occurs. This, in turn, requires an actual interference with the right of possession.

Plaintiffs failed to prove either an actual interference with possession or any hidden hazard from the presence of these materials.

Plaintiffs asserted an apprehension about future health risks. Washington's law of nuisance limits recovery for mental distress to two situations: 1) If the distress is manifested by physical symptoms; and 2) If the distress occurs in connection with an invasion of the plaintiff's person or security.

Plaintiffs failed to prove either situation — there had been no physical symptoms, and since the evidence showed no present health risk, the court held that there was no threat to plaintiffs' security.

— *Linda Grim McCormick*

Address Correction Requested

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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

Report on the Seventh Annual American Agricultural Law Association Conference

More than 150 educators, government officials, practitioners, farmers, industry representatives and guests met in Fort Worth, Texas, Oct. 23-24, 1986 at the American Agricultural Law Association's (AALA) Seventh Annual Meeting and Educational Conference.

Nineteen speakers addressed a wide range of topics, including the agricultural finance and credit crisis, agricultural labor laws and tax "reform."

David A. Myers delivered the Presidential Address on "Lawyers as Lawmakers," and Donald Uchtmann reported on the Euro-American Agricultural Law Symposium, an event co-sponsored by the AALA.

Donald B. Pedersen, professor of law and director of the graduate program in agricultural law at the University of Arkansas School of Law, Fayetteville, was awarded this year's "Distinguished Service Award" for his outstanding work in shepherding the development of the *Agricultural Law Update*, his day-to-day dedication in seeing to its monthly publication, and for his work in promoting the educational field of agricultural law.

The AALA Job Fair, held concurrently with the Annual Meeting, attracted considerable attention, and brought together 21 job seekers and potential employers in need of expertise in the field of agricultural law. Gail Peshel, Valparaiso University, again did a superb job of coordinating this event.

Philip E. Harris, University of Wisconsin-Madison, is the Association's new president-elect. James Dean, Denver, Co., has assumed his duties as president. Terence J. Centner, University of Georgia College of Agriculture, Athens, continues as secretary-treasurer. Joining the board of directors are newly-elected members Kenneth J. Fransen and Linda A. Malone.

Karin Littlejohn and Lawrence B. Kurland leave the board of directors. We express our deep appreciation to these two individuals for serving the organization well.

Next year's AALA Annual Meeting will be held Oct. 15-16, 1987, at the Omni-Shoreham Hotel in Washington, D.C.