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"The direction in which education starts a man will determine his future life."

— Plato

Eighth Circuit allows liquidating plan

In the November 1984 issue of *Agricultural Law Update*, the question of whether a creditor's Chapter 11 liquidating plan can be confirmed over the objection of a farm debtor was considered. In a pair of cases decided on Nov. 2, 1984, the Eighth Circuit Court of Appeals joined the Fifth Circuit in concluding that a farmer who files a petition under Chapter 11 of the Bankruptcy Code, but who fails to submit a plan of reorganization within 120 days from filing, is vulnerable to a liquidating plan filed by one of his creditors. *Matter of Button Hook Cattle Co. Inc.*, 747 F.2d 483 (8th Cir. 1984), and *Matter of Cassidy Land and Cattle Co. Inc.*, 747F.2d 487 (8th Cir. 1984). The court held that, while the Bankruptcy Code gives farmers special *defensive* protection by exempting them from involuntary Chapter 7 liquidations and involuntary conversions to Chapter 7, there is no evidence of Congressional intent to confer on a farmer an *offensive* capability denied to other Chapter 11 debtors — suspension of collection efforts upon filing of a petition, coupled with a bar on submission of a creditor's liquidation plan upon farmer's failure to file a timely rehabilitation plan.

— Phillip L. Kunkel

Equitable subordination of an operating lender's claim in bankruptcy

As a general principle, the Bankruptcy Code contemplates that all similarly situated creditors be treated equally with respect to their claims against a debtor. Exceptions to this general principle of equality apply to preferential transfers (Sec. 547), fraudulent conveyances (Sec. 548), unperfected transfers (Sec. 544), and certain statutory liens (Sec. 545). A further exception, developed by the courts, applies when a creditor engages in inequitable conduct which results in injury to or unfair advantage over other creditors of a debtor. The resulting adjustment of claims results from the application of the doctrine of "equitable subordination."

The doctrine recently has been invoked in the case of an operating lender who dealt directly with other creditors of a farm debtor. The debtor in *In Re Osborne*, 42 B.R. 988 (W.D. Wisc. 1984), a Chapter 7 bankruptcy, had been engaged in a cattle feeding operation. During 1981, when the debtor was experiencing severe financial difficulties, the operating lender, the Production Credit Association (PCA) of River Falls, Wisc., on several occasions met and discussed the debtor's financial situation with three other creditors.

When the debtor filed his Chapter 7 petition in January 1982, the three creditors brought an action seeking equitable subordination of the PCA's claim, alleging that the PCA controlled the debtor's cattle business and that it had misrepresented to them the degree of support that it would provide to the debtor.

The district court held that the PCA did not exercise the degree of control required by prior case law to compel subordination of its claim. (See *In Re American Lumber Co.*, 5 B.R. 470 (D. Minn., 1980), and *Matter of Teltronics Services Inc.*, 29 B.R. 139 (Bkrtcy. E.D.N.Y., 1983).) While the PCA, because of its security interest in most of the debtor's assets and the debtor's continuing need for funds, had considerable power over the debtor, it exercised that power only in isolated instances.

However, the court did not stop with the resolution of the control issue. It carefully examined the relationship of the PCA with each of the three objecting creditors. With regard to two of the creditors, a bank and an input supplier, the court found that the PCA had not made guarantees or commitments of continued payment of the debtor's obligations. Indeed, officials of the two institutions admitted that the PCA had not made any such commitments. Thus, the claim of the PCA was not subordinated to the claims of the bank and the input supplier.

However, with regard to a feed supplier, the court concluded that the PCA had engaged in conduct that was "at least inequitable." In reaching this conclusion, the court pointed to several factors: the PCA was clearly aware of the feed supplier's concerns about the size of the debtor's account; the PCA responded to feed supplier's inquiries with "equivocation and outright misrepresentations;" the PCA continued to reassure the feed supplier concerning payment even in the weeks immediately preceding its decision to terminate the debtor's loan; the PCA must have known that its decision to terminate the debtor's loan made the supplier's prospects for payment "bleak to nonexistent;" the course of conduct of the PCA was deliberate; the PCA had superior knowledge concerning the debtor's ability to pay and a

(continued on next page)

Excessive tax assessments overturned

Agricultural property owners were granted relief from a county's tax assessment because the tax assessors did not give sufficient weight to the existing agricultural use. *Sibley v. Cobb Co. Bd. of Tax Assessors*, 171 Ga. App. 65, 318 S.E.2d 643 (1984).

The Court of Appeals interpreted Georgia law as requiring property tax assessors to consider four criteria when assessing real property: (a) existing zoning of the property, (b) existing use of property, (c) existing covenants or restrictions in deed and (d) any other factors deemed pertinent in arriving at fair market value, including speculative value. The court found that the assessors had given disproportionate weight to the speculative value of the properties as opposed to their existing use, thereby causing the assessments to be excessive.

— Terence J. Centner

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CENTURY COMMUNICATIONS INC

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superior position due to its security interest; and the PCA knew that the feed supplier felt compelled to continue selling feed to preserve the cattle, although the PCA was the only party likely to benefit.

The district court concluded that "the PCA misrepresentations led [the feed supplier] on to continue delivering feed to the Osbornes despite their steadily growing account, and that misconduct on the part of the PCA caused injury to the supplier." 42 B.R. 988 at 1000.

The *Osborne* case presents grave risks to any operating lender that attempts to monitor a farming operation which is experiencing financial difficulties.

— Phillip L. Kunkel

Farmers Home Administration debt adjustment program

A brief description of the Farmers Home Administration (FmHA) debt adjustment program (DAP) appeared in Agricultural Law Update Vol. 1 No. 2 (November 1983). DAP is not to be confused with the FmHA special debt set-aside program discussed in the same article.

The Oct. 19, 1984 interim rule authorizing DAP has now been amended and made final. 50 Fed. Reg. 6880 (1985) (to be codified at 7 C.F.R. § 1980.124, and at Exhibit B to subpt. B of pt. 1980) (effective Feb. 15, 1985). DAP originally had provided for FmHA guarantees of certain non-FmHA loans to farmers upon write-down and forgiveness of at least 10% of the outstanding indebtedness. DAP now offers two approaches to lenders:

Lenders that participate in this program must write down existing indebtedness to the extent necessary to assure that the new guaranteed loan will show a positive cash flow each year of the loan. The write-down can take either of two forms:

> An upfront write off of existing indebtedness of at least 10%.
>
> A reduction in the interest rate, the present value of which reduction over the term of the loan must be equal to the value of an upfront write-down of existing indebtedness of at least 10%. Id. at 6882.

The lender will have to agree to more than the 10% minimum write-down, or an appropriate interest rate reduction in lieu thereof, if this is necessary to generate the required projected positive cash flow (cash in flow of at least 110% of each year's anticipated cash outflows).

Assuming a write-down of at least 10%, positive cash flow projections, adequate security, a borrower who meets FmHA eligibility requirements, as well as certain other essentials, FmHA will guarantee 90% — not up to 90% as under the original DAP scheme — of the remaining adjusted debt. If the interest rate reduction option is used in lieu of a write down of principal, the FmHA guarantee level will create the same government guarantee exposure that would have resulted had a principal write-down been used to generate the same positive cash flow situation for the farmer borrower. Sample calculations appear at 50 Fed. Reg. 6883-85 (1985).

Further changes in the DAP regulations are under consideration at this writing and may be announced in the Federal Register before the mailing of this issue of Agricultural Law Update. It is probable that the percentage in the positive cash flow test will be changed from 110% to 100% and that a third basic approach will be offered to lenders — some combination of an upfront write-down of indebtedness and an interest rate reduction.

— Donald B. Pedersen

Farmer failed to show impossibility of performance

The Court of Appeals of Kentucky found the defense of impossibility of performance to be inapplicable to a sales contract signed by a farm corporation to deliver 35,000 bushels of No. 2 white corn to a grain merchandiser. *Wickliffe Farms Inc. v. Owensboro Grain Co.*, No. 83-CA-138-MR (Ky. Aug. 24, 1984).

The farm corporation argued that a severe drought constituted an excuse by failure of presupposed conditions, codified as KRS§ 355.2-615 (UCC§ 2-615). The court disagreed, finding that the commercial code provision only excused a grower from delivery of a specific crop which failed if the contract designated the acreage upon which the crop was to be grown.

Parol evidence of additional terms was permitted by Kentucky's adoption of Section 2-202 of the Uniform Commercial Code (UCC) so long as the additional terms were consistent with the written contract. Parol evidence by the grower that the corn was to be produced off specific acreage was inconsistent with the written contract and thus failed to constitute a basis of possible relief for the grower.

— Terence J. Centner

Corporation ignored for income tax purposes

In *Bystry v. United States*, 596 F.Supp. 574 (W.D. Wis. 1984), the taxpayers formed a corporation for the purpose of operating a dairy farm. However, no assets were ever transferred to the corporation. The corporation had no officers, no bank account and filed no annual reports with the state. The assets that were supposed to be transferred to the corporation were used by the taxpayers in a dairy operation. Income and expenses of the operation were funneled through a bank account in the joint names of the parties that were supposed to transfer assets to the corporation. After about two years, disagreements arose between the parties stemming from the failure to transfer assets to the corporation.

Corporate tax returns were filed for 1975 and 1976, reporting the income and expenses from the joint operation. After the disagreements arose, the taxpayers retained a new accountant who reported the income and expenses from the dairy operation on individual returns for 1977 and thereafter. The new accountant also filed amended individual returns for 1975 and 1976, which reported the income and expenses from the dairy operation. The amended individual returns resulted in a refund from 1975 and 1976 as well as a net operating loss that was carried back to generate a refund for the previous three years.

The Internal Revenue Service (IRS) partially disallowed the refund claims. The reasons for denying the claims were that the amended returns were filed after the due date of the original return and that the income and expenses must be reported on the corporate return.

The court disagreed with the IRS. The court held that the returns could be amended anytime within three years of the due date of the original return. The court also held that the corporate structure should be ignored for income tax purposes since the parties never operated the dairy farm as a corporation. The fact that they intended to operate as a corporation is not enough to establish a corporation for tax purposes.

—Philip E. Harris

Moratorium provision applied to any adverse action on a borrower's debt

In *Shick v. Farmers Home Administration*, 748 F.2d 35 (1st Cir., 1984), the Farmers Home Administration (FmHA) held a second mortgage on a Massachusetts dairy farm, and a first chattel mortgage on livestock and equipment. The security instrument contained usual language forbidding sale or disposition of the collateral without FmHA's written consent and that failure to comply constituted default. Borrowers were at all times current in their payments to FmHA, but sold some of their livestock without consent. FmHA responded with a notice of acceleration. After an unsuccessful local hearing on the decision to accelerate, borrowers did not appeal to the next administrative level. Instead, this action was initiated, claiming violation of FmHA's enabling legislation.

The District Court granted the government's motion to dismiss on the ground that the plaintiffs had not exhausted administrative remedies. While finding merit in the District Court's determination, the First Circuit did reverse — in part because it agreed with borrowers that failure of FmHA to give notice to them of the availability of a moratorium on repayment of the FmHA loans at the time the loans were accelerated (7 U.S.C. § 1981a) excused borrowers from exhausting their remedies.

The District Court had found the moratorium provision inapplicable, arguing that it applied only to situations where borrowers were unable to make payments due on their loans. Interpreting the provisions more broadly, the First Circuit ruled that a borrower must be given an opportunity to demonstrate eligibility for moratorium relief "...whenever the FmHA takes *any adverse action* on his debt." In *dictum*, the Court emphasized that for a borrower to successfully state a claim for relief under §1981a, he must show three things: (1) that failure to pay is due to "circumstances beyond the borrower's control;" (2) that the borrower is temporarily unable to continue making payments; and (3) that any effort to make payments would unduly impair the standard of living of the borrower.

— John H. Davidson

Farmers Home Administration and the federal prosecutor

There is every indication of energetic criminal prosecution of farmers who, without prior consent, dispose of collateral mortgaged to the Farmers Home Administration (FmHA). In *U.S. v. Lisko*, 747 F.2d 1234 (8th Cir. 1984) the borrower repaid all loans after selling property without FmHA permission, and was sentenced to six months imprisonment plus three years probation.

— John H. Davidson

STATE ROUNDUP

This month we introduce a new feature in *Agricultural Law Update*. Reporters are being appointed for all states and will be submitting state agricultural law developments of local and general interest on a regular basis. We will publish a list of the names and addresses of all state reporters in a forthcoming issue.

NORTH DAKOTA. Statutory exception limiting landowner's use of honey bees for pollenation purposes upheld as Constitutional exception to state's two-mile radius restriction on commercial beekeeping locations. *Richter v. Jones*, Civil No. 34921 (S. Central Jud. Dist., 1985). — *Allen C. Hoberg, assistant attorney general.*

PENNSYLVANIA. Pennsylvania adopts the Worker and Community Right to Know Act, recognizing that employees, their families and the general public face potential danger from exposure to chemicals introduced into the workplace and the general environment. The Act requires employers to list hazardous substances and environmental hazards in the workplace. Employees and the general public have a right to this information. Act 159 of 1984, approved Oct. 5, 1984. Effective dates are staggered with the earliest being April 3, 1985. — *John C. Becker, Pennsylvania State University.*

PENNSYLVANIA. *El Concilio De Los Trabajadores v. Commonwealth*, 484 A2d 817 (Pa. Commonwealth Ct. 1984). Under the Pennsylvania Seasonal Farm Labor Act, persons who reside in living quarters owned, leased or operated by an employer or farm labor contractor and occupied by four or more unrelated persons, are defined as seasonal farmworkers even if their employment is neither seasonal nor temporary. In this case, workers were employed to grow and harvest mushrooms throughout the year. The court held that the Department of Environmental Resources has a duty to inspect mushroom industry farm labor camp housing meeting the above description. Guidelines and regulations inconsistent with the holding were declared invalid. — *John C. Becker, Pennsylvania State University.*

Mineral owner's tax treatment of oil and gas payments received independent of production

by Judon Fambrough

Mineral owners are offered several economic incentives for entering an oil and gas lease. As a rule, they are tendered (1) an outright sum for signing the lease (known as a bonus), (2) a promise of an annual stipulated sum (known as a delay rental) to keep the lease in force until production commences or the lease expires, and (3) a promise of a fraction of the oil and gas produced from the property (known as a royalty). In the event the lease is entered, the mineral owner (or lessor) may find other promises of additional economic value such as minimum royalties, payment of ad valorem taxes and compensation for damages to the land.

Each promised payment, if received, has certain tax implications to the recipient. Mineral owners should understand the proper tax treatment of each payment in order to avoid any tax penalties and to attempt some tax minimization.

The payments accruing independent of production can be broken down into three general areas. They are: (a) payments before production, (b) payments due to temporary interruptions in production and (c) payments for damages to the land. The mineral owner should remember that when dealing with the first two categories, the labels or titles attached to the payments in the lease do not necessarily control their tax treatment. Rather, two characteristics accompanying each payment are critical. They are recoupability — i.e., can the payment be recovered or deducted by the producer (or lessee) from the mineral owner's share of subsequent production and avoidability — i.e., can the future payment to the mineral owner be prevented or avoided by the lessee's either abandoning the lease or beginning development and production thereon.

(A) *Payments Before Production*

(1) Bonuses

Bonuses are an initial, unconditional payment disbursed to the mineral owner (lessor) for executing the mineral lease. Unless otherwise provided in the lease, bonuses are neither recoupable nor avoidable. In other words, the lessee cannot recover the bonus payment from the mineral owner's share of future production nor may the payment be avoided by terminating or producing the leased property. As such, mineral owners must report the bonus payments as ordinary income. However, a portion of the payment may be eligible for a tax deduction known as a depletion allowance.

There are two types of depletion allowances permitted by the Internal Revenue Code (IRC). One is cost depletion, the other is percentage.[1] The Tax Reduction Act of 1975 appeared to restrict the usage of percentage depletions to occasions where actual production occurs and then only up to 1,000 barrels of average daily production. Thus after 1975, lessors were relegated to the use of cost depletion for payments received in advance of production.

On Jan. 10, 1984, the U.S. Supreme Court ruled in a 5-4 decision that Section 613A (added by the Tax Reduction Act of 1975) was not intended to deny the allowance for percentage depletion on advance royalty or lease bonus income.[2] According to the case, "The legislative history of Section 613A discloses a clear congressional intent to retain the percentage depletion rules that existed in 1975, and under which taxpayers leasing their interests in mineral deposits were entitled to a percentage depletion on any bonus or advance royalty whether there was production of the underlying mineral or not." The decision has been heralded as a landmark decision for mineral owners.

Typically, bonuses are paid in a lump sum at the beginning of the lease period. Although some tax deductions are available for bonus payments via depletion allowances, mineral owners wishing to lower their tax burden even further may consider taking the bonus on an annual installment basis rather than in a lump sum. This would allow the income to be spread over more than one tax year.

To qualify for such installment reporting, the mineral owner must satisfy all three of the following requirements contained in Revenue Ruling 68-606. They are: (1) the installment bonus must *not* be transferable, (2) the installment bonus must *not* be readily saleable and (3) the taxpayer must be using the cash-receipts-and-disbursement method of accounting.

(2) Delay Rentals

Delay rentals (or rentals, as they are sometimes called) are a penalty paid by the lessee for failing to drill upon, or exploit, the leased property within certain time periods. Generally, the time periods are based on 12-month intervals. Delay rentals are required, not for extracting the oil or gas, but for the privilege of deferring drilling operation for another year. The failure of the lessee to pay required rentals often terminates the lease.

The tax treatment of delay rentals is quite clear. They are non-recoupable, avoidable payments. As such, the mineral owner must report them as ordinary income. No type of depletion allowance is allowed.

(3) Advance Royalties

Advance royalties are a payment tendered to the lessor, either in a lump sum or periodically, until such time as production commences. After that, no further royalties are paid until the lessee has recouped the advance royalties from the lessor's share of production. (See IRC 612-3b1). Revenue Ruling 77-489 implies that it makes no difference whether the payment is avoidable or not. Either characteristic may be present and the payment would still be characterized as an advance royalty. The critical factor is that it must be recoupable. To the lessor, advance royalties constitute ordinary income subject to the higher of cost or percentage depletion.[3]

Advance royalties are rarely found in connection with oil and gas leases. Instead, advance royalties are more popular in leases having much longer primary terms, such as in coal and lignite leases. The tax advantage more evenly distributes the lessor's royalty over the life of the lease.

(4) Minimum Royalties

It is difficult, if not impossible, to readily distinguish advance royalties from minimum royalties. The two share many common characteristics. The IRC frequently discusses the two payments in the same sentence or section.[4] The tax treatment afforded advance royalties are more clearly defined than minimum royalties.

IRC 612-3b3 defines minimum royalties as a substantially uniform annual payment required throughout the life of the lease, in the absence of mineral production requiring a greater amount. At first glance, it appears the major difference between minimum royalties and advance royalties is that minimum royalties are not recoupable. However, there are other subtle differences.

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Basically, the only accurate statement that can be made concerning minimum royalties is that they do not possess any uniquely distinguishing characteristics. They could possibly possess any combination of the four characteristics mentioned earlier — recoupable or non-recoupable, avoidable or non-avoidable. The exact manner in which minimum royalties are taxed depends solely upon their characteristics negotiated in the lease.

Probably the most common characteristics the owners will negotiate are avoidability and non-recoupability. In other words, the lessee can avoid the payments by terminating the lease. But at the same time, the lessee cannot recoup the payment from the lessor's share of future production. As such, the payments are taxed the same as delay rentals — i.e., ordinary income not subject to any type of depletion allowance.

It would be difficult to imagine a landowner negotiating a non-avoidable, non-recoupable minimum royalty payment. This would mean the lessee would be required to make the minimum payments for a stipulated period of time, regardless of whether the lease had terminated or not. However, if such a payment were obtained, it would be taxed to the landowner the same as bonus payments received on the installment basis as described earlier.

Minimum royalties are commonly found in oil and gas leases, but in a different form than just described. Basically, the lease provides that the minimum royalty payment will arise only after production begins. Then, if the lessor's share of subsequent production falls below some stipulated amount ($50 per acre per year in the example), the lessee must either make up for the difference or forfeit the lease. This type of minimum royalty provision keeps the lessee from maintaining a lease only with minimal royalty payments. (See Table A). To determine the taxability of these payments, the landowner must ascertain whether the minimum royalties are avoidable or non-avoidable, recoupable or non-recoupable.

(5) Exploration and Easement Rights

Payments for exploratory (or seismographic) rights and easement rights represent another important pre-production payment to mineral owners who also own the surface. Generally, these are treated in one of two ways. If the payments represent compensation (or rental) for the use of the land (and not for damages), the surface owner must report them as non-depletable ordinary income.[5] However, if the payments represent remuneration for surface or subsurface damages, the owner should be permitted to treat a portion of such amounts as a non-taxable return of capital, thus lowering the basis in the land. (See Section C on Damages for a full discussion). If the damage payments exceed the surface owner's basis in the land, the excess would constitute taxable income.

(6) Ad Valorem Taxes

The last pre-production payment generally available to mineral owners are the payment of the lessor's ad valorem (property) taxes by the lessee on the leased property. In most states, no ad valorem taxes are assessed on the mineral estate until after oil or gas production begins. The assessments are then made according to the percentage of interest each party has in the venture. For example, if the mineral owner has reserved a one-eighth royalty, the mineral owner would be charged with one-eighth of the annual mineral tax assessment and the lessee would be charged with the remaining seven-eighths.

Recently, mineral owners who also own the surface have been negotiating surface damage clauses in leases to offset this rule. A surface damage clause makes the producer liable for *all* surface damages regardless of the cause or nature.

The tax treatment of surface damages depends upon whether compensation is received by the surface owner. For example, assume surface owner A has two acres totally destroyed by operations of an oil com-

TABLE A
MINIMUM ROYALTIES AFTER PRODUCTION

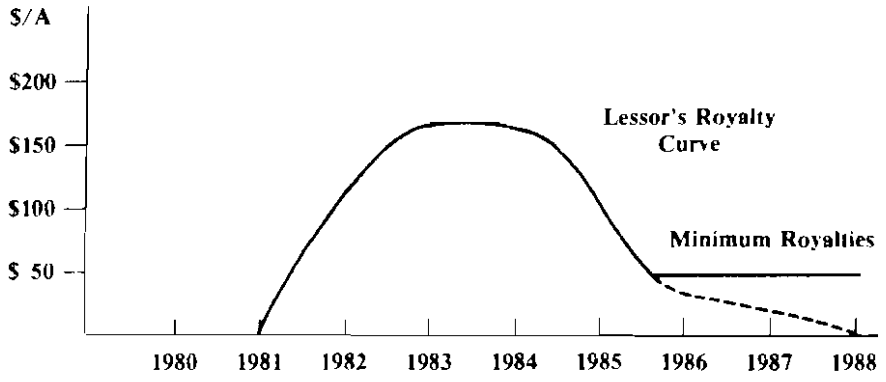

TABLE B
TAX SUMMATION OF PAYMENTS
RECEIVED BY MINERAL OWNERS INDEPENDENT OF PRODUCTION

	Avoidable	Non-avoidable
Recoupable	*1 • Advance royalties • Some minimum royalties	*2 • Advance royalties • Some minimum royalties
Non-recoupable	*3 • Delay rentals • Ad valorem taxes • Shut-in payments • Compensation for use of land (not damages) • Most minimum royalties	*4 • Bonuses • Few minimum royalties

All the above classifications may be altered by specific lease provision.

*1 Payments in this category represent ordinary income subject to the higher of percentage or cost depletion.

*2 Payments in this category have the same tax treatment as those in Category 1.

*3 Payments in this category represent non-depletable ordinary income.

*4 Payments in this category have the same tax treatment as those in Category 1.

pany. Damages are estimated at $10,000-$20,000 for lost profits to growing crops — the balance for permanent damages to the land. If A had purchased the surface acreage three years earlier for $500 per acre, how would the damage payments be taxed if A is fully paid?

First, A must report the damages to the growing crops as ordinary income. Sometimes such payments are characterized as lost profits. Either way they are taxed the same — as ordinary income.[8]

Secondly, the permanent damages to the land must be divided into two categories. One portion represents the non-taxable return of capital (or basis); the excess represents taxable income. Thus, $1,000 of the remaining $8,000 would constitute the non-taxable return of A's investment in the two acres. The remaining $7,000 would be taxable income. Since A has owned the property for over one year, the $7,000 would be capital gains income.[9]

A more perplexing tax problem faces surface owners who are not compensated for surface damages. In the leading case of *Pugh*,[10] the Board of Tax Appeals agreed that the landowner had sustained $50,000 of uncompensated damages to the land due to impregnation of the soil with oil and salt water. However, the taxpayer was not entitled to a loss deduction in the absence of a sale or other disposition of the property. "A loss is not sustained during the taxable year unless ascertained and realized more definitely than by an opinion of changed market value." The speculation could be removed by a sale or other disposition of the land. In no event, though, could the non-taxable loss for uncompensated damages exceed the taxpayer's adjusted basis in the land destroyed.

The Internal Revenue Service (IRS) has adopted the following guidelines for taxing the payments.[6]

(1) In the absence of production, the property taxes paid by the lessee for the lessor represent delay rentals to the mineral owner — i.e., non-depletable ordinary income.

(2) To the extent income generated from production equals, but does not exceed, the lessor's portion of the ad valorem taxes, the payment is considered royalty income to the mineral owner. To the extent income generated from production does not exceed the lessor's portion of the ad valorem taxes, the excess paid by the lessee represents non-depletable ordinary income to the lessor.

(B) *Payments for Temporary Interruptions in Production*

Most leases contain two provisions which allow the lessee the privilege of continuing the lease during periods when production is temporarily suspended. The first is known as a "shut-in," and the other as a "force majeure." Unless otherwise stipulated in the lease, the payments forthcoming from either provision are avoidable and non-recoupable. By this, they are non-depletable ordinary income to the mineral owner.

The shut-in provisions control the lease whenever the gas (and sometimes oil) is not being "sold or used" by the lessee. The leading cause of such interruptions are the lack of a market for the product or the unavailability of transmission facilities such as pipelines.

The shut-in payments have two different names. If the lease will be forfeited (or lost) by the lessee's missing the payment, it is called a shut-in royalty; if not, it is called a shut-in rental. In either case, the U.S. Fifth Circuit Court has ruled the payments are clearly non-depletable ordinary income in the same nature as delay rentals.[7] For areas not in the Fifth Circuit, the tax treatment should be scrutinized more closely.

The force majeure clause, on the other hand, governs the lease whenever operational activities must be suspended for reasons beyond the lessee's control. The leading causes are labor strikes, adverse weather conditions and governmental regulations. Generally, no payments are required to keep the lease in force during such stoppages. If payments should be required, they would receive the same tax treatment as the shut-in payments just described.

(C) *Payments for Damages to the Land*

As a general rule, the lessee or producer is not liable to the surface owner for any damages inflicted on the surface during the reasonable development of the oil and gas interest. This rule stems from the fact that the mineral estate is viewed in most jurisdictions as the dominant estate. This gives the mineral owner (and the mineral lessee) the right to use as much of the surface as is reasonably necessary for the full enjoyment and development of the mineral property. Only when the producer goes beyond what is reasonable or negligently injures the surface will the lessee be liable for surface damages.

Conclusion

The primary concern of most mineral owners when negotiating an oil and gas lease is to get the greatest monetary return possible. While this is a natural tendency, the mineral owner may find a great deal of each payment subject to taxation. By having some basic knowledge of the tax laws regulating the payments received independent of oil and gas production, the mineral owner should be able to realize both a high monetary return and the lowest possible tax liability.

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[1]IRC Section 612 allows cost depletion. IRC Section 613A allows percentage depletion.

[2]*Commissioner v. Engle* from Seventh Circuit and *Farmar v. U.S.* from U.S. Court of Appeals were heard and decided together on Jan. 10, 1984. As referred to in this article, the full text of the case was taken from Volume 52, No. 26, pp. 4033-4039 of *The United States Law Week*.

[3]TREAS. REG. Sec. 1.612-3(b) (1) as modified by the recent Supreme Court decision noted above.

[4]See TREAS. REG. Sec. 1.62-3(b) (3) for example.

[5]*A.L. Wasson v. U.S.*, 51 AFTR 1733 affd. at 1 AFTR 2d 564.

[6]*Rev. Ruling 72-165.*

[7]*Johnson et.al. v. Phinney*, 287 F 2d 544, 7 AFTR 2d 860, (5th Cir.; 1961).

[8]Levy Collins Jr., Paragraph 59, 174 P-H Memo TC. Here the court stated, "And it is well established that a sum received in settlement based upon a claim of loss of business profits constitutes taxable income, but where the settlement represents damage for lost capital rather than for lost profit, the money received is a return of capital and is not taxable."

[9]Ibid. Further in the opinion the court stated, "To the extent the payments were...for damages to capital, (they are) taxable only to the extent they exceed the basis (in the capital)."

[10]*Pugh v. Commissioner of Internal Revenue*, 49 F 2d 76, 9 AFTR 1280 (5th Cir.; 1931), Cert. Denied 284 U.S. 642.

Priority of security interests

Conflicting security interests in farm equipment presented the Court of Appeals of Kentucky an opportunity to reconcile Sections 9-306 and 9-308 of the Uniform Commercial Code (UCC), as embodied in KRS§§ 355.9-306 and 355.9-308. *J.I. Case Co. v. Borg-Warner Acceptance Corp.*, No. 83-CA-A-MR (Ky. Feb. 10, 1984).

An equipment manufacturer sold two pieces of farm equipment to a farm equipment dealer subject to a security interest perfected by the manufacturer. Pursuant to the terms of the security agreement, the dealer sold the equipment to customers. Both customers executed retail installment contracts, which the dealer assigned to Borg-Warner.

Borg-Warner filed financing statements covering the equipment and assumed the position of a purchaser of chattel paper who gave new value and took possession of the paper in the ordinary course of business. KRS§ 355.9-308 (UCC§ 9-308). Borg-Warner thereby qualified as an unpaid transferee of chattel paper and pursuant to KRS§ 355.9-306(5)(b) (UCC § 9-306(5)(b)), Borg-Warner's security interest took priority over the perfected security interest of the equipment manufacturer.

— Terence J. Centner

Recent publications

Arkansas Bar Association, *A System for Advising Landowners, Farmers, Ranchers and Agribusiness* (1984).

R. Coltrane, *Immigration Reform and Agricultural Labor* (USDA/ERS Ag. Econ. Report No. 510, 1984).

S. Redfield, *Vanishing Farmland: A Legal Solution for the States* (Lexington Books, 1984).

G. Douglass, ed., *Cultivating Agricultural Literacy: Challenge for the Liberal Arts* (W.K. Kellogg Foundation, 1985).

— Donald B. Pedersen

Capital gains treatment not rejected

A taxpayer who received soybeans as a gift from a farmer asked the Internal Revenue Service (IRS) for a ruling on the following two questions:

1. Are the soybeans a capital asset in the hands of the donee?
2. Can the donor's holding period be tacked to the donee's holding period for purposes of the long-term capital gain holding period?

In a letter dated Dec. 20, 1984, the IRS stated that it will not issue an advance ruling on these questions for two reasons. First, the determination requested is primarily one of fact. Secondly, the IRS does not issue advance rulings on the question of whether or not property is held primarily for sale to customers in the ordinary course of business.

This refusal to rule tacitly approves the taxpayer's position that the character of the grain in the hands of the donee depends upon the donee's use of the grain. The fact that the grain was inventory in the hands of the donor does not preclude the grain from being a capital asset in the hands of the donee.

Therefore, if the transaction is carried out properly, a farmer can not only shift the income from grain to a donee but the character of the income can also be converted from ordinary income to capital gains.

By refusing to rule on the questions presented, the IRS has given no indication of its position on the second question. While it did not take this opportunity to reject the argument that the holding periods can be tacked, it also did not tacitly approve of the argument by saying the determination was primarily one of fact.

—Philip E. Harris

Breach of warranty-tractor-loss of crops

In the recent case of *Sylla v. Massey-Ferguson Inc.*, 595 F. Supp. 590 (E.D. Mich. 1984), a farmer, using alternative theories of negligence, common law implied warranties and Uniform Commercial Code (UCC) warranties, sought to recover economic damages from the manufacturer of a tractor which malfunctioned and prevented the farmer from planting his crops. The judge rejected all of these theories and granted Massey's motion for summary judgment. A number of reasons were given. The court characterized the loss of crops as a pure economic loss (direct and consequential) and, under Michigan law, a plaintiff cannot utilize a negligence-produet liability theory to recover an economic loss.

Thus, the UCC must provide the source for a plaintiff's cause of action when a pure economic loss is involved. The farmer's claim was not sustainable under the UCC because the four-year statute of limitations in § 2-725(2) had run. The court, however, went on to discuss briefly the substance of the warranty claim. After noting the UCC warranty provisions, not common law warranty rules, were applicable, the court concluded that the record indicated the farmer had understood the acceptance of the tractor and the dealer's express warranty excluding all other warranties, express or implied. Accordingly, any common law implied warranty theory was barred.

A new informative source on warranties is B. Clark and C. Smith, *The Law of Product Warranties* (Warren Gorham and Lamont, 1984).

— Keith G. Meyer

Eighth Circuit adopts narrow view of lien avoidance powers

Under Seetion 522(f)(2), the debtor may avoid a non-possessory, non-purchase money security interest in certain types of property to the extent that such a security interest impairs an exemption in such property to which the debtor would have been entitled under State Law Exemptions or the Bankruptcy Code Exemptions.

Included in the types of property set forth in Section 522(f)(2) are household goods and furnishings, wearing apparel, appliances, books, *animals, crops,* musical instruments and jewelry that are held "primarily for the personal family or household use of the debtor" and "implements, professional books or tools of the trade" of the debtor.

In *Matter of Thompson*, 750F.2d 628 (8th Cir. 1984), the Eighth Circuit Court of Appeals adopted a narrow view of the lien avoidance powers of Section 522. In *Thompson*, the debtors attempted to avoid a non-purchase money, non-possessory security interest in 210 pigs, all of which were under six months of age. Under Iowa law, such an exemption was allowed.

The only issue, therefore, was whether the lien avoidance provisions of Section 522 could be applied to such property. The Court found that Congress had intended Section 522(f)(2) to apply only to those "personal goods necessary to the debtor's new beginning and of little resale value." According to the Court, the primary goal of the lien avoidance statute was to prevent creditors from forcing debtors in bankruptcy to reaffirm consumer debts. It was not intended to apply to hogs, which constituted a capital business venture.

The holding in *Thompson* would appear to directly conflict with the previous holding of the Third Circuit in *Augustine vs. U.S.*, 675 F.2d 582 (3rd Cir. 1982). In *Augustine*, the Third Circuit allowed the debtors to avoid liens in farm implements, including a tractor, totaling $11,800.

— Phillip L. Kunkel

Liquidations of Farm Credit System Banks and Associations

The Farm Credit Administration (FCA), acting through the Federal Farm Credit Board, has published proposed amendments to its regulation relating to voluntary and involuntary liquidation of Farm Credit System Banks and Associations. The existing regulations appear at 12 C.F.R. 611.1130. The proposed regulations incorporate the provisions contained in the orders that have been issued by the FCA to date in connection with specific receiverships, and set forth powers and duties of receivers, rights of creditors and stockholders, and inventory and examination requirements associated with receiverships. The proposed rule appeared at 50 Fed. Reg. 6000 (1985).

— Donald B. Pedersen

Agricultural Law Update
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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

AALA Distinguished Service Award

The American Agricultural Law Association 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 member of the Association 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 in five copies of no more than four pages each in support of the nominee. A nominee must be a current member of the Association and must have been a member thereof for at least the preceding three years. Nominations for this year must be made by May 1.

Second Annual Student Writing Competition

The Association is also sponsoring its second annual student writing competiton. This year, the Association 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 preceptive analysis of the issues, thorough research, originality, timeliness, and writing clarity and style. Papers must be submitted to the Association by May 1, 1985.

Inquiries concerning both programs should be directed to either:

Professor David A. Myers
President-Elect
American Agricultural Law Association
Valparaiso University School of Law
Valparaiso, Indiana 46383
(219) 464-5477

or

Professor Neil D. Hamilton
Chair, Awards Committee
American Agricultural Law Association
Drake University Law School
Des Moines, Iowa 50311
(515) 271-2947

AALA requests nominees

The AALA Nominating Committee requests your candidate suggestions and selection comments for the 1985-86 office of the president-elect and *two* new members of the Board of Directors for the three-year term of 1985-88. To be considered, nominations must be received by the Committee Chairman, J.W. Looney, no later than April 1, 1985. Please communicate your nominations and comments to:

Dean J.W. Looney, University of Arkansas School of Law, Waterman Hall, University of Arkansas, Fayetteville, AR 72701